CARMIGNAC'S NOTE

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VIGIL OF ARMS

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by Didier SAINT-GEORGES
Managing Director and Member of the Investment Committee
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Markets have become accustomed to a stable environment with weak growth and low-interest rates

Investors have clearly become accustomed to the idea of a stable environment with low interest rates and weak, but sustainable, growth. They were reassured by the markets' rapid recovery from the shock that followed June's pro-Brexit vote. Shored up by central banks, this environment has allowed markets to turn in a thoroughly respectable performance in recent years.

Consequently, investors seem largely unflustered by the looming US elections on 8th November, closely followed by Italy's referendum on 4th December, and then the Fed's Open Market Committee (FOMC) meeting on 14th December, which will be its last chance to raise its key interest rates at least once in 2016 (assuming it will not do so on 2nd November, the week before the presidential elections). From our standpoint, as we move into this year's last quarter, it makes sense to tactically raise our level of caution as regards market risk.

The economist Hyman Minsky, who died in 1996, is remembered for demonstrating that long periods of stability, by encouraging excessive risk taking, can themselves sow the seeds of instability. The start of the great financial crisis of 2008 has frequently been described as a "Minsky moment". Although we do not wish to over emphasise any similarities with the current situation, it has to be said that since 2009 the use of unorthodox monetary policies has meant that fixed income and equity markets have performed strongly, while showing utter indifference in the failure to relaunch economic growth (see our Note for September " All you need is Growth") and reduce debt levels.

In the absence of any improvement in the real economy, this bull market phase has led to growing popular discontent, weakening incumbent governments. The handling of the financial crisis has exacerbated the polarisation of the political debate by accentuating, through the effects of quantitative easing, the disparity between those who have gained from rising financial markets and the victims of feeble growth. According to the US PR agency Edelman, the difference in confidence in political institutions between the elite (the wealthiest 15%) and the rest of the population has never been so high: 12 points worldwide. The difference is greatest in the United States (almost 20 points), followed by the United Kingdom (17 points) and France (15 points). Disruptive discourses for protectionism and even isolationism are now being heard. The election of a candidate like Donald Trump as President of the United States, which was close to unthinkable a year ago, now looks plausible. A majority of the UK population voted to leave the European Union and populist parties are gaining ground throughout Europe. The markets tranquillity conceals both economic and political fragility (see our Note for April, Dancing on a Volcano.

Investor confidence as regards the US elections largely stems from the strong lead that Hilary Clinton is currently enjoying in the polls (as if they had not learnt anything about the reliability of polls following the Brexit). It is also based on a false premise.. At this stage, they trust that Donald Trump is merely grandstanding, and would become much more reasonable if elected. And should he want to behave unreasonably, Congress would anyway be able to stop him. Firstly, by underplaying the perceived risks, the wider acceptance of this idea increases the probability of Trump being elected. Secondly, this argument is fallacious. The CRFB (Committee for a Responsible Federal Budget) estimates that as it stands, Donald Trump's policies would increase the federal debt by USD 5.3 trillion over 10 years. As such, even if just a fraction of his economic programme were to be implemented, its impact would nevertheless have a massively negative effect on US public finances.

Furthermore, one should bare in mind that US institutions allow the President a tremendous amount of free reign in reviewing international trade agreements when it comes to "defending US interests threatened by unfair competition". The introduction of tariff barriers and the reviewing of major trade agreements such as NAFTA are clearly within the scope of the President's prerogatives, and would deal a sharp blow to world trade. The Peterson Institute, an independent economic policy think tank, also considers that Donald Trump's programme would be synonymous to declaring a trade war, with potentially disastrous implications for the US economy. Lastly, it should be noted that, under pressure from the left wing of her party, Hillary Clinton's campaign objectives also include fighting the causes of popular discontent. Like Trump, her programme features a substantial rise in the minimum hourly wage, which would place US corporate margins under even greater pressure. In other words, the US elections present us with a situation of unfavourably asymmetric risks, despite the current reassuring prospects.

At best, victory for the Democratic candidate would put an unpopular president in the White House, elected primarily out of protest against her Republican rival, who would be unable to pass her budget stimulus plans, as she would lack majority support in Congress (see "All you need is Growth"). A situation not unlike the current status quo, with probably heavier regulation. At worst, the US elections will result in a leap into the unknown, with a direct threat to world trade and US public finances, and possibly heightened geopolitical tensions.

The holding of a referendum on Italy's constitution (instigated by Matteo Renzi after he failed to win a clear parliamentary majority) also presents an asymmetric risk. If he wins, Matteo Renzi will be able to push through his reforms, as the Senate will have lost its power of veto. But this victory will not deliver a magic solution for Italy's floundering economy (growth was at 0% for the second quarter running), heavily penalised by low productivity, excessive debt and a fragile banking system. Conversely, a negative result would constitute a de-facto no confidence vote for Matteo Renzi. It would thus not only bring efforts for economic reform to a standstill, it could also precipitate the departure from Europe's political scene of one of its most pro-Europe leaders, dragging Italy back down into political uncertainty.

Lastly, on 14 December, Janet Yellen will have her last chance this year to respond to improving employment and inflation data by raising key interest rates. If the markets are already in turmoil at that point, due to a surprise result in the presidential elections, the Fed will probably think twice before adding fuel to the flames. However, barring exceptional circumstances, it will be difficult for the Fed to resist the temptation to raise interest rates by 0.25%. Will the economy and the markets come out stronger? There are reasons to be doubtful. Asymmetric risks prevail here too.

Quite possibly, investors will continue to be satisfied with sluggish economies flooded with liquidity.

Moreover, leading indicators for the global economy may continue their recovery, which started in the spring of 2016, for a few months longer (although our own analysis suggests otherwise). But risk management means being particularly vigilant in moments of fragility (see our Note for July "What is risk management?"). Minsky's analysis would have seen that the assurance of extraordinary support from central banks over several years has led both fixed income and equity markets to unstable levels.

Both asset classes have become vulnerable to external shocks, as already confirmed by "Minsky mini-moments", in 2013, in the summer of 2015 and at the beginning of 2016. Three more shocks may occur before the end of the year, while our macroeconomic expectations also suggest that the market might be disappointed by global growth. To address this fragility successfully, we think it wise to take a tactically more prudent stance on both equities and bonds.

Investment strategy

Currencies

Currencies were flat during September, with the notable exception of the Mexican peso, which moved closely in line with the US election polls. The Mexican currency has actually become a key tool for investors looking to hedge their positions against the consequences of a Trump victory.

Also worth mentioning is the continued strengthening of the yen since last summer, evidence of the central banks' increasing inability to weaken their currencies through quantitative easing. This justifies keeping our currency strategy of being mainly exposed to the euro, balanced by a US dollar position and a small position on the Japanese yen.

Fixed income

Interest rates were remarkably steady throughout September. Even long rates in Turkey, whose sovereign debt was downgraded during the month, failed to tighten. We observed a degree of pressure on yield premiums on certain bank issuers in Europe, but these remained contained.

Our fixed income allocation remained largely unchanged, and we continued to harness yields on emerging market sovereign bonds and corporate bonds in the European banking sector, while we reduced our other long positions. On the whole, we maintained our very prudent US fixed income positions, reflecting our assessment of the risk of mounting pressure against a backdrop of rising inflation.

Equities

The equity markets were generally stable in September, holding on to the gains which began in July. Once again it was emerging markets that posted the sharpest rises, especially China. We scaled back our equity exposure a little during the month in order to lock in some of the gains made since the end of June.

However, our thematic allocation remains largely unchanged, maintaining its focus on companies that offer growth prospects and visibility. Some of these companies, such as our technology stocks, are now finding favour among investors, while others are still being neglected, such as our pharmaceutical stocks, which have thus regained attractive valuations. One of the few changes recorded during the month was the sale of our Monsanto position, while its merger with Bayer has moved into a prolonged phase of negotiation with the regulatory authorities.

Commodities

Carmignac Portfolio Commodities turned in a positive performance in September, gaining from the rebound by energy stocks as OPEC reached an agreement at the end of the month to limit production. Although this agreement marks a shift in Saudi policy, namely towards greater discipline in the control of the cartel's production, it remains vague in terms of concrete commitments. We therefore consider it wise to remain selective as regards the oil and gas sector, even if recent developments gave investors cause for cheer.

We made several changes during the month, in particular selling our positions in Gulfport, Albermale and Bankers Petroleum in North America.

Funds of funds

Our funds of funds turned in a virtually flat performance for September. Our balanced, diversified position meant that our portfolio proved overall more resilient than our reference indicators. Managing market turbulence remains a key feature of our portfolio construction.