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CARMIGNAC'S NOTE

02.10.2018

When the tide goes out

October 2018

Published
October 2, 2018

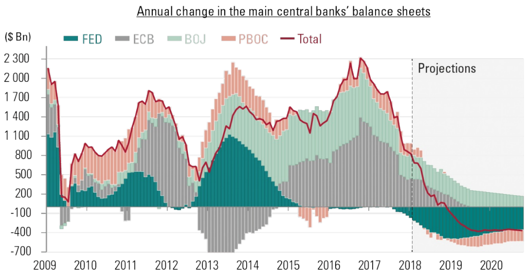
Length
8 minute(s) read

You would have a hard time these days refuting the view that the flood of liquidity pumped into the system by central banks since 2009 reached its spring tide in 2017. Moreover, ever since the first ebb-tide ripples appeared in early 2018 (via monetary policy tightening by the US Federal Reserve), the smaller fish have been gasping for air, chiefly in the emerging world – for now (see our July Note, "Three-way collision"). With the tidal stream only just now starting to ebb, the relevant question is how it will affect equity and bond markets over the coming months and quarters.

Paradigm shift

The narrative we are hearing from central bankers today leaves no room for doubt. The global liquidity flow is set to diminish steadily, before going openly into reverse next year.

LIQUIDITY: A MAJOR REGIME SHIFT
FOR MARKETS LED BY THE UNITED STATES



Sources: Bloomberg, Carmignac, July 2018

The Fed is already reducing the amount of dollars it makes available to the financial system – shifting, in a word, from quantitative easing to quantitative tightening. The US central bank plans to step up the pace of monthly liquidity withdrawal from $40 billion at the start of the year to $50 billion as of October. What is more, this comes in addition to a gradual but relentless drive to tighten monetary policy by lifting interest rates, a drive confirmed in late September by Fed Chairman Jay Powell. Crucially, however, dwindling liquidity in the market has had no impact on the state of the US economy. The Trump administration's lavish fiscal spending is working like a powerful growth pump which, combined with monetary tightening, is hoovering up dollars from around the world. As a result, countries dependent on dollar funding (like Argentina) are left high and dry, while the US continues to enjoy extremely favourable financial conditions.

In Europe, the ECB interest rates are not expected to rise until next summer, but QE will officially be over by the end of this year. That means that the European Central Bank will permanently eliminate its programme of buying eurozone government paper, or at least intends to do so. That change will undoubtedly usher in a radically different environment, above all for countries that rely heavily on investor confidence to finance their fiscal spending. In that respect, developments in Italy must be followed with the utmost attention. Without the safety net created by the ECB's large-scale, recurrent bond purchases, how high will Italian sovereign yields have to rise to attract buyers? The problem will obviously become even more acute if the new government goes through with its plan to jettison fiscal discipline. Such a move would put the country's national debt on a long-term trajectory that both investors and rating agencies would judge unsustainable.

The Japanese central bank governor just confirmed in September that the BoJ would be pressing ahead with the gradual reduction of its monthly sovereign bond purchases. Inflation remains stubbornly weak, compelling the Bank to proceed with infinite caution. But at barely over 0.10%, the yield on ten-year government bonds is still close to the all-time low it briefly hit in 2016, and is having harmful side-effects on the country's entire financial sector.

America First

The first external shock whose impact on financial markets has been aggravated by the paradigm shift under way is the Trump administration's increasingly belligerent protectionist stance, which is aimed primarily (though not exclusively) at China. The question is how long that impact will last.

At this stage, there is little or no basis for forecasting how US trade policy will play out in the short run. It isn't even clear whether its chief proponent, Donald Trump, knows himself. But in the medium term, such an unapologetic embrace of economic nationalism appears to mark a major shift. With its blanket rejection of the notion that free trade provides the best model for regulating international commerce from the standpoint of everyone involved, the Trump administration is basically asserting that world trade is a zero-sum game: your win is necessarily my loss. The unavoidable implication is that all trade agreements must be renegotiated to enshrine that principle – and to ensure that the United States emerges as the winner.

This (neo-)mercantilist outlook has obviously always been favoured by powerful nations – those in a position to impose terms of trade that are most advantageous to themselves. In other words, just as the Fed's monetary policy is attracting offshore capital back to the United States, the Trump administration is working, through protectionism, to take a larger cut of the wealth produced worldwide so as to strengthen the American economy. Little wonder, then, that investors currently put greater faith in the US financial market than in any other. Or, for that matter, that such a shift is generating major tensions. Finally, we should acknowledge that the US government has rightly woken up to the fact that China is now its primary long-term economic, geopolitical and ideological rival. China could easily give in to a variety of short-term demands for greater access to its market, but its leaders clearly understand that the key issue lies elsewhere.

The current state of affairs is creating short-lived bouts of investor panic that offer opportunities to buy stocks on the cheap (see our September Note for a discussion of opportunities in China's tech sector). However, tension between China and the United States may well outlive the short timeframe of US domestic policy and become a lasting feature of the financial market environment.

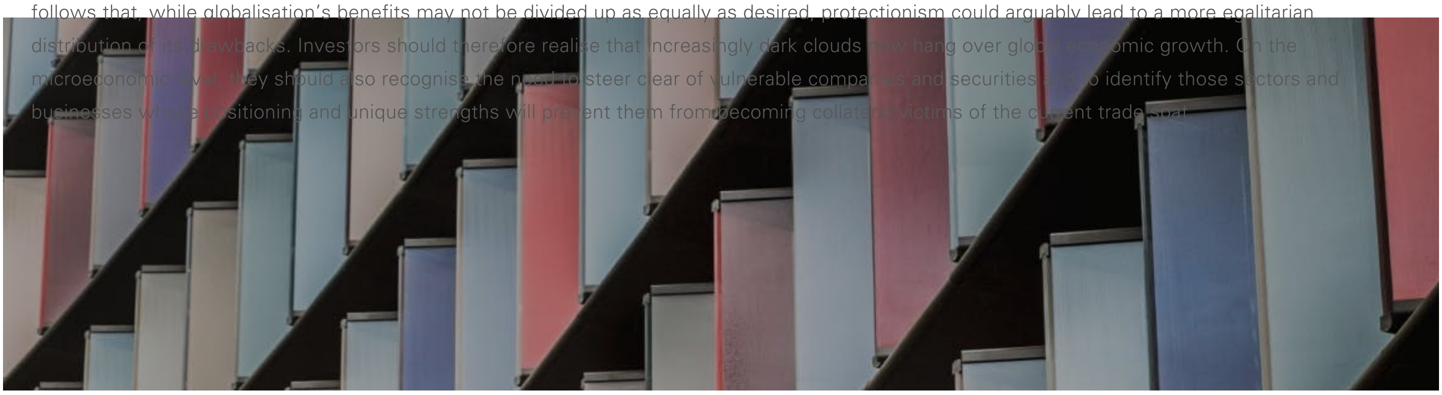
A lose-lose situation

> The key question is whether protectionism will actually prove beneficial to the US economy. Chances are it won't.

Globalisation has unquestionably been a blessing for corporate profit margins in that it allows big companies to optimise their supply chains. But just as unquestionably, it has done little to lift real incomes for wage- and salary-earners. That's why economic nationalism currently enjoys such widespread support in the United States. And why it won't simply go away if and when political power changes hands. The key question is whether protectionism will actually prove beneficial to the US economy. Chances are it won't.

If the Trump administration follows through on its threat to impose high tariffs, then a long list of imported goods from China, and perhaps soon from Japan and Germany, will become less competitive. But because US manufacturers are in no position to produce enough low-priced goods to replace them, they are unlikely to reap the benefits of that loss of competitive edge. With US industry currently operating at full speed, it would be unwise for manufacturers to boost capacity until some clarity has been achieved about where the trade negotiations are going. The primary effect of import tariffs would therefore be to force US consumers to spend more for the same goods – or buy fewer of them. In the first case, prices would rise; in the second, GDP growth would fall. So, ironically, the US economy's current position of strength doesn't amount to much of an advantage. Besides, protectionist measures targeting just a few countries might even enable others (like Vietnam and Mexico) to slip through and at long last sell a number of product lines to previously unattainable US consumers. That means the ultimate winners may not be the ones Donald Trump had in mind.

Returning now to China, due to the increasing weight of domestic demand in its GDP (the Chinese economy has ceased to run a current-account surplus), the impact of tariffs on overall growth should not be overstated. Furthermore, Beijing still has the option (albeit less than before) of sustaining growth through monetary, fiscal and banking-sector support. That said, an economic slowdown, however controlled, will be hard to avoid in China. It follows that, while globalisation's benefits may not be divided up as equally as desired, protectionism could arguably lead to a more egalitarian distribution of its drawbacks. Investors should therefore realise that increasingly dark clouds now hang over global economic growth. On the microeconomic level, they should also recognise the need to steer clear of vulnerable companies and securities and to identify those sectors and businesses whose positioning and unique strengths will prevent them from becoming collateral victims of the current trade spat.



The bond-market conundrum

> US inflation is no longer just a ripple on the water's surface. But bond markets have apparently yet to realise that.

Standard safe-haven assets like US and German government paper have been buoyed so far by widespread mounting political uncertainty, from the emerging world to Italy. As previously discussed, however, the global trend towards monetary policy normalisation has created the conditions for considerable upward pressure on bond yields. Those yields can be expected to increasingly reflect decent economic growth rates and the first signs of inflation. Treasury yields have already risen in the United States, where inflation is no longer just a ripple on the water's surface. In fact, the US economy is now on the verge of overheating. But bond markets have apparently yet to realise that.

In Germany, the growth engine is showing some signs of running out of steam, which is obviously bad news for European equity markets. On the other hand, German GDP is still growing strongly enough to suggest that sovereign yields will remain stuck at inordinately low levels – which is incompatible with the ECB's plan to stop buying bonds by the end of the year. This means that in the short run we are confronted with rather asymmetric risk. Unless we experience a sudden bout of risk aversion (for example if things really go south in Italy or Turkey, a development that can't be ruled out), yields on safe-haven assets in the United States and Germany are likely to rise.

In the medium term, however, the cyclical economic slowdown and ongoing deflationary forces of a secular nature (e.g., an ageing population, "Amazonification" of the economy and mounting debt levels) could well lead to greater risk aversion and to falling inflation expectations. From 2019 onwards, such a trend would stymie the drive by central banks to normalise monetary policy, weigh heavily on stock markets and push sovereign yields back down. Fine-tuned tactical management of equity exposure and bond-portfolio duration will therefore be crucial for active asset managers in the months to come.

The primary consequence of this new liquidity paradigm in 2018 is to amplify the effect of exogenous shocks, thereby leading to even more polarised performance between different geographies and sectors. Such polarisation is poised to become the new, long-term financial market environment, one requiring a highly selective approach to investment. The days of passive asset management are over.

Source: Bloomberg, Federalreserve.gov, 28/9/2018

Investment strategy

Equities

US monetary and trade policy, whose effect is to "hoover up" liquidity and the fruits of economic growth from around the world, has enabled US equities to go on outperforming their rivals abroad. However, the concomitant shift in the business, monetary and political cycles has continued to fuel market instability, prompting investors and fund managers to carry out temporary sector rotations between cyclical and growth industries. But that should not distract us from the deeper underlying trends. Portfolio construction and alpha generation are as vital as ever.

Companies with predictable earnings growth that is uncoupled from the business cycle remain the key drivers of our performance. In that category, we have continued to take profits on tech stocks, for example selling our holding in Amazon after it gained 70% since the beginning of the year. At the same time, we have stepped up our exposure to healthcare with a new stake in the French pharmaceuticals firm Sanofi. Our move to mitigate risk by offloading stocks and taking profits over the past few months has enabled us to increase our cash holdings, leaving us with greater leeway to strengthen our presence in market segments hard-hit by the triple cyclical shift mentioned above. For example, Chinese tech names are undervalued in relation to their US counterparts, whereas they still have a solid growth outlook due to their high exposure to the domestic market. Our only exposure to cyclical stocks is in the oil industry, where the supply–demand equation is still highly favourable to oil prices. We have likewise shied away from sectors and companies that are vulnerable to interest-rate hikes.

Fixed income

German and US yields resumed their upward climb in September after a pause of several months, reflecting mounting inflationary pressure. The US Federal Reserve is forging ahead with its rate-hike agenda, while Mario Draghi has spoken of a "vigorous pick-up" in underlying inflation that sets the stage for future policy tightening. With those factors in mind, we are actively managing our German and US sovereign bond duration.

Italy's coalition government has finally laid out its projected budget deficit, which would exceed both EU requirements and market expectations. Italian government paper has accordingly lost considerable ground, with yields jumping back to their high for the year. In light of the possibility that the country is on its way to a credit-rating downgrade and a confrontation with Brussels, along with political uncertainty ahead of the next European parliamentary elections, we are taking a cautious stance, while remaining flexible enough to take on tactical exposure to specific issuers in the event that we feel that the market shows unwarranted pessimism.

The current dollar liquidity crunch and rising US yields have maintained emerging-market debt in a state of vulnerability. While valuations are attractive, we won't be considering a return to EM bonds until a number of uncertainties have cleared up. We have continued with our cautious exposure to corporate credit at a time of persistently high valuations despite worsening financial conditions. However, we have kept a few positions that look singularly attractive, such as Teva and Altice.

Currencies

The forex market is at the core of the instability created by the current sea change in monetary, business and political conditions. GDP-growth and monetary-policy differentials, US protectionism, the crisis in Italy and the safe-haven status of specific currencies are the factors that are temporarily holding back the broad underlying trends in the key currencies – the euro, the dollar and the yen.

In response, we plan to stick to our policy of giving precedence to the euro, the reference currency for our investors, while maintaining more limited exposure to the greenback. Lastly, EM currencies remain a vulnerable asset class now that the US Federal Reserve has begun deflating the liquidity bubble.