



Why we maintain a conviction-based approach to investment

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Investors were worried about the state of the global economy – epitomised this summer by a collapse in bond yields and an incipient stock market correction. But when monetary policymakers sent out the long-awaited message this autumn that they could be counted on once again to do their part, the investment community heaved a sign of relief. In a synchronised effort the likes of which hadn't been seen since 2009, 60% of the world's central banks cut their key rates in the third quarter.

This concerted dovish shift included the European Central Bank's resumption of its asset purchase programme on 1 November, this time at a monthly pace of €20 billion. Likewise, the US Federal Reserve, after an abortive attempt at normalising monetary policy last year and a fair amount of stalling this one, returned to quantitative easing (though without openly admitting as much) with a pledge to buy \$60 billion worth of Treasury bills a month.

Amid this massive QE barrage, trade tensions between the US and China subsided enough to catalyse renewed, widespread investor confidence and clear the decks for an end-of-year market rally. Equity markets finally broke through the barrier that had previously kept them from doing much more than repair the damage they'd suffered in 2018 (see our September Note, « [Roads to nowhere](#) »).

We raised our exposure over the quarter to the rotation under way to capture as much upside as possible. However, we have deliberately maintained our basic approach to equity portfolio construction, which gives precedence to companies that enjoy secular earnings growth. In what follows, we will explain what underpins that bedrock conviction.

Central banks are targeting financial markets

A first point worth stressing is that the financialisation of the economy, particularly in the United States, has made it important in the past two decades for central bankers to concern themselves directly with how financial markets are faring. The leeway available to companies is correlated (and rightly so) with their stock market value. But above all, US consumers today have a greater share of their wealth invested in financial assets than in real estate. Booming financial markets thus support consumer confidence and economic growth at least as much they are supported by them. That explains why the Fed works unapologetically to keep the US stock market humming. The last twelve months have provided fresh evidence of this if ever it were needed: the equity market swoon in 2018 compelled the Fed to its monetary policy normalisation agenda.

With that degree of central bank sponsorship, the stock market rally had little trouble sparking renewed confidence in the broader economy, resulting in a sector rotation towards more cyclical names and a mild uptick in interest rates. This improved overall outlook is now tempting investors to position themselves for a remake in 2020 of the mini-recoveries the economy experienced in 2012–2013 and again in 2016–2017.

We, however, are quite unconvinced about the potential scope of such a cyclical upturn, and that is a fair reason for sticking to our "growth-stocks" orientation.



Banning recession

There is nothing really new going on here. Every time in the past decade that the threat of an economic slowdown has loomed up, the fear of recession has led to a vigorous monetary policy response, and with it a market rebound. Many investors have gradually come to believe that macroeconomic analysis is barely worthy of their attention. Or even that it's a false friend. In contrast, technical and quantitative analyses – based on the assumption that the same economic disappointments ultimately always have the same positive effects on markets – have garnered mainstream appeal.

If anything, that mindset has become more entrenched over the years. The reason is that endless central bank subsidies have allowed governments to maintain their excessive debt loads. They have also enabled small and medium-sized businesses that would have gone under long ago if they'd been forced to raise funds under normal conditions to expand, keep on investing and make do with extremely low profit margins. It thus looks increasingly like recession has been banned on the grounds that if one were to occur, it would throw large swathes of both the public and private sectors in the major developed countries into a credit crisis. Once again this year, investors have therefore felt comfortable betting that central banks (not to mention Donald Trump, who for reasons of his own is no less determined to prevent a recession in 2020) will do whatever it takes to steer the world economy towards a soft landing.

But there is a price to pay for this systemic Deus Ex Machina with the power to avert any cyclical downturn: it lowers the economy's medium-term growth potential. An infinite guarantee that interest rates will remain at rock-bottom or even negative levels encourages financial investment instead of capital spending and promotes debt financing – which in essence involves reducing future growth in order to stave off recession today.

The upshot? Low secular economic growth rates, increasingly anaemic and short-lived cyclical upswings and a dwindling number of companies that can grow their profits over the long term. Those are the companies we favour.

The liquidity bubble

The secular slowdown and the liquidity bubble reinforce our long-term convictions

This endless, institutionalised postponement of the day of reckoning has created a sort of all-purpose liquidity bubble. Though the economy has more or less been marking time for a decade, all financial asset prices have irresistibly risen in response to falling interest rates. That bubble is unquestionably making financial markets more fragile today, and the resulting divergence with the real economy has started to produce major social and political fallout. But a further consequence is also worth mentioning because it gives greater credence to our basic investment strategy.

The current bubble should be distinguished from a speculative bubble. Financial markets aren't being driven by the lure of oversized gains as they were in 2000 and 2007, but rather by savers' need to find somewhere to invest their excess cash for reasonable returns and at acceptable risk levels. The growing performance dispersion in the corporate bond market bears witness to this trend. This asset class still enjoys positive inflows, but these go increasingly to quality issuers, whereas the junk segment is beginning to experience its first accidents. In equities as well, though a degree of confidence in the overall economy has re-emerged over the past few weeks, it hasn't been enough to halt the progression of top-quality growth names. For example, the share prices of Microsoft, Apple, LVMH, Hermès or L'Oréal hit record highs in November. And even in the more cyclical part of the economy, lower-priced sectors that are confronted with major strategic challenges – e.g., autos, banking and brick-and-mortar retail – are still notably underperforming the more robust cyclical sectors like semiconductors and electronic equipment.

So even if the current liquidity bubble were to last and to go on fuelling the disparity between financial markets and economic reality, it wouldn't dent attractiveness of companies with superior business results – quite to the contrary.

The profit recession

Last of all, the secular slowdown that forms the backdrop for the various mini-business cycles inevitably entails mounting pressure on corporate profit margins, including in the United States. Through the wizardry of financial engineering and share buybacks, that pressure has stayed off the radar at big listed firms. Earnings per share for S&P 500 companies are still close to their historic highs.

But national accounting data (published by the Bureau of Economic Analysis) show that the growth rate for profits at non-financial US firms has been trending downward for the past ten years. In October, the pace slid to -4.9%, down from -1.1% in September. Eurostat reports a similar trend in Europe, and much the same can be said of China: the figures released in November confirm that Chinese manufacturing profits have been falling since the start of the year: -2% in August, -5% in September and -10% in October.

That means that the ability to keep profitability up throughout the business cycle is now more than ever a key, long-range differentiator. We therefore consider it an additional reason for sticking to our long-term investment style.



Looking further down the road

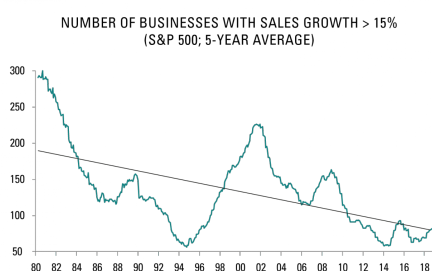
The technological revolution offers major investment opportunity

We are thus convinced that the most robust way for us to achieve long-range returns is to identify business models that can generate powerful growth and substantial profits over a five- or ten-year span.

Those business models don't require us to assume rising valuation multiples (they even leave room for lower valuation multiples!), and they are quite well suited to the current environment of low-key business cycles and mediocre growth rates. Moreover, we believe that the broad technological revolution under way is as epoch-making as the industrial revolution in the nineteenth century, and we feel it offers major opportunity for companies that successfully monetise the practical applications of that revolution.

To mention just a few perspectives, artificial intelligence is moving ahead by leaps and bounds – fuelled by the expansion of utilisable databases which are buoyed in turn by massive mobile-phone use. Its first tentative applications as in virtual reality software create tremendous potential, not only in video games (whose potential is boosted by use on social networks), but also in healthcare and education, and will also deeply affect how people consume, travel, and communicate.

All these offshoots of the technological revolution unfolding today provide a glimpse into how exciting investment opportunities can and must be developed on the basis of extremely rigorous analysis. This conviction is what informs our entire style of asset management.



Source: Carmignac, Bloomberg, 12/2018

Combining risk management and long-term convictions

Exactly one year ago, we concluded our Note with the following prediction: "Sooner or later, the leading central banks will have to raise the white flag and relinquish any further policy normalisation. When they do, the prospect of a return to reflationary policies may give wings to risk assets." To everyone's surprise, the central bankers announced just such a capitulation a month later, and 2019 proved to be a very good year for all asset classes.

2020 will no doubt pan out differently, because the recent return to an upbeat mood has taken valuations for risk assets to levels that leave little room for disappointment. The "Bubble of Everything" may not be on the verge of popping, but the stakes for financial markets in the event of an accident have increased considerably. By positioning themselves once again for a cyclical upswing in 2020, investors are wagering that US consumer behaviour won't disappoint them (although US banks have started making it tougher to take out consumer loans and the pace of job creation is winding down). They are also assuming that the "profit recession" mentioned above won't lead to stress in the credit market. Lastly, they are betting that trade, political and geopolitical uncertainty will become lastingly less pronounced. We aren't so sure that we're in for such an improvement in the overall outlook, and we feel that managing market risk could be crucial in 2020 if we encounter turbulence. But even with this active management of beta, our core approach to achieving returns still rests on generating considerable alpha in the equity, government bond and corporate bond markets. We therefore feel that our strategic preference for growth stocks that can look forward to predictable earnings is in no way an empty, common-sense boilerplate. It is a major performance driver, based on a highly demanding approach that in our view has a lot more to recommend it than short-term panaceas being offered.

Source: Bloomberg, 29/11/2019

Investment strategy

Equities

Based on the large inflows into equity markets, we can conclude that investors are expecting a return to utopian conditions characterised by accommodative central banks, substantial liquidity injections, low yet stable economic growth rates, and dwindling uncertainty. Those expectations have caused equities to broadly outperform fixed income. US stocks led the way, bolstered by the technology (up 5.4%) and healthcare (up 7.4%) sectors – both of which make up a key component of our equity portfolio. A similar trend could be seen in Europe where quality growth stocks posted the biggest gains. Emerging equities are still struggling, however – especially in Latin America, where we have little exposure, and in China, where we have beefed up our exposure and where protest movements have been particularly intense of late.

We still have a relatively high exposure to equities, since these markets are being supported by technical factors (such as risk premiums, liquidity, and traders' positions). And within these markets, we still favour companies with attractive growth prospects that are relatively independent of the business cycle. US companies are a case in point – even though valuations are currently above their long-term averages, these firms enjoy good prospects for growth in both revenue and profit margins. But opportunities are to be found even in Europe, where we still believe it's too soon to expect solid economic growth to underpin the companies operating in the region. Our holdings in emerging markets are focused mainly on the regions and sectors with the most predictable earnings growth. Or in other words, those most exposed to their domestic economies, especially in Asia. We recently added Ping An – China's biggest private-sector financial firm – to our portfolio. Ping An is at the forefront of new technology for data collection and processing, and offers particularly promising growth prospects, especially at its Insurance business. The recent dip in Chinese stock markets gave us an attractive entry point for this stock.

Fixed income

Today's reflationary monetary policies, coupled with lower political risk and easing fears of a recession, have pushed the highest-rated sovereign bonds into negative territory and caused the more cyclical bonds to outperform. Credit spreads have tightened, particularly in Europe but also in the US. Subordinated bank debt has done especially well, supported by a perfect storm of: (i) higher long-term interest rates; (ii) diminishing political risk; and (iii) relatively high bond yields.

We expect to see interest rates in the core eurozone countries move in a narrow band in the coming months, squeezed between greater upward pressure from expectations of fiscal stimulus and of an end to trade tensions, and greater downward pressure from central banks that are basically forced to keep interest rates low to maintain financial stability, given the huge debt overhang at governments, businesses, and households. We are therefore managing our portfolio's modified duration both actively and tactically.

The current environment of almost permanently low interest rates is particularly auspicious for carry strategies. But since we believe bonds are fairly overpriced, we are being highly selective in our credit investments. We are also being selective in our holdings of peripheral country sovereign debt; we took profits on some of our Italian bonds since we believe political risk could return given the increasingly visible rifts within the current governing coalition. We added euro-denominated Romanian debt to our portfolio. The country's 30-year bonds have a BBB- rating and offer yields of 3.35% – an attractive opportunity in absolute terms considering the well identified risks and fundamentals.

Currencies

After stumbling in October, the US dollar continued its steady march upwards. The US economy may be slowing but it is still doing better than any other – which is pushing up the greenback, particularly against the euro. Pound sterling has also held up well in light of recent polls that point to a comfortable victory for Boris Johnson's party in the December elections, since that means there is a higher chance that Parliament will approve his Brexit deal. However, this does not take account of the tight December 2020 deadline that Johnson has committed to for negotiating a free-trade agreement.

South American currencies are still the centre of attention, most recently with the sharp drop in the Chilean peso following the major protest rallies. That has given us an attractive entry point for exposure to a country with one of the most disciplined fiscal policies on the continent and a proactive central bank that has pushed real interest rates into negative territory – thereby giving the domestic economy a likely shot in the arm.

We believe the US dollar is overvalued and therefore maintain our cautious stance. The greenback probably won't depreciate until the Fed becomes more dovish – which could happen if, as we expect, the US economy disappoints in the first quarter of next year.

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