

MANAGEMENT REPORT – THIRD QUARTER OF 2018

Q3 2018

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Economic analysis

The ongoing trend towards liquidity absorption by central banks and the possibility that mild inflationary pressure will continue in the United States and, to a certain degree, in Europe both point to a regime change most strikingly evidenced by rising yields in the world's major bond markets. After a nine-year expansionary streak, the business cycle is now winding down. We believe, however, that the Federal Reserve will try to moderate its rate-hike programme in order to sustain GDP growth for as long as possible and nudge up inflation – the only two factors that can whittle away at the country's debt burden. Will the regime change we see affecting inflation and monetary policy keep equity markets humming? The current trade friction could easily bring the bull market to an end by adding its inflationary impact to the fallout from a global economic slowdown already under way.

The global outlook

Three months ago, we wrote: "As the no-holds-barred application of the 'Make America Great Again' catchphrase... 'America First' turns out to be more than just a slogan. It's actually the name of an unabashed, unconstrained and virtually unrestricted policy that is having a positive influence on US economic sentiment." It also explains "to a large extent why the US economy is currently doing so well – at the expense of the rest of the world". We went on to say: "By shifting gears and powering ahead – while the European Union is marking time – the US is dragging the world economy into a disturbing state of antagonism that the country's monetary policy normalisation can only heighten."

The Trump administration's fiscal stimulus is sustaining a domestic economic boom that allows the Federal Reserve to go on normalising monetary policy. At the same time, those policies are forcing countries in the rest of the world to live with interest rates that are increasingly incompatible with their own growth trends. This monetary tightening has continued to weaken emerging markets that are already grappling with China's dwindling room to manoeuvre. Meanwhile in Europe, widespread disillusionment is steadily swelling the ranks of parties demanding more national sovereignty – many of whose economic recipes sit uncomfortably with eurozone rules. The ongoing trend towards liquidity absorption by central banks and the possibility that mild inflationary pressure will continue in the United States and, to a certain degree, in Europe both point to a regime change most strikingly evidenced by rising yields in the world's major bond markets.

That upward trend, combined with an economic slowdown in China and a serious threat to the country's exports to the United States, has led to substantial losses in our global portfolios, particularly those including investments in the emerging world. Donald Trump's hardline stance, which appears to preclude negotiations with Beijing in the short run, has amplified the underperformance spreading across the EM space. Moreover, a buoyant US economy has given a shot in the arm to cyclical investment themes in which we were underweight, but without any positive spillover to the gold stocks we hold to keep portfolio risk down.

Will the regime change we see affecting inflation and monetary policy enable emerging markets to recover and, more broadly speaking, keep equity markets heading in the right direction? The current trade friction – by now termed a trade war by most commentators – could easily bring the bull market to an end by adding its inflationary impact to the fallout from a global economic slowdown already under way. However, that friction can also be equated with an aggressive negotiating style adopted by Washington to ensure that all of its key trading partners do their "fair" share of the work of maintaining overall balance in international trade.

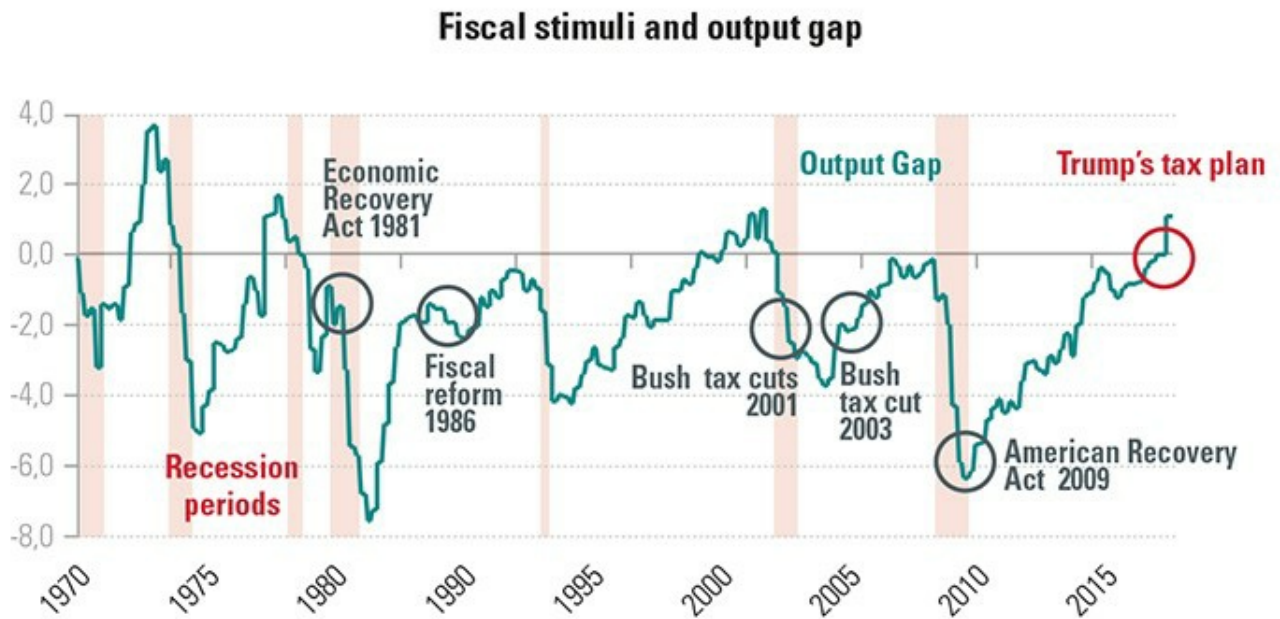
From that standpoint, Trump has already chalked up a number of clear wins, not only with his former NAFTA partners, but also with South Korea, while the tensions with Europe and Japan have subsided. But he still faces the challenge of reaching a deal with China, a country behind a large chunk of the US trade deficit. For the US President, the issue of intellectual property and forced technology transfer is a red line that could stand in the way of any broader agreement in the short term. At stake here is America's technological – and therefore economic – supremacy.

United States

Our baseline scenario for the United States over the past few quarters has involved a mild economic slowdown that wouldn't prevent the Fed from further normalising monetary policy. In our previous quarterly report, however, we also wrote: "On the other hand, we can't entirely rule out the prospect that [inflation] will continue rising... or remain at a high level. Expensive oil and full employment... could set the stage for a spiral in which wage inflation and rising prices for goods and services fuel each other, and thus eventually start to eat away at corporate profit margins."

What we were implicitly describing was the classical case of a disappearing output gap. For the first time since 2002, the output gap in the US economy has apparently moved into positive territory. When actual output exceeds maximum potential output, the risk of inflation increases, and with it the risk that the central bank will tighten monetary policy to the point of bringing economic growth to a halt. After a nine-year expansionary streak, the business cycle is now winding down. We believe, however, that the Federal Reserve will try to moderate its rate-hike programme in order to sustain GDP growth for as long as possible and nudge up inflation – the only two factors that can whittle away at the country's debt burden.

United States: an unusual timing in the economic cycle for fiscal stimulus



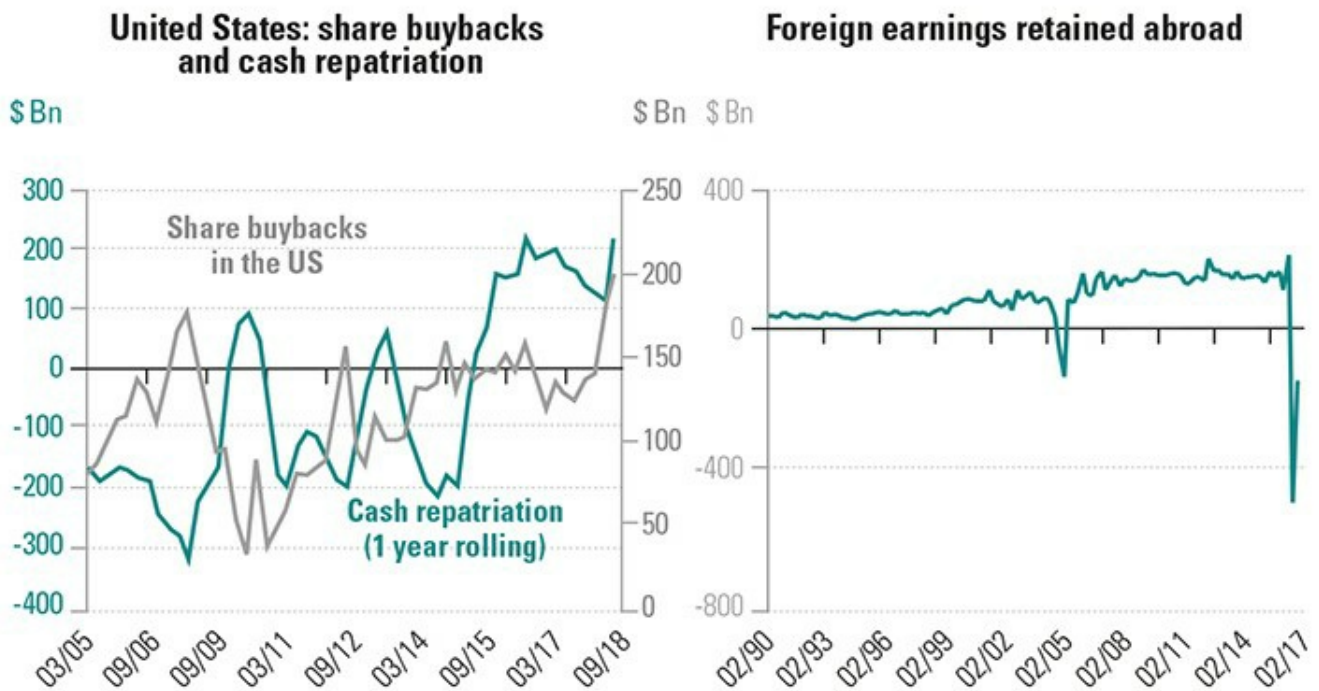
Source: Carmignac, 28/9/2018.

In March 2018, the Fed Chairman hinted at this when he stressed the importance of not raising rates too quickly: “We want to avoid inflation running persistently below our objective, which would leave us less scope to counter an economic downturn in the future.” In addition to requiring unconventional monetary policy, fiscal easing is fast driving up the US national debt. An abrupt hike in interest rates – whether engineered by the Fed or triggered by bond investors all too aware of the central bank’s easy-going approach to inflation – would make that debt burden unsustainable and halt economic growth in the process. So although the Fed can conceivably guide inflation by tightening policy in response to actual GDP growth and inflation rates rather than seeking to constrain them in advance, the danger of postponing such a move for too long is that the market could end up doing the central bankers’ job in their stead. The result would be a jump in long-term yields – one larger than the rise in inflation. That would prove devastating to the property market and shortly thereafter to the whole economy, given that real lending rates would outstrip the pace of GDP growth.

Nor are those the only reasons for wanting to avoid such a sharply steepening yield curve as the Fed has become a net seller of long-dated government paper as part of its shift to quantitative tightening, China no longer has trade surpluses to recycle in the US bond market and trade deficit caused by Trump’s policies makes further debt issuance by the US Treasury a necessity. The exercise assigned to Jerome Powell’s Fed involves lifting interest rates at an extremely fine-tuned pace, taking due consideration of both liquidity withdrawal by the world’s key central banks and a US economy high on fiscal stimulus even after nine years of steady growth. Trump’s fiscal policy has led US households to expect their income to grow by over 4%, and the Fed to forecast a double-digit increase in capital spending in its manufacturing business outlook

surveys. It has pushed up second-quarter GDP growth to 4.2% on an annualised basis (with 2.9% expected for the full year), while unemployment has plummeted to 3.7%, the lowest since 1969, and core inflation stands at 2.3%. The price to pay for this has been a rise in the Federal budget deficit from 3.2% to 5% of GDP since Trump took office.

Monetary tightening and repatriation create a biased situation in favour of the United States



Sources: Carmignac, Bloomberg, 28/9/2018

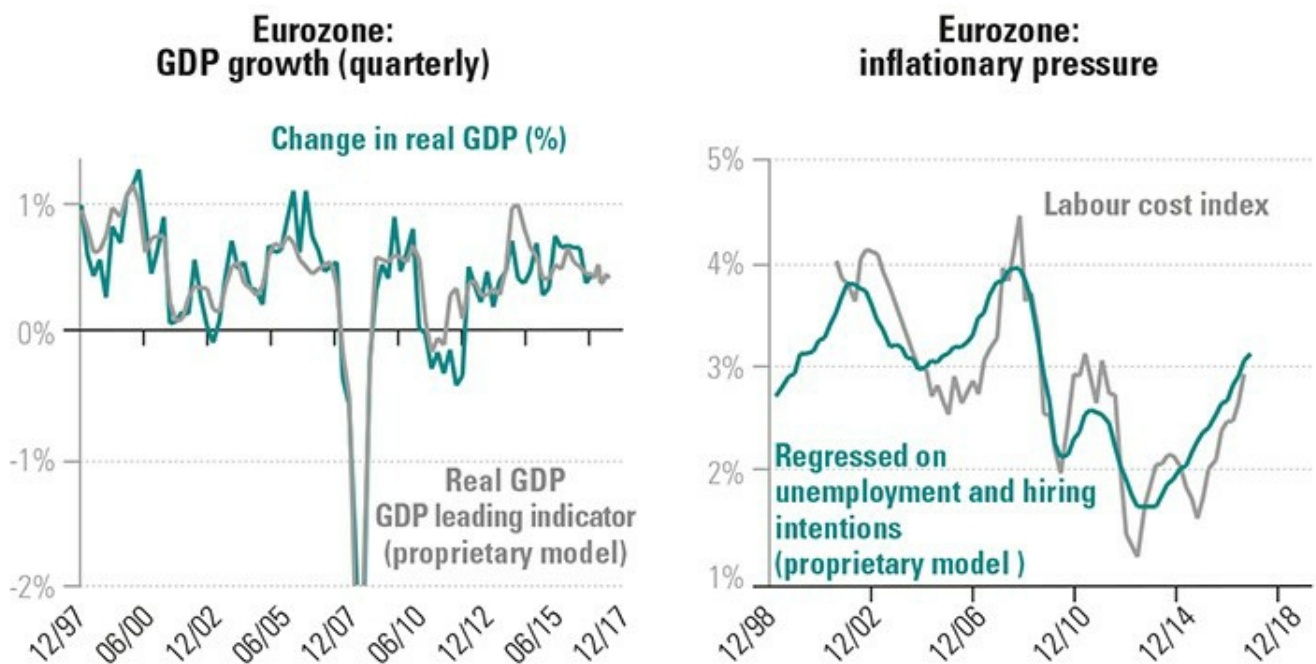
On the upside, the Fed is getting some help now that US companies have started repatriating cash from abroad at reduced tax rates. A large share of that money has gone into corporate share buybacks (\$800 billion to date in 2018). In response, pension funds have decreased the proportion of equities in their portfolios and shifted towards long-dated Treasuries so as to maintain their target allocations between stocks and bonds. This knock-on effect of the recent tax reform can partially offset the Fed's withdrawal as a long-term buyer of Treasury bonds and enable the central bank to normalise monetary policy without draining off too much liquidity in the United States itself. So we are dealing here with a near-ideal formula as long as profit repatriation from overseas continues and results in share buybacks and the purchase of long-dated bonds.

In contrast, the repatriation trend is bad news for the rest of the world: with so many dollars being "re-imported" to the United States, there is that much less dollar liquidity available elsewhere. Just how harmful repatriation has been to other countries can be gauged from the behaviour of risk assets in both emerging markets and Europe, where liquidity could well become a grave problem.

Europe

In Europe, political considerations currently override economic factors. Disappointment with feeble economic growth in southern-rim countries, the migrant crisis and the broader sense that the EU institutions operate undemocratically have together boosted support for pro-national sovereignty parties. Those parties may well put in strong showings across the continent in the May 2019 elections to the European parliament. Concerted fiscal stimulus throughout the EU could be a way to forestall a landslide victory at the polls for those forces. But the glaring lack of leadership in the European Union today makes that outcome seem just as improbable as a surprise pick-up in GDP growth, which has been winding down since the start of the year. In view of the anxiety caused by next spring's elections, investors and business decision-makers may well decide to wait out the storm. The fiscal orthodoxy and creative monetary policies we have grown so accustomed to these past years are now in danger of getting shoved aside, creating a huge amount of uncertainty that would be enough to kill off any urge by investors and companies to act boldly.

Eurozone: the ECB trapped between inflation and slower economic growth



Sources: Carmignac, Bloomberg, 28/9/2018

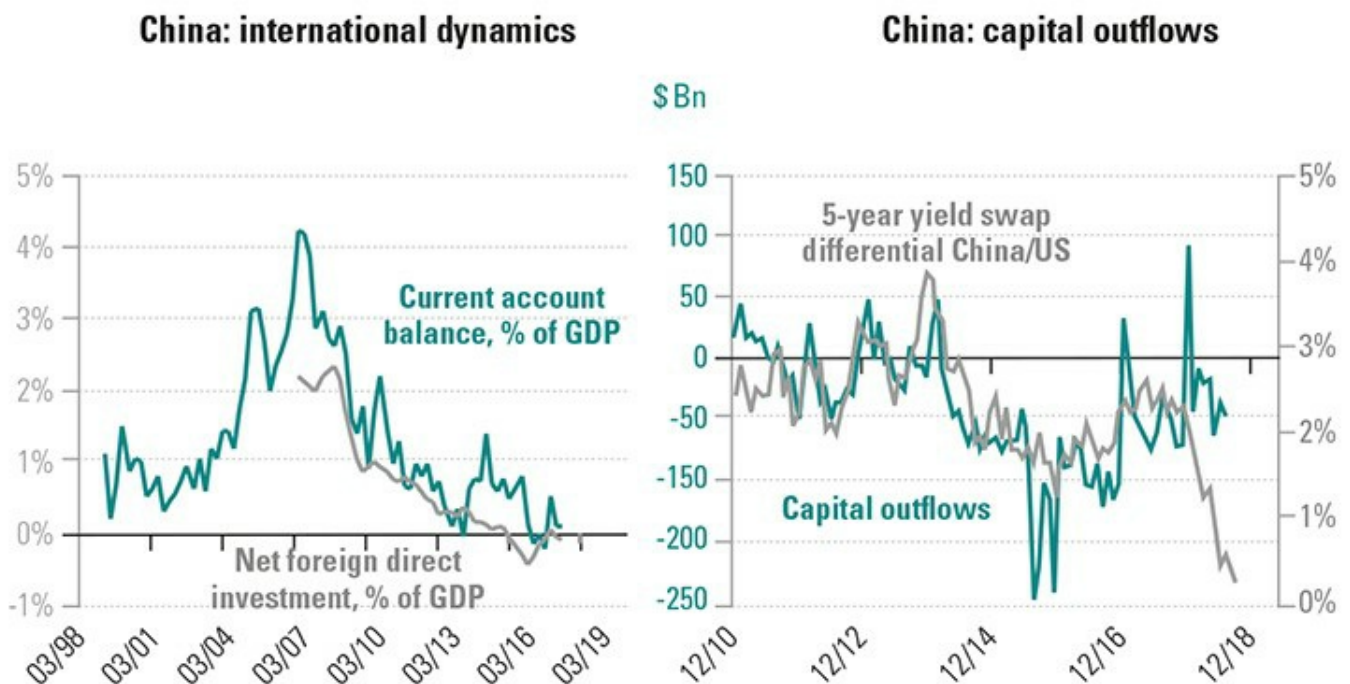
The economic slowdown in the EU is also accompanied by mild inflation, which has been fuelled by a largely unnoticed narrowing of the output gap in the banner year of 2017. Potential output in Europe's economies is so low that any upswing generates tension. Visible evidence for that tension can be seen in pay trends. The EU labour cost index is up 2.5% and the various attempts at modelling wage levels point to the same figure. Core inflation stands at 1.5% and the leading indicators for prices likewise suggest a 1.5% rate of increase. Annualised GDP growth as of the second quarter was only 1.6%, following a 2.7% growth rate for 2017 as a

whole. Large economic growth differentials can be observed among Eurozone member states, making the job much tougher for the European Central Bank, whose next president will soon be designated. The trend in sovereign credit spreads has recently driven Italian yields 270 basis points higher than French yields, while 10-year German government paper only pays 57 basis points despite 2.3% inflation and full employment in the country. We can accordingly expect a lot of volatility and considerable headaches for the ECB and its incoming president, particularly in light of what promises to be a turbulent political agenda.

Emerging markets and Japan

The emerging world is on the receiving end of the liquidity crunch resulting from gradual monetary policy normalisation, as well as of the tightening of US interest rates in response to the Trump-engineered domestic boom. China, where retail sales growth has slumped to a low since 2003 (6%) and nominal capital spending growth to its lowest level since 2000 (5%), has very few cards left to play. The country is no longer running a current-account surplus and net capital flows remain negative, making it impossible to devalue the currency or cut interest rates.

China: stimulus through rate cuts would speed up capital flight



Sources: Carmignac, Bloomberg, 28/9/2018

The policy introduced to increase the share of consumer spending in Chinese GDP has been a failure. And while an umpteenth stimulus plan focused on infrastructure is still an option, the country's public finances are

no longer in such good shape. The IMF estimates that, when local government spending gets factored in, the aggregate public-sector deficit is more like 12% to 15% of GDP. Furthermore, if the trade negotiations with the United States were to fall through, China would lose up to one percentage point of GDP growth. This leads us to believe that a trade deal is still possible. Not only is agreement a necessity for the People's Republic, but it will be imperative to sustaining US economic growth.

Investment strategy

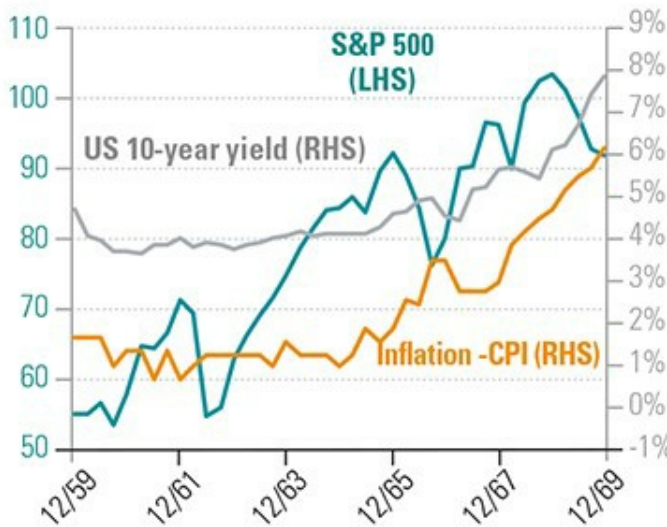
Rising US interest rates reflect the shrinking volume of global liquidity as much as, if not more than, the economic growth or inflation outlook. Taking over from quantitative easing, quantitative tightening marks a regime change that has already begun to affect financial markets and the economies most highly dependent on funding from abroad. The repatriation of profits earned overseas by US firms could initially strengthen the trends observed over these past few quarters. These include outperformance by US risk assets, more vigorous economic growth in the United States than elsewhere and a surge in US bond yields – brought about by the Fed on the short end and by investor expectations on the long end of the curve.

The yield on 10-year US Treasuries has climbed from slightly over 2% in the fourth quarter of 2017 to 3.25% recently, reaching a seven-year high although there have been no major changes in inflation expectations nor in the pace of economic growth. Given that 10-year yields have been fluctuating between 1.4% and 3.05% since 2011, the recent overshoot appears to corroborate our thesis that a new interest-rate regime is falling into place. With the Fed and the People's Bank of China both relinquishing their role as long-term buyers of US Treasury bonds, we feel that this shift in balance makes sense, and our Funds are positioned to take advantage of it. The upward pressure on yields is rippling moderately over to European bonds. They too will be impacted when the European Central Bank winds up its net asset-buying programme in the near future. As long as the Fed forges ahead with policy normalisation and the US economy keeps growing, we will be maintaining the negative overall duration of our portfolio. Sovereign bonds from Southern Europe remain attractive from an opportunistic standpoint, but the combination of dwindling liquidity and an unsettled political climate in Europe precludes viewing them as a priority investment focus. At the same time, we are keeping an eye on corporate credit spreads. A shrinking supply of liquidity will have an outsized impact on this asset class as soon as financial markets start to price in a US economic slowdown.

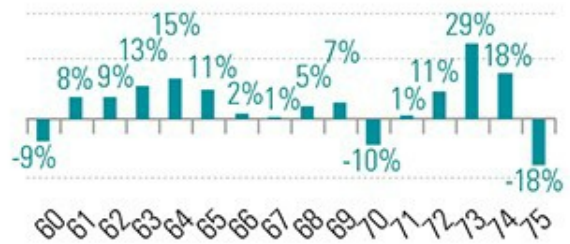
Similarities between today's economic climate and the 1960s

Heading for a "Nifty Fifty" period 2.0?

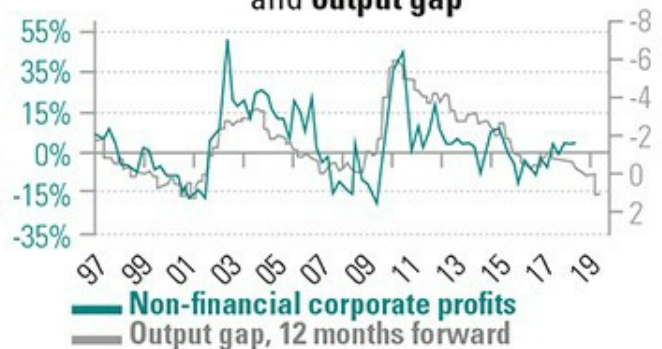
United States: 1960s



1960s: S&P500 EPS growth*



Today: US corporate profits and output gap



Sources:
Above: Bloomberg, 31/3/1969.
Below: Carmignac, 28/9/2018.
*Earnings Per Share

Equity investors will most likely continue to distinguish clearly between unleveraged, non-cyclical companies offering strong regular growth and the rest of the pack. Any business that can consistently generate earnings and dividends in the new environment taking shape will be richly rewarded in the stock market. What immediately comes to mind is a comparison with the mid-1960s, when bond yields and inflation picked up after a long period of stability while corporate earnings growth as a whole buckled. At the time, we saw stunning outperformance in the stock market by a few dozen names that met the above description. The narrowing US output gap portends higher inflation and an end to the current boom – occurring moreover against a backdrop of dwindling liquidity. Those factors in combination will mean trouble for most listed companies. Quality stocks, preferably American, will remain our core equity investments. On a more short-term, opportunistic basis, we are standing in wait for encouraging developments in the trade negotiations between the US and China. Any good news on that front would set the stage for recovery in markets and sectors badly bruised by the recent trade tensions, chief among them China and other emerging markets. We will also be on the lookout for signs of overheating in the US economy, which might prompt the Fed to overreact and thereby hasten the business-cycle reversal.

In the forex market, we see little in the way of clear trends that would warrant greater exposure on our part. The euro will be hurt over the coming months by an unstable, uncertain political climate, whereas the value

of the greenback is likely to adjust due to mounting deficits in the United States. And even before then, the US midterm elections have the potential to produce erratic movements in the euro-dollar exchange rate. The yen could well remain an excellent proxy for risk appetite, depreciating in risk-on phases and appreciating sharply in risk-off phases. Lastly, EM currencies will need a less overpowering US economy and less liquidity shrinkage before they can recover their former health.

Source: Bloomberg, 29/8/2018.

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