



A return to greater balance

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We have no real grounds, since we published our March Note [«Augmented reality»](#), to alter our basic take on financial markets. Though largely ignored by investors throughout 2018, the collision we forecast between a slowing world economy and monetary policy tightening has indeed happened – so unquestionably that the case is now closed. With the economic slowdown unfolding, central banks have seen the writing on the wall and continued to soften their stance in March. This return to greater balance has been reflected in equity markets, as they showed little change between the beginning and the end of the month (with the Euro Stoxx 600 up 1.4%, the S&P 500 up 1.1% and the MSCI World Index up 0.6%). At the same time, bond-market behaviour has reflected the persistent absence of inflation and, even more sharply, the bad economic news that went hand in hand with the abandonment of monetary policy tightening.

Some observers are banking on a powerful, 2016-style economic upswing; others fear we are sliding helplessly into a recession. Against that backdrop, the stock market seems to be operating on the more modest assumption that economic growth will settle in at a pace that is mediocre enough to ensure the continuation of favourable monetary policy.

The global economic slowdown is no longer controversial

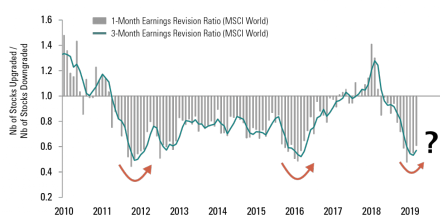
Apart from China, the world economy has continued to lose momentum, and most leading indicators and cyclical trends such as manufacturing PMI surveys tend to point in a bleak direction. Waning output in cyclical industries like semiconductors and motor cars suggests that replacement cycles for durable consumer goods are getting longer. However, what our analysts observed on a visit to China last month bears out the position we put forward in our March Note: *“Even an upswing as powerful as the one triggered by the 2016 stimulus programme can hardly be expected, the country should manage to stabilise the pace of its output growth, particularly in the industrial sector.”*

This may sound uninspiring, yet fixed income markets have responded dramatically – heading no doubt by the more cautious stance adopted by central banks. The yield on 10-year US Treasuries has slid from 2.7% to 2.4%, while the yield on Germany’s 10-year government paper has dropped below the symbolic 0% threshold (down from 0.2% at the start of the month) – shades of how the bond market interpreted the economic environment in early 2016.

Though less remarkable, equity market performance also indicates that economic expectations have again quite downbeat a point worth stressing despite the market rally of the past three months. A striking development on both sides of the Atlantic is that by far the best-performing sectors over the last six months – a period that includes the mini-crash of late 2018 and the market rebound in early 2019 – are the most defensive ones. In Europe, for example, the food, healthcare and utilities industries gained more than 10% during the period (while the Euro Stoxx 600 was down 2.5%). In the United States, consumer staples and utilities grew respectively by 4% and 10% during that time (versus a 3% drop on the S&P 500).

Financial market trends have thus continued to reflect a bearish overall view of the economy – even as the first “green shoots” were becoming apparent in March. In addition to the first tangible signs that Chinese manufacturing output was steadying, the share of downgrades to analysts’ corporate earnings expectations, while still constituting a sizeable majority, has declined slightly.

EARNINGS REVISION RATIO OF GLOBAL COMPANIES
BY FINANCIAL ANALYSTS



Source: Bank of America Merrill Lynch, 31/03/2019



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The market outlook

Going forward, the main question-mark facing investors is to what extent monetary and fiscal policy, which is now more supportive, will succeed in stemming the economic slowdown under way, or even reversing it as in 2016.

The fiscal outlook is a mixed bag across the globe. In Europe, it is favourable by and large, due mainly to social pressure in France, political determination in Italy and dwindling economic momentum in Germany where the upcoming fiscal stimulus will be equal to about 0.8 points of GDP). In China, as we've seen, infrastructure and military spending, which are entirely under central government control, should be adequate to the task. A first encouraging sign of that is that the country's manufacturing PMI survey rose above the 50 mark in March. In the US, however, the 2017 tax reform has indeed provided support, but is unlikely to exceed 0.6 points of GDP this year. Moreover, the strife between the Trump administration and the Democratic majority in the House of Representatives makes a further boost to fiscal spending improbable in the short term.

The dollar resiliently is making economic recovery in the emerging world that much harder

Regarding monetary policy as well, the outlook is similarly positive yet low-key. After the Federal Reserve's U-turn, the vast majority of central banks around the world have expressed a willingness to ease off again if need be, citing globally low inflation expectations to back up their views. The European Central Bank immediately comes to mind, but central banks in New Zealand, Switzerland, Brazil, South Korea and elsewhere have also followed suit. The trouble is that they have very little leeway to reverse course, in the short term at any rate. For starters, the Fed will have to phase out its balance-sheet reduction programme over several months before it can seriously turn around its monetary policy trajectory. This is keeping the dollar resiliently high relative to other currencies, making economic recovery in the emerging world that much harder. In the eurozone, Mario Draghi, who will be stepping down as ECB President in October – perhaps to be replaced by a more orthodox figure – will be unable to take bold action in the months to come. As for the Bank of Japan, it already holds 80% of all ETFs invested in Japanese equities!

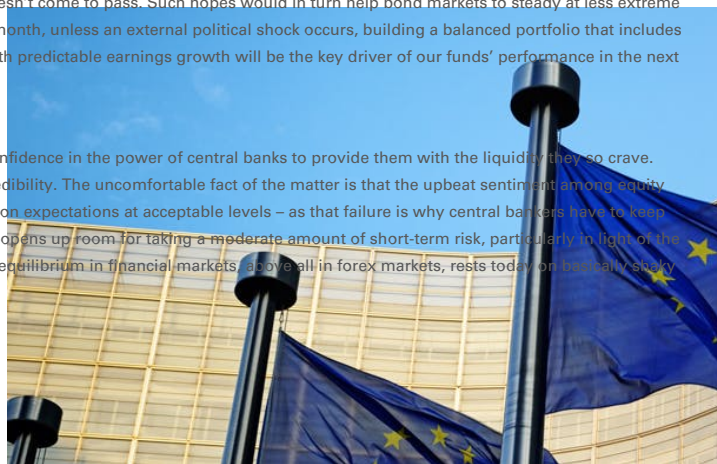
We can therefore plausibly assume that the global economic slowdown will continue on a subdued note for a few more months, accompanied, at least initially, by favourable but relatively toothless monetary policies.

That outlook may be enough in the short term to sustain equity investors' confidence in a gradual economic recovery, particularly if the trade dispute between China and the US gets settled in a reasonable manner and if the worst-case scenario for the Brexit saga doesn't come to pass. Such hopes would in turn help bond markets to steady at less extreme levels, while being further buoyed by low inflation expectations. As we pointed out last month, unless an external political shock occurs, building a balanced portfolio that includes a slightly larger share of cyclical stocks but still a majority of carefully selected names with predictable earnings growth will be the key driver of our funds' performance in the next few months.

In the medium term

Events in 2018 highlighted how dependent equity markets have become on investors' confidence in the power of central banks to provide them with the liquidity they so crave. That addition to "monetary manna" increasingly highlights the issue of central bank credibility. The uncomfortable fact of the matter is that the upbeat sentiment among equity investors today derives in part from the repeated failure of central banks to anchor inflation expectations at acceptable levels – as that failure is why central bankers have to keep trying to reflate the economy. The cautious mindset that currently dominates the market opens up room for taking a moderate amount of short-term risk, particularly in light of the first signs of economic stabilisation that have emerged over the past few weeks. But the equilibrium in financial markets, above all in forex markets, rests today on tenuous foundations. Considerable caution is therefore required in the medium term.

Source: Bloomberg, 01/04/2019



Investment strategy

Equities

After starting out the year with a bang, equity markets levelled off in March. US stock indices in particular ended the first quarter with some of the best results seen in nearly a decade. While a slowing global economy and political uncertainty over Brexit and other issues still weighed heavily on the overall market climate, cautious central-bank policies and China's moves towards stimulus continued to offer welcome support to equity markets. We have accordingly maintained our strategic emphasis on stock-picking.

Our long-term investments include positions in the payment industry. Though cash is still the main means of payment, the e-commerce boom and changing patterns of consumption among Millennials suggest an upcoming trend reversal. We have invested in Worldpay, PayPal and Visa to ride that trend. At the same time, investors have been steering clear of some European equity-market segments in response to the marked deterioration in the region's economic indicators over the past few months. One such segment is European banking, which exhibits a rather asymmetrical risk profile. We have initiated a modest position there, accompanied by an option strategy. We have also added a selection of high-quality US industrial stocks in order to balance out the cyclical component of our equity portfolio.

Fixed income

Government bond yields retreated substantially in March, reflecting the cautious approach of central banks and a slowing economy. During the month, we increased the overall modified duration of our fixed income portfolio with a balanced blend of developed-world sovereigns and more risky assets.

The Federal Reserve is hewing to its dovish stance, introducing a break in its rate-rise cycle to counter the slowdown in the US economy. Our strategy therefore focuses on carefully choosing the segments of the US yield curve worth investing in. In Europe, the slide of German 10-year yields into negative territory attests to the bearish mood among investors. The dovish tone adopted by the ECB has paved the way to carry strategies involving "semi-core" countries like France and Belgium and countries on the eurozone periphery.

Lastly, as we move further through what is already a long credit cycle, we expect to see rising risk aversion and increasing dispersion. While that suggests we need to maintain a prudent risk profile overall in the credit market, the current conditions have also spawned idiosyncratic opportunities, which we are taking advantage of, as we have with Altice.

Currencies

Since the beginning of the year, the forex market has been unkind to the euro, due to the uncertainty surrounding Brexit and weaker eurozone economic indicators, notably in Germany. Even though the Fed's more dovish stance of late and deteriorating US economic fundamentals should normally weaken the dollar, those factors are currently being offset by political uncertainty in Europe and an interest-rate differential that still works to the greenback's advantage.

In the absence of a clear direction for major currencies, we intend to keep our currency risk low by remaining overweight the euro and taking only limited exposure to the US dollar and the yen. How well emerging-market currencies fare will be further conditioned in part by how the dollar is doing, but a number of them, chiefly in Asia and the Middle East, already offer a few opportunities.

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