



An unstable balance



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Now that the connection between equity-market developments and interest rates has been established (see our March Note, [How to think about the issue of rising interest rates for investors](#)), it's time to start anticipating how that connection will pan out. The latest March figures still suggest that bond yields will climb further, and that equity markets may be in for a period of renewed volatility as a result. This risk is perhaps less acute in the short term. For one thing, significant market adjustments have already taken place. For another, a number of countervailing forces could restrain this mighty economic upswing beyond the short term. But our priority remains to manage the risk of an upcoming period of market instability so that we can make the most of the high-potential investments in our portfolio for the long run. The economic and political data that come out in the next few months could prove decisive in shaping a new financial market trend.

The accumulated delays in the European Union's vaccination process are taking a heavy toll

An overheating US economy is still a believable scenario

In the past few weeks, the United States has also seen an increase in new cases of Covid-19, due to the spread of its much more virulent variants. But a successful ramp-up of the country's vaccination programme – advancing at a pace of 0.8% of the population per day – has made the public health situation much more manageable than in Europe and the emerging world (China excluded). In particular, the number of new hospital admissions hasn't risen. This means that the US economy is already in the re-opening phase, with the direct relief cheques included in the Biden administration's American Rescue Plan already on their way to households. Our estimate is that previously shut-down sectors like hospitality, air travel and leisure have recovered to about 50% of their usual level of business. High-frequency data likewise suggest that the job market in most US states is tightening steadily. The momentum therefore looks set to continue, and the country's output may well grow by better than 7% in 2021. In stark contrast, the accumulated delays in the European Union's vaccination process are taking a heavy toll. Tough restrictions on economic activity will be unavoidable here for several more months. The eurozone economy will have a hard time expanding by more than 4% this year, despite a highly favourable basis of comparison. **This GDP growth differential clearly goes a long way towards explaining why the US dollar has gained ground since the start of the year – even with the country's twin deficits ballooning.** In the United States, a surge in pent-up consumer demand, combined with what is apparently unlimited fiscal stimulus, gives credence to forecasts of an overheating economy – in other words, growth accompanied by rising inflation.

Central banks on the horns of a dilemma

As we explained in our March Note, the Federal Reserve faces something akin to "Sophie's choice": either take the risk of overheating or accept a trend reversal in financial markets – or, to put it in more abstract terms, choose between upholding the priorities of a democratically elected administration and the duty of guaranteeing the financial system's stability. Because make no mistake about it: the Biden administration is now firmly determined to push through its \$2 trillion American Jobs Plan, probably soon to be followed by an additional \$1 trillion in social spending. The amounts under discussion are once again unprecedented, and the political imperative of supporting economic growth at least until the mid-term elections in late 2022 points to continuing fiscal largesse next year. By postponing any move to tighten monetary policy, the Fed is fuelling fears that the boom will eventually become inflationary and thus drive up long-term interest rates. Investors are rightly worried that the temporary inflation generated this year – by a combination of the low comparison basis, a recovery in demand and the supply-chain bottlenecks – will be prolonged by rising household incomes and declining unemployment, two explicit goals of the American Rescue Plan. **The prospect of an ongoing upward creep in long-term interest rates poses a potential threat, both to financial-asset valuations and to several sectors of the economy, first and foremost real estate.**

The Fed is thus under major pressure to tighten monetary policy sooner (by scaling back its monthly asset purchases and lifting its key rates). But such a move would necessarily push up short-term bond yields, thereby generating much the same kind of risk for financial markets, or even for the economy as a whole. **We feel this dilemma makes highly active management of interest-rate risk essential for our fixed-income teams.**

Economic cycles and sector rotation



Source: Bloomberg, OECD, Carmignac, 15/02/2021

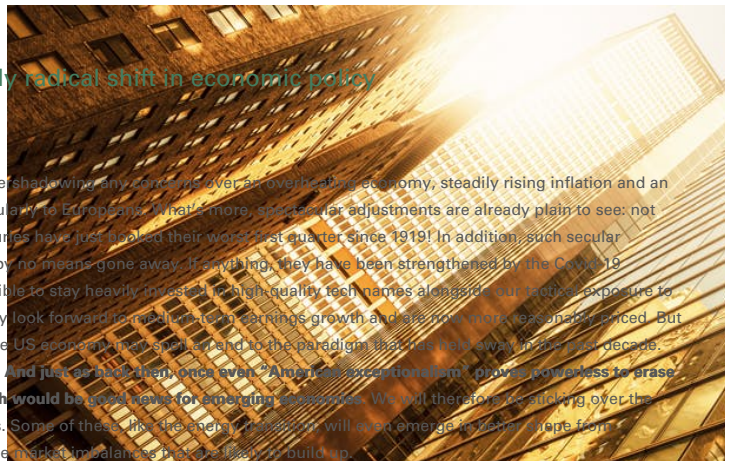
Against that backdrop, Europe's lag in economic recovery (attributable both to vaccination foul-ups and to the region's rather modest recovery plans when compared with those unfolding in the US), has at least offered the advantage – so far – of putting less upward pressure on interest rates. **And though it may seem counterintuitive, that same lag also explains the recent outperformance chalked up by European equities, particularly in cyclical industries.** But as the state of Europe's financial markets and economy can't be separated from global developments, we would be ill-advised to underestimate the likelihood that the EU will join in the broader trend despite the many structural obstacles in its path. This is particularly true now that the vaccination campaign seems to be gaining traction at last. **We have accordingly moved recently to a more cautious stance on European fixed income.**

As in the late 1960s, America today is undergoing a truly radical shift in economic policy

Unstable balance in financial markets

In terms of investor psychology, excitement about the economic upswing is currently overshadowing any concerns over an overheating economy, steadily rising inflation and an excessive upward drift in interest rates. Those dangers seem rather remote today, particularly to Europeans. What's more, some secular adjustments are already plain to see: not only have cyclical stocks recently outperformed by a wide margin, but US 30-year Treasuries have just booked their worst first quarter since 1919! In addition, such secular deflationary trends as demography, huge debt burdens and disruptive technology have by no means gone away. If anything, they have been strengthened by the Covid-19 pandemic. As we explained in March, the mitigating effects of those factors make it sensible to stay heavily invested in high-quality tech names alongside our tactical exposure to sectors that are poised to cash in on the economic recovery. Those tech stocks can clearly look forward to rapid and sustained earnings growth and are now more reasonably priced. But as risk managers, we feel we can't rule out the prospect that the new impetus given to the US economy may speed us back to the paradigm that has held sway in the past decade. **And just as hard then, such even "American exceptionalism" proves powerless to praise the country's colossal accumulated deficits, the dollar could eventually take a hit – which would be good news for emerging economies.** We will therefore be sticking over the coming months with a portfolio-construction approach focused on long-term convictions. Some of these, like the energy transition, will soon emerge to liberate us from market imbalances that have been built up.

Source: Carmignac, Bloomberg, 31/03/2021



Investment strategy

Equities

The cyclical upswing triggered by stimulus packages, dovish monetary policy and the re-opening of the economy is accelerating in the United States. This new business environment has unsurprisingly buoyed more cyclical sectors like commodities and banking. In contrast, rising interest rates have continued to hurt those stocks with the highest P/E ratios.

Because investors appear by and large to have priced in the positive fallout from this US economic boom, we have maintained a cautious stance on equities, including selling a number of names for which we had weaker convictions. The current business climate has also led us to stay invested in companies offering predictable medium-term earnings growth, buttressed notably by their ability to sustain profit margins – even in the event of higher inflation. For the most part, those firms stand to benefit from secular trends like the digital transformation. The percentage of US GDP going to capital spending on technology is expected to double over the coming decade, opening up promising medium-term growth prospects for a variety of software and cloud-computing companies.

Despite these long-range themes, we are maintaining our tactical exposure to companies that seem likely to benefit from the re-opening of the economy, particularly in Europe. The continent's lag behind the US in cyclical terms should create attractive opportunities for a number of names in sectors like travel. Moreover, the region's comparatively low interest rates suggest that European equity markets will be in a better position to handle any upcoming phase of rising rates and/or inflation.

Meanwhile, the Chinese equity market has retreated in the last few weeks under the impact of profit-taking and mounting uncertainty over issues like relations with the US. With the Chinese economy further along in the cyclical recovery than the rest of the world, we may be seeing a slowdown in the months to come that will work to the advantage of the names offering predictable earnings growth that we hold in our portfolio.

Fixed income

This latest period witnessed steadily rising expectations for GDP growth and inflation in the United States. In the very short term, those expectations continue to be fuelled by a pickup in realised inflation, caused most notably by an extremely low comparison basis following the slump in oil prices and in the sectors most badly battered by the pandemic. In addition, the US economy is fast on track to re-open thanks to a highly ambitious and effective vaccination campaign. And in a longer-range perspective, the Biden administration has initiated an unprecedentedly huge fiscal stimulus, while the Federal Reserve has restated its commitment to maintaining its ultra-loose monetary policy in the near future – despite any downside this approach may have. Those various factors have convinced investors that nominal and real interest rates are on their way up – and vindicated our choice of shorting US Treasuries.

On both the vaccine and the economic fronts, Europe is still a source of major disappointment, with the result that the region's bonds have fared better than their US counterparts. That said, we believe that the "reflation trade" will soon spread to the region, and that the massive delivery of vaccines in the second quarter will become a key driver of the re-opening of European economies in the coming months.

We have accordingly continued to reduce risk in our fixed-income portfolios, which now give precedence to segments that are lagging behind in the return to normal interest rates. We have thus sold off most of our sovereign bonds from the eurozone periphery. We have also taken advantage of the relative stability in corporate credit to dial back our exposure to that segment, as most credit spreads today offer precious little protection in the event of a sharp rise in interest rates. We have mainly reduced our allocation to subordinated bank bonds and travel-sector bonds – which have performed quite well. Our corporate credit portfolio remains narrowly focused on issuers that stand to benefit from the re-opening of economies, and on energy companies offering large enough spreads to be able to withstand higher interest rates, or even to score gains on rising prices.

We are maintaining our highly active management of core sovereign bonds. To deal with the risk of rising interest rates, we use a wide range of instruments that include short positions in nominal and real interest rates and long positions in inflation expectations – with a discriminating approach to the various yield curves so that we can take advantage of the uneven advancement of leading economies through the economic cycle. Those positions are mainly concentrated in the United States, the United Kingdom and to a lesser extent Germany.

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