



Holding steady

April 2020



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Published
April 2, 2020

Length
🕒 4 minute(s) read

A month ago, our take on the state of financial markets boiled down in essence to four observations:

- The current epidemic is a sort of “Black Swan” in that it constitutes an unpredictable, high-impact event.
- The western world are in danger of underestimating the epidemic’s exponential rate of increase.
- Governments will be compelled to introduce policies that will have a devastating impact on the economy.
- A decade of central-bank subsidies has left financial markets vulnerable.

Though with the wisdom of hindsight we may now wish that we had pushed our analysis in an even more radical direction, it was still clear enough to help us proceed very cautiously throughout March.

In the short term, unlimited quantitative easing and the US fiscal spending package have enabled us to do away with some of our hedges under favourable conditions. But these unorthodox moves were an absolute necessity. It cannot be said today that the volcano has been extinguished, which is why we are maintaining maximum vigilance.

Our aim in this Note is to go further with our effort to put this truly exceptional period into strategic perspective so that we can better gauge the implications and ramifications it may have.

The first phase of the crisis is drawing to a close

As we mentioned last month, it took the medical community, politicians and investors a while to realise how serious the matter was, due to a number of well-known psychological biases.

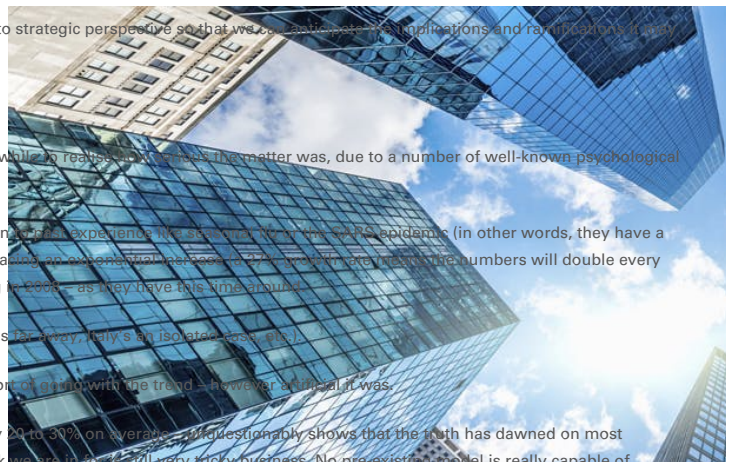
The first one is mental model bias. People tried to relate this unprecedented phenomenon to their experience like seeing storm in the SARS epidemic (in other words, they have a hard time recognising a Black Swan event when they see one). Or they denied we were facing an exponential increase in 21st century, are instead the numbers will double every three days). The delayed reactions caused by this kind of mental bias proved devastating in 2008 – as they have this time around.

Next comes ingroup bias: many underestimated how interconnected the world is (China’s far away, Italy’s an isolated case, etc.).

Last of all, a form of herd instinct had led a large number of investors to prefer the comfort of going with the trend – however artificial it was.

The speed with which equity markets have corrected since the beginning of the year – by 20 to 30% on average – unquestionably shows that the truth has dawned on most investors. However, accurately quantifying the immediate and long-term economic shock we are in for is still very tricky business. No pre-existing model is really capable of measuring how strict confinement of 40% of the global population for an indefinite period will actually play out.

It is therefore safe to assume that financial markets will in the near term be buffeted by powerful spates of instability. Only further down the road can we hope to have any real clarity about what form the following phase will take.



What will “the day after” look like?

It's usually a bad idea to think about life on the other side of the river until you've successfully made it through the eddying currents still to be crossed. On the other hand, trying at least to envision it makes a fair amount of sense for investors.

To start with, we can't stress enough how fraught the financial backdrop was when Covid-19 first hit. Central-bank policies were fast approaching the point of having gone as far as they could go, whereas they had yet to bring nominal GDP growth back up to where it had been prior to 2008.

Over the past several days, those same central banks have been “betting the farm” in an effort to restore government and corporate debt markets roughly to their normal state. This looks so far like a promising bet, though it's too early to say whether it will be a winning one. But in any case, the crucial point is that central banks can no longer claim to be driving an economic recovery in any shape or form.

We are thus entering a new era. In terms of stimulus, governments will have to do most of the heavy lifting this time around. This raises the question of how the resulting debt load can be financed, given that big levy on the private sector would be counterproductive, and shrinking public service budgets would be politically a non-starter. The central scenario that seems to be emerging is thus one of lastingly high fiscal deficits that will force central banks into the position of government debt-buyers – this time of “first resort” – in order to keep financing costs down to tolerable levels.

It is worth noting that this major shift to ballooning fiscal deficits – financed directly by central banks at rock-bottom lending rates – could:

- (1) Become harder to manage if inflation expectations were to pick up
- (2) Spawn monetary instability or even distrust in paper money

The “day after” the huge shock to confidence could also be characterised by more cautious behaviour: - Individuals will save more money.

- Governments will want to onshore the production of goods deemed “strategic”.
- Companies will question the lure of just-in-time supply chains.
- Investors will rediscover the value of maintaining a safety cushion in their risk-taking.

We doubt such a state of affairs will be conducive to a V-shaped global economic recovery once the public health crisis is over (a view apparently corroborated by the initial economic data from China).

For savers, this may herald an end to the passive investment miracle and revive interest in active investment styles that show an ability to manage market risk and identify companies that will stand out from the crowd in the long run.

What does this mean for our portfolios?

In light of the market instability we believe will continue in the short term, we plan:

- (1) To keep our hedging policies in place in all asset classes, while we actively and tactically manage our exposures
- (2) To go on investing in companies related to digital transformation themes in sectors ranging from retail (including food) to healthcare to entertainment, most notably cloud gaming
- (3) To maintain our presence in China, whose domestic economy makes it a prime location for investing
- (4) To take selective advantage of corporate credit opportunities.



Just as the dedication evinced by doctors and nurses and the self-discipline shown by ordinary citizens will eventually win out over the epidemic despite the trying conditions they face, we as asset managers must hold steady and continue focusing on risk management and long-term convictions so that we can most effectively serve the interests of the clients who have entrusted us with their savings.

Source: Carmignac, Bloomberg, 31/03/2020

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