THE WIND IS PICKING UP

December 2016

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01.12.2016

Once again the consensus was misleading: the Donald Trump risk did materialise on 8 November. However, investors' initial fears soon gave way to widespread ovation. Game theory certainly played a role: the consensus was so pessimistic about the consequences of Trump being elected that it could only feel better. This sudden optimism also probably reflects a change of focus among investors, who initially concentrated on the candidate's outlandish statements, before noticing certain benefits of his economic programme. However, the main thing to bear in mind when trying to understand the scale of the markets' reaction is that promises of investment, tax cuts and protectionism have not come out of the blue.

As we reminded readers in September (see our Note "All you need is growth": "The failure of central bank policy raises the question of additional fiscal stimulus"), public demand for fiscal stimulus, focused on domestic demand, has been growing in the West for nearly a year now that central bank intervention is drawing to a close. Trump's plans are part of this trend and will serve as a further catalyst. It would be wrong to underestimate its knock-on effect. Because the United States is the United States, this economic stimulus package will have global ramifications, even if it is scaled back in the face of realities. In particular, it will probably stir the growing temptation in Europe to break free of the financial orthodoxy imposed by Brussels. A new westerly wind, with inevitable gusts and moments of calm, is picking up in the fixed income, equity and foreign exchange markets.

A strong dollar is the first ramification of the Trump programme

It will be hard for infrastructure spending to reach the dizzy heights that Donald Trump has announced. However, there is a real need for public infrastructure in the United States, and the goal of meeting this featured in both candidates' manifestos. This Keynesian aspect of the announced policy must therefore be taken seriously. However, we should be aware that implementing such projects and, ultimately seeing their benefits spread to the rest of the economy, will take time and will be bound by financial constraints. As is often the case, the markets are eager with anticipation.

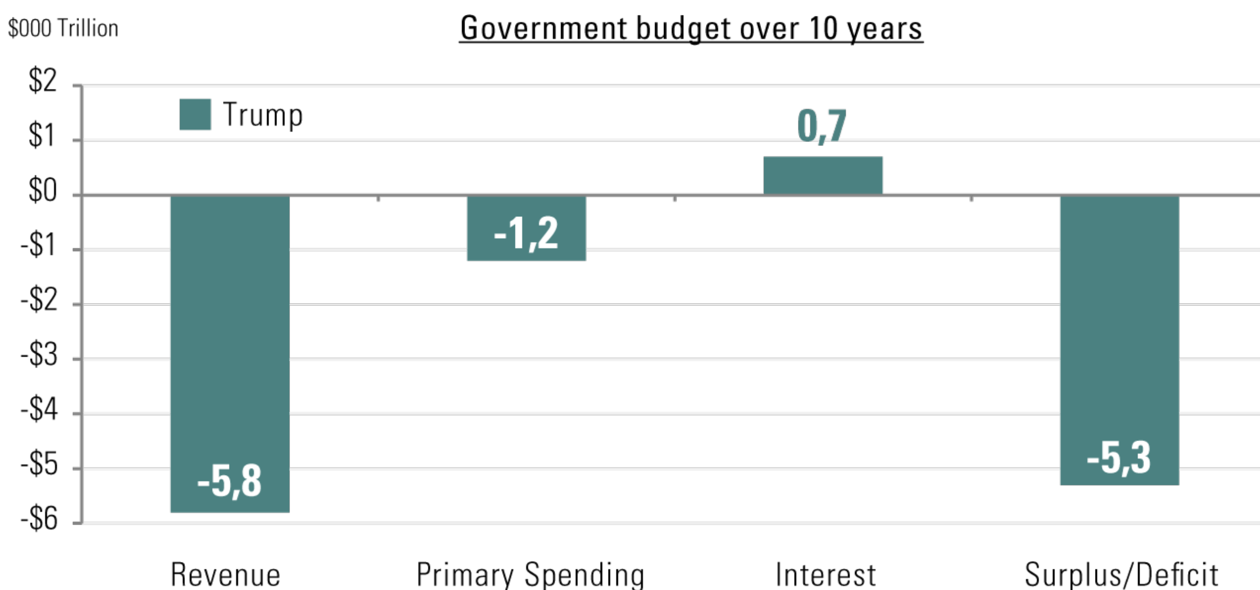
The tax aspect of the programme is certainly the most decisive. Due to the Republican majority in Congress, it may be introduced fairly quickly, and it constitutes a radical supply-side policy. Income tax cuts could boost

consumer confidence, which was on the wane. And, most importantly, the reduction in corporate tax (to 15%) could give the economy powerful leverage. It will naturally have a direct effect on the net earnings of many US businesses, but the most important factor is that it could finally kick-start private investment. It is by no means certain that this will happen. There is indeed no guarantee that firms will decide to invest rather than pay off their debts. However, economic conditions may make this more likely.

As it happens, Trump's election comes at a time when leading economic indicators are beginning to stabilise globally, which at the very least suggests a slight improvement in the cycle. This is particularly the case in the United States where the latest manufacturing figures have started to pick up, after falling last year due to the collapse in the oil industry. Trump's stimulus package will therefore benefit from at least a slight tailwind, which it will help to strengthen and spread.

At the very least, the massive reduction in tax pressure will encourage firms to prioritise investment within the US. It could also attract more foreign investment. Capital flows into the United States could plausibly speed up as a result. We should view this as a very powerful, lasting force behind the dollar, which could also allow the Federal Reserve to ease back the pace of its monetary tightening.

WHAT MATTERS IS THE TAX REFORM SPENDING GETS CUT UNDER TRUMP



The second ramification is a lasting decline in fixed income markets

Here again, the Trump factor needs to be viewed in context. Fixed income markets had already become very expensive, pricing in "secular stagnation" forevermore. Active bond managers therefore had plenty of time since the beginning of the summer to slash their portfolios' modified duration. A few weeks after Trump's election, the bond markets' return towards more reasonable valuations is about completed. But now comes a potentially brighter economic outlook, and higher inflation expectations.

It is too early to herald a tectonic shift in long-term yields. The world has not suddenly become inflationary: at the moment it is just happy to become less deflationary. Even in the United States, where inflation has already picked up and justifies interest rates rising more quickly than in Europe, we are still only talking about a cyclical spurt: demographic pressures and public debt remain structural restoring forces. Rapidly rising interest rates are therefore among the main risks, requiring flexible bond management, but they could still be tolerable for equity markets.

Third key ramification: another hornet's nest for emerging markets

A cocktail of strong dollar, higher interest rates and protectionist threats clearly does not bode well for emerging market economies. However, the markets were quick to price this in. Mexican assets, which are directly targetted by Trump's threats, have been particularly badly hit. They now price in a complete implementation of Trump's campaign promises. But will he be that radical? There are reasons to be doubtful.

Trump will have no other choice than to find a compromise between "protecting" the United States' blue collar workers and protecting the interests of US companies, which need Mexican labour, Canadian natural resources and Asian production costs. Meanwhile, trade relations with China will be heavily influenced by the geopolitical modus vivendi to be maintained in the Far East. Trade deals will doubtless be renegotiated, and global agreements may give way to bilateral treaties. However, it is unlikely that 25 years of economic globalisation can be reversed. Looking beyond short-term tension, the emerging markets that have been able to re-establish solid fundamentals since 2013 seem to have been punished excessively since 9 November, all asset classes combined.

The markets have been looking for a new way forward since 2015, when they realised that, on its own, central bank intervention was reaching the limits of its impact on both the real economy, which remains sluggish, and financial asset prices. A general move towards more expansionist fiscal policies now seems to be their guiding light. It meets with popular approval, and fits in with central banks' growing constraints. The US election is a decisive stage in this transition. European countries will be next with many going to the polls in 2017.

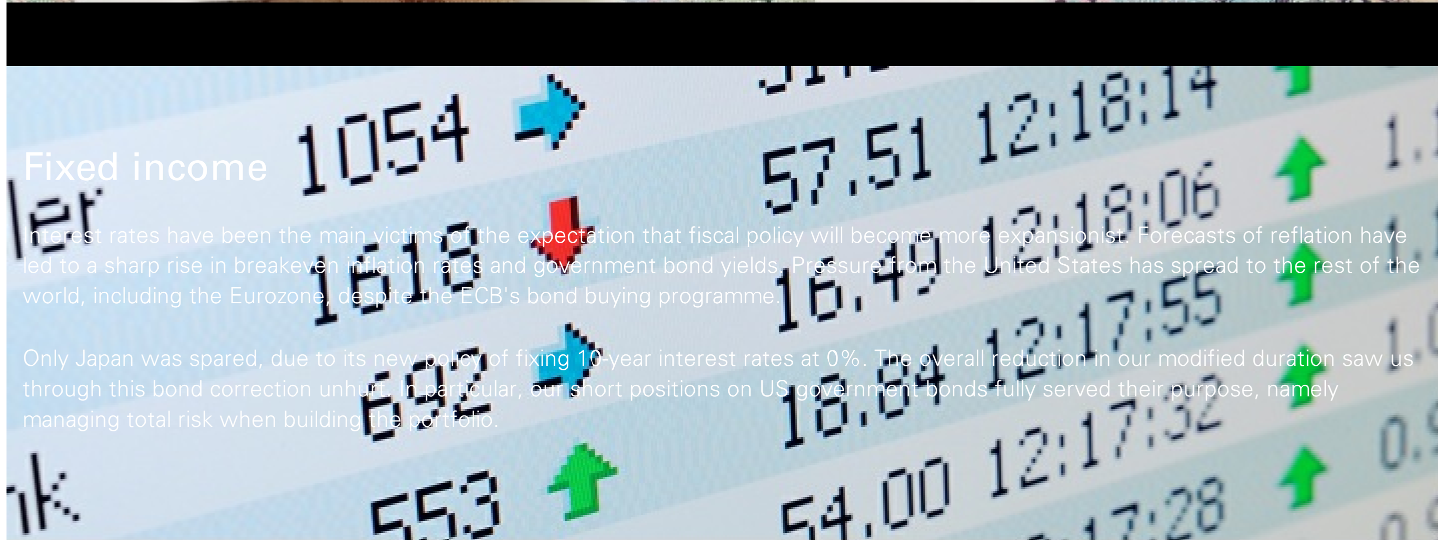
A new market regime is shaping up, mainly involving a trend reversal for interest rates, currency appreciation in countries that are able to attract capital, and far-reaching sector and regional rotation within equity markets. However, we should bear in mind that this change of trajectory is driven by major shifts in political leadership, which in Europe's case could put fresh pressure on the cohesion of the Eurozone in 2017. Markets that, rightly, are adjusting very quickly to this transition between economic models, would be well advised to keep be monitoring the political risks attached.

INVESTMENT STRATEGY

Currencies

The dollar was the big winner of forex developments in November. Expectation of expansionist fiscal policy being combined with further monetary policy normalisation in the United States contributed to the dollar's surge. Emerging market currencies suffered, albeit without experiencing any widespread panic.

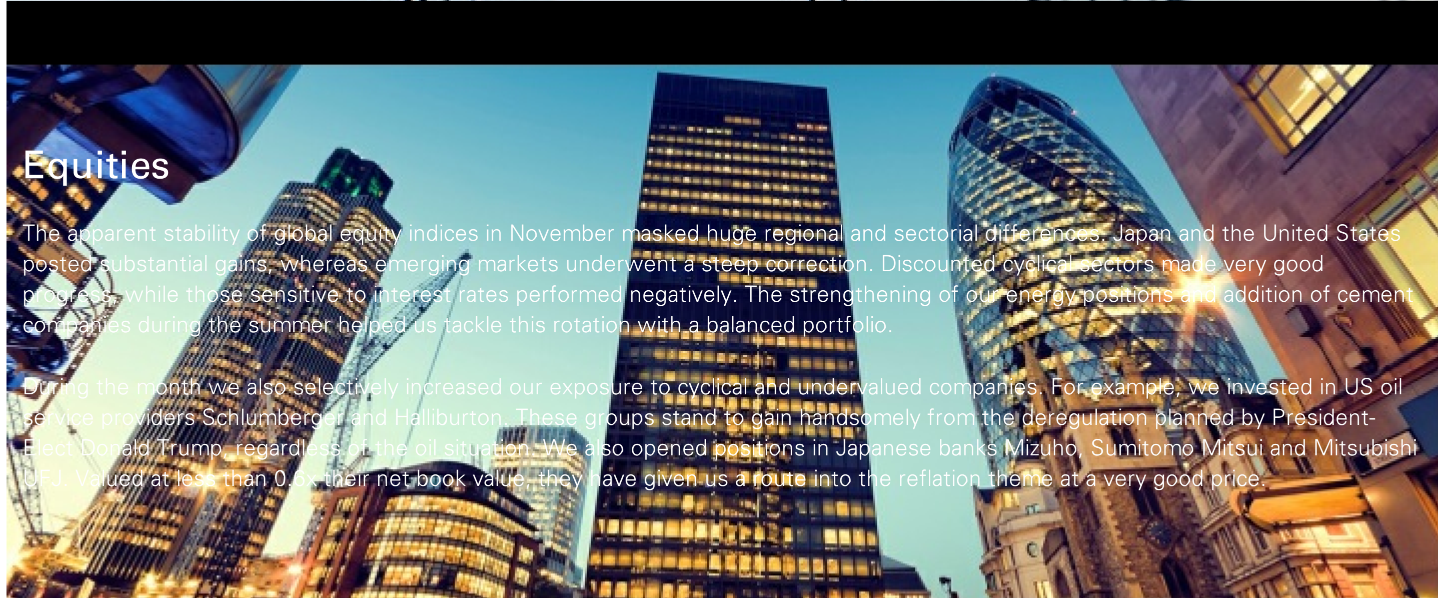
The two EM currencies most under pressure were the Mexican peso and Turkish lira, though for very different reasons: the lira is suffering from mediocre fundamentals, whereas global investors are using the peso to hedge against the uncertainty created by Donald Trump. This justifies an active, selective approach to currencies. We have thus increased our exposure to the dollar, and tactically hedged our positions on emerging market currencies and the yen.



Fixed income

Interest rates have been the main victims of the expectation that fiscal policy will become more expansionist. Forecasts of reflation have led to a sharp rise in breakeven inflation rates and government bond yields. Pressure from the United States has spread to the rest of the world, including the Eurozone, despite the ECB's bond buying programme.

Only Japan was spared, due to its new policy of fixing 10-year interest rates at 0%. The overall reduction in our modified duration saw us through this bond correction unhurt. In particular, our short positions on US government bonds fully served their purpose, namely managing total risk when building the portfolio.



Equities

The apparent stability of global equity indices in November masked huge regional and sectorial differences. Japan and the United States posted substantial gains, whereas emerging markets underwent a steep correction. Discounted cyclical sectors made very good progress, while those sensitive to interest rates performed negatively. The strengthening of our energy positions and addition of cement companies during the summer helped us tackle this rotation with a balanced portfolio.

During the month we also selectively increased our exposure to cyclical and undervalued companies. For example, we invested in US oil service providers Schlumberger and Halliburton. These groups stand to gain handsomely from the deregulation planned by President-Elect Donald Trump, regardless of the oil situation. We also opened positions in Japanese banks Mizuho, Sumitomo Mitsui and Mitsubishi UFJ. Valued at less than 0.6x their net book value, they have given us a route into the reflation theme at a very good price.

Commodities

Carmignac Portfolio Commodities delivered a positive performance over November. The Fund managed to tap into the commodity sector's strong gains while keeping a focus on quality companies able to deliver sustainable performance. For example, during the month we added DSM, a Dutch multinational which we think has a solid competitive position in food supplements.

Funds of funds

Our Funds of funds delivered a positive performance over November. Our derivative strategies, aimed at increasing our Funds' underlying cyclical exposure, have allowed us to fully benefit from the markets' rally since Donald Trump was elected.

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