MANAGEMENT REPORT – FIRST QUARTER OF 2017

Q1 2017

by Frédéric LEROUX
Fund Manager
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The world's economies are growing in sync, though moderately, with consumer spending playing only a minor part. Emerging markets and Europe stand most to gain from those conditions. In the United States, the postponement of tax reform has lessened the risk of inflation, but could well bring to light just how fragile the cyclical upswing is. While equities should benefit from this moderate, slightly inflationary, growth taking shape, developed-country government bonds still offer little value.

The global outlook

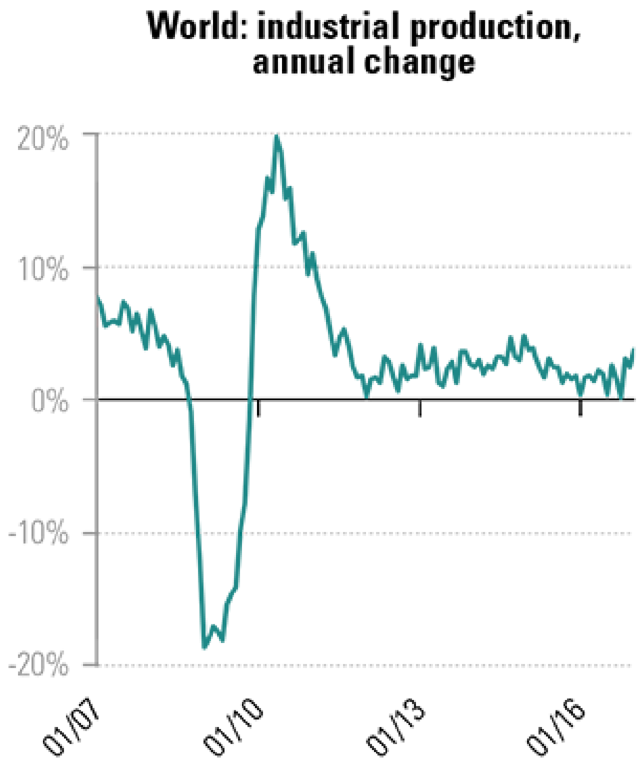
In our two preceding reports, we discussed the drivers of the shift we anticipated to a growth-focused economic and financial regime characterised by a resumption of inflationary pressure. After a decade that saw central banks repeatedly step in to keep the economy from sliding back into recession and forestall deflation, the current cyclical recovery can be hailed as a welcome return to normal that should make forecasting somewhat easier for us.

Today, the monetary authorities in the developed world have gone over to policies designed to spur growth, which they consider both the payoff for ten years of consistent effort and the only way to achieve a sustainable reduction in debt. They will almost certainly refrain from any moves that might undermine the fragile upturn under way, even if that means living with slightly higher inflation.

In the first quarter of 2017, first China and then other emerging economies, Japan and Europe turned in figures confirming that they were part of the new expansionary phase. The US economy seemed in contrast to settle into a holding pattern – pending follow-through on the new President's pro-growth narrative. On the whole, the world's economies are growing in sync, though moderately, with consumer spending playing only a minor part. However, less vigorous consumer spending should in the near term temper the inflationary pressure that we observed in Europe and the United States at the start of the year and keep central banks sidelined. All that is good news for financial assets.

As we anticipated at the beginning of the year, the stock market rally has continued with very low volatility, bond markets are still on the defensive and the US dollar has lost ground – despite the strong consensus that it would appreciate. But the waiting game as investors watch what happens in Washington has resulted in the underperformance of cyclical stocks and the rebound of growth stocks.

A synchronised global cyclical recovery



Source: Carmignac, CEIC, 31/03/2017

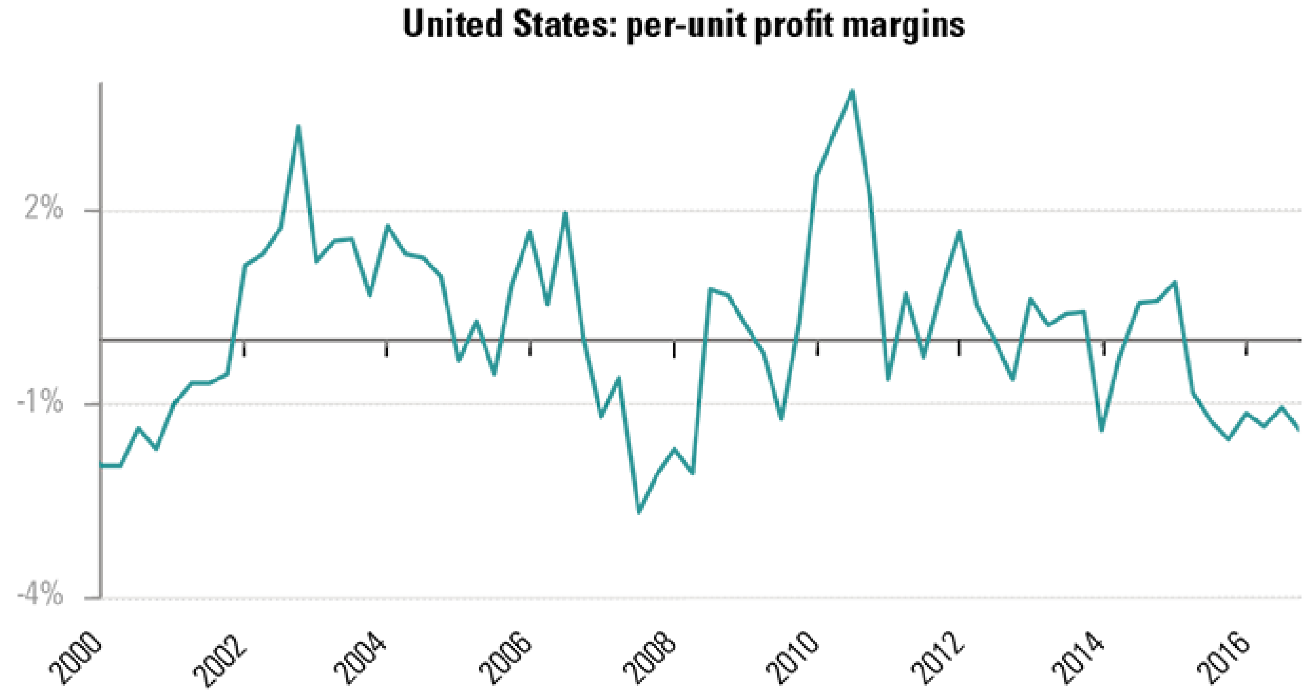
With the French presidential election runoff now just a few days away, it is our responsibility as risk managers to incorporate political variables into our strategy, even though the electoral odds and the encouraging economic upswing suggest rather that moderate global growth and the ongoing rotation from fixed income to equities will sustain the trends of these past few months for some time to come.

United States

The hopes raised by Trump's win at the polls have propelled US leading economic indicators up to impressive levels. The consumer confidence index has hit a 13-year high and the ISM manufacturing index has climbed to its best level in 30 months. However, converting that improved sentiment into additional consumer spending will require higher employee earnings and/or lower taxes, given that hourly wage growth has continued to hover between 2.5% and 3%. On the investment front, while the numbers look fairly auspicious, with new durable goods orders up 4%, corporate profit margins have yet to turn around. They even slid at an annual rate of 1.4% in the fourth quarter of 2016.

United States: low margins argue against expectations for a sharp rebound in capital spending

The planned corporate tax cut would clearly help



Source: Carmignac, CEIC, december 2016

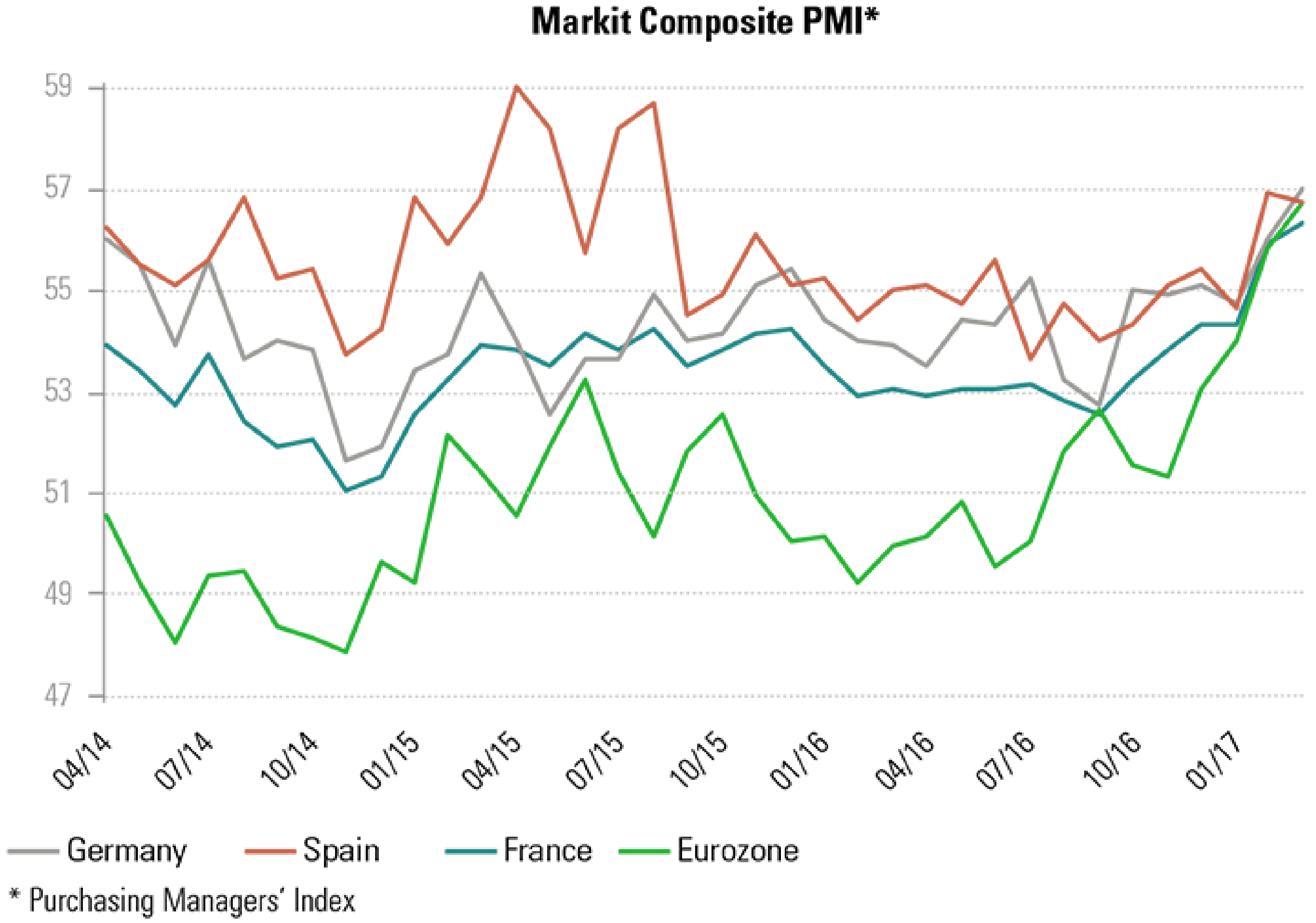
If the stimulus programme and/or the business-friendly tax measures promised by the new US president were actually implemented, they would give capital expenditure and employment a welcome boost. But Trump's failure to build a majority behind repealing Obamacare inclines us to think that both of those planned reforms will be postponed until the fourth quarter, meaning that they won't have any real impact until next year. Trump does, however, have considerable power to make headway via executive orders, particularly in the area of deregulation.

Would a watered-down version of Trump's agenda be bad news for economic growth and the financial markets? Not necessarily. With or without expansionary fiscal policy in Washington, the global business cycle is trending upwards. Even a few middle-of-the-road measures would be enough to pull the US economy out of a possible soft patch, with no danger of domestic or global overheating. But that's no reason to fall into complacency. Large portions of the US economy are on shaky ground. The automobile industry, for example, wouldn't be humming along as it is today if the companies hadn't offered generous sales incentives to reduce inventories.

Moreover, growth in the leading indicators for manufacturing activity as a whole has been slowing – a common harbinger of trend reversals. We may well be facing just such a reversal if Trump's economic agenda is consistently thwarted. Given that the stock market has already priced in all kinds of good news, congressional gridlock could trigger a downward adjustment in share prices that would be only partially offset by softer bond yields. We sense an underestimation of US core inflation today, and with it an overestimation of the ability of the Federal Reserve and the bond markets to adjust to disappointing macroeconomic data. In our view, year-on-year inflation as measured by the CPI will be driven up to 2.6% at year-end by rising prices for non-discretionary goods and services. As the current cycle winds down, the United States sorely needs fiscal stimulus, even if it entails higher inflation.

Europe

Eurozone: a synchronised upturn



Source: Bloomberg, 31/03/2017

Europe is still reaping the benefits of the ECB's continued dovish monetary policy, with an economic upturn that is appreciable in France, Germany and Spain. The European Commission's Economic Sentiment Indicator has reached a 6-year high, as has the IFO in Germany. Europe's economy and markets have made it through a genuine electoral minefield – first the Brexit vote, then Renzi's failed referendum in Italy andthe US presidential election – without veering off course. The German elections this coming October could bring victory to the Social Democrats, who advocate economic policies supportive of growth and further monetary policy normalisation in the euro area. In the short run, however, we have the French presidential election to contend with.

At the time of writing, a few days ahead of the second round, the odds of a doom and gloom scenario materialising seem relatively slim. But slim doesn't mean nil and, more importantly, we may well be dealing with widespread anxiety between the two rounds. How, in our view, are financial markets likely to react to such heightened stress? To start with, by driving down the euro to prepare for a steady waning of commitment to the European ideal. Next, at least initially, yields on German government paper – Europe's primary safe-haven asset – will retreat and share prices will buckle as risk aversion spreads like wildfire. But whatever the instant impact of those changes, demand for German government bonds may be short-lived. After all, why would a non-European investor anticipating the end of the euro want to hold Bunds?

Furthermore, from a stock market standpoint, a much weaker euro would tend to give Europe's export-oriented firms an immediate competitive edge. Apart from shorting the euro, the best medium-term hedge against an extremist victory at the polls – which is not our baseline scenario – might well consist of increasing exposure to US Treasuries – the universal safe-haven asset.

Leaving aside the low probability that the worst will come to pass – and prove as disastrous as expected – we maintain our upbeat stance on Europe's economy. Further ECB largesse, the prospects of a policy mix more supportive of growth and the encouraging direction taken by leading indicators all corroborate our conviction that things are looking up for the European economy. We believe that the markets will recognise as much once the electoral uncertainty and the risk of extremism are behind us. The cyclical upturn is likewise perceptible on this side of the Atlantic and, unless a political black swan surfaces, we should still be in a good position to anticipate significant market developments, such as higher share prices, rising bond yields and a stronger euro – all under the guidance of a central bank not overly concerned with inflation.

Emerging markets and Japan

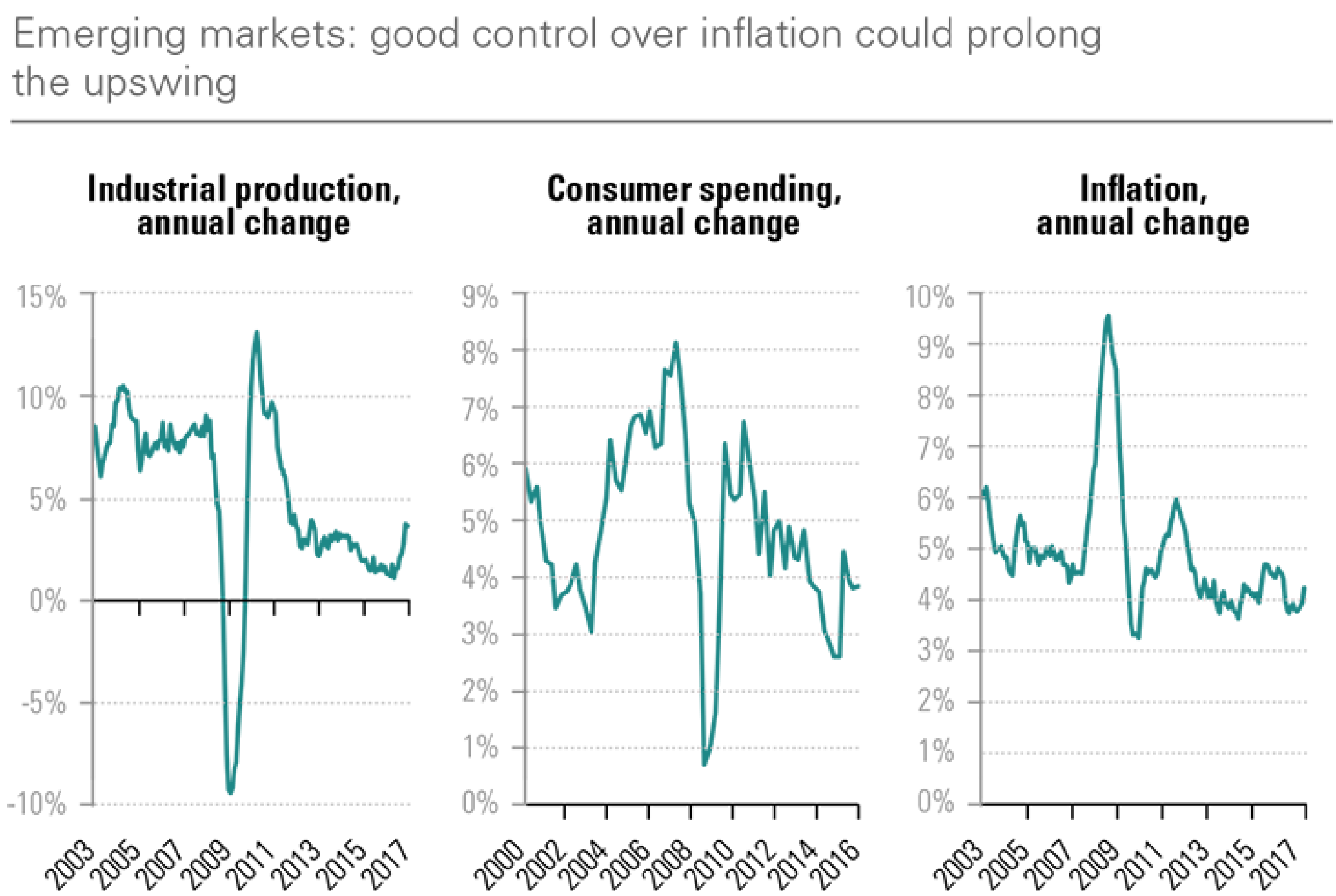
The economic news is good in both the emerging markets and Japan, and it is gaining traction. In the Land of the Rising Sun, the leading indicators for retail trade and capital spending are heading upwards. Only inflation is still struggling to pick up, which guarantees that Japanese monetary policy will remain loose. China, meanwhile, has provided ample proof of the stabilisation under way, with industrial production surging 9.6% (though at 9.3% consumer spending shows less vitality).

Quite a few other countries are enjoying economic tailwinds as well, including Hungary, Malaysia and Taiwan, while Mexico is surmounting Trumpophobia. In India, the outcome of the massive banknote ban carried out to crack down on the underground economy has belied the initial fears that it would trigger a recession. Industrial production has in fact recovered from –0.9% last September to +2.5% recently.

South Korea's exports have rebounded by an impressive 10%. This widely used proxy for the state of the global economy and world trade provides further confirmation of the 3.3% uptick in trade volume already seen. The country also has inflation well under control, suggesting that a sustainable upswing is in the offing.

Although global GDP growth – estimated to reach 3.4% in 2017 – is hardly spectacular to date, there can be little doubt that the world's economies are moving in sync. Emerging markets will be the first to profit from the new reality. We believe that those countries now have the means to bounce back from seven years of disappointing performance. In the advanced countries, the monetary policies deliberately introduced only after the cyclical upturn had taken hold should boost GDP growth and specifically give wings to risk assets. Any and all means will be deployed to keep output from sagging.

If the sluggishness now affecting the US economy after the interlude of the past few months were to drag on, it could be offset in part by vigorous growth in other world regions. However, successful implementation of a few of Donald Trump's reforms would truly give the global economy a welcome shot in the arm.



Source: Anderson, february 2017
Source: Anderson, december 2016
Source: Anderson, february 2017

Investment strategy

The United States currently lags behind the rest of the world in terms of GDP growth, and such differentials have in the past been a negative for the greenback. We are therefore sticking to the outlook put forward in our previous report for a strong euro, buttressed by rising current account surpluses and output increasing at a more robust pace than is commonly anticipated. We feel that nothing but a political earthquake in France could disqualify that view. The yen's recent gains will in all likelihood give way to a new bout of weakening, shaped by the Bank of Japan's highly expansionist policy and a global economic environment that encourages Japanese capital to seek greener pastures abroad.

A synchronised global upswing should in any case keep bond yields from sinking too low, but on the other hand, the current pause in US economic growth also means that yields won't spike significantly in the near term.

In today's climate of persistently low interest rates and solid earnings expectations, equity markets should remain favourable. While more selective stock-picking is called for in the US after such a strong rally, that is less true in other regions where the economic upturn is a more recent development. We may soon be witnessing a substantial catch-up drive boosting not only European equities – once electoral uncertainty is a thing of the past – but also oil stocks and Japanese financial stocks, two investment themes that enjoyed less favour at the start of the year.

We have hedged against political risk in France with USD/EUR call options and call options on US Treasuries, combined with European equity index put options for the reasons discussed above.

Source: Carmignac, CEIC, Anderson, 31/3/2017