MANAGEMENT REPORT – FOURTH QUARTER OF 2018

Q4 2018

24.01.2019

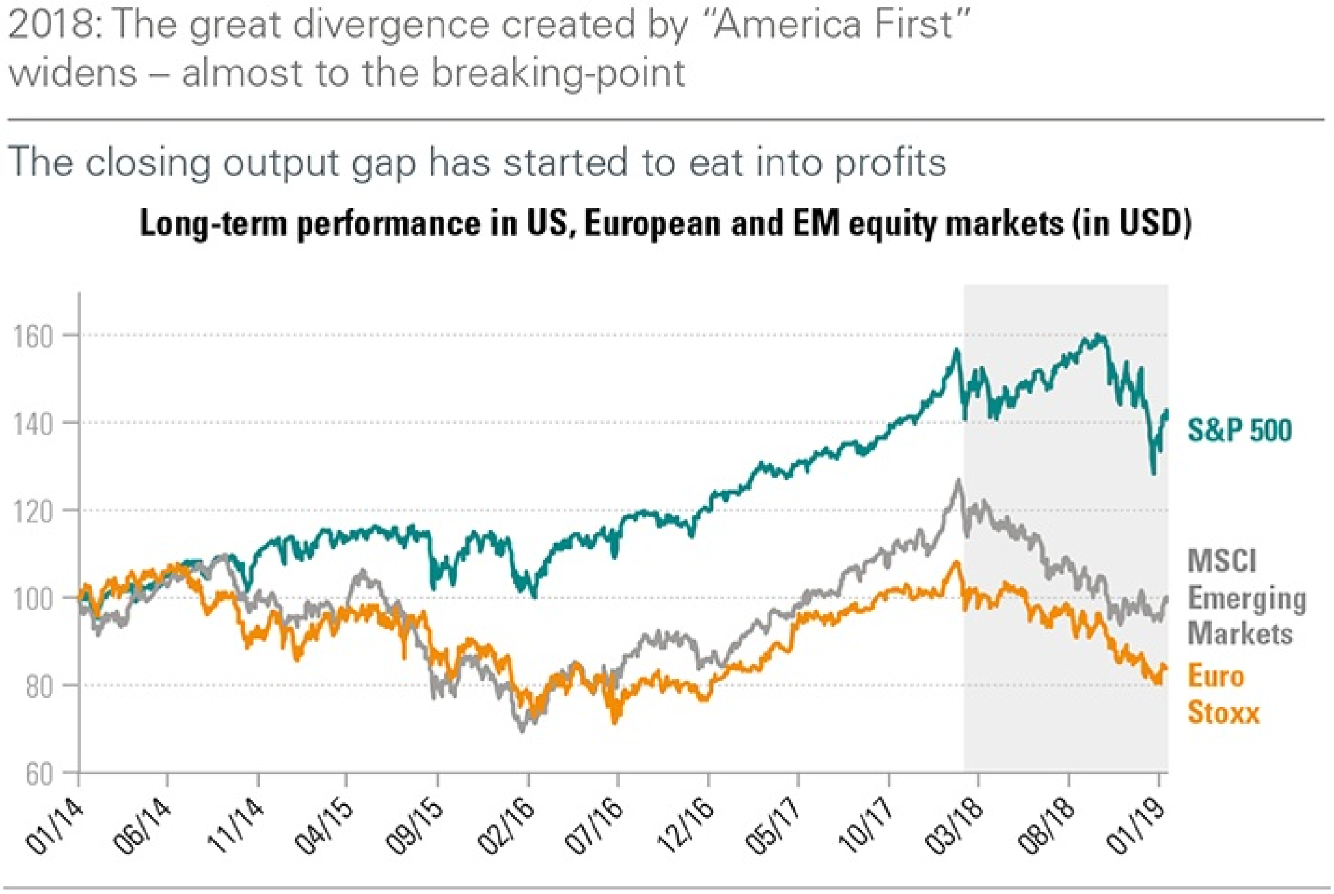
Economic analysis

As we exit what was a grim quarter for financial markets, the crucial question for the economy and the markets themselves will likely be whether the Federal Reserve is going to bend sufficiently to the turmoil the Fed has witnessed – and partly caused – in the markets, in order to stave off a worldwide recession in 2020. Europe is hardly in a position today to provide adequate economic or monetary responses to a slowing economy and mounting popular discontent, which means that we can't count on the continent to fuel global growth on its own. Likewise, China will be powerless to stem the serious domestic economic slowdown under way as long as the Fed sticks to its monetary tightening script. In the United States, full employment and the attendant rise in wages have kept the Fed from changing its tack, and it will be some time before the US central bank can deliver the monetary policy reversal that investors are so eagerly awaiting. How will the economy and the markets react to that lag? And what factors, if any, could make the wait for a reversal in US monetary policy easier to swallow?

The global outlook

In our previous report, we wrote: "The Trump administration's fiscal stimulus is sustaining a domestic economic boom that allows the Federal Reserve to go on normalising monetary policy. At the same time, those policies are forcing countries in the rest of the world to live with interest rates that are increasingly incompatible with their own growth trends." In addition, we pointed out: "For the first time since 2002, the output gap in the US economy has apparently moved into positive territory. When actual output exceeds maximum potential output, the risk of inflation increases, and with it the risk that the central bank will tighten monetary policy to the point of bringing economic growth to a halt."

Those macroeconomic conditions were made even more dismal by investor misgivings about the imposing stance that the United States has taken in trade negotiations with China, as well as by the perception that the US boom is drawing to a close due to rising capacity constraints. The upshot has been a wrenching downward adjustment to risk asset valuations around the world. That market correction finally spread to US risk assets, which had been bucking the global trend for three quarters. Q4 2018 proved to be one of the worst quarters – not only for many stock-market indices, but also for corporate credit as spreads widened on the back of dwindling market liquidity and fears over a slowing economy.



Sources: Carmignac, Bloomberg, 16/01/2019

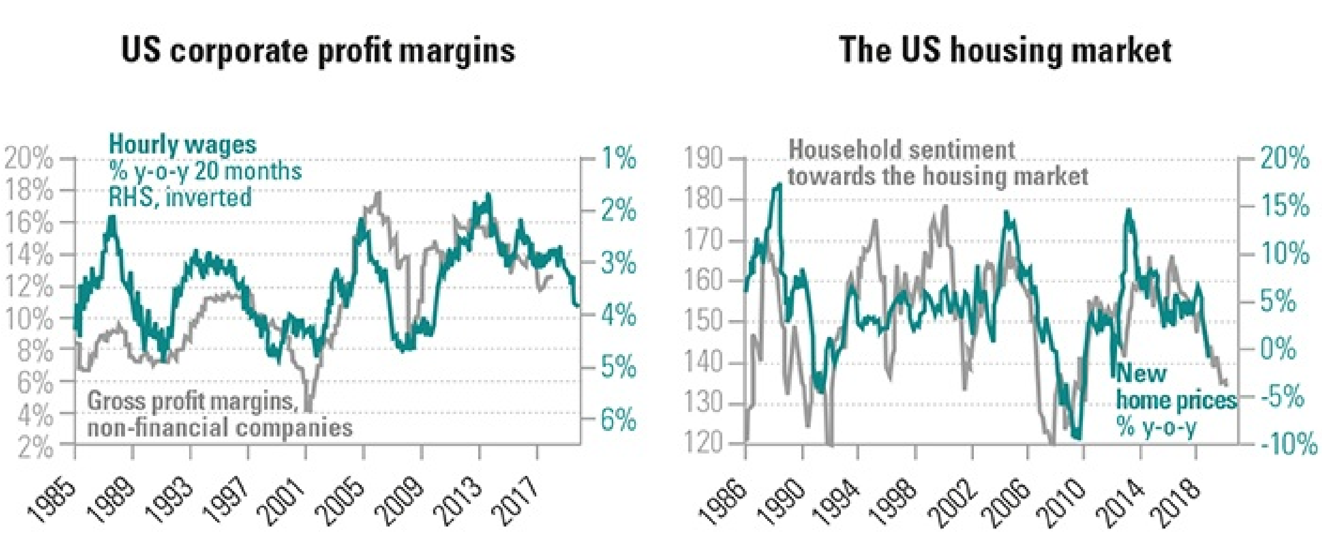
In trying to anticipate developments, we were led astray by our assumption that the US stock market was an impregnable fortress. As it turns out, that fortress crumbled under the combined impact of the monetary tightening engineered by the Fed under Jay Powell's leadership, concerns over trade policy, worries about corporate earnings and the domestic political strife caused by President Trump's erratic behaviour. More broadly speaking, we made the mistake of underestimating the extent to which a shrinking pool of global liquidity would affect financial markets at a time of resilient US economic growth.

As we exit what was a grim quarter for financial markets, the crucial question for the economy and the markets themselves will likely be whether the Federal Reserve is going to bend sufficiently to the turmoil the central bank has witnessed – and partly caused – in financial markets, in order to stave off a worldwide recession in 2020. Europe is hardly in a position today to provide adequate economic or monetary responses to a slowing economy and mounting popular discontent, which means that we can't count on the continent to fuel global growth on its own. Likewise, China will be powerless to stem the serious domestic economic slowdown under way as long as the Fed sticks to its monetary tightening script. Lastly, the elimination of the output gap in the United States has started to crimp profit margins by saddling companies with rising costs. That trend may well constrain capital spending for some time to come. The country's positive output gap also puts the Federal Reserve Board of Governors in a tricky position. They now need to consider the far-fromnegligible likelihood that the domestic economy will slow dramatically, and at the same time manage the risk that inflation may spike in the short term, as usually occurs in the late phases of business cycles. Full employment and the attendant rise in wages have kept the Fed from changing its tack, and it will be some time before the US central bank can deliver the monetary policy reversal that investors are so eagerly awaiting. How will the economy and the markets react to that lag? And what factors, if any, could make the wait for a reversal in US monetary policy easier to swallow?

United States

Leading economic indicators in the country have all started pointing towards an impending slowdown. Waning momentum is apparent in cyclical segments of the US economy, which include real estate, manufacturing in general and the motor car industry in particular. Moreover, this is happening against a backdrop of weaker world trade caused by the trade dispute with China.

United States: The drivers of a cyclical reversal are already here



Source: Carmignac, Datastream, Bloomberg, 01/2019

In contrast, consumer spending has been further buoyed by a tighter labour market, rising wages and tax reform, which will provide a further boost during the first quarter of 2019. US households stand to gain in the first half of the year from a number of higher standard deductions and the doubling of the Child Tax Credit provided for in the tax bill passed in January 2018. Meanwhile, job creation is soaring, with the result that unemployment remains stuck between 3.7% and 3.9%, even though the labour force participation rate has risen to 63.1% – a five-year high – whereas the country's ageing population should normally hold that rate down. This suggests renewed optimism among the unemployed, many of whom now have higher hopes of finding a job. At the same time, we have seen a steady climb in average hourly earnings to an annual pace of 3.2% (marking a ten-year high). Falling unemployment has paid off in the form of rising wages over the past 18 months, and the labour market still shows no sign of slackening. As we explained in our previous quarterly report, the elimination of the output gap makes the Federal Reserve's job that much harder. When actual output exceeds maximum potential output, prices and wages tend to rise. Today that rise is taking place just when the first signs of an economic slowdown are appearing on the scene. Consumer spending, employment and wage levels are admittedly only lagging indicators of economic trends, but they are currently close enough to the "overheating" mark to dissuade the Fed from dealing proactively with the slowdown gradually taking shape. The most harmful effect of the output gap's demise is that corporate profit margins are sinking as a result of rising costs – coupled with persistent deflationary pressure that keeps sales prices down.

Moreover, the bearish turn in the US equity market occurred at a time when a number of companies were issuing profit warnings in early October. With this risk of lower earnings already on the horizon, the market then plummeted in response to Jay Powell's announcement that the state of the economy would not affect the pace at which his institution would run down the bond portfolio it had built up in the years of quantitative easing. That highly negative market reaction induced the Fed to strike a more understanding tone, although the slide in the dollar gives the US central bank an objective reason to stand pat on its monetary policy tightening agenda.**A reasonable inference at this stage is that the chipper mood in the market since the start of the year will be short-lived. The Fed will most likely wait for additional evidence of a slowdown before loosening policy.** We can therefore expect the prospects of a sharply slowing US economy to provoke fresh bouts of investor jitters, even though the Fed will be working further to prevent risk assets and the dollar from suffering excessive swings by hewing to its recently adopted policy of taking its lead from the financial markets rather than from macroeconomic trends.

Emerging markets

The emerging markets as a whole are still bearing the brunt of the trade dispute under way between the United States and China. The 35% slump in crude prices in the fourth quarter – another byproduct of that conflict – has increased the pain for net oil exporters while decreasing the pain for net oil importers in the EM space. The serious economic slowdown under way in China stems in part from the government's drive to rein in shadow banking – and the delay in redirecting conventional bank lending to private-sector firms. Without a more aggressive policy mix to counter the slowdown, we expect that actual output growth will fall to about 5% – a three-year low – and will enjoy a modest pickup only in the second half of 2019.

China: GDP growth closer to 5% than to the official 6.4% figure

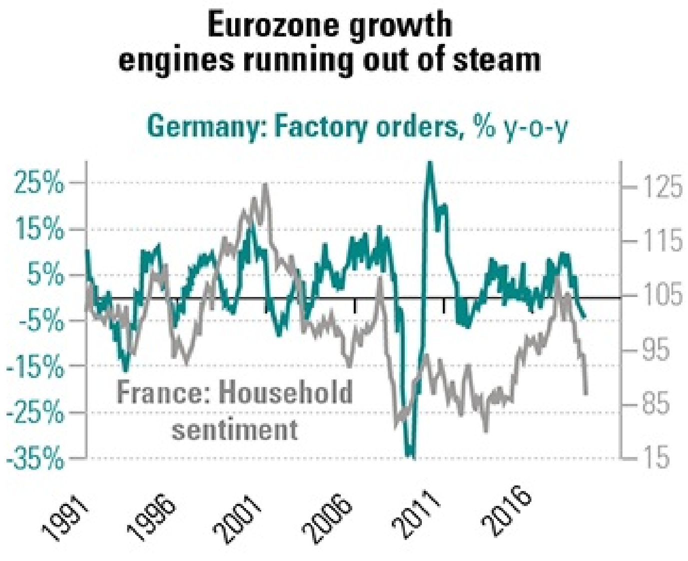
Sources: Carmignac, Datastream, Bloomberg, 01/2019
*Growth estimated from monthly data on power generation, rail and port freight, etc., yielding more realistic figures than official GDP calculations.

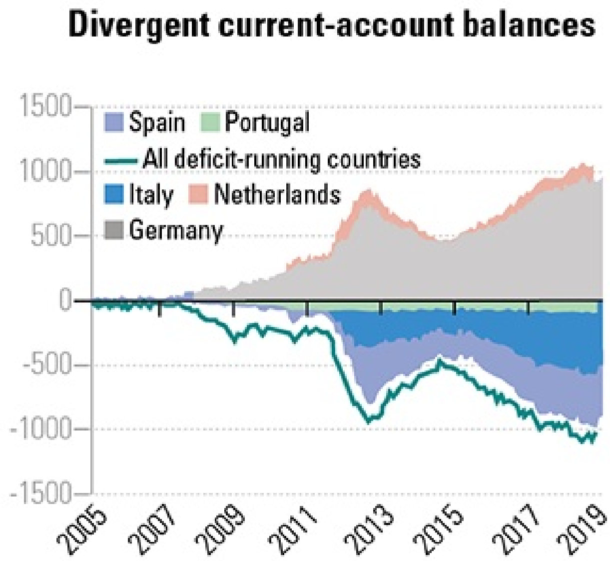
Beijing's fiscal stimulus programme at the start of this new year is barely equal to 0.3 percentage points of GDP, bringing the projected government deficit to 2.8% of GDP. Meanwhile, China's monetary policy stance is neutral at best. The disinflation under way in the country (after gaining 2.5% in September, prices inched up by just 1.9% in December) could set the stage for higher real interest rates, which would cause a lot of pain in such a highly leveraged economy. The economic slowdown has depressed Chinese bond yields to the point that they are no longer very far from US yields. In such a setting, greater monetary stimulus could trigger capital outflows and a currency depreciation that would bring back memories of the summer 2015 devaluation. Furthermore, a weaker yuan would only make relations with the Trump administration worse. The People's Bank of China won't get any greater wiggle-room unless the Fed loosens monetary policy and/or the trade tensions between the two countries subside. However, the mere suggestion made recently by the Fed that its monetary policy would be wholly dependent on US economic data – which analysts anticipate will be weak – has revived risk appetite.

Europe

A cloud of gloom continues to hang over Europe. Though Germany should see fiscal stimulus in the vicinity of one percentage point of GDP and upbeat construction data, declining world trade has exerted downward pressure on factory orders (down 4.3% in November) in particular and exports in general (down 1.9% year-on-year), while consumer spending is as lacklustre as before.

Eurozone: A slowing economy and structural imbalances





Sources: Carmignac; Datastream, Bloomberg, 01/2019

In Italy, the government has managed to wrest approval from Brussels for a stimulus programme worth a few tenths of a percentage point of GDP that is forecast to deliver output growth of just 0.4% in 2019. Meanwhile, developments in France exemplify the current deadlock in Europe. The government's attempt to deal "virtuously" (i.e., as prescribed by the EU treaties) with the country's structural weaknesses has fallen through. The level of taxation has apparently reached the breaking-point and street protests have succeeded in imposing a fiscal stimulus boost equal to 0.4 percentage points of GDP – for the time being. In any event, France's and Italy's stimulus programmes will be powerless to halt the ongoing deterioration in leading indicators across Europe, though they may slow the pace – something hardly to be sneezed at. The European Central Bank doesn't appear to have much latitude for helping the eurozone economy back onto a path to higher growth, but it will likely reach for its standard toolkit (including TLTROs and Operation Twist) if stresses caused by the upcoming EU parliamentary elections put an additional dent in the currency bloc's economic output.

The political challenge from Italy and the revolt in France against what protesters perceive to be a decline in disposable income and downward social mobility call for the utmost attention. Those trends may well be powerful warning signs that a clean break is needed with the policy mix that has held sway for so long – one that combines loose monetary policy with fiscal austerity. Given the mediocre results that that policy mix has achieved in terms of boosting economic output, the patience of Europe's population is increasingly wearing thin. It can't be ruled out at this stage that economic policy governance will worsen further while people place even less trust in the political system than before. A likely outcome is that after the convergence in eurozone bond yields ground to a halt in 2018, we will see those yields diverge further in 2019.

Even with several world regions facing troubled economic conditions, the Federal Reserve probably won't shift to a more dovish stance as fast as investors would like. Donald Trump's economic agenda has produced a variety of effects that would argue against loosening US monetary policy too swiftly, particularly given the risk of a surge in inflation. This brings us back to the distortions created by the closing output gap. Of course, the US central bank may yet become more accommodative if Jay Powell senses that the global economic outlook has worsened to the point of requiring an adjustment to US interest rates and to the pace of quantitative tightening – that is, how quickly the Fed runs down its bond portfolio. That option, which the institution's former Chair Janet Yellen was compelled to adopt when she reversed course, would unquestionably give a welcome boost to both financial markets and the world economy. In the absence of a wait-and-see attitude from the Federal Reserve, the world's more troubled economic regions could still get a breather if the Sino-American trade talks turned out well. Such an outcome would help perk up the Chinese economy and would lift economic sentiment in general. In addition, it would postpone a broad-based global economic slowdown and free up the People's Bank of China to noticeably implement monetary policy without having to worry too much about a hard-to-control depreciation of the yuan.

Investment strategy

After a disastrous fourth quarter that saw a 17% tumble in both the Euro Stoxx 50 and the Nasdaq 100, **equity markets** have started the new year with a genuine opportunity to bounce back. And though the macro environment described above may eventually undercut that potential, in the short term at least, both the Fed's change of tone and the confident expectations for a positive outcome to the trade negotiations between China and the US should be conducive to such a rebound. The recent market correction has driven stock valuations down to a level that we consider attractive by and large, even if we adjust for what still seem like unduly upbeat forecasts for corporate earnings growth: 7.5% in Europe and 6.4% in the United States. For example, the prospective P/E ratio on the Euro Stoxx index slipped from 13.1 to 12.0 between May and January, while on the S&P 500 it dropped from 16.8 at end-September to 15.2 in January. The Fed may also show greater sensitivity to weakening economic conditions in China and Europe and therefore reverse its policy tightening programme sooner than expected, but we feel that the priority for the US central bank over the coming months will be to deal with the consequences of the positive output gap in the US. More lucrative buy opportunities will emerge once the Fed has clearly thrown in the towel. As the new year gets under way, we at Carmignac Patrimoine have opted for an opportunistic approach to equity exposure that aims to take advantage of share prices which have become sufficiently attractive once again.

In fixed income, the perception of a more dovish Fed has led to steeper sovereign yield curves, which we have used to our advantage. It's harder at this stage to arrive at convictions on duration exposure, so we are sticking to an essentially defensive approach. Given that we expect the United States to get drawn into the slowdown affecting the other leading economies and that the global liquidity supply is still contracting, we are determined to carry on with our strategy of gradually exiting corporate credit that we initiated over eighteen months ago. Likewise, flagging eurozone GDP growth, combined with the end of the ECB's net bond-buying programme and the upcoming EU parliamentary elections, have made us wary of any clear-cut positioning based on the assumption that credit spreads between Southern Europe and Germany will narrow.

In the **forex market**, l'embellie à court terme sur l'euro pourrait se poursuivre à la faveur des premières résolutions positives sur le front des négociations commerciales. Mais nous estimons qu'au-delà de ce rebond lié aux hésitations récentes de Jerome Powell, la réalité du comblement de l'*output gap* aux États-Unis imprimera de nouveau une pression haussière sur le billet vert, d'autant que l'euro pourra souffrir de l'incertitude de l'élection européenne et de la possibilité d'un retour des vieilles méthodes d'assouplissement monétaire. La faiblesse du dollar se matérialisera lorsque l'on pourra plus légitimement qu'aujourd'hui anticiper le retournement du cycle monétaire américain et cette faiblesse sera, nous semble-t-il, à mettre à profit contre les devises émergentes plutôt que contre l'euro.

Source: Bloomberg, 31/12/2018.