MANAGEMENT REPORT – SECOND QUARTER OF 2017

Q2 2017

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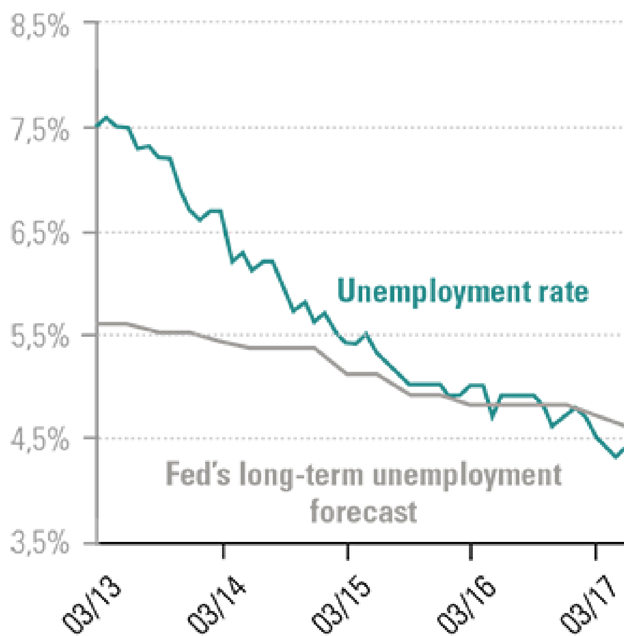
The current environment of moderate global economic growth is conducive to monetary policy normalisation. Tighter financing conditions should in turn push up bond yields and have a positive impact on mainly cyclical risk assets, particularly if the state of the economy warrants such moves by central banks. Moreover, the flagging US business cycle should serve as an effective bulwark against an abrupt drying-up of global liquidity, which would hurt equity markets.

The global outlook

In our previous report, we wrote: "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."

Developments in this past quarter have borne out our forecast of US growth spreading slowly to the rest of the world, and unaccompanied by inflation. They reflect a temporary break in the scenario we put forward in the second half of 2016, which posited a cyclical upturn made possible by increased inflation. In both the United States and Europe, that pause in the reflation dynamic has taken the form of falling inflation rates over the past three months and lower inflation expectations. The apparent failure of full employment in the US (where the unemployment rate is 4.3%) to send wages higher, couple with the impression that oil prices alone have the power to influence price levels, have lent credence to the idea that inflation isn't back in town after all and that central banks may still just be an investor's best friend. So as we anticipated, the euro has gained further ground against the dollar, buoyed by the better growth outlook in the eurozone relative to the United States. At the same time, sovereign yields have barely budged while stock prices have continued upwards.

Fear of wage pressure pushes the Fed to act



Source:
Left: Carmignac, CEIC, 30/06/2017
Right: Carmignac, CEIC, 31/05/2017

The ECB's remarks in late June about possible monetary policy normalisation, just shortly after the Federal Reserve reiterated its determination to maintain its efforts in that direction, came as a major surprise to financial markets. In reaction, European and American bond yields jumped and yield curves steepened. Share prices initially slid, putting cyclical industries at an advantage, and the euro appreciated against the dollar, even though only a moderate rise in key rates on both sides of the pond was expected. Is the central banks' newfound commitment to a return to normal the first step towards an inopportune shift in monetary policy? Or does it tell us rather that they have more accurately gauged the strength of the economy than consensus economists, who have probably concluded from recent experience that economic booms rarely last long?

The determination shown by central banks in the US, the UK, Australia and now the eurozone to normalise monetary policy, however gradually, foreshadows a less liquid market environment. Central bankers today routinely refer to concepts like the Philips curve and the Non-Accelerating Inflation Rate of Unemployment to suggest that rising wages may fuel inflation, given the tight labour markets in several countries. Whereas they rightly predicted that the latest bout of inflation, which peaked last February at 2.6% in the United States and 2.0% in Europe, would be short-lived, they now claim that the current phase of feeble inflation will soon be over. Virtually coordinated announcements of policy normalisation by central banks, combined with strong recent US leading indicators and a global economy growing moderately but in relative sync, tend to validate our non-consensus expectation for a return to cyclical trends, including an expansionary phase that will be vigorous enough to force central banks to step in and apply the brakes. Financial markets will have to adjust

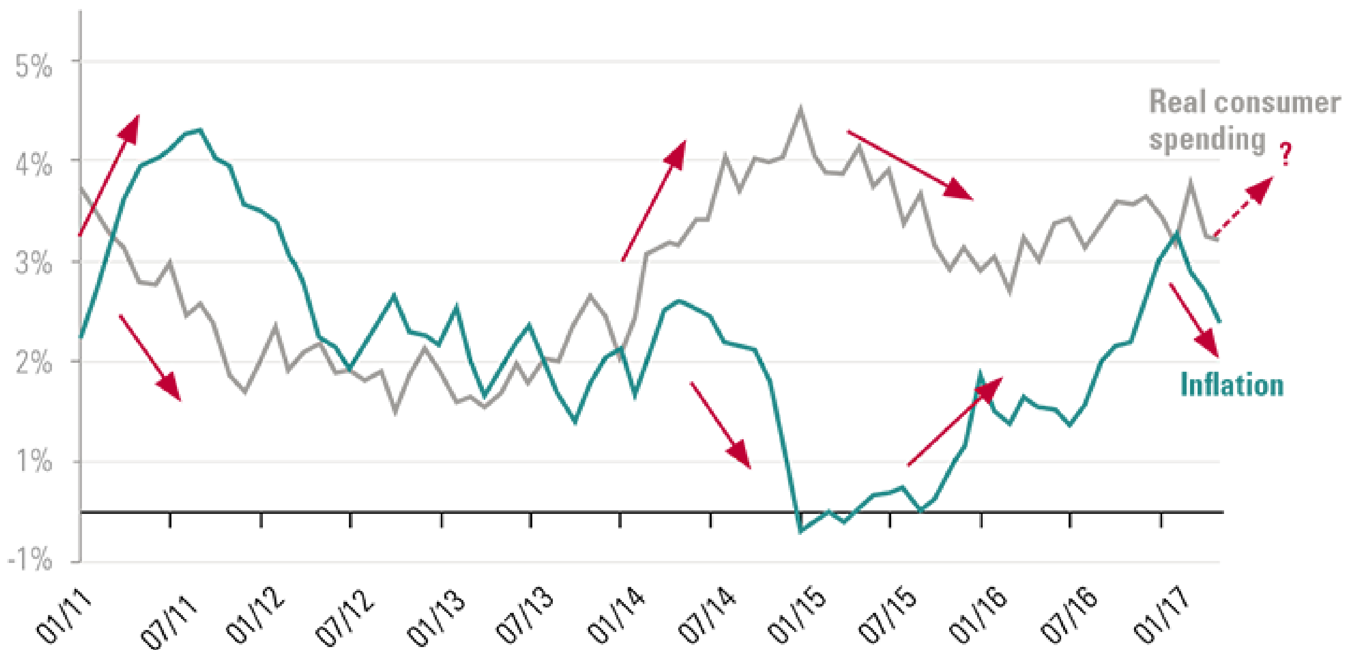
to a gradual shift towards less liquidity and higher interest rates, and we are in fact surprised to see them anticipating a single 25 bp rate increase in the United States over the next 12 months and a 10 bp increase in the Eurozone over the next 18 months. The tighter financing conditions we are forecasting should push up bond yields and have a positive impact on cyclical risk assets, particularly if the state of the economy warrants such moves by central banks and if inflation doesn't shoot up too abruptly. In the meantime, political factors are unlikely to have much of an impact on market trends.

United States

In the United States, a country enjoying uninterrupted economic expansion since 2009, the implementation of the stimulus policies promised by Donald Trump looks less and less likely every day. Though we wouldn't go as far as to predict that the US President will have no positive surprises for us on the tax or regulatory front, we do feel that the United States will no longer be the primary growth engine in the current global upswing.

The days when the Fed deliberately pursued policies that lagged behind the cyclical upturn out of fear of deflation and of stifling the recovery are over and done with. Today, being proactive is the name of the game. Going forward, any upward movement in wage levels or inflation will be countered with monetary policy normalisation at a faster pace than anticipated by the market, as will any increase in the size of bubbles forming in market segments suchas unlisted securities. The Federal Funds rate, it should be recalled, was hiked in June even though inflation had eased from 2.6% to 1.9% in just three months' time, growth in hourly wages hovered at a paltry 2.5% and growth in corporate profit margins – a key determinant of capital spending – was stuck stuck in negative territory (–1.2% in the first quarter).

United States: the recent low inflation could temporarily push up consumer spending



Source: Carmignac, CEIC, 31/05/2017

A modest uptick in growth seems likely to us now that lower inflation and rising real disposable income (+2%) have put more money in consumers' pockets. The upshot is that the abundant liquidity that has been available in the US up to now is set to dwindle – just when the consensus position says that higher inflation is off the agenda. That view has indeed been encouraged by the recent spread of price-growth moderation to rents and to prices for cars, mobile phones, apparel and other areas. To be sure, due to a broad range of well-known structural factors such as debt levels, population trends and new technology, we recognise how hard it is for the economy to produce strong, lastingly inflationary growth. But we still believe that the Fed's eagerness to accelerate the pace of monetary policy normalisation – at a time of extremely low unemployment and a probable increase in consumer spending as a result of the recent disinflation – will give renewed vigour to the global business cycle and once again generate opportunities in global-growth-oriented investment themes.

Europe

In Europe, where economic recovery is a more recent development, there is less reason to worry about the pace of short-term expansion (+1.9%). That expansion is being fuelled by a robust 6% annualised growth rate in capital investment – the highest since 2006. With an end to disinflation now in sight (after price inflation fell

from 2% in February to 1.3% in June), real consumer spending can confidently be expected to increase at better than 2%. In addition, the upcoming elections in Germany should pave the way for a fiscal policy mix more favourable to consumers, which will have a positive impact on the rest of Europe. Under the leadership of Emmanuel Macron, France seems to have recovered the kind of energy that was conspicuously absent for far too long. The banking troubles plaguing part of Southern Europe also appear to be on the mend and Italy has returned to GDP growth of over 1%. Nor would we be going too far out on a limb in saying that a reinvigorated French-German relationship could well lead to initiatives that will strengthen the positive cyclical trend under way across the continent. There is still political pressure to work towards more sharing in Europe, with greater convergence between economies battered by the crisis and those that are in better shape. Lending activity has also picked up in the Eurozone. After five years of stagnation, the volume of loans to non-financial companies and households, excluding mortgage loans, is back on an upwards trajectory. With the world's economies now expanding in sync, the upswing in Europe amply justifies Mario Draghi's optimistic stance and increases the likelihood of a first move to monetary policy normalisation in the next few months. Europe might just prove to be the engine of global growth in the near term.

France: first signs of a new dynamic

Eurozone: government spending, % of GDP

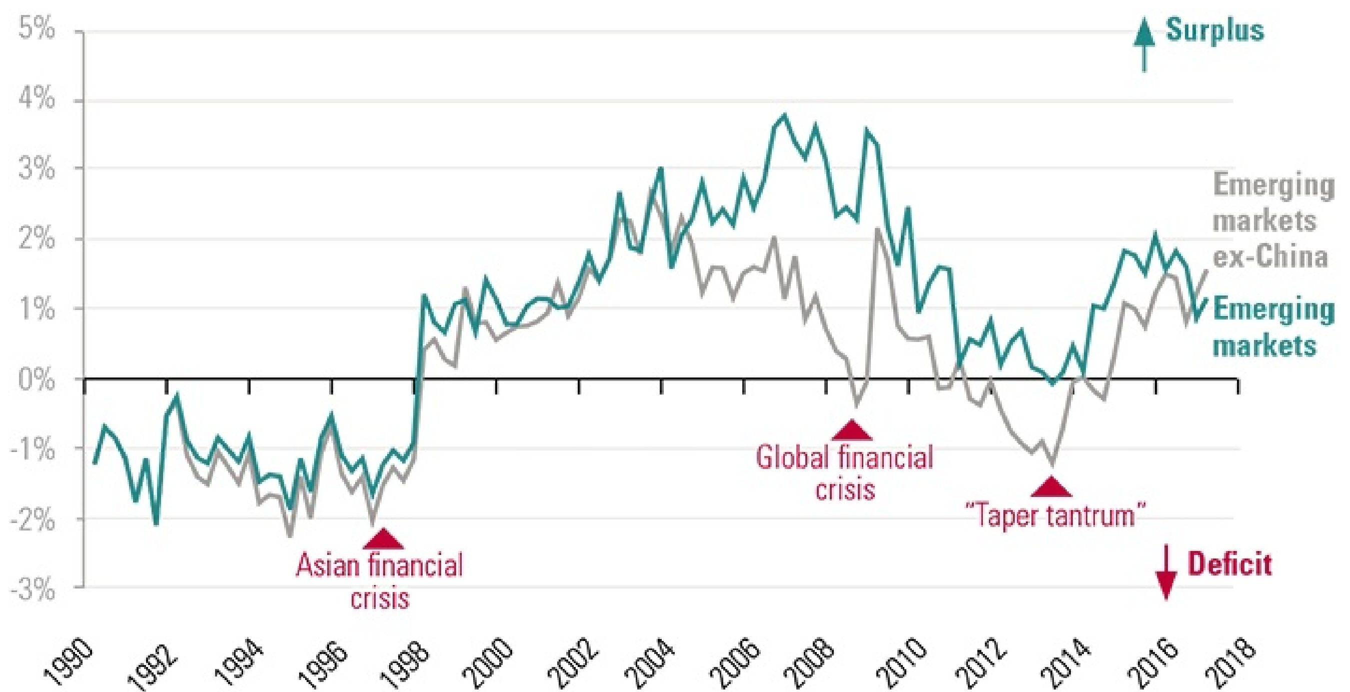
Source: Gavekal Research, "A New Franco-German Axis" , 05/05/2017

Emerging markets and Japan

Things are still going well in the emerging world. Leading indicators for manufacturing activity have forged ahead in many countries across the various geographic areas, and we don't expect any unpleasant surprises

from China, at least not until the Communist Party Congress in October. Continuous improvement in current account balances and a relatively weak dollar give emerging markets the leeway to handle higher US interest rates. In most such countries, inflation is heading downwards, with the result that exchange rates are getting better and there is more wiggle-room for monetary policy. Brazil is a key beneficiary of those developments. However, the recent hike in agricultural prices calls for careful attention. If this trend were to gather momentum, it could undermine the virtuous circle under way in the least advanced economies.

Emerging markets becoming less dependent on the rest of the world



Source: Bank of America – Merrill Lynch, "the Inquirer: Financial Vulnerability at Multi-Decade lows ", 28/06/2017

Investment strategy

As expected, the euro benefited from the gradual diffusion of US economic growth to the rest of the world, gaining ground against the dollar. With the EUR/USD exchange rate flirting with 1.15, we consider the greenback to be correctly valued. We have therefore substantially reduced our major underexposure to the dollar. Statements from both sides of the Atlantic on the pace of monetary policy adjustment will guide us in determining our next moves in terms of dollar exposure. As monetary easing looks set to continue in Japan with no indication of a change of course, we plan to keep our yen exposure very low.

On the interest rate front, after correctly anticipating that there would be no significant increase in yields, we have taken a position that will enable the Fund to benefit from rising US and European bond yields, and that is in line with our constructive view of global economic growth. We are surprised at how passively markets

have responded to the less dovish stance taken by central banks in developed countries, and we expect yields to rise in all of them. In contrast, we see real value in emerging-market sovereign bonds.

Equity markets did particularly well during the economic lull of these past few months, with US, emerging-world and Japanese indices climbing to impressive heights. Europe, where optimistic expectations for the outcome of the French elections initially drove share prices up, has since experienced a mild correction. We believe that Europe and Japan should be allocated a large share of our investments in cyclical stocks, as we confidently expect the market rallies there to continue. We don't think that the announced monetary policy tightening and the first rate increases will hurt the stocks of companies operating in cyclical sectors, particularly because we expect the adjustment to be gradual. **In fact, we consider the flagging business cycle in the United States to be the best bulwark against a sharp contraction in global liquidity.** Gradual adjustment of interest rates should also help businesses in non-cyclical sectors with a high-growth track record to score further gains. And our tech stocks are among them.

Source: Carmignac, CEIC, Anderson, 31/6/2017

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