A decade-long enigma about to be resolved

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Author(s)
Didier Saint-Georges

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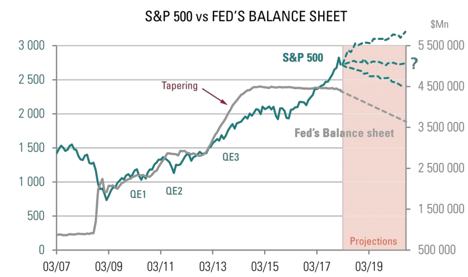
Ever since developed-world central banks threw themselves headlong into ultra-loose monetary policies at the beginning of 2009, the big question has been how exactly they would unwind them. If unconventional monetary policy ultimately failed – that is, if inflation and GDP growth plummeted – financial markets would almost certainly have been rocked by a devastating crisis of confidence. That risk is now behind us. The prevailing view among market participants these past few years has been that economic growth and inflation rates were out of the danger zone, but still low enough to warrant unlimited continuation of highly accommodative monetary policies. That view was supportive of all asset prices. 2018 is finally bringing investors the hoped-for happy ending from an economic standpoint. Growth and inflation have picked up, allowing central banks to make the case that the interventionist monetary policies of the last several years have worked, and can therefore be scrapped. But that also means we have entered an inevitable phase of market instability, where the tough question will be how to assess the implications of this exit process for all asset classes.

Investors today are asked to make a judgement that is every bit as tricky as the one they had to make in 2009, when they needed to gauge the impact on markets of the new era of abundant liquidity taking shape at the time.

When monetary policy entered uncharted territory in 2009, we were treated to a whole slew of spectacularly wrong forecasts. The prospect of an inordinate expansion of the money supply prompted many economists to predict a major surge in inflation that would drive bond yields up sharply. At the same time, they argued that equity markets could hardly perk up as long as economic growth remained so feeble. Needless to say, things worked out quite differently, with both stock and bond markets experiencing unprecedented rallies. Moreover, in a supremely ironic twist, as long as central banks were unsuccessful in kick-starting GDP growth and inflation, they could be counted on to provide investors with further support in the form of massive cash injections. In the process, they encouraged those investors to take on additional risk as a means to capture somewhat higher returns at a time in which interest rates were being deliberately driven lower and lower. Getting market forecasts right is no less critical today – as unconventional monetary policies unwind – than it was back in 2009, as both situations were equally unprecedented.



Source: Bloomberg, Carmignac, 28/2/2018

The consensus up until now has been that the process of exiting monetary stimulus will be favourable to equity markets

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The tax cuts passed by the US Congress late last year have raised hopes of an economic surge in the country. On average, analysts now reckon that in 2018 output will grow by close to 3% and inflation will top 2%. Forecasts for the Eurozone, meanwhile, are for roughly 2.5% GDP growth with inflation close to 1.5%. With this favourable economic climate set to continue, earnings growth forecasts for 2018 have been lifted several times since the start of the year; earnings per share are now expected to go up 18.4% in the US and 7.5% in the Eurozone. That brighter outlook for American companies may explain why US stocks in general and tech stocks in particular have gained further ground despite upward pressure on bond yields, and why they are still outperforming their European counterparts. However, this consensus view is going to be confronted with two distinct challenges, one in the short term and the other a bit further down the line.

In the short term, bond markets will continue to generate instability.

After years of compression through central bank intervention, US, Japanese and German government bond yields have entered a dicey process of gradual adjustment to real market prices. That adjustment will be anything but plain sailing. Market participants will constantly have to rethink the economic forces at work, the signs of rising inflation they may detect and the impact of central bank reaction functions. A serious look at the recent US tax reform strongly suggests that it will force the US government to borrow more – just when the Fed is starting to reverse its own contribution to liquidity by shrinking its balance sheet.

It follows that one of the key challenges in the coming months will be quantifying the net impact that such a dramatic shift in the supply-demand equation will have on Treasury yields. That shift is likely to create even greater instability in equity markets as investors' views get tainted by renewed fears of higher US inflation – fuelled by an unfavourable base effect and rising wages, the Trump administration's renewed embrace of protectionism and lingering political uncertainty in Italy. In addition, the sheer volume of assets managed using passive investment styles and investment algorithms is liable to magnify erratic market swings.

Once that period of instability is over, the question will be what the new market paradigm will look like.

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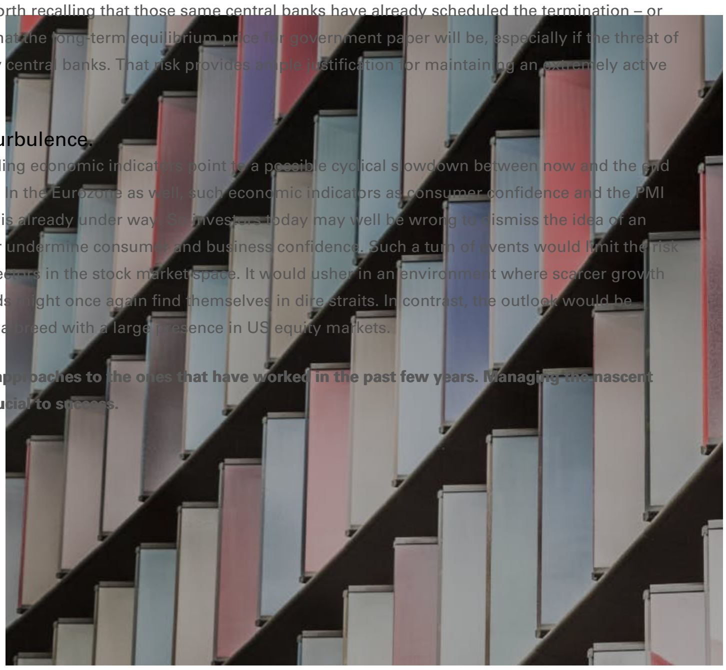
The imbalances that have built up over the past ten years raise major adjustment issues. Debt levels, both for governments and businesses – which have by and large taken advantage of low interest rates to increase their leverage – stand higher today than just after the 2008 financial crisis. The number for the entire US economy is now equal to 250% of GDP, while the Japanese government alone has reached the 200% mark. In the Eurozone, public sector debt has risen from 72.8% of GDP in 2009 to 83.2% today. Investors expect the current economic upswing to bring higher inflation in its wake. For the time being, the upside of that expectation is that it lowers the real cost of debt and strengthens the case for investing in equities to offset the erosion of the value of cash.

From this standpoint, the main risk is that the Fed and other central banks might respond to this improving environment by tightening monetary policy too sharply. Investors are wagering at this point that central banks will be sensible enough to keep their key rates low or negative – even at the risk of lagging behind inflation trends – in order to avoid toppling the fixed-income house of cards. Now, that wager may seem rational, but it's worth recalling that those same central banks have already scheduled the termination – or even reversal – of their asset-purchase programmes. More importantly, no one knows what the long-term equilibrium price for government paper will be, especially if the threat of inflation lasts, when demand from private-sector investors has to take up the slack left by central banks. That risk provides ample justification for maintaining an extremely active approach to managing bond duration.

But another scenario could well materialise after the current phase of turbulence.

The US business cycle is already close to its peak. Despite the tax cuts, the country's leading economic indicators point to a possible cyclical slowdown between now and the end of the year. Meanwhile, China has just released disappointing PMI readings for February. In the Eurozone as well, such economic indicators as consumer confidence and the PMI have fallen off slightly – a first since 2016. And in the United Kingdom, the trend reversal is already under way. So investors today may well be wrong to dismiss the idea of an upcoming cyclical slowdown, particularly if the current market turbulence were to further undermine consumer and business confidence. Such a turn of events would limit the risk of a deeper bond-market correction, but it would also heighten the disparities between sectors in the stock market space. It would usher in an environment where scarcer growth becomes the new paradigm, and companies in cyclical industries or with heavy debt loads might once again find themselves in dire straits. In contrast, the outlook would be brighter for high-growth firms with healthy balance sheets and good earnings visibility – a breed with a large presence in US equity markets.

Going forward, no investment strategy can deliver results unless it rests on alternative approaches to the ones that have worked in the past few years. Managing the nascent market instability and crafting portfolios correctly for the new era awaiting us will be crucial to success.



Source: Bloomberg, 03/03/2018

Investment strategy

Equities

Stock markets started out the year with a bang, before retreating in February. It wasn’t so much concerns about the economic outlook as higher interest rates that explains the market correction and the jump in volatility that took place in the past month. From the United States to Europe, and from Japan to the emerging world, market indices were down across the board. There was considerable divergence among sectors, however. Those most vulnerable to interest rate hikes – for instance, utilities, real estate and telecommunications – took a beating, whereas sectors positively correlated with interest rates, like financial firms, gained ground.

Our portfolio, which gives pride of place to tech stocks, did quite well in those conditions. With sound balance sheets and good prospects for earnings growth, tech companies are less sensitive to changes in bond yields. We have actively managed the equity exposures of our global funds, and will continue to do so in the phase of instability that has just begun.

Fixed income

After rising sharply in January, US Treasury yields inched up further in February. Yields on 10-year bonds advanced slightly faster than those on 5-year paper, with the dual result that the yield curve steepened again and fears of recession were allayed. Meanwhile, there was a pause in the upward trend of German yields, while sovereign yields in several non-core Eurozone economies showed renewed volatility. Lastly, corporate credit spreads continued to widen, albeit moderately.

Due to our cautiously balanced portfolio, with a low overall modified duration and only limited and selective exposure to corporate issues, we were able to take the recent bond-market turmoil in our stride. We have maintained our arbitrage strategy for capturing risk premiums on bonds while hedging against interest rate hikes. We are accordingly still long government bonds from the Eurozone periphery (Italy, Spain, Portugal and Greece) and emerging markets (chiefly in Latin America) and short “core” sovereign issues from the US and Germany. At the end of the month, we reduced portfolio risk by scaling back all of our positions.

Currencies

Though February saw a lull in the euro’s appreciation against the US dollar (following an over 3% gain in January), the yen continued to strengthen. The Japanese currency has risen more than 5% against the greenback since the beginning of the year and is approaching the technical threshold of 106 yen to the dollar – a critical level for the currency hedges put in place by major Japanese export firms.

Given that our currency strategy is geared to low dollar exposure and higher yen and euro exposure, it has been a positive contributor to our overall performance since the start of the year.