



Beneath the fury, the economic cycle

April 2018



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Published
April 4, 2018

Length
6 minute(s) read

As this first quarter of 2018 draws to a close, a lot of investors still seem to be wondering about this new era of market instability. Fretting about an imminent US-China trade war or fanning the flames of revolt against “big tech” might be a good way to get riled up against a convenient array of culprits. But the main issues lie elsewhere (see our March Note, [“A decade-long enigma about to be resolved”](#)). The period of instability that we have just entered is entirely different in nature from what we have seen in the past. It isn’t attributable any longer to the threat of deflation or an economic slump. It rather reflects major confusion about how the unfolding combination of more hawkish monetary policies and more dovish fiscal policies will ultimately impact economies and financial assets that “heroic” central bank action has kept on a sugar high for years now.

We feel that a few words are in order about how friction over trade actually affects economic growth and what the issue of privacy actually means for data aggregators like today’s tech giants. We will then go on to summarise what we consider a credible scenario for what will happen when that period of instability has been overcome.

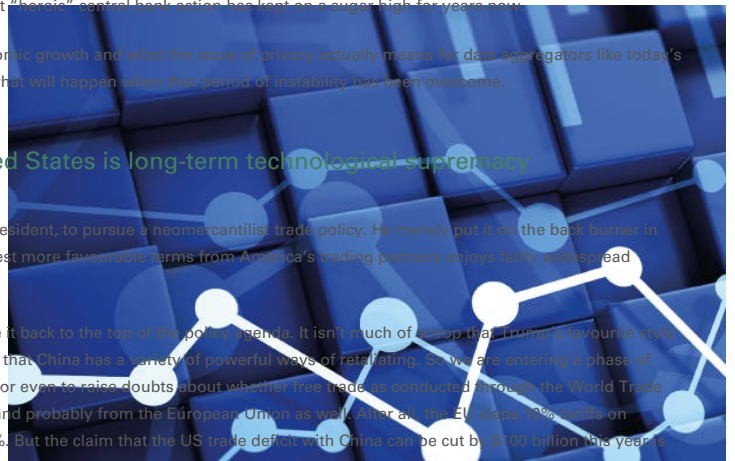
The so-called trade war

The real economic issue pitting China against the United States is long-term technological supremacy

Donald Trump has never made a secret of his intention, either as candidate or later as President, to pursue a neomercantilist trade policy. He merely put it on the back burner in 2017. Moreover, the idea of exploiting what is deemed to be a position of strength to wrest more favourable terms from America’s trading partners enjoys fairly widespread support in US public opinion.

And with mid-term elections scheduled for November 2018, that aim was bound to make it back to the top of the policy agenda. It isn’t much of a secret that Trump’s favourite style of “negotiating” consists of holding a gun to the other party’s head. Nor, for that matter, that China has a variety of powerful ways of retaliating. So we are entering a phase of posturing, threats and counter-threats that are likely to undermine investor confidence – or even to raise doubts about whether free trade as conducted through the World Trade Organization has much of a future. We may actually see a few concessions from China, and probably from the European Union as well. After all, the EU slaps 10% tariffs on imported American cars, whereas European cars shipped to the US are taxed at just 2.5%. But the claim that the US trade deficit with China can be cut by \$100 billion this year is both unfounded and preposterous, given that integrated global supply chains make this an extraordinarily complex issue.

Still, it’s worth bearing in mind that in the US President’s approach to politics, sabre-rattling is primarily for domestic consumption. A failure to grasp that point is certainly the reason why several foreign policy experts recently had to quit Trump’s White House, thereby eliminating what had become an untenable level of cognitive dissonance. The main risk in the near term is that consumer spending and US exports will be among the first casualties of the current protectionist offensive. But in any event, the real issue pitting the US against China lies elsewhere – in the question of who will have long-term technological supremacy. The Trump administration would therefore do well to take a greater interest in the inadequate level of private- and public-sector research and development spending in the country, and in the lasting damage they will do by creating new barriers for scientists and other skilled people seeking to enter the US.



Facebook, Amazon, Google and the rest of the gang

We shouldn't be surprised to see Occupy Silicon Valley moments

As his recent blistering Twitter attack on Amazon makes clear, Donald Trump is cashing in on the latest wave of outrage – a wave intensified by the recurring problem of personal data protection and especially Facebook's most recent foul-up. The social media heavyweight is certainly less concerned over legal battles (as it is amply covered by the terms of service blindly agreed to by most users) than over possible damage to its image: Suppose the recent fiasco sends business and private users packing in droves? But that seems most unlikely. Opinion polls clearly show that social network users already had very few illusions about the degree of privacy afforded by the systems they use. They know that the services provided by social networks are "free" only in the sense that you pay for them by supplying your personal data to the network owners – also for free.

In this area, it looks like we are heading inevitably towards stiffer regulation, in line with the EU's General Data Protection Regulation (GDPR), which will become enforceable as of May 2018. Companies will unquestionably need to set up more robust systems to manage data usage, transparency and controls. So we shouldn't be surprised to see Occupy Silicon Valley moments like this one. GAFAM and the like have plenty of traditional media rivals – including in other countries – that have lost a tremendous amount of business to them and that can be expected to take advantage of any such flare-up to fan the flames of outrage. These competitors will no doubt put forward ethical arguments, and perhaps justifiably, that will lead to regulatory changes. But let's not kid ourselves. Whatever adjustments that may be required are unlikely to undercut the value of web technology – from the standpoint of users and advertisers alike. The qualified information that the latter get from digital platforms gives them a return on investment that conventional media are simply unable to match.

Furthermore, the whole tech sector is getting lumped together with Facebook and Amazon, although many of its smaller firms in fact have very different business models. This means that every correction to tech stock prices is likely to offer long-term buy opportunities to those investors who carry out in-depth analyses of those firms' products, yet diversified business models.

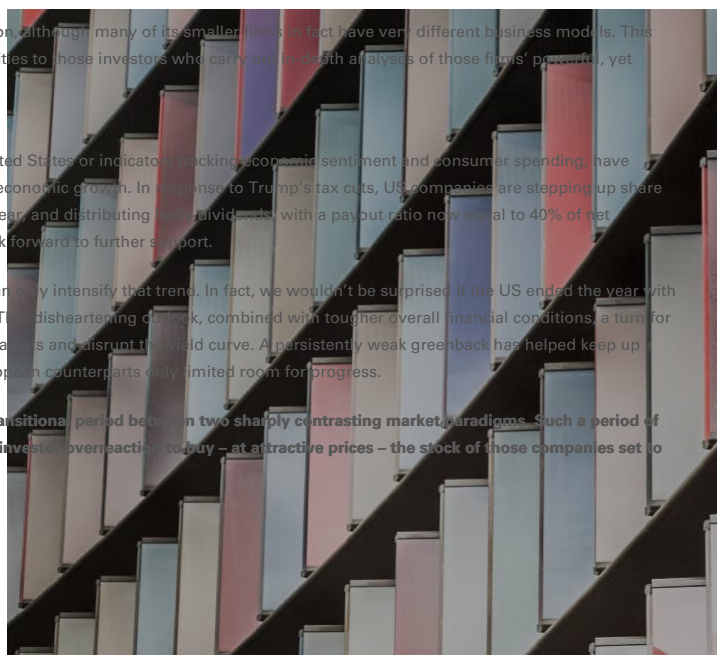
Meanwhile, the business cycle moves onward

None of the recently released economic indicators, whether PMIs* in Europe and the United States or indicators tracking economic sentiment and consumer spending, have belied our forecast that investors may soon be wrong-footed by a change in the pace of economic growth. In response to Trump's tax cuts, US companies are stepping up share buybacks, which look set to rise from \$450 billion in 2017 to as high as \$600 billion this year, and distributing ~~more~~ dividends, with a payout ratio now equal to 40% of net earnings, a level not reached since the late 1990s. The US stock market can therefore look forward to further support.

But the broader economy is beginning to lose momentum, and the tension with China can only intensify that trend. In fact, we wouldn't be surprised if the US ended the year with GDP growth in the vicinity of just 2% – a figure well below the 2.8% consensus forecast. The disheartening outlook, combined with tougher overall financial conditions, a turn for the worse in the credit market and tighter monetary policy, has started to upset equity markets and disrupt the yield curve. A persistently weak greenback has helped keep up stock and bond markets in the already healthy emerging economies, but offers their European counterparts only limited room for progress.

We are accordingly maintaining our view that the current market instability reflects a transitional period between two sharply contrasting market paradigms. Such a period of heightened fragility calls for active risk management and a policy of exploiting bouts of investor overreaction to buy – at attractive prices – the stock of those companies set to win out in the new market paradigm likely to emerge in the coming months.

* PMIs (Purchasing Managers Indexes) are indicators derived from surveys of manufacturing companies.



Investment strategy

Equities

After another month of losses, most stock markets closed the first quarter in the red. The downtrend was common to a wide variety of geographies, suggesting an overall increase in risk aversion among investors. We have responded by considerably scaling back our exposure to equities. In addition to putting in place hedges, we have exited a number of positions, most notably in companies exposed to consumer credit and thus on shaky ground in the event that interest rates are hiked without a concomitant pickup in GDP growth.

In our tech stock portfolio, while some large-cap names from the US took a beating in the past month, our strategy of diversifying into smaller competitors like GrubHub and emerging-market companies like Hikvision helped cushion the impact of the market correction affecting the tech sector as a whole. Due to the profitable growth profile shown by those firms, we continue to view them as excellent value, but with tax rules and regulations shifting fast, highly selective stock-picking is still imperative.

Fixed income

Sovereign yields as a whole have eased, with only a few exceptions like Turkish government bonds. Yields on 10-year US Treasuries slid below the 2.80% mark in March – even after the Federal Reserve upped its benchmark rates again in the course of the month.

As we had previously closed out our short positions in US Treasuries and pared back those we held in German government paper, we were able to benefit from price movements with our long positions in non-core EU bonds (Italian, Spanish, Portuguese and Greek) and emerging-market sovereigns, chiefly in Latin America.

Our selective allocation to corporate bonds also helped us take the recent increase in credit spreads in our stride.

Currencies

In contrast to other asset classes, forex showed no major spike in volatility over the past month. The leading developed-world currencies ended the month with fairly little change. However, the euro booked modest gains against the dollar and therefore made a positive contribution to our currency strategy, given that we have no exposure to the greenback. Emerging-market currencies turned in patchier performance. For example, the Mexican peso appreciated sharply, whereas the Brazilian real lost ground.

Our diversified allocation to EM currencies enabled us to smooth out these variations. During the month, we took profits on part of our allocation to the yen. We believe a more uncertain political environment in Japan could make the country's currency less attractive as a safe-haven asset going forward.

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