Fooled by the Cassandra syndrome

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A year ago we called the start of a global economic recovery (see Carmignac's Note of December 2016, "The wind is picking up"). While that seemed to us to open up bright prospects for equity investors, we feared the US Federal Reserve might respond with a more hawkish monetary policy that would depress bond markets in 2017. In fact, nothing of the kind happened. Not only the cyclical upswing did occur, even more vigorously than we had anticipated; it also spread across the planet, with the result that all 35 OECD are currently expanding. And yet all that hasn't produced so much as a ripple in bond markets. Significantly, the yield on German government bonds today stands exactly where it was on 1 December 2016 – at a meagre 0.36% – although the pace of German GDP growth has in the meantime picked up from 1.8% to 2.8%, the most important elections in the eurozone have turned out well and the European Central Bank has reiterated its intention to pare back its monthly bond purchases from €60 billion to €30 billion as of January.

Ongoing central bank largesse has helped keep the world economy humming, and that, combined with persistently low inflation readings, has boosted investor confidence to unprecedented levels. The upshot is that highly indexed investment styles – particularly those leveraged – have come out on top again this year, making managing market risk unnecessary. The Cassandra syndrome is therefore still very much with us. However, readers should bear in mind that in Greek mythology, the problem didn't lie with Cassandra's predictions, which were unfortunately accurate, but with the refusal of others to believe or act on them when there was still time to do so.

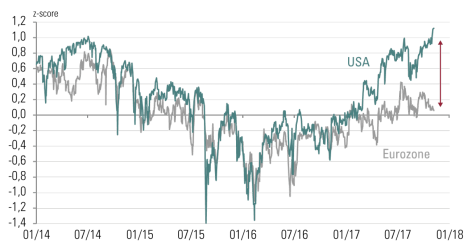
The challenge in 2018 will be to correctly assess how the current "dream-come-true" environment is likely to evolve as the business cycle matures and monetary policy at long last moves resolutely towards normalisation.

Europe – from the depths of despair to cloud nine

Just when financial markets seemed overwhelmed by gloom about the EU's future following the Yes victory in the June 2016 Brexit referendum, the eurozone economy was actually starting to perk up. The heartening outcome of the French and Dutch elections soon thereafter helped put the Euro Stoxx 50 on an upward trajectory that translated into a 17% gain over a twelve-month period. At the same time, investors on the other side of the Atlantic experienced a 14% appreciation in the euro against the greenback. The primary political risks still on the horizon have to do with how forcefully France's reform programme will be carried out, how pro-European Germany's future administration turns out to be and how effectively Spain and Italy manage the domestic policy issues confronting them. The point, in any case, is that systemic risk has evaporated – and with it all the chatter about ditching the common currency.

That said, turning the European boom into stock-market gains will be easier said than done in 2018. The region's large firms earn a sizeable share of their revenue in the rest of the world, which makes them less sensitive to the eurozone upturn and exposes them to the negative impact of a stronger euro on their profits (see below). Furthermore, share prices for small- and mid-cap companies, which are more in sync with the economic rebound in the euro area, have already doubled on average over the last five years – meaning they have performed twice as well as the Euro Stoxx 50. A final point worth noting is that once the ECB's plan to downsize its asset purchases kicks in early next year, the big question will be how exactly that shift will affect interest rates, and therefore all market valuations.

FINANCIAL CONDITIONS IN THE EUROZONE AND USA



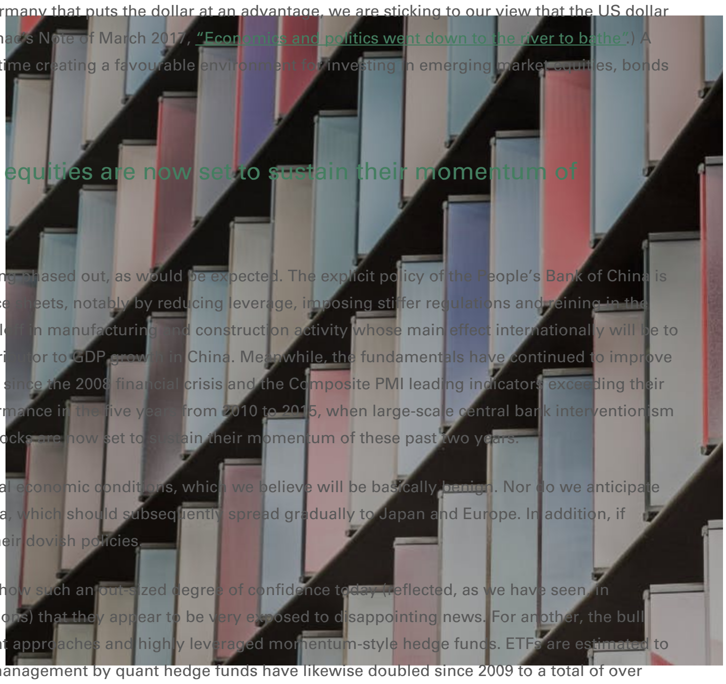
Source: Bloomberg, Kepler Cheuvreux

The United States – from high hopes to sobering reality

> We are sticking to our view that the US dollar is in for long-term depreciation

You have to hand it to Donald Trump: he's done much better than we expected in galvanising consumer and business sentiment with the promise of sweeping tax reform. But in the US even more so than in Europe, those hopes have little upside left now. While a tax reform is now likely be voted into law, the financial markets have partially priced it in already. This means that sooner or later the natural swings in the US business cycle will recover their pre-eminent role. Our estimate is that the first signs of an economic slowdown will be noticeable in the first half of next year. But however counter-intuitive it may sound, that trend shouldn't lead to underperformance by US equities relative to their counterparts elsewhere. That's because the United States boasts more large, high-growth companies with good earnings visibility than anyone else (after all, Europe still lacks the equivalent of GAFA). Once again, that will give the US stock market a defensive advantage in the event of an economic slowdown. Moreover, in such an environment, monetary policy normalisation can be expected to proceed at a cautious pace.

All that suggests that the US currency will be the locus of risk. Serious disappointments on the macroeconomic front will most likely induce the Fed to reconsider its plan to shrink its balance sheet and lift interest rates four times in 2018. A further potential source of dollar weakness is that if the Republicans' tax plan gets passed in its current form, it will swell the national debt. It should be stressed that 2017 was the third year in a row in which the federal budget deficit took a turn for the worse – despite an expanding economy. So leaving aside the possible short term relief caused by an interest rate differential with Germany that puts the dollar at an advantage, we are sticking to our view that the US dollar is in for long-term depreciation. (That was already our outlook in early 2017. See Carmignac's Note of March 2017, "Economics and politics went down to the river to bathe".) A weaker dollar will subject European stock markets to mild headwinds, while at the same time creating a favourable environment for investing in emerging market equities, bonds and currencies.



Momentum in the emerging world

> After five years of sub-par performance up to 2015, EM equities are now set to sustain their momentum of these past two years

The powerful fiscal stimulus that fired up the Chinese economy from early 2016 on is being phased out, as would be expected. The explicit policy of the People's Bank of China is now to resume its drive to tackle the systemic risk lurking on financial institutions' balance sheets, notably by reducing leverage, imposing stiffer regulations and reining in the shadow banking system. As of 2018, the country will therefore be experiencing a mild falloff in manufacturing and construction activity whose main effect internationally will be to lower demand for raw materials. The new economy, in contrast, remains a growing contributor to GDP growth in China. Meanwhile, the fundamentals have continued to improve in other emerging economies, with current account surpluses rising to their highest level since the 2008 financial crisis and the Composite PMI leading indicators exceeding their best readings since 2013. The emerging economies turned in sub-par stock market performance in the five years from 2010 to 2015, when large-scale central bank interventionism in the developed countries ensured investor preference for rich-world equities. But EM stocks are now set to sustain their momentum of these past two years.

We can accordingly expect that in 2018 financial markets will have little to fear from global economic conditions, which we believe will be basically benign. Nor do we anticipate anything worse at this stage than a mild cyclical slowdown in the United States and China, which should subsequently spread gradually to Japan and Europe. In addition, if inflation remains as weak as we expect, central banks will have no trouble maintaining their dovish policies.

We see the threat to financial markets coming from elsewhere. For one thing, investors show such an out-sized degree of confidence today (reflected, as we have seen, in historically narrow credit spreads, extremely low market volatility and high equity valuations) that they appear to be very exposed to disappointing news. For another, the bull market of the past several years has given a shot in the arm to passive asset management approaches and highly leveraged momentum-style hedge funds. ETFs are estimated to account for as much as 70% of average daily stock trading volume today. Assets under management by quant hedge funds have likewise doubled since 2009 to a total of over $400 billion. So the main risk facing financial markets is that even a slight deviation from the ideal scenario that investors have in mind may be enough to trigger an abrupt, virtually automatic wave of profit-taking.

To conclude, we feel that those gunning for superior performance in 2018 will be able to rely more than before on economic fundamentals. But they must also brace themselves for bouts of volatility of the kind that financial markets haven't seen in quite some time.

Source: Bloomberg, 28/11/2017

Investment strategy

Equities

With equity exposure close to the maximum allowed for our funds and an overweight position in emerging markets, our equity strategy has greatly benefited from the solid stock market performance of these last two months. Emerging-world and Japanese stock markets experienced the strongest rallies, while European markets turned in somewhat disappointing results, including a mild correction in November. While European third-quarter earnings releases were good on the whole, a combination of no upward revisions and worries over a rising euro took the edge off investor enthusiasm. The market was particularly rough on Altice, for example. Although we considerably scaled back our exposure beginning in March, the correction that hit the company's share price still detracted from the overall performance of our equity portfolio in November. With the cyclical boom likely to peak soon, we have stepped up our focus on valuations. On that basis, we sold our holding in Nvidia, a US manufacturer of semiconductors used in artificial intelligence and video games, following its remarkable share price gains. But at the same time, we took a position in Apple, an attractively valued company that can look forward to further robust growth thanks to iPhone X sales. We also took advantage of Ryanair's volatile share price to acquire a position at a reasonable cost in the company. Due to a highly competitive cost structure, Ryanair is poised to expand its market share at the expense of legacy airlines.

Fixed income

Tightening spreads between Italian, Spanish and Portuguese sovereigns and German government paper in the past two months have been the performance engine in our fixed income portfolio. We raised our exposure to EU-periphery bonds with investments in Greek sovereigns to take advantage of the country's improved economic outlook – even with a risk premium of nearly 5%. Now that the Greek government has met its fiscal targets, the way has been cleared for the country to exit its economic adjustment programme in mid-2018 and return to normal financing conditions. In our hunt for bond market segments offering real value, we have continued to short German bunds and to buy emerging-market sovereigns that combine attractive yields with sound macroeconomic fundamentals, for example in Brazil, Mexico, Russia and Argentina. Lastly, we have maintained our highly selective approach to corporate credit. The recent upward pressure on European high-yield bond prices should serve as a reminder to all that we need to prepare well in advance for the upcoming change of liquidity regime.

Currencies

Over the last two months, the euro has seen ups and downs relative to the US dollar (consolidating in October, then gaining ground in November) that highlighted the importance of tactically managing our exposure to the EU's common currency. After initially equalling out our positions in the two currencies, we reverted in November to a substantial exposure to the euro, as we believe that the sources of long-term appreciation for the common currency (which should also boost the euro's weight in international currency reserves) are still intact. In addition, we took a position in the Japanese yen, whose safe-haven status should help lessen the overall volatility of our portfolio as the year draws to a close.

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