How 2020 is changing the game

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Imagining the future is never an easy task when the shock wave from a blast is still propagating, and when people around you are still struggling to emerge from the wreckage. The 2020 public health crisis quite clearly fits that description. Daily news feeds on the still-rapid spread of the virus, endless details about successive emergency relief programmes and monthly updates on economic activity have a way of cluttering our mental space. At the same time, the last leg of the US presidential election campaign sometimes feels more like a bar-room brawl between two old geezers than a contest between rival political platforms.

And yet, due to its unique severity, the shock we've experienced in 2020 may well have momentous long-range consequences for investors.

> Due to its unique severity, the 2020 shock is likely to have momentous long-range consequences

Those consequences are likely to determine potential GDP growth rates in Europe, the United States and the emerging world. They are also likely to influence future consumer price inflation and currency stability – issues that no one concerned with the outlook for equity, bond and foreign exchange markets can afford to dodge.

The future of growth

For the time being, virtually all the Covid-related loss of income in Europe and the US has been covered by the corresponding governments. This unprecedented public-sector support has helped produce heartening signs of recovery, bolstered in part by a restocking phase after inventories were depleted in the preceding months. The third quarter of the year has thus seen a powerful rebound that has given a boost to exports from China, where the economy is close to resuming its normal growth rate. Within a few months or even a few weeks, the US Congress should pass a new stimulus plan which, combined with the first tangible news on an effective vaccine, could provide further economic momentum and revive the animal spirits of financial market participants.

However, this newfound government interventionism has brought about a mind-bending increase in fiscal deficits that could be financed only by a no-less-extraordinary degree of central-bank intervention.

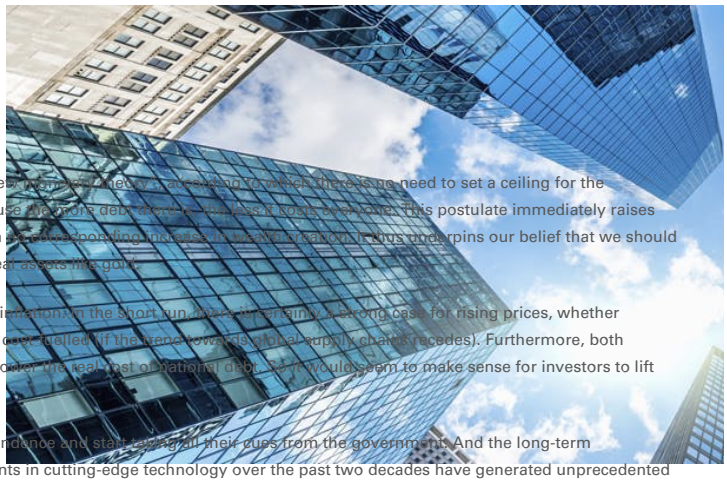
We would be guilty of wishful thinking, or at any rate undue optimism, if we expected that trend to continue without a hitch. The issue of fiscal deficit sustainability can't be sidestepped indefinitely. And it's being made that much more acute by the innate reluctance of central bankers – the people tasked with guaranteeing overall financial stability – to expand their asset purchase programmes without restraint. This suggests the need to build an "upper-bound scenario" for government spending into our long-term outlook.

The probable discovery of a vaccine will no doubt soon help us make our way back to some kind of "normality". But we feel it would be wrong to underestimate the time lag until an ideal vaccine – requiring a single injection, storable at room temperature, at least 70% effective and generating antibodies that remain active for a long period – can be produced and administered widely enough to make the pandemic's impact on our behaviour a thing of the past.

Moreover, the after-effects of the 2020 economic shock will continue to hold down production and investment – and therefore employment – particularly in such sectors as aviation, oil extraction, tourism, food service, commercial real estate and retail. At the same time, shifting workers out of those industries into high-potential areas like technology services and the energy transition will entail formidable career transition challenges. Such examples of fallout from the pandemic are in turn feeding into an underlying trend towards overleveraging, which has already been hindering a vigorous and sustainable economic upswing for over a decade.

This leads us to establish a medium-term decline in potential GDP growth as our baseline macroeconomic scenario. The implications for equity markets will be fairly straightforward. With central banks manifestly unable to tighten monetary policy, interest rates are set to stay rock-bottom, and will therefore provide support for stock valuations. And the sectors best suited to this low-key economic environment (see our September Note, "**The unrelenting law of evolution**"), for a discussion of the "Darwinian" consequences of the 2020 shock) will be well-equipped to increase their competitive edge – and with it their relative outperformance in the market.

Potential GDP growth rates have been weakened, making it impossible for central banks to tighten monetary policy



The future of inflation

The prospect of a very arduous economic recovery has unsurprisingly given wings to "new monetary theory" according to which there is no need to set a ceiling for the monetisation of fiscal deficits (i.e., expansion of the money supply to pay for them) because the more debt there is, the less it costs everyone. This postulate immediately raises the question as to the intrinsic value of currencies when money gets lavishly printed with a corresponding increase in money creation. It thus underpins our belief that we should maintain limited currency risk in our portfolios and even have significant allocations to real assets like gold.

The other question raised by a scenario of almost fully monetised deficits has to do with inflation. In the short run, there certainly is a strong case for rising prices, whether demand-driven (if consumers tap into the huge volume of currently available savings) or cost-driven (if the trend towards fragmented global supply chains recedes). Furthermore, both governments and central banks ardently advocate such a pickup in inflation, as it would lower the real cost of national debt. So it would seem to make sense for investors to lift their inflation expectations mildly, at least in the short term.

But as suggested above, central banks aren't ready yet to relinquish their claim to independence and start taking all their cues from the government. And the long-term deflationary forces at work will be with us for quite a while. Moreover, colossal investments in cutting-edge technology over the past two decades have generated unprecedented economies of scale that are slashing the cost of the services delivered by that technology. This means that in addition to upending business models, new tech necessarily has a deflationary impact – thereby adding to the effects of overindebtedness. And in case we hadn't realised already, the 2020 public health crisis has revealed that a wide range of technology solutions can now respond – with almost unlimited capacity – to even staggering hikes in demand for virtual communication, access to information and data storage.

So it isn't because the ECB's Christine Lagarde and the Fed's Jerome Powell have stated their willingness to let inflation creep above their 2% target that it necessarily will – and especially not in the short term. What those statements do demonstrate, however, is that both central bank leaders are determined to keep real interest rates as low as possible. That provides bond markets with a fairly clear outlook and gold prices with additional support.

To sum things up: Though the prospect of a near-term improvement on the economic and public health fronts does argue in favour of some exposure to the "re-starting the economy" investment theme in our portfolios, the 2020 shock has strengthened our convictions on medium-term macroeconomic trends. Those convictions are what underpins our approach to portfolio construction. The backbone of our funds is accordingly made up of high-quality growth stocks (selected on the basis of the differentiated views provided by our equity analysts) gold miners, corporate bonds meticulously selected for issuers' ability to get through these troubled times with no major difficulty, and low currency risk.

Source: Carmignac, Bloomberg, 6/10/2020

Investment strategy

Equities

Equity markets flagged a bit in September in response to the uncertainty created by US politics and a second coronavirus wave in Europe. Profit-taking was focused on the top performers since the start of the year – meaning growth stocks. Even so, careful portfolio construction and stock-picking have demonstrated how effectively these tools can help asset managers make it through such periods of temporary sector rotations.

With little clarity on the business cycle for the months to come, secular growth stocks – a large portion of them in China – will continue to form the backbone of our equity investment strategy. Our baseline scenario of a feeble recovery does not, however, rule out the possibility that markets will begin pricing in the re-opening of economies, especially now that hopes are high for an upcoming rollout of an effective vaccine. That prospect is reflected in our equity portfolio through companies exposed to such re-opening and to gold. The former are mainly European outfits operating in asset-light segments of the travel , such as Amadeus, a Spanish provider of IT systems for plane ticket reservations and the like. In contrast, we are steering clear of companies – particularly carmakers and airlines – that have emerged from lockdown in such a battered state that their business models are badly shaken.

We have also participated in several initial public offerings. In fact, the IPO market has just experienced its busiest quarter since 2000. As with stock-picking, we take an extremely disciplined approach to companies seeking to go public. Before we invest, our analysts conduct in-depth research to assess the earnings growth that each company's business model potentially has to offer. Furthermore, as long-term asset managers, we view IPOs as a way to access attractive points of entry for long-range investments, rather than as short-term speculative bets.

Fixed income

After delivering bold monetary and fiscal policy responses to the Covid-19 crisis, central banks and governments seem to have taken a breather in September – despite the signs of an incomplete V-shaped global economic recovery and a second coronavirus wave, with Europe as its primary locus for now.

This political void of sorts is occurring in the runup to the US presidential election and against a backdrop of an upsurge in new cases of Covid-19. It has accordingly put a damper on risk appetite, most strikingly in the credit markets, which have undergone a mild correction although core interest rates have held steady. However, we still expect governments and central banks to adopt new stimulus measures in short order, once the political uncertainties in the US have cleared up.

This explains why we continue to believe that corporate bonds offer an attractive risk/return profile, based on the safety net provided by central banks and investors' excessively bearish attitude towards otherwise solid companies operating in sectors hurt by the pandemic. We are therefore maintaining our large exposure to credit, using a selective approach centred on high-conviction names. Core interest rates, which are currently rock bottom and enjoy less central-bank support, don't in our view offer much value at the present time. In Europe, we took advantage of the Italian bond rally set off by the Democratic Party's strong showing in the main regional elections to take profits. Lastly, we are sticking with our selective exposure to emerging-market fixed income. The risk/return trade-off looks particularly good on Chinese bonds as they offer real yields that are substantially higher than their G7 peers.

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