The late-cycle minefield

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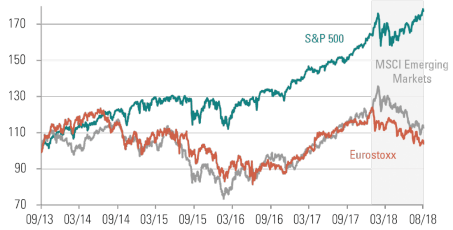
In our July Note published at the beginning of the summer ("Three-way collision"), we highlighted the dangers facing financial markets if three cycles ended concurrently: the monetary cycle (deflation of the liquidity bubble), the business cycle (a global economic slowdown) and the political cycle (resurgent economic nationalism). Developments since then have unfortunately corroborated our interpretation of the first tremors felt in the spring. The monetary component has primarily hurt emerging markets by drying up the flow of US dollars. The business-cycle component has affected commodity prices as well as Europe – unlike the United States, which is still riding high on the Trump administration's expansionary fiscal policy. Lastly, the political component has, here too, mainly hit Europe and the emerging world.

It's always tricky business sailing through late-cycle phases. Just when the first casualties start to fall – often among the most vulnerable – other economies are able to muster enough stamina to make one last desperate stand. This results in jarring performance gaps among regions, sectors and asset classes.

When three cycles come to an end at the same time, strange things start to happen

5-year performance of U.S., European and Emerging Markets (in USD)



Source: Carmignac, Bloomberg, 30/08/2018

The United States: making the most of "so far, so good"

The US stock market has been on a roll for three months, in sharp contrast to those in most other countries. The S&P 500 is currently up 9% since the year began, while the Euro Stoxx Index is down 2% and the MSCI Emerging Markets Index has shed 8%. This major divergence suggests that even with mid-term elections coming up soon in the United States, investors are still convinced that for the time being the America First doctrine is what matters for their portfolios.

US GDP growth figures remain stunning, well above what we anticipated (4.2% on an annualised basis in the second quarter). So do corporate earnings. And in July the US Consumer Confidence Index climbed to its highest level in nearly two decades. The US stock market has been outperforming for a while, but the trend is even more pronounced today. With fiscal stimulus taking up the slack from monetary stimulus at this stage, and with a rising dollar since the spring both reflecting and encouraging renewed capital inflows into the country, the United States is decidedly in a sweet spot in this late-cycle period. It is the only economy to get a shot in the arm as we enter the home stretch. So far, so good.

But we would do well to bear in mind that at the finish line, the US growth engine will also feel the impact of the global economic slowdown. Higher tariffs and sanctions against Iran will begin to take a bite out of US consumers' wallets. Tighter monetary policy will make financial conditions a lot less easy than they have been. And the magnitude of the budget deficit will become increasingly glaring. At that point, the US stock market will topple from its pedestal, most likely weakening the greenback in the process.

In the meantime, however, the troubles besetting the rest of the world merely reinforce the US market's privileged status. So it's worth remaining overweight there, but keeping a close watch on any signs indicating that we are entering the ultimate phase in the cycle.

Europe's structural weaknesses put to the test

Europe's economic slowdown is already leaving visible scars. For most leading indicators, the trend has reversed, and the same goes for consumer confidence and manufacturing activity. In our June Note ("The countdown"), we stressed how hard that shift would make it for the European Central Bank to go through with its plan to phase out its asset purchase programme by the end of the year. But that handicap now seems to have been factored in and, as suggested above, it may soon be the US economy's turn to produce disappointing news.

That said, the political turmoil in Italy may give rise to new existential doubts about the future of the European Union. The budget that the Five Star–League coalition plans to submit in Brussels on 15 October could kick off a period of high-voltage negotiations that include posturing, threats and one-upmanship. Of course, we may see a cruelly ironic twist of fate that allows the Italian government to use the tragic bridge collapse in Genoa to win approval for a hefty infrastructure spending programme that won't be counted against the 3% deficit ceiling. But it would be unwise to bet on it. The governing coalition's pledge to introduce a guaranteed minimum income, slash taxes and scrap the current pension reform all at the same time will more likely bring about a sustained increase in Italy's fiscal deficit. That prospect clearly can't be shrugged off by the European Commission, the ECB or the credit rating agencies – meaning it could also affect the value of Italian sovereign bonds and bank stocks. European assets should therefore be treated with considerable caution.

The emerging world as primary collateral victim of the late-cycle collision

As indicated above – and even more than we anticipated – the emerging economies have borne the brunt of the market stress since the start of the year. In drying up the global flow of dollars, the Fed has weakened the entire EM asset class and literally wrecked those countries most reliant on dollar financing (first Argentina, then Turkey). The trade standoff initiated by the Trump administration thus amounts to a double whammy, with contagion doing the rest of the damage.

On the brighter side, India's stock market performance (up 10% since the beginning of the year) is unquestionably the payoff for its ongoing robust domestic economic growth and credible monetary policy. Developments in China are also quite instructive. Beijing has made it clear that it fully intends to shield its domestic economy from the threat of a slowdown – a threat the US government's attitude has heightened.

As a result, cyclical stocks have done well. Ironically enough, the very growth stocks that were the top performers of the past two years are therefore the ones that have lost ground. Tech names in particular have taken a real beating, just when their US counterparts listed on the Nasdaq were breaking previous records.

What will these changes imply going forward? There can be little doubt on three counts:

- With US monetary policy normalisation only just beginning, we can expect ongoing pressure on the emerging world as a whole.
- We should also refrain from making any one-way bets in the "trade war" engineered by the United States. On this issue, there is simply no basis for taking a firm stance at this point.
- Lastly and most importantly, we should keep our eye on economic fundamentals – the only reliable wellspring of lasting market performance.

With that in mind, we can assert that China's growth stocks, most of them catering to domestic demand and many operating in the tech segment, now hold out tremendous potential for long-term performance.

> Chinese growth stocks now hold out tremendous potential

To sum things up, when three cycles come to an end at the same time, strange things start to happen. Time bombs begin to explode here and there, while the few available bomb shelters are soon overcrowded. In more technical terms, market corrections occur, initially without major contagion, while stock market leadership narrows strikingly. Halfway through 2018, the US stock market has greatly outstripped its global rivals, but just one name – Amazon – accounts for over a third of the overall performance. Add in Microsoft, Apple and Netflix and you have four stocks that have generated more than 80% of total gains in the S&P this year.

Asset management has become a perilous business. Its practitioners need to keep a level head in analysing the growing number of fragilities – and the highly concentrated bets prevailing in the markets.

Source: Bloomberg, 31/08/2018

Investment strategy

Equities

The concomitant shift in the business, monetary and political cycles has continued to fuel market instability. US equities, first and foremost tech stocks, have been the biggest winners of this past month, offering more predictable growth and earnings in today's risk-averse environment. In contrast, emerging-world equities have retreated further as US-dollar liquidity has evaporated and trade tensions have heated up. Meanwhile, European share prices have continued to suffer from a slowing economy and political uncertainty.

We view the current late-cycle phase as the main risk confronting stock markets, one requiring careful allocation to specific sectors and geographies and rigorous stock-picking. In this environment, we are maintaining our high exposure to quality names, chiefly in the United States. In addition to our investments in e-commerce and video games, we have upped our exposure to healthcare companies, including Philips Electronics, a formerly sprawling conglomerate that has refashioned itself as an innovative provider of healthcare-related technology. We have also taken advantage of weaker valuations for Chinese tech stocks to beef up a number of our positions such as Tencent, a company supported by strong domestic exposure and diversified growth drivers due to the wide range of services available on its platform.

Fixed income

In August, the dollar liquidity crunch and political turmoil did further harm to higher-risk fixed-income assets like emerging-market and Italian debt. The result was to strengthen the safe-haven status of US Treasuries and German Bunds.

In such a complex fixed-income landscape, we have moved to limit risk in our portfolios. We have sharply scaled back our allocation to EM debt, for example. While those assets still offer attractive valuations, we see too many risk factors in the developing world. We accordingly feel it is too soon to go back to sovereign bond-buying there. In corporate credit, the combination of an outlook for weaker economic growth, tighter borrowing conditions and a lesser appetite for risk point to the need to further reduce our exposure. In Italy, the new government's fiscal roadmap for 2019 is expected at end-September. We consider that reason enough to steer clear of Italian bonds. Lastly, we are still long US Treasuries as part of our drive to build up a portfolio robust enough to hold up well in an unstable environment.

Currencies

The Federal Reserve's move to deflate the liquidity bubble has starkly revealed where the weakest links in the emerging-market chain are. Investors have been trouncing the Argentine and Turkish currencies, and nothing that Argentina has done to support the peso (including hiking its benchmark interest rate to 60% and accepting an IMF loan package) has produced any relief to date. At the same time, the euro–dollar exchange rate is still being jostled by conflicting announcements on tariffs, monetary policy and economic growth expectations.

We have made no changes to our currency allocation. We have retained our long position in the yen to reap the benefits of its safe-haven status, and maintained our US dollar allocation to offset our exposure to commodities and emerging-market assets.

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