FLASH NOTE

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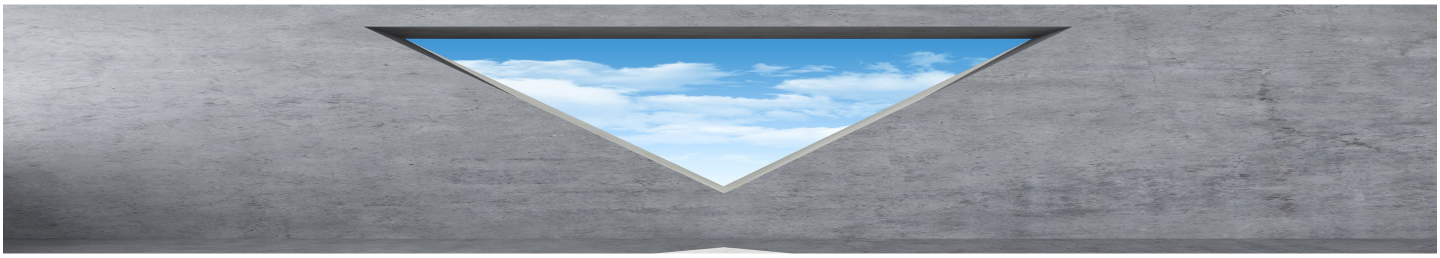

Carmignac - H2 2023 Outlook

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Resilient economies and sticky inflation mean central banks won't pivot in H2 2023. They will keep pushing the terminal rate until a recession dynamic is unmissable in the data.
But their resolve will face political tests as we move into 2024.
In fixed income, nominal and real-yields, as well as credit appeal.
In equities, markets are expected to continue walking a tightrope as long as the economy slows and doesn't fall off a cliff and the pace of disinflation keeps rates, and hence equities in check. We're leaning towards defensive stocks and sectors given the slower economic backdrop.

Economic perspectives – Raphaël Gallardo, Chief Economist

« The real cycle in developed economies has so far proved resilient to monetary tightening thanks to pandemic-induced changes in corporate and fiscal governance. Cash buffers accumulated in the private and local government sector, orders backlogs and higher desired inventories, and industrial policies all cushioned the effect of rampant monetary tightening.

But G10 central banks are not done. Sticky wage inflation, falling potential growth and low equity risk premia prevent them from declaring the end of the tightening cycle in 2023.

After a seemingly 'immaculate' disinflation to 3% in the next 12 months, returning to the 2% target will not be quite so smooth. It will require an increase in unemployment to typical recessive levels. Because risky assets do not embed in their pricing a recession scenario or an erosion of margins consistent with a return to the inflation target, the economic slowdown could be compounded by financial market volatility.

2024 will test central banks' resolve to follow Volcker's steps. As they keep pushing the unemployment rate higher, central bankers will face mounting financial stability risks and escalating political pressure. If they lose control of the recessive dynamic, fiscal dominance will be their main concern in 2025.

In China, geopolitics trump economics. The growth model is broken, but rather than trying to fix it, the leadership is focused on preparing the economy to weather "extreme scenarios". Monetary and regulatory easing will not suffice to stave off debt-deflation risk this year. We expect more forceful fiscal easing to come by Q4, which should allow a pick-up in global trade in early 2024. »

Our investment strategy – Kevin Thozet, member of the investment committee

Fixed income

« For now, we prefer core bonds with long to intermediate maturities (5 to 10 years).

Central banks' dependency on economic data means one has to prepare for a variety of scenarios. Confirmation of the economic slowdown and the pace of disinflation will push interest rates to much lower levels across the board. Conversely, if the economy shows even greater signs of resilience, this would lead central bankers to raise policy rates further, which in turn would weigh on the longest-term bond yields as more pronounced tightening of monetary policy increases the likelihood of the economy contracting sharply.

Real yields are also appealing given there is little to no easing being priced over the foreseeable future on the one hand and overly auspicious inflation expectations on the other. »

Credit market: mine the gap!

« Tighter lending conditions in the wake of restrictive monetary policy and slower economic growth is expected to result in a pick-up in default rates. And yet, both students of Schumpeter and vigilant credit investors can see long-term benefits.

Credit spreads are factoring in default rates greater than the GFC euro debt crisis period. This is a tempting divergence as the cost of risk has finally returned. Credit is expected to draw attractive returns on par with equity markets' long-term returns. »

Equities

« Markets are walking a tightrope. While the economy slows (but doesn't fall off a cliff) and the pace of disinflation keeps pace, rates and equities have been kept in check.

The fall in volatility (VIX at three-year lows) from its correlation component tends to be particularly conducive for stock selection. And the economic slowdown suggests a bias towards defensive stocks and sectors. We see opportunities in:

- **Healthcare**: Combining short-term resilience and long-term growth prospects.
- **Consumer**: Attention will shift to the lower cost base and how to benefit from a policy pivot (when it eventually comes), but a rotation from non-cyclical consumer to discretionary spending is far away. The key question is how disinflation and the economic slowdown will impact spending along with the risk of increasing price wars as retailers vie for attention.
- **Technology**: The AI bridge and a shift towards spending orthodoxy add depth to a sector which tends to fair well given prevailing economic conditions of falling long-term rates and slower growth.
- **Gold**: The emergence of a multipolar world along with risk of fiscal dominance provides long-term tailwinds for gold, a potentially appealing asset in a period of geopolitical uncertainty and mounting recessionary concerns. »

Further sources of diversification

« Emerging market debt in local currencies displays both a high carry, given the level of nominal yields and promising capital appreciation, given the level of real yields, should growth surprise on the downside. Along with long-term growth tailwinds. Besides, the segment is relatively immune to the "risk-on, risk-off" market narrative.»

See also: correlation and diversification