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2019, or the conclusion of the three-way collision

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Author(s)
Didier Saint-Georges

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As we enter the last weeks of 2018, our contention that market behaviour today reflects the concurrent monetary, economic and political shifts taking place should no longer raise many eyebrows (see our December 2017 Note, "Fooled by the Cassandra syndrome", and more recently, this past July, "Three-way collision").

But financial markets rarely adjust smoothly to new circumstances. They may start out in denial, as they did in January, only to scramble their way into correction mode, as they did in February and again in October. That makes it tricky to effectively implement even a sound strategic vision and, in that regard, 2018 will be remembered as a particularly disappointing, frustrating year for fund managers.

Even so, one can hardly anticipate market behaviour without first performing an overarching analysis. The time has now come to extend that analysis to 2019. A mere change of calendar year in no way signals the end of our three-way collision scenario. However, this collision is now likely to affect the fixed-income, equity and forex markets in differing ways. And while considerable caution is called for across all asset classes, there will also be upside opportunities that shouldn't be left unexploited.

Understanding how monetary policy normalisation interacts with the real economy

It's worth recalling the notion of "iatrogenics" which we introduced in our March 2016 Note, "Sleepwalkers". This medical term refers to any treatment that initially saves the patient, but subsequently produces side effects that prove detrimental to the patient's health. In 2018, as central banks finally began to reverse the tide of liquidity being injected into the markets, we witnessed the first side effects of years and years of investor addiction to what were in essence subsidised borrowing costs.

A stronger US dollar and the interest-rate hikes initiated by the Federal Reserve are among those side effects, and have therefore received a lot of attention. But they are by no means unusual developments at this stage of a business cycle. Conversely, the shrinkage of the Fed's balance sheet – after it had swollen by roughly $3.6 trillion since late 2008 – offers a striking example of iatrogenics. The repercussions of withdrawing $50 billion in liquidity a month from the financial system are as complex, and probably as underestimated, as were those triggered ten years ago by the start of quantitative easing.

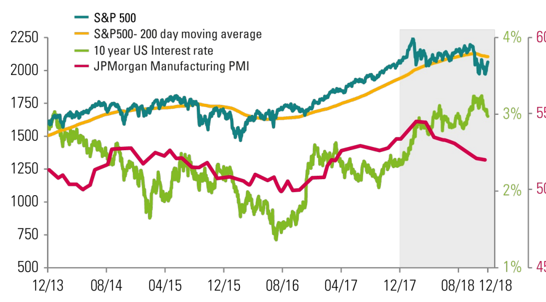
Events in 2018 have already demonstrated, for example, that such a reduction in the supply of available dollars, combined with a Trump-engineered tax reform designed to encourage capital repatriation, has siphoned off the dollars held in emerging markets and reinjected them into the US economy. That outcome alone is in large part responsible for the major stock and bond market corrections that have buffeted Latin America and Asia.

In broader terms as well, global economic growth and above all world trade depend heavily on how much dollar liquidity is available. The Fed has in a sense become the central bank of global growth. Little wonder, then, that China's exports have already slowed – even before Washington's protectionist measures targeting Beijing heighten the impact of the ongoing collision, once the truce hammered out in Buenos Aires expires. Moreover, that slowdown comes on top of a more structural decline in output due to the need to deleverage the Chinese economy.

Economic indicators in Europe, which tend to move in tandem with world trade, have likewise gone into reverse, and the recent relapse in French consumer sentiment hardly bodes well for domestic demand.

But even American exceptionalism increasingly shows tangible signs of vulnerability, whose primary cause is the Fed scaling back its balance sheet just when the Trump administration's Federal budget entails a huge increase in the debt-funded deficit. This additional collision has lifted US 10-year Treasury yields from 2.4% at the start of the year to peaks exceeding 3.2% in October and November, and the resulting jump in mortgage lending rates has crimped residential investment. Aggravating the collision, the role of the wealth effect in sustaining consumer spending – one of the major channels through which QE stimulated the real economy – has begun to teeter as the real estate and equity markets hit their first bumps in the road. Lastly, US capital expenditure stalled in the third quarter. The uncertainty surrounding the trade tensions with China has clearly put a damper on corporate investment plans.

EQUITY MARKETS, INTEREST RATES AND GROWTH



Source: Bloomberg, 30/11/2018

No doubt about it: the current slowdown in the global economy is colliding with a drive for monetary policy normalisation that can only weaken growth further.

Enter the political cycle. From Brazil to Europe, from the United Kingdom to the United States, the winds of rebellion are blowing. And they are challenging the mechanisms of globalisation and free trade that had supported worldwide economic growth and profit margins for multinational firms.

At the same time, and most notably in Europe, public opinion is becoming more and more polarised, and turning away from the conventional, often highly fragmented, political mainstream. Representative democracies thus find themselves under serious pressure and increasingly bypassed by the direct – and frequently confrontational – expression of political and social discontent. That discontent is being reflected in mounting resistance to the fiscal virtue mantra that has held sway since 2008. Already well entrenched in the United States, this brand of opposition has spread to Italy and is likely to be one of the outcomes of the social tensions that France is now experiencing. Its impact on fixed-income markets is to drive up sovereign yields. Equity markets will in turn be affected by a likely shift in economic policy – in Europe at any rate – in favour of labour rather than capital.

> The end of a given monetary policy stimulus unavoidably raises the cost of risk, thereby reducing price/earnings ratios

The resulting market outlook

With monetary policy stimulus no longer a given, a new cycle of lower risk appetite has visibly been kicked off in 2018. Central banks' policies of regularly and massively purchasing financial assets suppressed market volatility and therefore encouraged investors to take risks. The return to uncertainty, or even the new certainty that available liquidity will necessarily decrease, has unavoidably raised the cost of risk, thereby reducing price/earnings ratios and widening credit spreads. Those trends are set to continue into the new year.

A key risk facing equity markets, perhaps even more so in the United States than in Europe, is that further confirmation of the economic slowdown under way will push down company earnings – and the considerable financial leverage built up over the past decade will make matters that much worse. In corporate credit as well, the cyclical increase in default rates – which is occurring together with an upward trend in risk-free interest rates – means much greater vulnerability for investment-grade bonds, whose returns have all but ceased to reward the associated credit risk.

Government debt levels could also put more fragile economies in a bind as GDP growth falters. Think of Italy: if the economy were to slow appreciably, we can expect investors and credit rating agencies to question the sustainability of the country's national debt. On the upside, the continuing rise in the cost of risk can be expected to keep yields on sovereigns with long-standing safe-haven status within reasonable limits.

Sooner or later, the leading central banks will have to raise the white flag and relinquish any further policy normalisation. When they do, the prospect of a return to reflationary policies may give wings to risk assets, with cash-starved emerging markets no doubt heading the list.

> Sooner or later, the leading central banks will have to raise the white flag

We consider that outcome plausible in 2019. But it's hard to imagine it happening until financial conditions have tightened sharply enough to force central banks to change their tune. That tightening might be triggered by an over-correction in the stock market – which, it is worth mentioning, would create attractive entry points as investors sprint for the exits. In the meantime, the three-way collision scenario we have identified can be expected to continue, albeit interspersed with periods of calm. So our outlook for 2019 boils down to a highly cautious blend of watchfulness and opportunism.

Source: Bloomberg, 30/11/2018

Investment strategy

Equities

After three quarters of extreme financial market disparities that propelled American equities to new highs, the bull trend was finally halted in October. US stock exchanges underwent a massive correction that dragged equity markets around the world down in the process. The Fed's monetary policy normalisation drive has predictably curtailed P/E ratios, making it sensible to moderate our previous single-minded focus on high-quality growth names and give greater weight to their valuations.

Consequently, we have switched from hyper-growth stocks to growth stocks that look good from both the financial and the valuation perspectives. This includes companies like Alphabet, Booking.com and Electronic Arts. They are reporting revenue growth of 10-20% with a reasonable P/E ratio of 18 to 20. More generally speaking, we have been reducing the number of stocks to focus only on our highest convictions, counterbalanced by increased cash holdings. In the near term, the speed of market correction suggests technically oversold positions, which may leave room for a potential relief rally. However, with disparate performance still the name of the game, we are sticking to a defensive portfolio construction, combined with lower equity exposure and option strategies designed to capture the upside of possible technical rebounds.

Fixed income

In our core rate portfolio, we have several reasons for maintaining duration neutrality. The changing correlation between bond and equity markets, political risk in Europe, a slowing global economy and inflation on the wane – due in particular to an unprecedented tumble in oil prices – all point to a pause in the rate-rise cycle. In the United States, Jay Powell's less hawkish recent statements suggest that the Fed Board realises that the country's economic indicators are beginning to flash red. However, financial markets still seem complacent, above all in Europe, where the consensus forecast is for a relatively dovish hiking path in the eurozone, whereas US yields already price in higher growth and building wage pressure, and the Bank of Japan is adjusting policy for a steeper curve.

We are therefore gearing up for active management of our core fixed-income positions in the months to come. The stretched valuations of corporate bonds put the entire asset class at risk now that economic fundamentals are gradually weakening and liquidity is continuing to dry up. Those factors have led us to reduce our exposure to corporate credit and raise the level of cash and cash equivalents in our portfolio.

Currencies

The forex market shows no clear trend for the exchange rate between the euro and the US dollar, the two key currencies. There are still many factors that could weaken both of them. The greenback is hampered, as before, by a rising fiscal deficit and the first signs of a slowing US economy. The euro, in turn, continues to suffer from the risk of resurgent political instability and less vigorous GDP growth than in the United States.

In response, we have been reinforcing our exposure to the euro as part of overall FX risk reduction in the portfolio. Lastly, EM currencies remain a vulnerable asset class now that the US Federal Reserve has begun deflating the liquidity bubble.