A journey into uncharted territory

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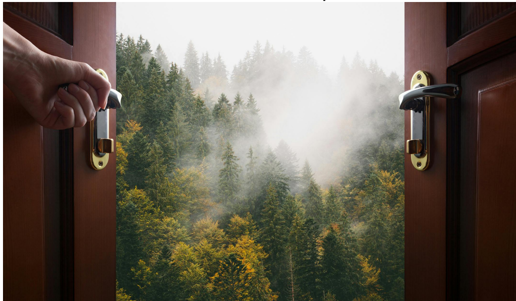
Investors are used to dealing with uncertainty – the very essence of financial markets – as they seek to anticipate what is necessarily an elusive future. However, these past six months have driven uncertainty into entirely uncharted territory, and in more ways than one. Rather than panicking, we feel we can and should rationally analyse what is occurring so as to grasp its full implications. That, after all, is what risk management is all about.

A brief review of financial market patterns



Since the start of the year, equity markets initially responded to the extraordinarily potent economic shock caused by the Covid-19 lockdown measures, and subsequently to the unprecedented interventions by governments – which increased fiscal spending – and central banks – which financed that spending. As this tour de force winds down, the sense of a huge disconnect between financial markets and the real economy has rightly made many investors wary.

That said, there is nothing really surprising about recent short-term market behaviour, as it reflects the same underlying patterns we've been seeing for ten years. Those patterns rest on three assumptions:

1) Weak real consumer demand precludes any risk of consumer-price inflation. The inflation caused by an expanding money supply is therefore to be found primarily in financial asset prices.
2) The ongoing uncertainty keeps central banks in a state of alert and suggests that they can be counted on to intervene promptly whenever required.
3) The overall scepticism among investors and the resulting cautious positioning should prevent the formation of bubbles, and thus help support financial markets.

However, this short-term uncertainty – a factor that markets now handle with their eyes closed – is currently masking the emergence of other, much deeper forms of uncertainty. And though it may be too soon to eliminate them, we feel that this is a good time to start incorporating them into our thinking.

Public health – the first unknown

The first big unknown pertains to public health. The fact that the pandemic remains active, particularly in the United States and several emerging-world countries, or may even be globally resurgent has created a radically unprecedented situation.

Whole sectors of the economy will have to adapt to what are bound to become lasting shifts in how we work, communicate, stay informed, consume and get entertained. The process of adjusting to such far-reaching changes could lead to considerable pressures in specific industries (e.g. conventional media, transport and mass leisure) – while at the same time spurring strong, profitable growth in others (as reflected in the sharp rise in the e-commerce uptake rate and the sea change in how media content gets produced and consumed).

These factors are already shaping the sector and thematic positioning of our funds, and will continue to inform our thinking over the months to come.

The economy – the second unknown

The second major unknown has to do with the consequences of colossal fiscal deficits, which are driving up national debt at a time of extremely shaky economic growth.

The current baseline scenario for investors is that the world economy is on the road to across-the-board "Japanification", consisting of low GDP growth and astronomical debt levels. What makes that combination possible are high savings rates and central-bank balance sheets overloaded with debt instruments issued by governments (and soon the private sector too).

The assumption that interest rates will remain rock-bottom – a sine qua non for the survival of such an arrangement – is made credible by the currently low economic output compared with potential output. That output gap removes the risk of demand-fuelled inflation.

Another noteworthy development is the stunning comeback of the welfare state.

The vast majority of the US population earns too little income to be able to build up precautionary savings, whereas the stock market is continuing to set record highs. Mounting inequality has become a source of growing rebellion in society. In the upcoming US presidential election, that rebellion could support an unapologetic commitment to state intervention, based on a strengthened public sector and much broader redistribution of society's wealth.

In Europe, clearly no country is powerful enough to tackle on its own the daunting challenge of sustaining economic growth in such unsettled worldwide conditions. That realisation is encouraging Germany to work towards European integration, thus giving the eurozone greater cohesion. At the same time, the need for growth could also sweep aside a good many misgivings about spending money on major infrastructure programmes, above all in the crucial area of preserving the environment. The integration imperative (in Europe and elsewhere) and the advent of large-scale socially responsible investing should thus be viewed as themes greatly favoured by current circumstances. We have incorporated those themes into our portfolio construction.

However, within a time span that is hard to estimate at this point, that outlook may hit a wall if investor confidence in currencies ever wanes. We may be heading for a climate of general distrust towards major currencies, which we feel will require careful management. We have accordingly maintained very little currency risk in our portfolios, and we also hold gold stocks to be able to deal with a limit-bound scenario for fiat money.

Like any major trauma, the current public health crisis, which has since morphed into an economic crisis, is shining a merciless spotlight on existing fragilities. It is underscoring the value and necessity of robust risk management. And it is acting in many respects as a powerful accelerator of history. In today's rapidly changing environment, those companies best suited to the emerging dynamic will consolidate their lead. The challenge in the coming months will be to navigate what are almost sure to be unstable markets, while keeping an eye out for the winners of tomorrow.

Source: Carmignac, Bloomberg, 30/6/2020

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