



Financial markets caught between too much and too little confidence



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With summer drawing to a close and equity markets going strong, investors would do well to focus on two key issues. The first is China's recent shift to much tighter regulatory scrutiny. The second, which is equally important for the stock market, is where bond yields will be heading in the coming months.

The issue of Chinese political risk

The recent government crackdown on specific segments of China's new economy is far tougher than similar moves seen in 2015 and 2018. By going after several sub-sectors of the new economy in a short timespan, the government is seeking to provide a lasting fix for a number of imbalances like market dominance and social inequality, with the result that valuations have been significantly impacted. But does this suggest that, to ensure "common prosperity" or in the interest of the strategic rivalry in high tech between the US and China, decision-makers in Beijing are prepared to permanently weaken the country's top internet groups and to attack private property or the legal structures like "variable interest entities" that were established to enable Chinese companies to offer shares abroad? Our answer is a resounding "no".

Such a policy would fly in the face of the government's strategic and necessary aim to gradually open up China's capital markets. Put in place a few years ago, the "Stock Connect" link between the Hong Kong Stock Exchange and stock markets in the People's Republic by now ensures a steady flow of financial investment into China, representing a decisive step forward in the trend towards market opening. Such a move would also conflict with Beijing's long-term goal of boosting the yuan's status as an international reserve currency.

What's more, the Central Financial and Economic Affairs Commission has just clarified the Communist Party's societal objectives, emphasising the gradual nature of the changes under way and the Party's eagerness to foster a healthy private sector in China. A number of statements by government figures over the last few days likewise underscore how important the Hong Kong Stock Exchange is to China and clearly indicate that Beijing has no intention of putting a stop to the listing of Chinese companies in the United States.

But given how severe the current regulatory clampdown is, does it make sense to at least start including higher valuations in China in the models used to value Chinese companies? Once again, our answer is "no".

Most of the measures announced are still consistent with the Chinese Communist Party's long-range goals and ambitions. And however harsh those measures may seem, the government's will to tackle, for the sake of common prosperity, the increasingly blatant harm being done to society by the market imbalances achieved by a number of leading new-economy firms is not really that different from a range of concerns frequently voiced in western economies. Similarly, exorbitant after-school tutoring costs and skyrocketing property prices in the vicinity of good schools reflected the trend towards increasingly unequal opportunity for children – which is by no means unique to China. And to cite a further example, the precarious working conditions of millions of self-employed meal delivery people was becoming a social problem.

We believe that China is still a market worth investing in

The current wave of stricter regulations for specific heavyweights in China's new economy has certainly hurt market performance relative to those companies' US peers. The Nasdaq Golden Dragon China Index, which comprises a number of leading Chinese tech names, has retreated by 23% since the start of the year, whereas the Nasdaq 100 has gained 18% over the same period. The new measures have even led to corrections in corners of the Chinese equity market that weren't directly targeted by them. For example, the providers of internet infrastructure used by online companies – such as those operating cloud services and data centres – have lost a large share of their market capitalisation. The result is that many companies are now attractively valued when compared with historic P/E ratios and their US peers.

For all these reasons, we believe that China is still a market worth investing in – provided that you proceed selectively. We are therefore sticking with our convictions on a range of Chinese new economy stocks. As before, our approach is based on identifying companies with strong growth potential, competent management and healthy balance sheets that have predictable long-range trends working for them. And considering the pace and orientation of the latest government announcements, it seems increasingly likely to us that this new regulatory environment will gradually improve. That will enable investors to start pricing in new information and see for themselves that the companies discussed here are quite attractive indeed.



A directionless bond market for now

In line with our central scenario of an upcoming cyclical slowdown, as described in our July Note, [“The iron law of the business cycle”](#), bond yields resumed their downward movement at the beginning of the summer. So should investors position their portfolios for declining yields in the months to come? We don’t think so.

The predicted rise in US hiring could eventually translate into substantially higher wages, particularly for lower-skilled workers. In addition, a number of items used to calculate monthly inflation such as rents (weighing 40% of the CPI basket) are likely to extend the rising price trend initially caused by supply-chain disruptions. If they do, inflation may prove to have greater staying-power.

The Fed might thus find itself saddled with a kind of ‘stagflation 2.0’

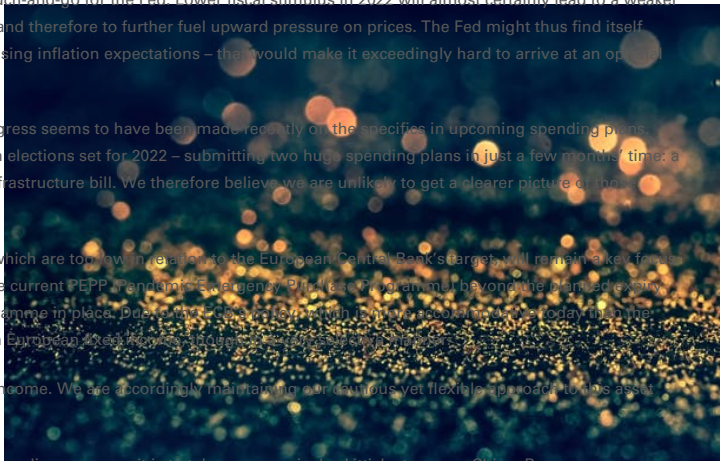
The Fed seems to be on its way to normalising monetary policy, but with a very gradual approach. Its main indicator, the labour market, is showing signs of tightening, though the Delta variant of Covid-19 still needs to be monitored closely. As signalled at the Jackson Hole Symposium, it looks like the US central bank will start dialling down its asset purchases towards the end of the year, probably in December. But the situation is still tough and on for the Fed. Lower fiscal stimulus in 2022 will almost certainly lead to a weaker GDP growth rate in the US. However, we expect that rate to remain well above potential and therefore to further fuel upward pressure on prices. The Fed might thus find itself saddled with a kind of “stagflation 2.0” – i.e., slower economic growth accompanied by rising inflation expectations – that would make it exceedingly hard to arrive at an optimal monetary policy.

It is still unclear where the Biden administration’s fiscal policy is heading. Significant progress seems to have been made recently on the specifics in upcoming spending plans. Even so, the Biden administration has truly gone out on a limb – especially with mid-term elections set for 2022 – submitting two huge spending plans in just a few months’ time: a “physical” infrastructure bill that is designed to get bipartisan support and a “human” infrastructure bill. We therefore believe we are unlikely to get a clearer picture of their plans before October at the earliest.

Europe currently offers a more benign environment than the US. Inflation expectations, which are too low in relation to the European Central Bank’s target, will remain a key focus for the ECB’s policymakers. The latter will likely continue to discuss whether to extend the current PEPP (Pandemic Emergency Purchase Programme) beyond the planned expiry date in March 2022, rather than automatically reverting to the older Asset Purchase Programme in place. But overall, we are less bullish on the economic recovery today in the European “recovery” stage than we were in the US.

All this suggests that the time hasn’t come yet for highly directional positioning in fixed income. We are accordingly maintaining our cautious yet flexible approach to this asset class.

This means that today it is just as unwarranted to have blind faith in anticipated monetary policy moves as it is to take an excessively skittish stance on China. Because we manage our bond portfolios with the utmost caution, we are poised to adjust to any shifts in monetary and fiscal policy. In our equity portfolios, we are overweight growth names that have the resilience needed to weather possible disappointments regarding GDP growth. And we are maintaining our convictions on a range of high-potential Chinese stocks whose prices have recently fallen to very attractive levels.



Investment Strategy

Equities

Over the summer, equity markets continued to rally in unsynchronised fashion. In the developed countries, the rebound was driven by higher second-quarter earnings and an interest-rate environment that is still kind to risk assets. In the emerging world, however, the Chinese government's announcements on stiffer regulation of mega-firms triggered a market selloff. With the government now clarifying its aims, the market should be better equipped to assess the situation and consequently to stabilise.

Our holdings in China are highly selective. They are mainly in companies that serve the domestic market and are aligned with the government's long-range plans. These holdings continue to offer attractive growth prospects, and at current valuations they have considerable upside potential in our view. We own stocks in the following sectors: tech (cloud service providers, semiconductor makers and web companies), healthcare and renewable energy.

In the developed world, leading economic indicators show signs of going into reverse, while inflation might well surprise to the upside. At the same time, earnings forecasts are heading downwards as investors focus increasingly on the outlook for 2022. We therefore continue to favour companies we expect will do well in the current climate, i.e., companies with predictable earnings growth and strong pricing power. But the fact is that very few companies can thrive in such an environment. In general terms, stock-picking looks set to become our key performance driver again in a climate where returns may well diverge increasingly.

Fixed income

Fed Chairman Jerome Powell restated at the Jackson Hole Symposium that he would be in favour of tapering his bank's stimulus programme before the end of the year if the US jobs market continues to tighten. The future of short-to-medium-term US interest rates remains hard to assess. On the one hand, you have the Delta variant of Covid-19, flagging labour market data and uncertainty over fiscal policy and consumer spending. On the other, you have mounting inflationary pressure that could prove to be less transitory than forecast.

That uncertainty is reflected in how bond markets have behaved over the past few weeks. We have accordingly opted for moderate modified duration. In Europe, we have tactically scaled back our holdings of non-core sovereign bonds in which we were invested in the past few months. In sovereign debt, then, we continue to favour countries with plenty of room for easing, for example China. The country, which is already quite far along in the economic cycle, offers interest rates that are amply positive in real terms, and has room to adjust fiscal and monetary policy. This contrasts sharply with the kind of financial repression that holds sway in the West.

In corporate credit, a possible withdrawal of liquidity and weaker GDP growth could lead to wider credit spreads. However, in the current atypical cycle marked by enduring financial repression and deeply negative real interest rates, a policy of actively selecting bonds stands a good chance of paying off.

Source : Carmignac, Bloomberg, 31/08/2021

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