CARMIGNAC'S NOTE

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HOLDING STEADY

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A month ago (see our Note dated 2 March, "**The cost of fear**"), our take on the state of financial markets boiled down in essence to four observations:

- The current epidemic is a sort of "Black Swan" in that it constitutes an unpredictable, high-impact event as theorized by essayist Nassim Taleb.
- The western world is now entering the phase of exponential increase in infection rates, which many may well underestimate.
- Governments will have no other option than to introduce extraordinary prevention and control policies that will have a devastating impact on economic activity.
- Central banks have suppressed volatility and subsidised the cost of capital for a decade, leaving financial markets vulnerable.

Though with the wisdom of hindsight we may now wish that we had pushed our analysis in an even more radical direction, it was still clear enough to help us proceed very cautiously throughout March.

We also stated that "fiscal spending would be required … in addition to monetary policy intervention", while stressing that "the United States might be the first country to take decisive fiscal action". On this last score, we hit the nail on the head. The Fed promptly returned to a program of unlimited quantitative easing, and after briefly wavering the ECB literally followed in the Fed's footsteps. The US Congress agreed a bit later to an unprecedented fiscal spending package.

In the short term, these developments provided favourable conditions for us to do away with some of the hedges we had previously put in place. But these unorthodox moves were an absolute necessity and they provide an indicator of just how high the pressure was on equity markets and perhaps even more so on fixed-income markets. It cannot be said today that the volcano has been extinguished, and that alone is reason enough to maintain maximum vigilance.

The current period is truly exceptional in public health, economic and financial terms. Our aim in this Note is to go further with our effort to put it into strategic perspective so that

we can anticipate the implications and ramifications it will have.

The first phase of the crisis is drawing to a close

As we mentioned last month, it took the medical community, politicians and investors a while to realise how serious the matter was, due to a number of well-known psychological biases.

The first one is mental model bias. People consistently try to relate even dramatically novel phenomena to past experience – in this case, seasonal flu or the SARS epidemic (in other words, they have a hard time recognising a Black Swan event when they see one). Or they fail to grasp what an exponential increase entails – i.e., that a 27% growth rate means the numbers will double every three days, or that a forest fire can be put out with one glass of water if you act in the first few minutes, whereas a few hours later not even a group of Canadair water bombers can douse the flames. The delayed reactions caused by this kind of mental bias proved devastating to the economy and financial markets in 2008 – as they have this time around.

Next comes ingroup bias, which conditioned many to underestimate how interconnected the world is. The outbreak in China was initially perceived to be remote and largely irrelevant to Europe; the epidemic in Italy was viewed as specific to the country; and then the drama unfolding in Europe was shrugged off by the United States.

Last of all, a form of herd instinct had led a large number of investors to prefer the comfort of going with the trend – however artificial it was. Yield and volatility suppression over the past decade had thus come to be seen as the new normal, giving legitimacy to risk-taking and leverage under any and all circumstances. The economist Hyman Minsky is famous for demonstrating that too much stability paves the way to market fragility, but his observations had been conveniently forgotten. The "rude awakening" we are now experiencing seems to be drawing to a close.

The speed with which equity markets have corrected since the beginning of the year – by 20 to 30% on average – unquestionably shows that the truth has dawned on most investors. However, accurately quantifying the immediate and long-term economic shock we are in for is still very tricky business. No pre-existing model is really capable of measuring how strict confinement to varying degrees of 40% of the global population in nearly 80 countries – including 70% of the US population – for an indefinite period will actually play out. It is therefore safe to assume that financial markets will in the near term be buffeted by powerful spates of instability. Only further down the road can we hope to have any real clarity about what form the following phase will take.

What will "the day after" look like?

It's usually a bad idea to think about life on the other side of the river until you've successfully made it through the eddying currents still to be crossed. On the other hand, trying at least to envision it makes a fair amount of sense for investors.

To start with, we can't stress enough how fraught the financial backdrop was when Covid-19 first hit. Central-bank policies were fast approaching the point of having gone as far as they could go, whereas they had yet to bring nominal GDP growth (real growth plus inflation) back up to where it had been prior to 2008.

Over the past several days, those same central banks have gone "all in", to use a piece of poker lingo, "betting the farm" in an effort to restore government and corporate debt markets roughly to their normal state. This looks so far like a promising bet, though it's too early to say whether it will be a winning one. But in any case, the crucial point is that, even if central banks are still able to maintain the financial system's integrity, they can no longer claim to be driving an economic recovery in any shape or form.

> **"A scenario of lastingly high fiscal deficits is emerging, with the potential to spark distrust in paper money"**

We are thus entering a new era. In terms of stimulus, governments will have to do most of the heavy lifting this time around. (They are already providing income replacement for as long as the economic lockdown goes on.) But as most of them have yet to overcome the precarious financial condition the 2008 crisis left them in, the question of how such an unprecedented fiscal spending drive can be financed must be addressed. A big levy on the private sector would obviously be counterproductive, whereas shrinking public service budgets would be socially and politically a non-starter. The central scenario that seems to be emerging is thus one of lastingly high fiscal deficits that will force central banks into the position of government debt-buyers – this time of "first resort" – in order to keep financing costs down to tolerable levels.

It is worth noting that this major shift to ballooning fiscal deficits – financed directly by central banks at rock-bottom lending rates – would become much harder to manage if inflation expectations were to pick up. For the time being, the deflationary forces at work appear to be powerful enough in both secular and cyclical terms to make a surge in inflation unlikely, but that risk can't be dismissed out of hand. A further consequence of this shift could well be mounting distrust in paper money once governments begin openly printing it to finance deficit spending. That distrust could open the floodgates for a phase of monetary instability in which real assets – and here the example of gold springs instantly to mind – would come out ahead.

> **"The shock to confidence affecting all economic agents seems hardly conducive to a V-shaped recovery"**

We suspect that "the day after" could be characterised by considerable behavioural hysterisis – blowback from the shock to confidence affecting all economic agents. As we indicated last month: "It's human nature to seek insurance after a storm breaks." Just as individuals will be likely in the future to hold a larger share of cash savings (53% of the US population have no precautionary savings), governments will almost certainly want to onshore the production of goods suddenly deemed "strategic", companies will question the lure of just-in-time supply chains, and investors will rediscover the value of maintaining a safety cushion in their risk taking.

We doubt such a state of affairs will be conducive to higher corporate profit margins or, for that matter, to a V-shaped global economic recovery once the public health crisis is over (a view apparently corroborated by the initial economic data from China).

For investors, this may herald an end to the passive investment miracle and revive interest in active investment styles that show an ability to manage market risk and identify companies that will stand out from the crowd in the long run.

What does this mean for our portfolios?

Because we expect the market instability to continue in the short term, our hedging policies in all asset classes remain in place, while we actively and tactically manage our exposures. In contrast, our underlying equity portfolios show great stability. The names we hold, most of them related to digital transformation themes, span sectors ranging from retail (including food) to healthcare to entertainment, most notably cloud gaming.

It is worth noting that China – whose current account balance is being buoyed by falling energy costs and a collapse in Chinese travel abroad – possesses the kind of domestic economy that makes it a prime location for investing in such themes. A final point is that the reduction of systemic risk by central banks over the last several days has enabled us to buy a select number of corporate bonds on extremely favourable terms.

Just as the dedication evinced by doctors and nurses and the self-discipline shown by ordinary citizens will eventually win out over the epidemic despite the trying conditions they face, we as asset managers must hold steady and continue focusing on risk management and long-term convictions so that we can most effectively serve the interests of the clients who have entrusted us with their savings.

Source: Carmignac, Bloomberg, 31/03/2020

Investment strategy

Equities

The current public health crisis shows just how fragile financial markets have been over the past several years. Years of unconventional monetary policy have eliminated volatility and directed investors towards risk assets. The upshot is that the brutal deflationary shock caused by plummeting demand – and worsened by the oil shock – has set off a wholesale collapse in equity markets. To tackle this abrupt surge in financial and economic risk, central banks and governments finally announced sweeping measures that gave markets a breathing spell. We took advantage of it to partially and tactically re-expose our portfolios to equities.

However, as the latest fiscal support policies are geared more to income replacement than to economic stimulus, we are focusing our equity portfolio on companies whose growth profiles are relatively unaffected by macroeconomic developments. At the same time, we are keeping our distances from companies with heavy debt loads, given that the lockdown could drain the cash reserves of some of them.

We have also maintained our exposure to Chinese stocks now that the country is gradually emerging from confinement and its balance of payments is improving. Our exposure is limited, however, to domestic "new economy" names.

For this portfolio of international holdings, we are actively managing our equity exposure on the assumption that the macro environment will remain unstable for quite some time.

Fixed income

All asset sub-classes in the fixed-income market were seriously unsettled during the period. After liquidity began drying up in credit markets, fears over a solvency crisis triggered a huge jump in credit spreads, even for the highest-rated issuers. Sovereign bonds from countries considered safe havens also took a hit, with the US Treasury market – the most liquid of all – coming under serious pressure. Fortunately, swift, massive action by the Fed and other central banks was enough to ease that pressure.

We are sticking with our highly cautious approach to government bonds, both core and non-core. Though the measures announced by the ECB will provide support for sovereigns from the eurozone periphery, we still don't feel these bonds offer a good enough risk–return profile, particularly as national debt is likely to rise and GDP growth to be extremely low. We have therefore taken advantage of the renewed liquidity ushered in by the ECB's policy to scale back our exposure further.

In corporate credit, the revenue replacement schemes offered by the various governments to stave off a slump have reduced solvency risk for top-tier issuers and thus given us an opportunity to return selectively to this asset class.

We have kept our exposure to emerging-market debt low. Many EM central banks are still haemorrhaging dollar liquidity – a disturbing sign of fragility.

Currencies

The US dollar, as it turns out, was in great demand over the period, both as a means of payment and as a reserve currency. The serious pressure on US yields convinced the Fed to pump unprecedented amounts of liquidity into the market. Now that the Fed’s interventions – announced as being unlimited – are seen to have stemmed the dollar liquidity strain, the appreciation of the greenback should slow.

We have therefore kept the euro – the reference currency for our strategies – as our primary currency exposure in order to limit exchange-rate risk in an abidingly uncertain environment.