



Long-term investors should be wary of populism

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The British equity market has gained 20% since the referendum on 24th June resulted in favour of Brexit. The S&P 500 is up 9% since Donald Trump was elected President of the United States. Does that mean that, irrespective of any objections one might have on social or even moral grounds, the victory of populists at the polls should be considered in investors' interests at least on financial grounds? We don't think so.

SYNCHRONIZED IMPROVEMENT IN LEADING INDICATORS



Source: Carmignac, OCDE, 31/01/2017

We are convinced that the enviable, to date, rally in British and American stocks is driven less by the economic virtues of the winners' policies than by the global economic recovery under way. As a reminder, the Emerging Market Index has added 16% in the past year the Euro Stoxx Index 18% and the Nikkei 17%. The rally also reflects the victory of the short-term hopes created by campaign promises over sober analysis of how the proposed policies will play out in practice.

As in twentieth-century Europe and Latin America, populism today involves appealing directly to "the people": a charismatic figure bonding with his followers to form an exclusionary "us" in a defiant struggle against "them", i.e. The media, the establishment, immigrants, China, Brussels, judges, opposition parties, banks, the wealthy, foreigners, etc.. Angry tweets to supporters have logically become the suitable modern communications tool for populist leaders. The referendum is also logically their favourite expression of democracy. Its hallmark "us against them" mantra is what gives populism its combative edge. It also provides a striking illustration of how "minority rule" works when a small, but highly determined group manages to upend a long-standing majority that has lost the ability to rally its troops.

However, the primary reason why mainstream political leaders now find themselves shaken is that they have failed to respond effectively to genuine popular discontent, which has been doubled with a keen sense of injustice. Populists, thus, draw sustenance from economic truths that would be suicidal to disregard. But they offer poor solutions. They pass off economic nationalism as a workable alternative to our increasingly interdependent world. They advocate security at the expense of freedom and conservatism at the expense of innovation – undermining cooperation, diversity and the rejection of parochialism in the process, all of which are crucial to long-term success.

Like last year, 2017 will be a year of high-stakes elections in Europe. And the outcomes will have major consequences for savers.

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« Brexit means Brexit »

With all due respect for the democratic will of the British people, we feel we must call a spade a spade. The vote for Brexit was politically driven, but its economic impact for the United Kingdom will be great. Although we would hope that EU negotiators won't exploit what suddenly became a better hand of cards to punish the British for how they voted, the negotiations, which formally kicked off on 29th March, are shaping up to be tough going for the United Kingdom. Not only will the European Commission present it with a divorce bill of roughly €60 billion prior to the start of actual talks, but Britain will also walk towards an inevitable deterioration of its trading terms with its number-one business partner – , all this for the sake of "taking back control".

All trade agreements rest on mutually agreed constraints. So that the current preferential access to the Single Market within the EU's harmonised regulatory framework will have to be replaced by a vast number of no less constraining agreements, to be bargained over one at a time. Sterling's 16% slide since the June 2016 referendum reflects how much of the UK's wealth Brexit may ultimately destroy. That depreciation has already wiped out 80% of what British investors have earned in the stock market over the past nine months. It also conjures up the spectre of a rising cost of living for the country's population (inflation already rose from 0.5% in June 2016 to 2.3% in February 2017) and of employers moving jobs out of Britain to sidestep trade barriers.

Donald Trump: all tweeted out?

Consumer and small business confidence in the United States has picked up impressively since Donald Trump won the election. His promises to slash taxes, ease regulation, raise tariffs and boost government spending have had a powerful psychological impact that could in part become self-fulfilling. This hope has enabled financial stocks to significantly outperform the rest of the market over the past six months, gaining 24% versus 9% for the S&P 500. But this hope is far from being in the money. So far, the only genuine recovery we are seeing is in manufacturing, and it is being fuelled primarily by what is an ordinary cyclical upswing. There are no tangible effects to speak of following the surge of consumer confidence, which makes sense given that the large debt overhang for households and the private sector in general automatically limits the extent to which consumer spending can accelerate. In fact, the financial markets are beginning to send out quite a different message, one suggesting that populist campaign promises are best taken with a grain of salt. The dollar has lost ground since the start of the year, while the technology has recovered its sectorial lead on the S&P 500. At the same time, emerging market equities are up 12% since the beginning of the year, reflecting a refusal to be cowed by the hard line that Trump has attempted to impose.

The US president's recent failure to make good on his vow to repeal Obamacare – even with a Republican majority in Congress – might also be viewed as a wake-up call. In a country as politically polarised as the United States today, lining up a majority behind concessionary solutions remains as daunting a challenge as ever. Populist rhetoric can get you into power, but in a system of representative democracy, it soon comes up against the deep divisions plaguing society. Having campaigned on tax reform, Donald Trump cannot afford to miss this second chance to get one of his policy planks through – This time his credibility is seriously at stake. The issue has even greater economic implications than healthcare, and it will be at least as challenging to deliver on.

One option might be to bundle tax reform with the proposed government spending package in an effort to bring a few Congressional Democrats on board. But in any case, passing a reform will surely be a complicated and risky balancing act. After failing to cut the government's healthcare bill, the White House must now be able to explain how tax reform can be financed, particularly as the proposed Border Adjustment Tax has increasingly come under fire. So once again, Trump is confronted with the difficult task of building consensus around his overblown campaign pledges. In the long run, US stock market performance depends in no small measure on the quality of the country's large, high-growth companies and on an ecosystem built on supporting innovation. Protectionist policies and a swelling government deficit will do nothing to strengthen either of those advantages.

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The wave of deep-seated discontent sweeping Western democracies today underscores the importance of addressing the downsides of globalisation. But in their hostility to free trade, populists make the mistake of viewing global growth and international trade as a zero-sum game – which they hope to win by driving a hard bargain with other countries. Now, while such an aggressive stance may temporarily look feasible for the United States, China will almost certainly prove in short order to be a tougher nut to crack than Washington anticipated. But it should be painfully obvious that no country in Europe stands to gain from a go-it-alone approach. France in particular has a pressing need for foreign partners that can buy its exports and finance its current account deficit. It would be particularly ironic to see populism win out in Europe just when the economy is finally picking up, and when Germany and France have never been closer to initiating at long last the vital process of convergence. Today more than ever, investors would do well to be on their guard against political risk. Only in this scenario will they be in a position to take advantage of the many opportunities that lie ahead.

Source: Bloomberg, 30/03/2017



Investment strategy

Equities

Equity markets can look back on yet another month of solid gains despite the political uncertainty, prompting us to maintain our equity exposure at close to the maximum allowed level. Europe posted a particularly strong rally in March, with the leading Eurozone market indices adding anywhere from 3% to 8%. Due to the high international exposure of Europe's listed companies, the cyclical nature of their businesses and the discounts they continue to trade at, the prospect of a synchronised global economic recovery has given European stocks a powerful boost.

We have accordingly upped our exposure to this theme. Taking advantage of exaggerated concerns over possible fines related to its diesel emissions tests, we initiated a position in Renault. The French carmaker's geographic mix makes it much less vulnerable than Volkswagen, a firm with a major presence in the United States. We have also increased our exposure to India, currently one of the most promising markets for equity investment as the economic reform process launched by Prime Minister Narendra Modi gathers momentum. We thus added IndusInd Bank, an Indian private bank with tremendous growth potential, to our global equity strategy. IndusInd Bank is sitting nicely while its publicly traded rivals are still groaning under the weight of bad debt on their balance sheets.

Fixed income

Our deflation scenario materialised in March, a month that saw the ECB sharply raise its inflation forecast and the Federal Reserve quicken the pace of monetary policy normalisation with a 25 basis-point hike in the Federal Funds Rate. Even so, markets still seem to doubt the pick-up in inflation will last. This goes in particular for the euro area, where the expected level of inflation (as measured by the 5-year forward 5-year breakeven inflation rate) has declined since February.

We have moved tactically to protect part of our profits by scaling back our short positions in US treasuries and German bunds, but we are still wagering that the synchronised global upturn will drive inflation higher than is commonly assumed. As previously, most of our long positions are in financial sector private placement bonds and debt issues from Brazil, Mexico, Russia and other emerging markets. Yields on emerging market debt have continued downward in the past month as macro-economic figures showed further improvement, to the point of pushing inflation down markedly in Brazil and Russia.

Currencies

The euro was the leading beneficiary of trends in March, booking substantial gains against the dollar, the yen and the British pound. Our move to boost our exposure to the single currency at the start of the year has thus paid off handsomely. Although political developments in Europe could generate volatility in the coming weeks, the confirmation of an economic recovery on the continent, combined with a return of international investors into European assets, should provide ongoing support to the euro and further justify our large exposure to it. At the same time, as part of our risk management policy, we have maintained our positions in the Swiss franc. But we have bought back our short positions in the yuan, as our recent trip to China reassured us that the country is on its way to financial stabilisation.

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