

The countdown

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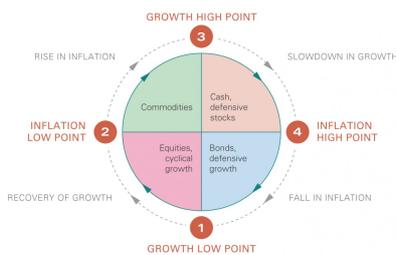
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Close to a decade of unconventional central bank intervention in the financial markets made what was once irrational look sensible. Investors no longer needed to worry about the business cycle, inflation, stock valuations or even risk concentration, as sovereign debt purchases by central banks were what ultimately determined financial asset prices. The carefully-timed policies implemented by the various monetary authorities to compress interest rates suppressed market volatility. They also created a crowding-out effect that kept credit spreads tight and stock markets humming. There was equally little concern over how sharply the fiscal tightening imposed on governments after the 2008 financial meltdown skewed the distribution of income and wealth to holders of capital – and away from wage- and salary-earners. That growing gap has unquestionably been a major driver of political insurgency these past two years on both sides of the Atlantic. Protest movements critical of the free-market order are now pressuring governments to tone down their fiscal virtue and finally loosen the purse strings.

The political challenge to EU discipline recently posed by Italy's anti-establishment parties can accordingly be viewed as one of many European echoes to the America First mentality. The Italian echo has already generated significant financial market stress. After flocking almost unanimously to the risks "sponsored" by central banks, investors now suddenly find themselves on quite shaky ground. For the time being, though, the global economy is still growing at a decent pace, corporate earnings remain enviably high and central banks have been sticking to very dovish policies. Together, those factors still constitute a reassuring safety net for investors.

But the day that such macroeconomic and monetary policy support starts to fade away, financial markets will be subject to real-life stress tests – and so, by the way, will active asset management styles. Both flagging economic growth and mounting unease among central bankers are already observable. That means that the countdown is on.

What to own at each stage of the business cycle



Source: Carmignac

Italy's troubles are symptomatic of broader eurozone vulnerability

This time is not different

The main economic indicators released in May substantiate our message of an upcoming slowdown in global growth, as explained in Carmignac's Note from last month, "Beneath the fury, the economic cycle". Despite Trump's tax reform, capital expenditure has yet to pick up in the United States, while consumer spending is now progressing at a slower tempo. In the euro area, while economic indicators are still at elevated levels, there has likewise been a clear loss of momentum these past two months. The same goes for Japan.

And this time, our contention that the business cycle will soon go into reverse is being borne out by "conventional" symptoms that had been off the radar during the near-decade of market distortion caused by monetary policy. Not only have cyclical, industrial, and heavily indebted companies seriously underperformed in the stock market since the start of the year, but we are also seeing the first upward pressure on prices – prompting economists (in the United States at any rate) to lift their inflation expectations and pushing up bond yields.

The maverick Uncle Sam

The current US administration has been playing fast and loose with more than just established practice in foreign trade and geopolitics.

President Trump's fiscal spending goals will inevitably require the Federal government to borrow a great deal more, just when the Federal Reserve is shifting gears – shrinking its balance sheet instead of swelling it by purchasing US Treasuries as it did from 2009 to 2015. The regrettable conjunction of those two policy moves has undoubtedly contributed mightily to the upward trend in US yields.

Meanwhile, on the other side of the Atlantic, the ECB is continuing to buy large quantities of European sovereign debt even as the economy improves. A further, essential point is that the eurozone countries have so far held to their virtuous deficit-reduction policies. As a result, 10-year bond yields have been as much as 2.5 percentage points lower in Germany than in the US and, up until Italy's recent political bombshell, there had been ongoing, remarkable convergence in yields across the currency bloc.

Virtue under pressure

The US presidential election and the UK Brexit referendum had sparked fears about the eurozone's future in 2016, but Emmanuel Macron's 2017 victory at the polls in France stemmed the centrifugal forces at work in the currency bloc. Elected on a programme for reforming both the French economy and European governance, the new president seemed to offer – in the nick of time – a credible alternative to a hazardous return to the past.

One year later, no party in Europe, however fervent about national sovereignty, is explicitly calling for ditching the euro, and the obstacles encountered by Britain at the Brexit negotiating table aren't exactly encouraging secessionist leanings elsewhere. Moreover, the entire eurozone is now enjoying healthy economic growth. But the embers of breakup are still smouldering. Across the continent, public opinion remains highly divided. Many citizens are still receptive to demands for an end to fiscal discipline, not only because they favour a more just distribution of national wealth, but also because they have bought into the "my country first" credo.

The economic upswing has concealed the eurozone's persistent structural weaknesses

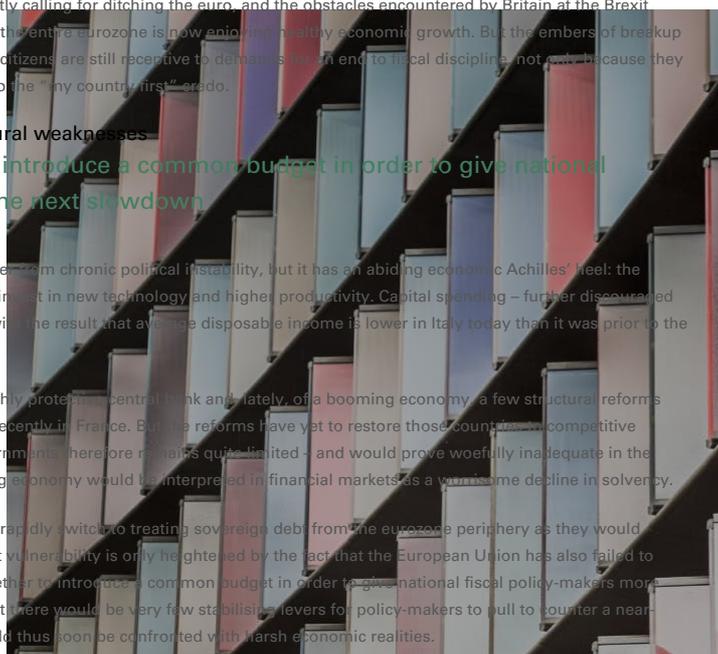
The eurozone is still far from agreement on whether to introduce a common budget in order to give national fiscal policy-makers more room to manoeuvre during the next slowdown.

Those sources of tension are particularly palpable in Italy. Not only does the country suffer from chronic political instability, but it has an abiding economic Achilles' heel: the preponderance of small businesses which, while often very dynamic, are ill-equipped to invest in new technology and higher productivity. Capital spending – further discouraged by top-heavy regulation and stiff taxes – has been insufficient for the last twenty years, with the result that average disposable income is lower in Italy today than it was prior to the crisis, while income inequality remains stubbornly high.

Italy's troubles are symptomatic of broader eurozone vulnerability. With the help of a highly protective central bank and, lately, of a booming economy, a few structural reforms have admittedly been carried out: starting in 2011 in Italy, for example, and much more recently in France. But the reforms have yet to restore those countries' competitive strength or to make a serious dent in their national debt. The fiscal leeway for their governments is therefore remains quite limited – and would prove woefully inadequate in the face of an economic downturn. Any increase in government spending to steady a slowing economy would be interpreted in financial markets as a worrisome decline in solvency.

In a way, the latest events in Italy have thrown a key risk into stark relief: investors could rapidly switch to treating sovereign debt from the eurozone periphery as they would corporate bonds, using credit analysis to determine the level of yields they demand. That vulnerability is only heightened by the fact that the European Union has also failed to make headway with institutional reform. The eurozone is still far from agreement on whether to introduce a common budget in order to give national fiscal policy-makers more room to manoeuvre when and if government spending may be required. That means that there would be very few stabilising levers for policy-makers to pull to counter a near-term economic slowdown in Europe. The convergence process of the past few years could thus soon be confronted with harsh economic realities.

The coming months will therefore be crucial for asset allocation. Making the right macroeconomic calls is more important for active fund managers today than it has been for many years.



Investment strategy

Equities

Differences between sectors were once again what called the tune in the stock market. Alongside tech stocks, which continued to outperform, the energy sector rebounded as investors started factoring rising crude prices into their outlook for oil companies. That made our tech and oil positions positive contributors to our Funds' returns once again. During the month, we left our sector allocation largely unchanged, apart from building a short position in financial stocks, the primary casualties of Italy's turmoil.

In contrast, geographic differences cast a larger shadow in May. Emerging-world equities significantly underperformed, most notably in Latin America. But because our stock-picking is dictated much more by the intrinsic strengths of issuing companies than by their "nationality", we made only minor changes to our allocation.

Our biggest move during the month – initiating a position in the German sportswear manufacturer Puma – bears witness to that idiosyncratic approach. Now that the company is no longer part of the Kering group, we feel it is in a position to boost its growth by focusing on specific market segments (like the 16-to-24 Generation Hustle cohort) and catch up with the margins posted by its peers, whether the European economy is booming or not.

Fixed income

Political developments in Italy triggered indiscriminate upward pressure on bond yields across the eurozone periphery towards the end of May. At the same time, core eurozone yields eased markedly. With our flexible investment approach, we focused on scaling back our short positions on German government paper. Furthermore, we built a long position in US Treasuries, which in our view can serve as an insurance policy against systemic risk, while also delivering decent returns.

Meanwhile, ongoing monetary policy normalisation by the Fed is still exerting pressure on bond markets around the world. With no let-up in the widening of corporate bond spreads, we have kept our credit exposure low. We continue to focus on a few names offering what we consider an attractive risk/return profile like the drug-maker Teva and the telecoms company Altice.

However, the growing spreads on emerging-market paper haven't prompted us to change much other than our currency exposure. Yields are more attractive there than in the developed world, and the countries we are exposed to enjoy sound economic fundamentals.

Currencies

This past month saw significant turmoil in the forex market. Aside from the greenback's accelerating appreciation against the euro, emerging-market currencies were what drew the most attention. Those currencies depreciated across the board, with some of them, such as the Turkish lira and the Argentine peso, even well on their way to crisis territory. Credible economic policies will be crucial to ending the current turbulence. In that respect, Argentina scored a few points and halted the peso's slide at the end of May.

To navigate those choppy waters, we are maintaining our strategic focus on risk reduction. We have bolstered our long position in the yen, which has worked well as a safe-haven currency over the past few weeks, and substantially increased the weight of the US dollar in our overall allocation. Lastly, we have tactically beefed up our hedges on our positions in emerging-market currencies.

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