

THREE-WAY COLLISION

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After largely calling the tune for the developed world's leading economies – and especially their financial markets – for several years, central banks now appear to be bowing out. The US Federal Reserve in particular has stopped pumping cash into the system and has started draining cash out. This shift on the part of central banks has tremendous importance for investors, because it is shaking the whole market edifice built up in the course of a decade of overabundant liquidity. But it also leaves the field open for two other forces that unconventional monetary policy had kept at bay until recently: the business cycle and government policy.

On the first count, the broad cyclical upswing of the last two years – currently being prolonged by President Trump's expansionary fiscal policies – has left investors complacent for now. The business cycle is beginning to show signs of running out of steam, however (see our June Note, ["The countdown"](#)). On the political front, the free-market globalised economy in recent years, which has driven up asset prices but brought little in the way of rewards to wage- and salary-earners, has sparked rebellion in the United States, Latin America and Europe. Put simply, the neoliberal economic status quo is increasingly coming under attack. Last year we discussed the medium-term challenges that this new political landscape, however understandable it may be, is creating for investors (see Carmignac's Note of April 2017, ["Long-term investors should be wary of populism"](#)).

Even though investors seem momentarily focused on political risks alone, what most threatens to upend financial markets at this point are the concurrent monetary, economic and political shifts taking place.



Source: Carmignac

Are we really heading for a trade war?



Donald Trump should not be viewed as a Homeric hero fated to wage all-out war until he or his adversary is utterly wiped out

The United States' current assault on China's trade fortress, combined with a dwindling global supply of dollars, has already begun to claim casualties. The Chinese stock market is down 15% since the start of the year, and the malaise is spreading to emerging-world assets and above all currencies. The economies most highly dependent on dollar financing from abroad have obviously taken the worst hit. Chief among them is Argentina, whose steadily progressing but still shaky reform process has been virtually washed away by a sudden wave of investor distrust. The current US administration includes influential proponents of an ideology that overtly identifies China as a strategic enemy, a rival that has to be stopped in its tracks.

If Washington's aim is indeed to use a spat over customs duties as a ploy for preventing Beijing from implementing its Made in China 2025 strategy, then we're in for a long, destructive confrontation. President Xi Jinping is clearly not about to give up on his ambition to move China further up the global industrial value chain. The recently announced US tariffs on German cars are likewise meeting with stiff resistance as the European Union closes ranks to fend off the attack. But does it really make sense to view Donald Trump as a

kind of Homeric hero fated to wage all-out war until either he or his adversary is utterly wiped out? It could just as reasonably be argued that there are down-to-earth, short-term political grounds for the US administration's latest moves. Trump naturally has his sights set on the midterm congressional elections scheduled for 6 November, particularly as the Republican Party is by no means ahead in the polls at this stage. A deal with China and, if possible, with the European Union prior to such a high-stakes vote could – and unquestionably would – be touted as a heroic victory that might well draw American voters away from the Democrats. That means investors wishing to develop a sound investment strategy shouldn't preclude the idea of a rational outcome to the whole affair.

A combination of vibrant economic growth in the US, widespread risk aversion and the Federal Reserve's unwavering stance is currently buoying the greenback, but that could change as the business cycle goes into reverse. And as the probability of the worst-case scenario playing out diminishes, we may well start to see attractive opportunities for buying high-quality emerging-market assets.

In the near term, the need to preserve clients' capital under all scenarios justifies great caution, but asset managers will also have to show flexibility and responsiveness as there is no guarantee that the worst will happen.

Is the eurozone doomed?



The real risk for Europe's financial markets is still a contractionary phase in the business cycle, given that monetary stabilisers are spent and fiscal stabilisers are woefully inadequate due to a lack of reforms

We have seen mounting opposition to a eurozone construct that has alternately been termed inefficient, rigid, bureaucratic, unjust or even undemocratic. But that sentiment has to do with the currency bloc's shortcomings, not with the fact that it exists in the first place. Those who tend to panic whenever a political current vaguely calls for ditching the euro are missing a key point: public opinion throughout the eurozone has grasped just how prohibitively expensive it would be for any member to revert to its national currency.

Right or wrong, the euro is "irreversible," as Mario Draghi recently stressed. There is an urgent need to reform the way the entire European Union operates, however. Otherwise, we can expect recurring earthquakes that will sooner or later topple the whole building. French President Emmanuel Macron is well aware of this, as is Angela Merkel, who could make use of her last term of office as Germany's chancellor to promote much-needed reforms. For example, she could consolidate her governing coalition around a plan for tax reform that would draw on the ample fiscal leeway her government has to bolster the economy.

By evincing that kind of political leadership, Merkel would provide a credible response to an already perceptible economic slowdown. Germany would also enhance its stature as the locomotive driving European growth, instead of carrying on in its current role as a stickler for member-state compliance with the Maastricht criteria. Once the CSU, the CDU's more conservative coalition partner, receives adequate assurance that its concerns over migration are being addressed, it would certainly agree to a programme for

lower taxes. Arguably one of the most common mistakes made by pundits in the English-speaking world is that every time a crisis looms up in Europe, they underestimate the political determination that can be mustered to ensure the eurozone's survival. In our view, the real risk in the near term will come from a contractionary phase in the business cycle (see Carmignac's Note from June 2018, "[The countdown](#)"), given that monetary stabilisers are spent and fiscal stabilisers are woefully inadequate due to a lack of reforms.

Protectionist threats understandably generate lots of anxiety among European business people. But that also goes for the United States, where company leaders have started pointing out to the Trump administration the scale of the risks involved. Ironically enough, because Trump's protectionist drive will have very little direct, immediate impact on the US economy, it's that much more likely that he will maintain his intransigent posture for the time being. The upshot is that politics has become the primary focus of investor concern, making the outlook highly unpredictable and prompting considerable caution. But policy-makers should in the end have enough common sense to steer us towards benign compromises.

We believe that the real risk facing financial markets is more complex and therefore less easily grasped in the short run by investors. It consists in a possible three-way collision: destabilising economic policies, a cyclical economic slowdown and central banks with little room left for intervention – all at the same time.

Investment strategy

Equities

Political rhetoric was the primary influence on stock markets in June. Trade war fears jolted emerging-market equities, first and foremost in China. European equities likewise took a beating as mounting political risk in Italy looked set to undermine the EU integration process. Against that backdrop, US tech stocks once again stood out from the crowd, with the rebound in Facebook's share price after its weakness in March as a major source of resilience.

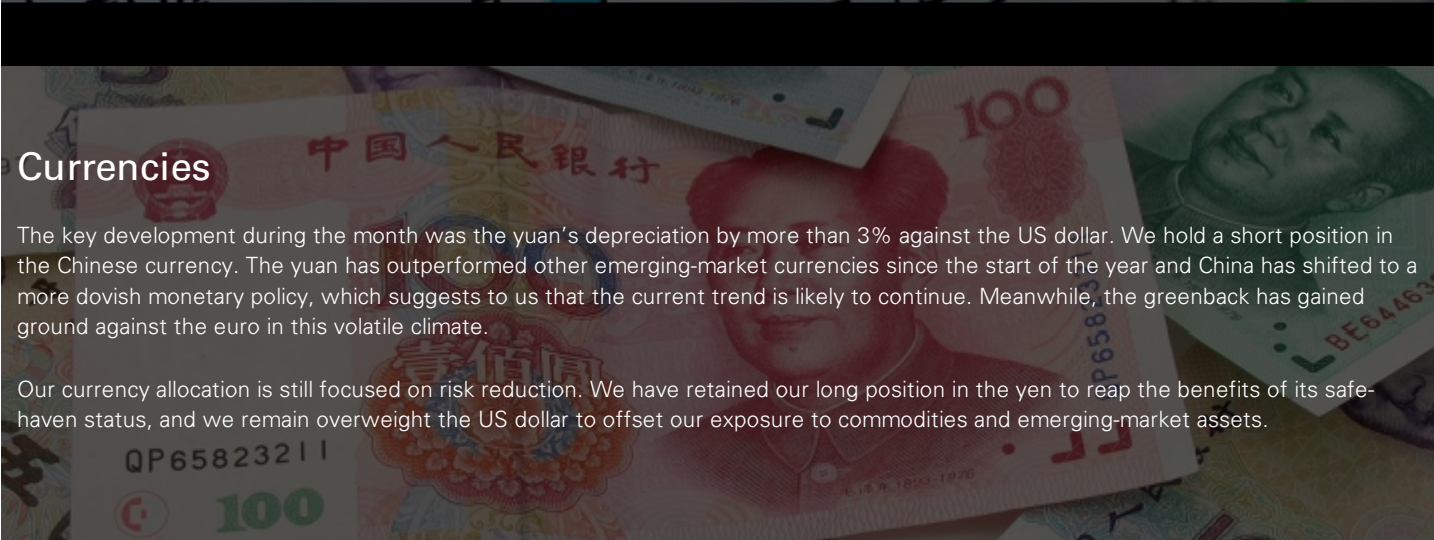
The instability created by changing political, monetary and economic paradigms has led us to step up our exposure to high-quality stocks and shy away from those in sectors that are highly vulnerable to the shifts under way. Alongside our tech holdings, we have sought out opportunities in consumer goods made by companies with decent long-term growth prospects at a time of stiff competition from innovative online business models. We have also taken profits on a few tech companies with high valuations. In order to mitigate portfolio risk, we have put in place a certain number of short positions, particularly on US bank stocks, which have been hurt by a flattening yield curve and shaky macroeconomic indicators.



Fixed income

Monetary policy divergence between the European Central Bank and the Federal Reserve became more pronounced in June. Buoyant US economic growth encouraged the Fed to press ahead with its scheduled rate hikes, whereas the ECB has pledged to refrain from raising rates until the end of summer 2019. The political turbulence at the end of June rekindled fears in the bond market, with the result that non-core eurozone sovereign yields rose while German and US yields subsided. Emerging-market yields continued to head upwards.

Those conditions led us to go further with the risk reduction process we initiated early in the year by paring back our exposure to non-core eurozone and emerging-market debt. At the same time, we made selective use of derivatives to mitigate credit risk. Lastly, we have remained long US Treasuries, which in our view can serve as an insurance policy in the event that conditions take a turn for the worse, while also delivering higher returns than European sovereigns.



Currencies

The key development during the month was the yuan's depreciation by more than 3% against the US dollar. We hold a short position in the Chinese currency. The yuan has outperformed other emerging-market currencies since the start of the year and China has shifted to a more dovish monetary policy, which suggests to us that the current trend is likely to continue. Meanwhile, the greenback has gained ground against the euro in this volatile climate.

Our currency allocation is still focused on risk reduction. We have retained our long position in the yen to reap the benefits of its safe-haven status, and we remain overweight the US dollar to offset our exposure to commodities and emerging-market assets.

Source: Bloomberg, 30/06/2018

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