MANAGEMENT REPORT – 3RD QUARTER 2016

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Economic analysis

The transformation of the political landscape in developed countries and doubts about the effectiveness of monetary policies suggest that fiscal firepower will now be used to stimulate growth. But what about the economic and financial balance to which central bankers have accustomed us in recent years?

Global perspective

In our previous report, we upheld our scenario of global growth justifying the pursuit or strengthening of highly accommodative monetary policies. It looked as if these would continue to benefit risk assets despite numerous and persistent sources of economic and political uncertainty.

This outlook called for strong investment in high visibility companies, along with defensive levels of modified duration and a neutral exposure to the dollar. Overall, these choices proved astute even if they could have been enhanced through a closer connexion to the economic cycle via our equity investments.

We also mentioned the probability of fiscal stimulus, which with the help of slack monetary policies seemed capable of generating economic growth where monetary weapons alone had failed. In light of Brexit, support for Donald Trump, "no" campaigners' lead in opinion polls for Italy's constitutional referendum, and the increasing popularity of extremist votes in Europe, a return of these expansionist fiscal policies seems likely.

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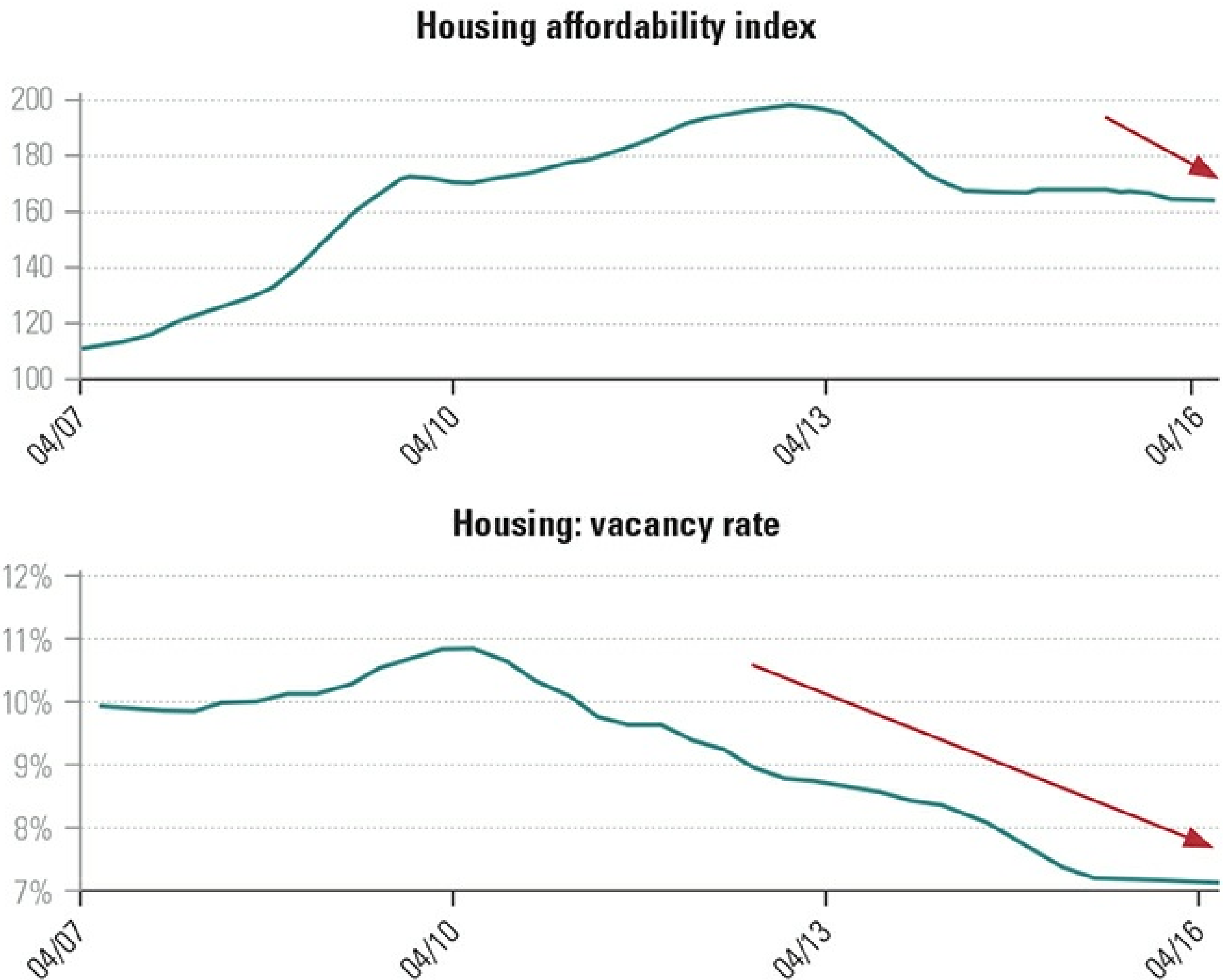
United States

In the United States, the annualised rate of growth is still expected to rebound to 2.5% - 3% after three particularly sluggish quarters (1.04%). This improved growth should come with a slight rise in inflation due to upward base effects alongside steady rent increases. The constant decline in the housing affordability index

creates more demand for rental properties, and landlords are taking advantage of this at a time of low yields on traditional savings and bond investments.



Healthcare prices - up 4% in the consumer price index - and energy prices will be other factors in fresh inflation. Consumer spending growth will probably drop towards close to 2.25% but the contribution from inventories and industrial investment should bring about the cyclical improvement that the consensus is forecasting.

Indeed, investment has suffered greatly from the oil sector's weakness in response to the four-fold drop in crude oil prices between June 2014 and February 2016. The mere stabilisation of investment in this sector will help this GDP component catch up. However, we are not expecting a solid, sustained recovery in investment as corporate profit margins are still falling and production capacity utilisation remains low: the US economic upturn that the consensus is predicting will occur, but will be disappointing nonetheless.

For the time being, November's presidential election has prevented the Federal Reserve from continuing its normalisation of to normalise its monetary policy. Indeed, the possibility of a Donald Trump victory could create volatility on the markets, and raising interest rates just before this event would compound the problem. Once this political milestone for the global economy is behind us, the Fed could make a fresh attempt to rein in its support, giving way to a more expansionist fiscal policy driven by the White House's new chief resident.

Both candidates seem eager to work on the budget and raise public spending by cutting taxes and/or investing in infrastructure. In this event, it seems unlikely that the monetary normalisation which we expect, and which would be damaging for bond markets, would immediately weaken equity markets; the minor spurt in growth would work in their favour.

However, substantial fiscal stimulus is by no means certain. Barring a sudden economic downturn, gaining the approval of a Congress in which neither candidate seems likely to win a clear enough majority looks trickydifficult. Hitting the debt ceiling in 2017 will not make matters any easier.

Japan

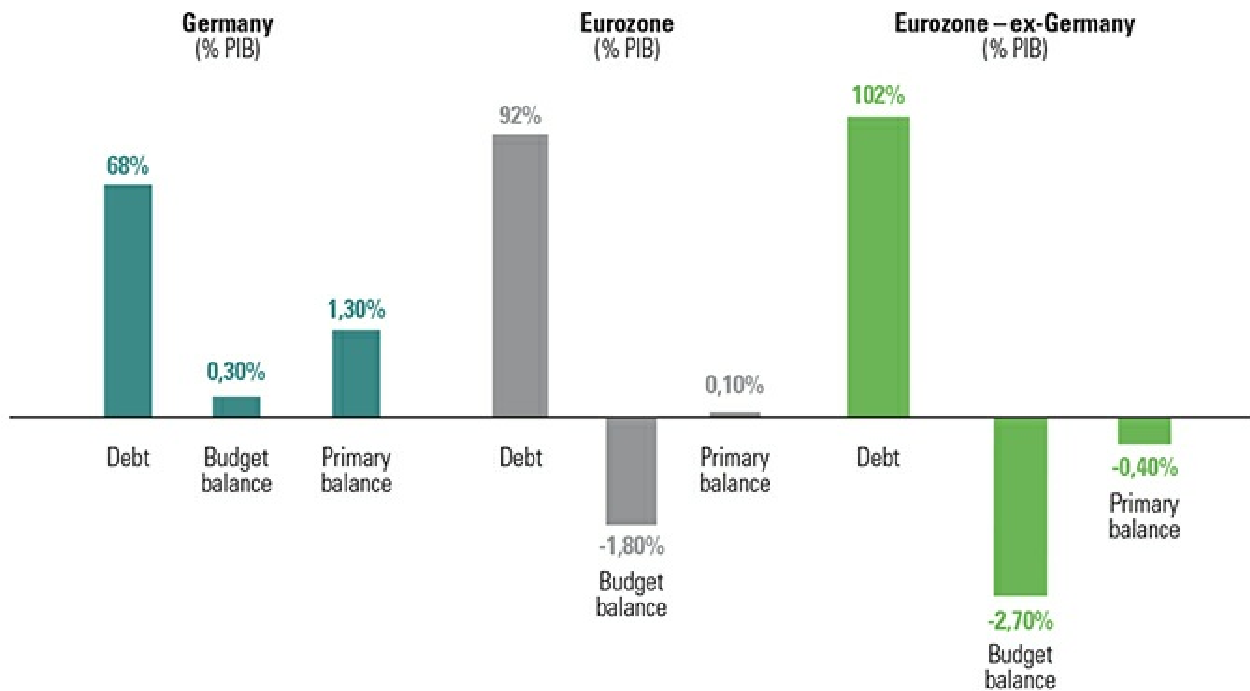
In Japan, we believe the implications of the central bank's latest decision are much greater than generally perceived. This involves keeping nominal 10-year interest rates close to zero. Not content with setting short-term interest rates and influencing long-term rates by purchasing large amounts of bonds, as per other central banks across the world, the Bank of Japan is now fixing the nominal 10-year government bond yield! It looks as if Japan is about to stake everything it has after 26 years of economic crisis compounded by the catastrophic effects of its ageing population on economic growth.

We therefore need to reconsider the yen's real true potential for appreciation when investors are feeling risk averse. We believe that 'out of control' fiscal deficit and an overworked minting plate suggest that the yen will depreciate whatever happens. This indefinite commitment to keeping 10-year yields close to zero in the world's third biggest bond market will have implications for long-term yields in the rest of the world. By encouraging Japanese investors to seek superior returns in other markets, this policy by the Bank of Japan is exerting downside pressure on global bond market yields.

Europe

No major changes are to be reported in Europe on the economic front: growth remains soft, Germany is suffering from weak global trade, and the rest of the eurozoneEurozone is desperately hoping that Germany will save the day with a fiscal policy made possible, justifiable and necessary by the country's surpluses. In all likelihood, Angela Merkel's loss of popularity will encourage her to make some minor deviations from Germany's sacrosanct fiscal orthodoxy just one year ahead of a general election.

Europe: economically necessary, fiscal stimulus is financially inappropriate except in Germany



Source: Carmignac, CEIC, 30/09/2016

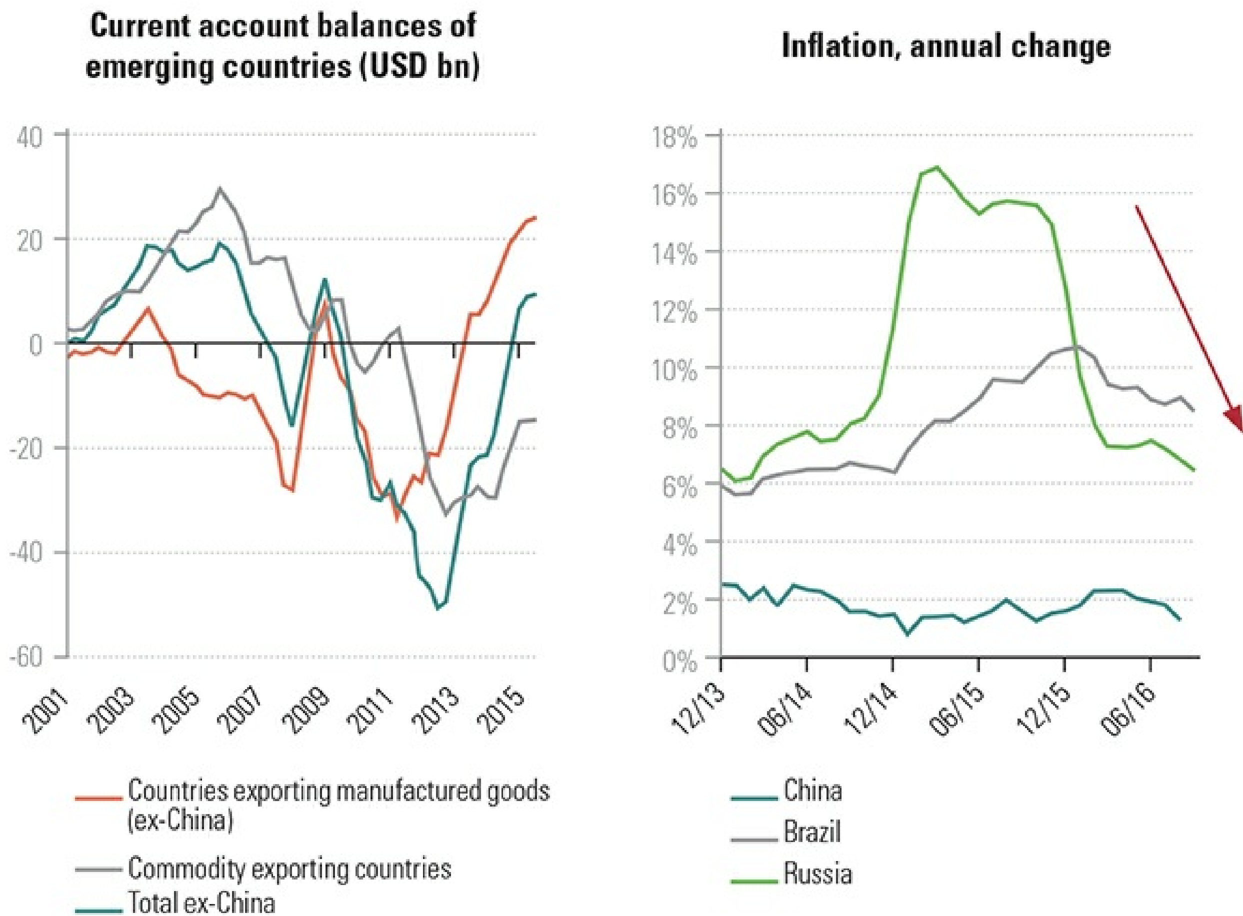
Economic growth in the Eurozone should come to 1.5% in 2016 and 1.3% in 2017, which would tend to show the limits of the ECB's monetary policy in creating growth. However this may provide reduced support for consumer spending in coming months due to strong disinflation.

It is on the political front that changes have happened in Europe. After the British people expressed its desire for independence, nationalist surges are spreading in many European countries due to economic failure and the migrant crisis. So while budgetary policies are financially unjustifiable everywhere except Germany (public debt stands at 102% of GDP in the Eurozone excluding Germany, and the budget deficit at 2.7% of GDP-worryingly close to the 3% limit), the people is increasingly in a position to demand these measures.

We fear that due to the complexity of European governance, this option will only really possible if there is a new threat of recession; however political tension and its associated risks could also push the Eurozone towards less fiscal orthodoxy. As in Japan and the United States, the promise of a change in the economic and financial balance is taking root in Europe.

Emerging countries

The emerging world is giving an unusual impression of calm. China's stabilisation, through a combination of accommodative monetary policy and considerable fiscal expansion in recent quarters, now sits alongside an economic upswing in the other BRICS:



Brazil, Russia, India and South Africa are also seeing their inflation ease and current accounts improve. This brighter situation affords more economic and monetary policy leeway, and reduces dependency on foreign capital.

So to some extent the emerging world seems less vulnerable if US interest rates were to rise and global liquidity were to dry up a little. Furthermore, higher oil prices are excellent news for the many exporting countries in the emerging world.

As such, emerging stock markets should continue to outperform developed stock markets, and emerging currencies should remain on their upward trend.

Investment strategy

The sovereign bond market is about to enter a difficult period in the developed world. The Fed and the ECB's desire to scale back their monetary support, the possibility of fiscal policy adjustments in the United States and Europe, the stabilisation of the global economy and the slight rise in global inflation- despite the Bank of Japan going all-in - mean we have to seriously consider the possibility of a change in the economic and monetary balance. Moreover, the political agenda is particularly busy, with the US election at the beginning of November, Italy's constitutional referendum in December, and French and German general elections in 2017. Each of these public votes presents an opportunity for nationalist parties to push an alternative economic policy based on fiscal expansionism and in some cases less open borders.

This combination of destabilising political and economic factors naturally leads us towards a rather defensive positioning.

Our exposure to equity markets is partially hedged with short futures positions in the indices of countries that look most vulnerable to shocks. We have strengthened our energy investments to give the portfolio more exposure to a theme capable of performing well during periods of economic recovery. At the same time, we have slightly reduced the weighting of high visibility companies that are more sensitive to rising interest rates. The rate at which government bond yields rise will be decisive for equity market performance. Equities could withstand a controlled increase if this came with expectations of an economic recovery, and not just in response to monetary normalisation and widening budget deficits.

On the bond front, caution remains the watchword. Many sources of opportunity remain but we have significantly reduced the duration of our investments. All in all, we see little value in the government bonds of developed countries. The real opportunities are to be found in the emerging world, due to disinflation and improving currency account balances.

The foreign exchange market is also brimming with opportunity. The euro's steadiness against the dollar due to different forces cancelling each other out contrasts with the pound's structural weakness and the constant appreciation of many emerging market currencies. We prefer to remain underexposed to the dollar in these particularly uncertain times, as we focus on delivering absolute returns. We also question the yen's hitherto unfailing ability to benefit from risk aversion, now that Japanese monetary policy looks set to weigh on the yen.

Worldwide, we are expecting fresh volatility, which could mark the start of a massive reallocation of bond investments to equities once the heaviest uncertainties have eased. Whereas the prospect of fiscal stimulus would reassure the equity market, it would destabilise bond markets if monetary support were to be withdrawn too quickly.

Source of data: Carmignac, CEIC, 30/09/2016

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