QUARTERLY REPORT

11.07.2019

MANAGEMENT REPORT – SECOND QUARTER OF 2019

Q2 2019

11.07.2019

Economic analysis

Central bankers maintained their highly dovish tone throughout the past three months, offering unmistakeable evidence of their commitment to keeping the economy on its feet. Though we are struck by the central bank U-turn in response to what is still basically a mild economic slowdown, we also recognise that the gradual de-anchoring of inflation expectations is real, warranted – and disturbing. The key question, then, is this: how serious is the threat of a marked global economic slowdown – which, if it came to pass, would undermine our baseline scenario of an ongoing financial market rally? The US jobs market still shows vitality, while in Europe the deceleration seems for the most part to be behind us. Moreover, as long as neither GDP growth nor inflation picks up, central banks can be expected to maintain or strengthen their monetary stimulus. Monetary policy easing and the low risk of a sharp economic downturn should thus form a winning combination for financial assets.

The global outlook

In our previous report, we asserted: "The most striking development in the past three months has been the U-turn executed by the US and EU central bankers. In their public statements, they are now drawing attention to the possibility of a cyclical slowdown. We agree that the slowdown is broad-based, but still consider it modest in scope." That observation led us in turn to ask: "But are the first signs of a slowing US economy, faltering output in Europe and the elusive goal of maintaining even a modest rate of inflation really sufficient grounds for the current central-bank angst or the International Monetary Fund's showing of concern at a time when equity markets the world over are surging impressively?"

Without going into whether those fears were rational or not, we wrote that the protection pledged by central banks against the effects of a slowing economy encouraged us to raise our exposure to equities, to expect a decline across the entire US yield curve and to implement carry strategies in Europe. It turns out that we were right on all counts.

Central bankers maintained their highly dovish tone throughout the past three months. Financial markets are now pricing in three or four US interest-rate cuts over the coming twelve months, as opposed to just one

three months ago and two rate increases six months ago. In Europe, a 10 basis-point decrease looks increasingly likely, as does a revival of quantitative easing.

The entire US yield curve from 1-year to 10-year issues sagged by about 50 basis points in the second quarter, while German yields slid by between 10 and nearly 30 basis points for those same maturities. Moreover, spreads on Southern European debt fell on average by almost 50 basis points during the period. This dramatic global retreat in yields and convergence in Europe together bear witness to the apparently unrelenting, across-the-board downward pressure on inflation and to efforts by central banks to counter that trend as they do whatever they can to shore up inflation expectations. Though we are struck by the central bank U-turn in response to what is still basically a mild economic slowdown, we also recognise that the gradual de-anchoring of inflation expectations is real, warranted – and disturbing. If those expectations were to trend inexorably downward, we could find ourselves caught in a vicious deflationary cycle in which declining prices breed declining economic activity. So as long as neither GDP growth nor inflation picks up, central banks can be expected to maintain or strengthen their monetary stimulus, which will continue to keep markets humming. The key question, then, is this: how serious is the threat of a marked global economic slowdown – which, if it came to pass, would undermine our baseline scenario of an ongoing financial market rally?

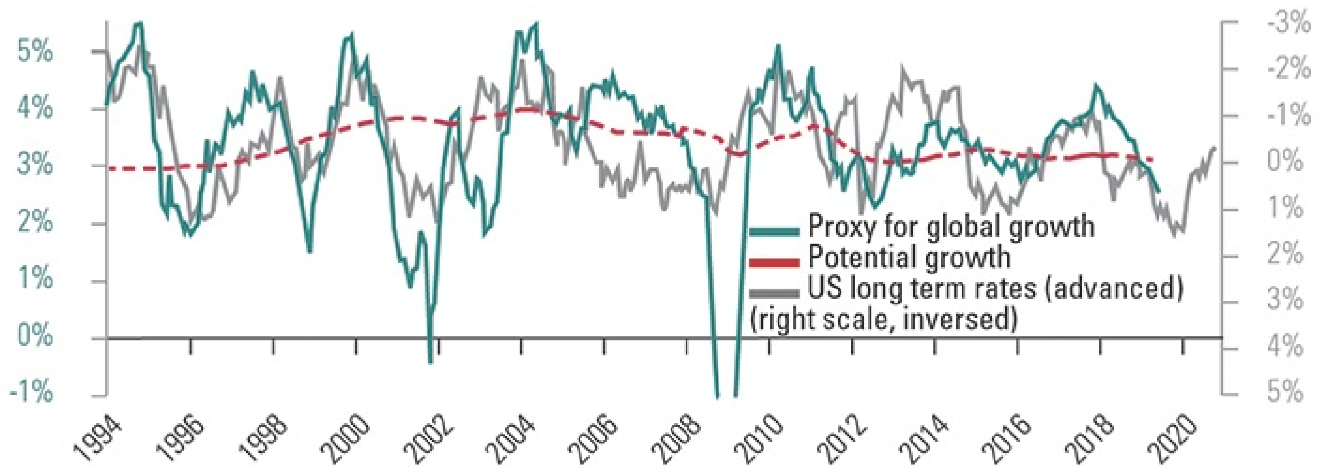
United States

The first signs of slackening in the United States can be seen most notably in capital expenditure. It was growing at a 10% clip a year ago, while in May 2019 the pace was just 4%, and the leading indicators for capex have entered negative territory. Even so, the Federal Reserve still attributes most of that weakness to trade tensions and to the little clarity businesses have as to how and especially when those tensions will play out. Meanwhile, with the jobless rate at a mere 3.7%, hourly wages still rising at better than 3% and the last wave of tax refunds brought about by Trump's tax reform helping to pad consumers' wallets, personal consumption expenditures have held up well, growing at a 3% rate. But it should also be mentioned that leading economic indicators in the US already point to GDP growth of just 2%. The slowdown in manufacturing has yet to affect the country's service sector, and the Federal Reserve seems much more concerned about low inflation. The fact that the low jobless rate has not translated into higher wages remains puzzling now that it looks like the expansionary phase of the business cycle is coming to an end, a phase normally accompanied by wage hikes – but which haven't materialised to date. In our view, the Fed believes a series of rate cuts will be necessary to prolong the boom – given that the previous round of monetary policy tightening (halted in late 2018) had gone a bit too far – and above all to drive up inflation. Our models suggest that inflation, which currently stands at close to 2%, will drop to 1.6% at the end of the summer.

Over the coming months, we expect US GDP growth to continue levelling off at a very gradual pace until it reaches 1.5%, with the Fed keeping a close watch to ensure that the country doesn't experience a sharper downturn or outright recession in 2020. The US job market in any case shows enough vitality to give the economic boom another extension.

The Cycle Should Rebound Supported by Accommodating Monetary Policies

Global Growth and long-term US interest rates



Sources: Carmignac, Bloomberg, 28/06/2019

Europe

In Europe, the deceleration seems for the most part to be behind us. The OECD's leading economic indicators for the eurozone, though still in negative territory, have stabilised. Those for Sweden – which with its large volume and variety of manufacturing exports to a wide range of countries provides a portent of upcoming cyclical changes – are beginning to perk up. Similarly, France appears to be recovering from the soft patch it hit unexpectedly in 2018. The country's manufacturing PMI has turned positive and Italy looks poised to follow suit. The employment outlook in the currency bloc as a whole continues to point in the right direction now that the jobless rate has dipped to a low of 7.5%, lifting consumer sentiment to an 18-year high. Germany has retained its title as the "poor cousin" in Europe's growth family. Not only is the country the primary casualty of a US-Chinese trade war that has caused Beijing to rein in shipments from overseas manufacturers; that shortfall has been compounded by the adjustment problems besetting its automotive sector and an eroding competitive edge in German manufacturing overall. The upshot is that the country's manufacturing PMI has sunk to its lowest level in seven years. A return to normal in world trade is thus way up on the wish-list of a doubt-ridden Germany, where the negative interest rates imposed by the ECB have sent property prices and rents sky-high – a serious source of distress in a nation composed so largely of tenants.

As the inflation outlook in Europe is similar to the one in the United States, the ECB has agreed to engineer a market-friendly about-face of the kind that Mario Draghi has already carried out several times. The return of the "Draghi put" – shorthand for the assurance provided by the ECB that it will do whatever it takes to prevent a severe economic slowdown or a slump in prices – makes us confident that the eurozone can avoid

a major downturn.

Emerging markets

Emerging markets have suffered over the past few quarters from a fairly robust US currency that has held them back from freely implementing the economic and monetary policies their stage of development requires. Those countries' imports of capital goods are down 10%, highlighting their inability to carry out policies that could push back against economic slowdown and against the detrimental effects of the current trade war. The most striking feature of the second quarter was the failure of China's small-scale stimulus plan; it was stymied by trade tensions at a time when the government doesn't seem to be in much of a hurry to counter the slowdown under way. President Xi presumably believes that Trump's America has more to lose than China does from the economic slowdown that would kick in if the negotiations demanded by the US President were to drag on. The possible dollar depreciation we have mooted – resulting from monetary easing, which tends to go further in the US than elsewhere, and from the country's yawning fiscal and trade deficits – would provide the emerging world with the additional liquidity and leeway it needs. On the other hand, belated monsoon rains in India and an invasion of armyworms eating their way across northern China's farmland are likely to reduce agricultural output sharply in the world's two most populous countries – and local consumer spending in the process.

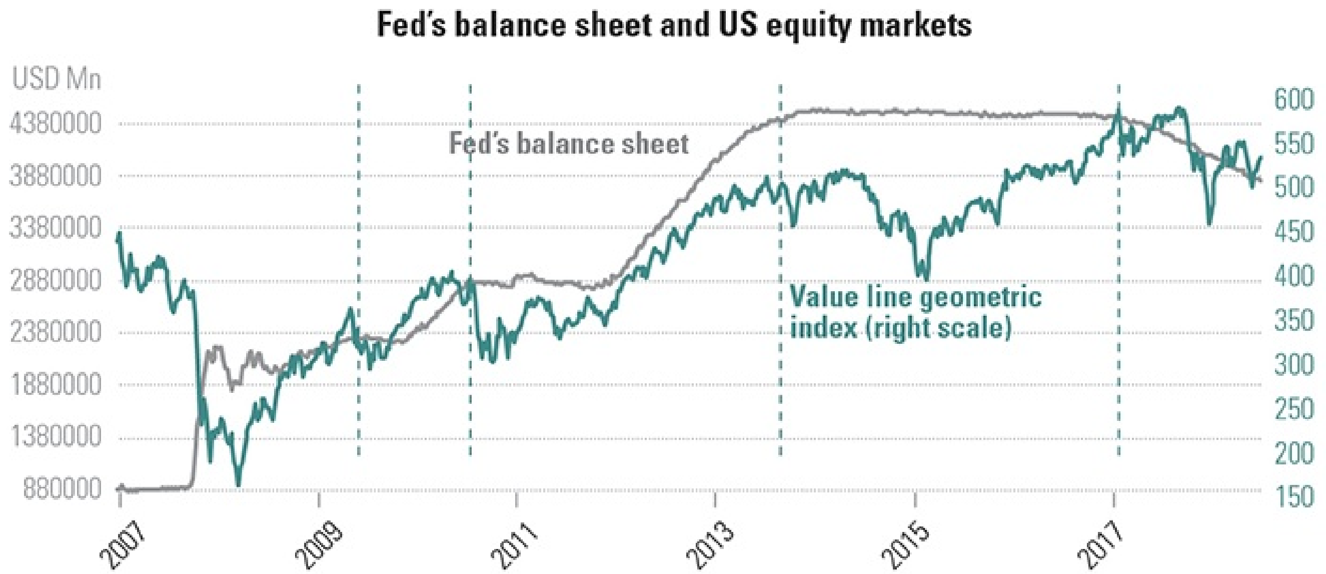
We accordingly feel that there is little risk of a major global economic downturn despite the advanced stage of the US business cycle. The leading developed-world central banks will be pulling out the stops and seem increasingly susceptible to government prodding – a situation one would normally associate with non-democratic countries. Trump's pressure on Jerome Powell, the former attorney currently at the helm of the Federal Reserve, and the appointment of Christine Lagarde, also a lawyer by training and once France's Minister of the Economy, to head the ECB both provide overwhelming evidence of the waning ability of central bankers to counterbalance political agendas the way they used to. The absence of inflation gives central banks the chance once again to restart economic stimulus if need be – and vindicates their efforts to do so. Trade talks have by now become a standard component of investors' macro landscape. Trump will most likely try to hammer out a deal – while carefully adjusting the timing to raise his odds of getting re-elected. In the months between now and then, financial markets will probably stick to their expectations for a positive outcome at the negotiating table, though that by no means precludes moments of doubt and spikes in volatility.

Investment strategy

Monetary policy easing and the low risk of a sharp economic downturn are forming a winning combination for financial assets.

The Link Between Liquidity and Equity Markets is Obvious

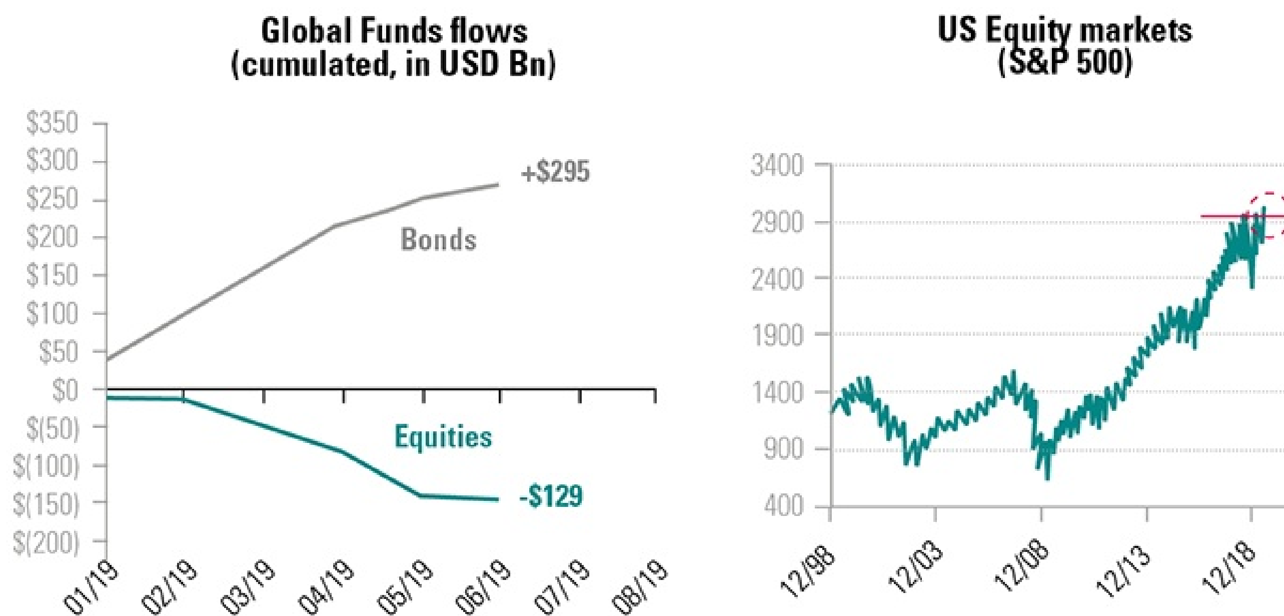
Will the return of QE favor an outperformance of laggards?



Sources: Carmignac, Bloomberg, 28/06/2019

Stock markets stand the greatest chance of benefiting from this new economic environment, yet they would appear to be out of favour with investors. European and US equity funds are experiencing steady outflows despite the ongoing market rally. We interpret this atypical behaviour as a contrarian indicator predicting a bullish future. In other words, the current bearish positioning of investors in the stock market should encourage them to jump back on the bandwagon as the economic scenario we predict gradually unfolds.

US Equities: News Highs Despite Outflows



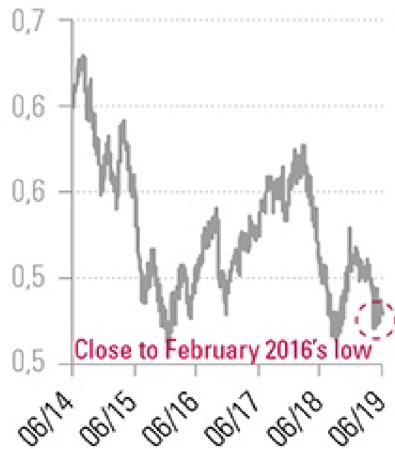
Sources: GS, Carmignac, Bloomberg, 28/06/2019

Non-cyclical growth stocks remain a core component of our portfolio, given that we don't expect a robust expansionary upswing any time soon. That said, we can't rule out the possibility that the share prices of more cyclical companies will get a short-term boost at the first signs of an improving economic outlook, particularly as they are seriously underrepresented in leading fund managers' portfolios today. If our expectations for a weaker US dollar prove to be right, we will resume our hunt for highly select emerging-market equities.

Turning now to the **bond market**, the increase in liquidity set to take place in Europe should allow us to maintain our yield convergence strategies and take advantage of idiosyncratic opportunities in corporate credit. Despite the sharp fall in US yields at the start of this year, we think the US yield curve could still offer potential capital gains if the economic slowdown continues for a few more months at its current modest pace.

In the **forex market**, the expected weakening of the US dollar would open the floodgates for the currencies of the more robust emerging economies to appreciate and for EM interest rates to subside.

Towards a Rebound of Emerging Assets



Sources: Carmignac, Bloomberg, 28/06/2019

The primary risk according to our outlook is that investors will lose confidence in the power of a new round of quantitative easing to sustain economic activity, given that greater liquidity could well drag GDP growth down. This is nowhere truer than in Europe, where the ECB's limited room for manoeuvre will soon make fiscal stimulus a necessity across the **eurozone**, above all in Germany. Our duty is therefore to keep our guard up and avoid reacting complacently to government policies that have more to do with the urge to please the crowd than with sound management of the economy. By the same token, more proactive fiscal policies in the eurozone could bring about economic and monetary conditions that are quite unlike anything either the markets or we ourselves have been in the habit of seeing over the last two decades. This is clearly a time to keep our wits about us.

Sources : Carmignac, Bloomberg, Datastream, 29/03/2019.

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