CARMIGNAC - H2 2024 OUTLOOK

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DIVERGENCE, DILEMMAS AND DEBATES

- Economic synchronisation has given way to divergence.
- In the US, persistent inflation grips the Federal Reserve's (Fed) easing intentions. Meanwhile Europe has commenced rate cuts. Japan must respond to a collapsing yen, and China's dilemma between monetary independence and forex stability is reaching a climax.
- Geopolitical fragmentation, against the backdrop of a fraught US election campaign, is likely to accelerate and challenge elevated asset valuations.
- The path ahead for financial markets is not expected to be as linear as in the past six months.
- In this environment, with risk of renewed supply-led inflation shocks in 2025, shorter-term government bond maturities, credit and a barbell strategy combining inflation hedges and selected low-risk quality equities are favoured.

ECONOMIC PERSPECTIVES – RAPHAËL GALLARDO, CHIEF ECONOMIST

"2024 commenced with an upbeat tone but hopes of a synchronised rebound have faded.

Different degrees of inflation persistence and labour market resilience have led to a divergence in real wage growth in developed countries: continued acceleration in the UK and the Euro area, *versus* deceleration in Japan and the US. Synchronisation prevails only in the upturn of the manufacturing cycle, confirmed by the latest business surveys in South Korea, Taiwan, Germany and Sweden.

In the US, consumer fatigue should be partly offset by resurgent capex, driven by industrial policies (re-shoring, decarbonisation), re-armament and the artificial intelligence (AI) race. As a result, an incomplete soft landing is still our central scenario and a narrow window is open for two Fed rate cuts this year. However, the cyclical downshift means the economy will be a liability for Biden in November's election. A red sweep would usher in stagflationary policies (tariffs, deportations and unfunded tax cuts, albeit deregulation would boost potential growth).

In contrast, the euro area is a sweet spot. Supply-led disinflation and the lagged catch-up of wages to the previous inflationary period, is enabling the European Central Bank to cut rates, with a nascent recovery in both exports and consumption. A right shift in the EU elections will prove a blowback to the green agenda, but will accelerate re-shoring through an emboldened anti-China agenda.

In Japan, another false start is on the cards. The weak yen will claim another victim among Japanese Prime Ministers in September. Yen debasement laminates consumer purchasing power in an economy where the commodity import bill claims 10% of GDP, and goods and utilities make up 50% of the CPI basket[1]. The policy mix should engineer a stronger yen in order to initiate consumption-led growth. After the failure of forex interventions, the Bank of Japan could use the option of quantitative tightening.

The Chinese economy is still humming thanks to short-term policy stimulus, but the engines of the "new productive quality forces" should soon run out of steam: exports face rising Western protectionism, credit to industrial sector peaked in 2023. Medium-term, Xi's foreign policy is incompatible with the current export-led development model. China needs negative real rates to inflate away its internal debts, but the consequent yuan devaluation would be met with another protectionist backlash in the rest of the world.

However, over and above domestic issues, geopolitics will be driving economies over the coming years. We've entered a 'Cold War II', which started with Russia's invasion of Ukraine. It's a trade war, a financial war, a conventional arms race and a technology race. We expect an escalation of tensions in the second half of the year. The new geopolitical paradigm fuels risks of supply-led inflation shocks, but also drives a capex cycle as the US and China seek to outmanoeuvre each other in arms and technology."

INVESTMENT STRATEGY – KEVIN THOZET, MEMBER OF THE INVESTMENT COMMITTEE

"The high level of real interest rates, early signs of a slowdown and the possibility of a 'Fed Put' if the economy was to deteriorate sharply, support the gradual increasing of exposure to interest rates. The dovishness of Fed Chair, Powell fuelling the easing of financial conditions despite the official 'high for longer' stance illustrates that the FED's reaction function is convex: if inflation grinds higher, he will hold interest rates where they are. And if employment comes down, he will slash policy rates.

In government bonds, two-year maturities are favoured. Longer-term rates could underperform given the optimistic disinflationary trajectory and the increase in government debt at a time when the monetary authorities are seeking to make ‘insurance cuts’ and reduce their balance sheets. In credit markets, premiums aren’t far from previous, or all-time lows. Historically, the combination of low bond yields and low credit spreads have been disadvantageous for the asset class but the current higher-yield environment means credit spreads act as a kicker for investor returns and a cushion for volatility.

Historically, in an environment where prices of equities and bonds were negatively correlated, the diversification benefits of ‘low-’ and ‘high’-risk assets was important for portfolio construction. As a result, Markowitz’s[2] ‘efficient frontier’ has served investors for decades. But we are in a new world. The correlation between equity and bond prices turned from negative to positive as the nature of inflation changed. Today’s inflation (commodity shocks, supply-chain disruptions, embargos..) is driven by supply, not demand, meaning that inflation can remain even if aggregate demand fades, hence the efficient frontier has turned from convex to concave, erasing the benefits of diversification.

As such, to re-introduce diversification in portfolios, investors need to hold inflation hedges such as gold or other commodities, as well as lower-valued stocks. But such hedges are also high volatility assets. They’re decorrelating assets but not low risk ones. Therefore, it needs to be compensated with ‘low-risk’ quality stocks such as technology and pharma mega caps that benefit from both high earnings growth and an oligopolistic position.

A barbell strategy can help address re-correlation risk and such an approach can be implemented in various promising themes. Firstly, in the AI space. We combine low-risk quality stocks across the value chain and utilities or energy stocks that will benefit from associated electrification needs. Secondly, the ‘new economy’ has spillover effects to the ‘old economy’. Europe is in a different spot with prospects of a cyclical recovery which isn’t inflationary yet. The region has world leaders in healthcare and consumer staples, as well as attractively valued sectors more exposed to the economic cycle. And thirdly, one can seek to profit from investors’ ambivalence towards emerging markets between the most loved and most hated (but investable) country. India – the most loved - has high potential economic growth supercharged by capital expenditure and benefits from the ’China Plus One’ strategy of businesses aiming to diversify into other countries. This should translate into sustained company earnings. While in China, more than 5,000 listed companies provide a vast pool of opportunities in the (deep) value stock space.

Over the short term, traditional risk parity is expected to serve portfolio construction. But with reinflation risk rising, over the long term, ‘inflation risk’ parity should prevail. Such an evolution is to be ramped up in investment strategies going forward.”

[1]Source: Bloomberg, June 2024.

[2]The father of modern portfolio construction theory.