



An elusive return to normal



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Investors will most likely remember two main things about the state of financial markets in 2020. The first is that they violently yoayed. After initially panicking at the sight of governments wilfully inflicting untold economic damage in a bid to arrest a pandemic veering out of control, investors gradually realised that such a deliberate move to engineer a slump would necessarily be accompanied by monetary and fiscal support commensurate with the collapse at hand – in other words, inordinately large. The second memory investors will come away with is the stark contrast in performance between winning and losing sectors. For portfolio managers to make it through this unprecedented period, it was imperative to actively manage market risk and to go about picking stocks and bonds with the utmost discipline.



The US political horizon has cleared up in the meantime, and effective vaccines will soon be widely distributed. That combination has given investors a sugar high: they are banking on a return to normal in 2021 and, for a few weeks now, on an end to the woes of those sectors most severely battered over the last eight months. However understandable such a reaction may be, we suspect that the return to normal may prove to be trickier than is commonly thought. This isn't to suggest that successful investment performance will be impossible. It simply means that, even if you join in the giddy mood that currently holds sway, you need to keep a level head.

Public policy at the crossroads

The extraordinary fiscal relief rolled out by governments and the monetary-policy support provided by central banks have shown an outstanding degree of coordination in 2020. Necessity being the mother of invention, long-standing commitments to a modicum of economic orthodoxy have been temporarily put on the back burner. However, a return to broadly normal conditions inevitably raises the question of where public policy will be heading.

On the fiscal front, it is already apparent from the way the European Union's institutions operate that even just a few unyielding member states – Hungary and Poland at this point – have the means to block rapid implementation of the EU Recovery Plan. In the United States as well, it's anyone's guess as to how much cooperation the incoming Biden administration can elicit from the Senate. A Democratic majority in the upper house is still an arithmetic possibility if both of the party's candidates in Georgia win on 5 January. But the opposite outcome is at least as likely, and a renewed Republican majority could well make a point of rejecting the administration's key Federal spending proposals, as happened to Barack Obama in 2010–2011.

It will take a long time for even a robust upturn to repair the colossal damage done to the economy in 2020

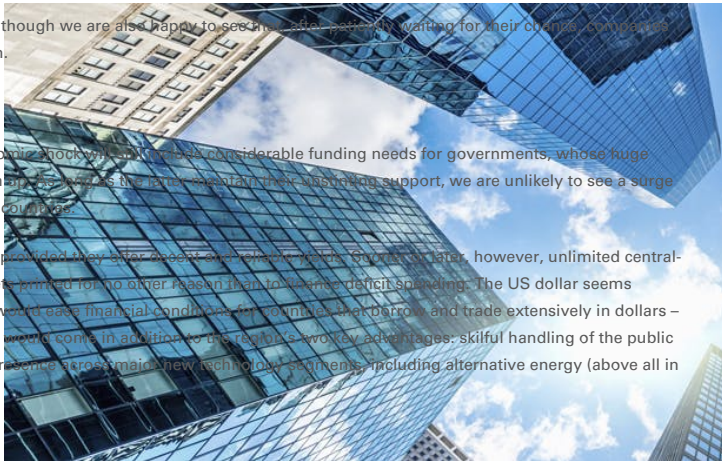
Besides this manifest lack of clarity on future policy, there is a very real risk that, as today's exceptional circumstances recede, the conventional advocates of fiscal restraint will come back to the charge. And while we can reasonably expect large-scale vaccination to give a hefty boost to confidence, travel and consumer spending, watered-down stimulus programmes will almost certainly have the opposite effect. In our view, markets are so busy celebrating a return to normal that they might be overlooking the obstacles to growth that are still very much with us, particularly as global debt and underemployment have both risen further. It will take a long time for an upturn, however robust (if only due to a favourable comparison basis), to repair the colossal damage done in 2020 to a world economy already hampered by weak secular growth. To be sure, the possibility that across-the-board central-bank largesse will eventually trigger a sharp increase in inflation can't be ruled out entirely. But we feel that the currently forecast cyclical recovery should not be mistaken for a trend reversal at this stage. Destruction will not be creative in the short run – assuming it ever is.

For all those reasons, we will be sticking with our bias in favour of quality growth stocks, though we are also happy to see the capital markets waiting for their chance. Companies exposed to the re-opening of the economy can at long last contribute to our returns again.

The emerging world waiting in the wings

It's worth noting that, even if fiscal spending is restrained, the fallout from the 2020 economic shock will entail considerable funding needs for governments, whose huge deficits will make it impossible for them to get along unless their central banks back them up. As long as the former restrain their spending support, we are unlikely to see a surge in bond yields – a development that would spell trouble for government budgets in most countries.

Be that as it may, within the fixed-income space, we continue to favour corporate bonds, provided they offer decent real yields. Even so, later, however, unlimited central-bank support might end up undermining the intrinsic value of currencies when money gets printed for no other reason than to finance deficit spending. The US dollar seems particularly in danger of falling victim to such a fate. On the upside, a weaker greenback would ease financial conditions for countries that borrow and trade extensively in dollars – first and foremost emerging economies. In China's sphere of influence at least, that boon would come in addition to the region's swifter advantages: skilful handling of the public health crisis, which has paved the way to a swifter economic recovery; and an enviable presence across major new technology segments, including alternative energy (above all in electric vehicles).



The emerging world enjoys two key advantages: a swifter economic recovery and an enviable position in high-growth sectors

It also seems to us that a possible slide in the dollar, and perhaps other currencies confronted with similar challenges, could put gold back on its upward trajectory in 2021.

To conclude, as the world emerges from the “anomaly” experienced in 2020, sectors unduly hurt by the crisis should soon be back to more normal valuations. But beyond that adjustment, it is important to keep in mind that with regard to equity-market performance, long-term earnings growth will remain the ultimate judge and jury. As we pointed out in our October Note (“**How 2020 is changing the game**”), with interest rates set to stay rock-bottom, the world economy still sluggish and macroeconomic imbalances getting worse, earnings growth will remain scarce – and fragile even when it does occur. We will therefore continue to construct our global portfolios around four key “antifragile” types of assets: shares of companies with predictable profit growth, China and its broader regional sphere of influence, winners in the energy transition, and gold miners.

Investment strategy

Equities

Good news on the vaccine front and the outcome of the US presidential election have led to an epoch-making equity-market rally driven by the sectors most badly battered since the start of the year (banks, carmakers and energy companies). Massive uncertainty in 2020 had pushed their share prices so far down that there is nothing mysterious about such a catch-up process. Aside from this extremely rapid share-price adjustment for such value stocks (despite significant strategic shortcomings in some cases), what prompted our global fund managers to take part in this rally was above all our “re-opening of the economy” investment theme, which we began building into our portfolios on the lows recorded in March–April. In doing so, we have remained extremely selective, focusing primarily on asset-light companies in the tourism sector that enjoy market leadership and high barriers to entry.

The prospect that the Covid-19 pandemic will soon be under control has also encouraged us to up our exposure to med-tech companies that were weakened by the postponement of elective surgeries.

Our core portfolio is made up, as before, of companies relatively unaffected by the business cycle and that thrive on secular growth trends. As most of them posted rising share prices, we have engaged in profit-taking, selling our holdings in electronic payments firms, for example. We reinvested the proceeds in companies that we feel the consensus has continued to overlook. These include a number of top-tier European and South Korean carmakers that are currently transitioning to electric vehicles, a business that will give them a source of sustainable performance over the years to come. The electric vehicle theme is also represented in our portfolios via Chinese pure plays and Korean battery manufacturers.

To position our portfolios for 2021, we will therefore be maintaining our emphasis on companies with predictable earnings growth in tech, consumer goods and healthcare. We will be balancing those holdings with basically robust businesses whose revenue temporarily fell as a result of the pandemic.

Fixed income

Progress on vaccines and a more predictable post-election environment in the US elections have set off a powerful rally in risk assets like corporate credit, non-core EU sovereigns and emerging-market debt. Meanwhile, core interest rates have been maintained at extremely low levels due to actual and anticipated intervention by central banks. As 2020 comes to an end, several fixed-income market segments have recovered roughly to pre-crisis valuation levels. However, this return to normal may well heighten the differences in fundamentals among issuers. We will accordingly continue to favour corporate credit, with three major themes making up the bulk of our exposure: the re-opening of economies (airlines, aircraft manufacturers and travel), energy, and banking (chiefly through subordinated bonds).

The rock-bottom yields on core sovereign bonds offer little opportunity despite what is sure to remain highly accommodative monetary policy. This explains why we still have only limited exposure to US Treasuries. In debt from the eurozone periphery, we have sold some of our Italian holdings following their excellent performance in the past few weeks.

There are opportunities to be had in the emerging world, but they are still partially contingent on dollar depreciation. We are therefore sticking with our diversified, selective positioning. For example, Romania’s euro-denominated debt still offers attractive spreads for a country poised to benefit from the EU Recovery Fund. Our single largest holding of local currency-denominated debt is still in China, where real yields remain high and the central bank has adequate leeway for further policy easing. Lastly, we feel that EM currencies like the rouble also have considerable potential to drive returns for our funds.

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