Augmented Reality

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Author(s)
Didier Saint-Georges

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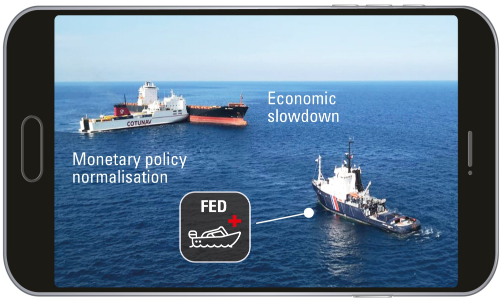
As we sensed at the beginning of the year (see our January Note, "50 shades of black"), stock markets recovered sharply from the mood of panic prevailing at the end of 2018, through a rebound fuelled by the Federal Reserve's U-turn on monetary policy normalisation. The MSCI World Index gained 11.21% in the first two months of the year, cancelling out the entire correction it experienced in the fourth quarter of 2018. The unavoidable question is whether that rebound stands a good chance of continuing over the months to come.



Carmignac - Photo : © Maritime Préfecture

> A collision between monetary and economic cycles was the backdrop to market movements in 2018. But it won't be this year

The global economy has slackened further and its weak points are still unmistakably present. From the build-up of political uncertainty in Europe and the United States to the threat posed by overleveraging at a time of waning GDP growth, investors have ample grounds for wanting to play it safe this year. But that uninviting reality is being "augmented" – or at least mitigated – by what is objectively speaking a more placid environment than last year. Financial markets are now fully cognizant of the unfolding economic slowdown. And so are central bankers, who no longer feel required to stick to their script of unrelenting monetary policy tightening. A collision between monetary and economic cycles was the backdrop to market movements in 2018. But it won't be this year.

We can rather expect a lacklustre configuration that will hardly be conducive to sustainable trends. With the markets gradually and gingerly breaking free from the collision-course conditions that characterised 2018, what is called for are investment strategies geared to generating alpha instead of to managing beta and betting on a clear market direction.

Any number of political developments have the potential to upend financial markets this year, from eleventh-hour Brexit negotiations between the European Commission and the UK government to new twists in Sino-American trade talks, and from fresh US threats to hike tariffs on imported German cars to the upcoming EU elections. Over the next few months or even weeks, these major hazards from the standpoint of investor and consumer confidence – and therefore economic growth – will come to a head, which makes them a cause for short-term concern. But a more likely outcome is that the various protagonists will ultimately stop short of shooting themselves in the foot through their brinkmanship. Because – however unwise it would be to expect politicians to behave wisely – the contending forces may well work out a modus vivendi of sorts, providing investors with welcome relief after months of anxiety.

Leaving aside short-term developments, market trends are still likely in 2019 to be shaped primarily by the overall health of the economy, which now looks quite underwhelming. The global slowdown has continued as we anticipated.

In the United States, the construction sector shows signs of further weakness, and things don't look any better in manufacturing – the Markit PMI survey for manufacturing slid to 53.7 in February, its lowest reading since 2017. But as long as demand for services holds up (the key indicators have remained fairly steady for the past year) with the help of a still-booming job market, overall output growth should slow only moderately. This forecast recently gained further plausibility when the Federal Reserve abruptly ditched its dogmatically hawkish stance, openly acknowledged its fear of market pressure and expressed increasing disregard for short-term inflation indicators.

Meanwhile, a positive resolution of the US-China trade dispute could provide a tangible boost to business sentiment and investment. Such an outcome will of course depend on whether the parties can walk the fine line between long-term ideological confrontation and their mutual interest in striking a deal that allows them to save face without being self-destructive. But the US economic slowdown, the forthcoming presidential election campaign in the country and the financial market swoon observed in December all raise the odds for a deal that both sides can at least claim represents progress for them.

In Europe, the Markit Manufacturing PMI fell to below 50 in February, thus giving the lie to the contention that the economic slowdown late last year could be blamed essentially on a temporary sag in German car production caused by efforts to comply with the new WLTP CO_2 emissions standard. But while higher consumer spending – made possible by a pick-up in wages and job numbers on the continent – should keep the slowdown from getting much worse, we will see no serious improvement without a hike in demand from China, and so far that hike looks modest at best. That leaves the European Central Bank no other alternative than to hew to its extremely accommodative policy.

China is still struggling to wend its way between excessive leverage, trade tensions and a cyclical economic slowdown (see our January Note 50 shades of black). Beijing's policies to sustain consumer spending are likely to steady GDP growth in 2019, particularly in the event of a trade deal with Washington. But that certainly won't be enough to give European exports the kind of boost they got in 2016.

The world economy as a whole therefore appears to be heading in these first few months of 2019 for a landing – the softness of which will be moderated by central banks, whose plans to tighten monetary policy are increasingly off the agenda.

> The upside of this slow-growth phase is that stock price dispersion could heavily influence portfolio returns, contrary to 2018

This suggests that equity indices are likely to score only mediocre gains with respect to their current levels: average valuation levels have recovered since the start of the year and the prospects for corporate earnings growth look meagre. The upside of this slow-growth phase is that stock price dispersion could heavily influence portfolio returns, whereas performance in 2018 depended much more heavily on judgements about overall market direction. More specifically, the shares of companies with reasonable valuations that succeed in sustaining profit margins and business growth will most likely trade at a substantial quality premium in the bleak economic climate we expect to see in 2019. Generating alpha should likewise take precedence this year over making one-way directional bets in the fixed-income market, above all for corporate bonds.

Source: Bloomberg, 28/02/2019

Investment strategy

Equities

Equity investors are unlikely to forget these past two months. After booking its worst monthly performance in December since 1931, the stock market began the new year in style, chalking up its fifth best-performing January. With prospects for economic growth getting dimmer and encouraging monetary or political surprises becoming less probable, we favour alpha generation strategies, keeping our exposure to equities fairly low and avoiding pronounced sectoral biases.

Since the beginning of the year, we have gradually beefed up our equity holdings, seizing opportunities to invest in companies with sound fundamentals and attractive share prices, most notably in China (Midea, Zhifei). We have also invested further in healthcare, adding EssilorLuxottica and Merck to our portfolio. As before, thematic investing is central to our strategy for generating alpha. For example, we consider low-cost airlines an attractive segment where we have recently stepped up our presence with a position in Spirit Airlines. Due to their large addressable market and the flexible pricing they offer travellers eager to shop around for bargains, those carriers are operating in a sector with solid prospects for expansion. However, we are also paying close attention to valuations in what is still a shaky environment. We have accordingly taken profits on such top contributors to our performance as Mercadolibre and ServiceNow.

Fixed income

Central banks are treading cautiously in response to the ongoing global economic slowdown. Recognising there are risks that could undermine the health of the economy, the Fed has called time out on its monetary policy normalisation drive. The ECB has likewise adopted a more dovish tone in response to continuing decline in the eurozone's economic indicators and inflation expectations. That has resulted in lower sovereign bond yields across the currency bloc except for Italy, a country still buffeted by a weak economy and doubts about how sustainable its national debt is. Credit spreads have also returned roughly to where they were during most of 2018.

We have maintained a slightly positive modified duration for our Funds along with a cautious positioning, achieved through limited exposure to sovereign debt from non-core eurozone countries and emerging markets, as well as to corporate credit. We recently upped our EM exposure slightly, in particular by buying "quasi-sovereign" paper from the likes of Pemex. We also initiated a position in Belgian government bonds, which we feel offer attractive carry opportunities in the eurozone. And for the time being, we remain strategically positioned for a steeper US yield curve.

Currencies

In the forex market, the Fed's change of course and the first signs of a slowing US economy have worked to the euro's advantage since the start of the year. But a number of factors – Brexit, the EU parliamentary elections and the US current account deficit – currently make it hard to determine exactly where the forex market is heading.

We have therefore maintained our strategy of limiting currency risk in our portfolio. Our view is that after rebounding at the start of the year, a few EM currencies, particularly in Asia and the Middle East, continue to hold out a fair amount of opportunity.