THE VIRUS AND THE RUBICON

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Most investors have grasped that today's extraordinarily loose monetary policies and the start of the Covid-19 vaccination campaign raise the prospect of an economic recovery in a few months' time that should mean extremely bullish news for equities.

This explains the current upbeat mood, but it also brings to mind the observation that concluded our January 2020 Note: "… investors are still giddy from the market rally at the end of last year, and thus increasingly vulnerable…."

We're therefore uncomfortable with the broad consensus among investors as the new year gets under way. Though we remain fairly constructive on equities in the short term, what is shaping our medium-term strategic thinking is that, while the Democrats have won an absolute majority in both houses of the US Congress on a platform of large-scale fiscal stimulus, that positive outlook is tempered by the imbalances that such a stimulus is likely to create. So market developments in 2021 may prove to be trickier than is commonly thought.

Bumping up against reality

Financial markets have rightly hailed the announcement of the first vaccines in November and the current rollout process as the beginning of a new phase – one in which we can at last perceive the light at the end of the tunnel. Once the vaccination campaigns have achieved critical mass, consumers will regain the confidence (and the permission) they need to satisfy their long-restrained wants.

The trouble is that the progress in that direction isn't exactly going smoothly. From logistical challenges to vaccine hesitancy, and from the delicate job of managing priorities to varying degrees of success in the different countries, the return to normal somehow keeps receding from view. All those issues heighten the probability of further strict lockdown measures – and will almost certainly increase the duration of yet another trying phase.

While that eventuality doesn't necessarily spell danger for financial markets as long as governments and central banks continue to provide adequate support, it does suggest that we are right to stick with portfolios that have companies with predictable earnings growth as their backbone.

Towards a medium-term regime change for financial markets?

With the US Senate now controlled by the Democrats, we can expect a debate on the risk of inflation, which would be partly stoked by a weaker greenback. In fact, everything from interest rates to equity valuations depends on the future of inflation. So the issue calls for careful examination.

The Democrats will undoubtedly demand the implementation of Joe Biden's campaign platform, including the most progressive proposals. But they won't be able to achieve that without support from moderate lawmakers. This means that the more radical points in the new administration's programme are unlikely to be put into practice, even if we expect a substantial new stimulus bill in 2021.

In addition, population trends and technological disruption continue to exert a powerful long-term deflationary influence. We therefore believe that there is little risk of significant inflation in 2021 beyond a temporary base effect.

This rather benign near-term outlook can't tell us much about long-term trends, however, because the fact remains that governments and central banks – particularly in the US – crossed the Rubicon in 2020. From here on in, it will be politically and socially quite hard to engineer a U-turn away from the government's growing involvement in the economy.

A Democratic majority in Congress could well mark the start of a sustained challenge to the economic model inaugurated forty years ago in the "Reagan-Thatcher" era – a model based on deregulation, lower taxes and a generally smaller role for government. The incoming US Secretary of the Treasury, Janet Yellen, is an out-and-out Keynesian and makes no bones about it. This new philosophy on economic growth could well translate into policies geared openly to redistributing more of the country's wealth to wage- and salary-earners, and this more balanced distribution could reverse the current trends in productivity and inflation. Investors need to prepare for that, which is why we have taken positions in a few US cyclical sectors and in gold mining.

A model that has been around for forty years deserves the benefit of the doubt, and economic uncertainty is the name of the game in the short run, notably in Europe. One last point: in 2020, one country bucked the dominant trend of forging blindly ahead. China has not only handled the pandemic quite well and avoided printing money galore; Beijing has also figured out (or was forced to figure out) how to “decouple” from the US. The Chinese market today is where a large share of our high-conviction investments are to be found.

The overall balanced nature of our portfolios and our resolutely active approach to asset management should once again provide us with the means to generate performance in what promises to be a complicated year – and therefore one offering lots of opportunities.

Source : Carmignac, Bloomberg, 31/12/2020