



## What else?

June 2017



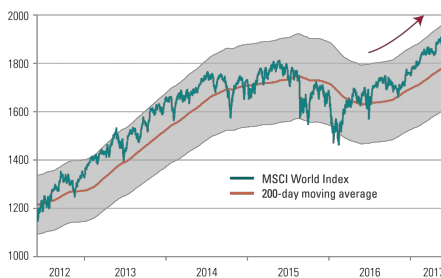
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Published  
June 1, 2017

Length  
6 minute(s) read

The French election didn't deliver the deathblow to the European integration process after all, which means that financial market exuberance can be expected to hold up for a while. Not only is liquidity still plentiful – quantitative easing has pumped over a trillion dollars into the system worldwide since the start of the year – but the global economy is enjoying a moderate upswing, the dollar is weak, interest rates are still low and oil prices have steadied. What more could you want?

This favourable alignment of market conditions has worked very much to the advantage of major global growth stocks since the beginning of the year. The dominant tech names in particular have increased their lead on the back of yet another set of solid results in the first quarter. With the cyclical upturn gradually spreading, financial markets in Europe and above all in the emerging world are at the very least on par with the S&P 500 since the start of the year.



Source: Bloomberg, 29/5/2017

Bond markets have also picked up speed, with gains averaging 4%, as continued soft inflation readings have eased central bank concerns.

On this road paved with "good inflections", a particularly gratifying sign is that economic fundamentals are at long last taking primacy over market movements. But as we enter the second half of 2017, this would perhaps be a good time to review the concept of reflexivity – as this process operates constantly between economics and politics (see our [March Note](#)) – and set out our view of the dynamics that have driven markets to their current levels.

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## So far, so good

For now, financial analysts can point to real economic developments to justify their steadily rising estimates for corporate earnings in 2017. Japanese companies led the pack in the first quarter, with profits up 28% over the prior-year period. Not far behind were European firms (up 23%), followed by their American counterparts (up 14%). A noteworthy point is that this trend has been powered by surging revenues, which reflect both growing sales volumes and a return to firmer prices. Interestingly, Europe leads the current expansion in business activity (up 10%), trailed by the US (up 8%) and Japan (up 4%). With the year off to such a promising start, analysts' forecasts for profit growth in 2017 are on average 15% in the eurozone, 12% in Japan and 10% in the United States.

Corporate profits in the second quarter should be further buoyed by the improvement in economic fundamentals, with eurozone companies cutting a particularly fine figure. Consumer confidence in the region, as calculated by the European Commission, climbed in May to its highest level since July 2007. It should also be borne in mind that the improved sentiment didn't emerge until last autumn, which suggests that it will probably last for another several months, particularly as the German powerhouse has lost none of its drive. In fact, the IFO Business Climate Index has never been higher since German reunification in 1991.

However, if we look further ahead than the next few months, a number of dark clouds appear that may well dampen the euphoric mood.

## Reflexivity

For the future, we need to monitor the reflexive connections between the economy and politics in the United States, the United Kingdom and the eurozone.

For now, the winners of various elections held in the past twelve months can savour their victories. But they can also thank their lucky stars. From London to Washington and from Paris to Seoul, new heads of state have started their terms of office with much more economic wind in their sails than anticipated. And if the past is any guide, the economy is what matters most to investors. That said, it would be a mistake to ignore the process of "reflexivity" between politics and the economy – in other words, feedback loops connecting cause and effect. Sluggish global economic growth since the end of the Great Recession, the contrast between that sluggishness and the spectacular stock market rally since 2009, and the failure of government policy to lessen the income gap between ordinary wage-earners and the beneficiaries of asset-price inflation – fuelled by quantitative easing – have together generated widespread discontent that has caused major political disruptions. Those disruptions will in turn have economic consequences that will be reflected in market behaviour.

In the United States, President Trump's economic policies may ultimately prove to be less disruptive than one could have surmised from his loudly-trumpeted campaign rhetoric. Under the combined pressure of budgetary constraints, the Republican Congressional majority's lack of party discipline (perhaps a good thing) and a spate of legal imbroglios, the sweeping fiscal reform he promised – which drove up the dollar and kept investors' mouths watering until the end of 2016 – may never make it to first base. As a result, the US business cycle will likely soon succumb to the inevitable process of ageing.

Brexit, in contrast, is definitely going to happen. Moreover, as Theresa May's government intends to abide by the will of the British electorate expressed in June 2016, the country's withdrawal from the European Union is likely to seriously shift the direction of its economy (see our [April Note](#)). Under the impact of a weaker pound, inflation already rose to an average of 2.5% in March and April – accelerating the downward trend in real wages to its fastest pace since 2014. The resulting fall in disposable income led to April's disappointing retail sales, and the UK economy already experienced much slower growth in the first quarter: 0.3%, versus 0.7% in the fourth quarter of 2016. Sterling may well continue to bear the brunt of the adjustments required of an economy with a large current-account deficit, which the uncertainty surrounding Brexit will make it increasingly hard to finance.

In the eurozone, France's voters fortunately didn't let themselves be wooed by the snake-oil remedies on offer. This improves the prospects for a cycle of reforms that will add value, however difficult they may be to implement. The Government's stated will to heighten economic convergence between France and Germany also bodes well for the political survival of the European integration process, as it would entail greater federalism. The eurozone could thus soon emerge as a credible alternative to the United States as a sound, growing economic region. Such a momentous shift of balance is however unlikely to take on tangible form until after the September elections in Germany, at best.

## Mounting market fragility

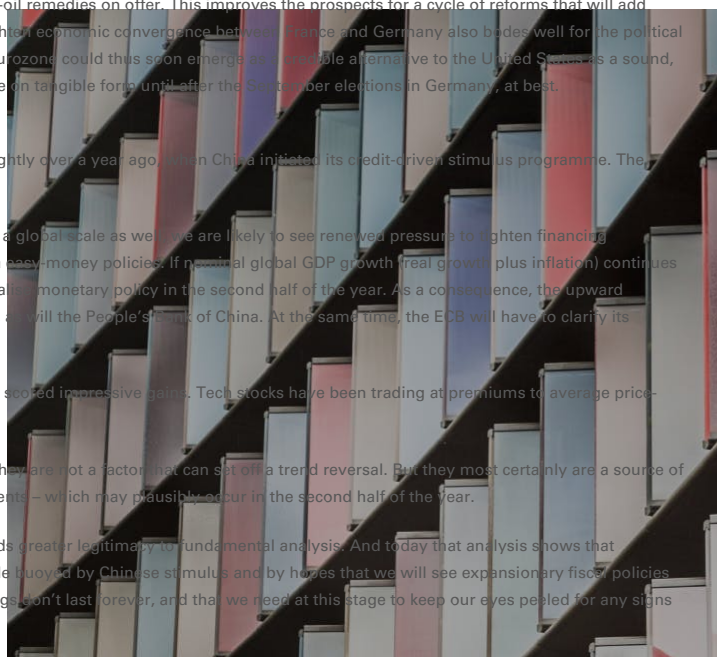
The rebound in global economic indicators, commodity prices and inflation got going slightly over a year ago when China initiated its credit-driven stimulus programme. The question today is what the next phase of the cycle will bring.

The Chinese government has taken steps to rein in the country's bank lending boom. On a global scale as well, we are likely to see renewed pressure to tighten financing conditions now that political risk has ceased to be a valid argument for maintaining extra-easy-money policies. If nominal global GDP growth (real growth plus inflation) continues to rise, even at a moderate pace, central banks will be compelled to move faster to normalise monetary policy in the second half of the year. As a consequence, the upward trajectory in asset prices can be expected to slow. The Fed will certainly take such action, as will the People's Bank of China. At the same time, the ECB will have to clarify its intentions.

Nor will such a shift in central bank policy only affect cyclical stocks, which have recently scored impressive gains. Tech stocks have been trading at premiums to average price-earnings ratios not seen since the dot-com bubble in 2000.

In and of themselves, market valuations are merely a reflection of investor perceptions; they are not a factor that can set off a trend reversal. But they most certainly are a source of fragility. They heighten the potential for over-reaction to external shocks or disappointments – which may plausibly occur in the second half of the year.

To summarise, the new primacy of economic fundamentals over market movements lends greater legitimacy to fundamental analysis. And today that analysis shows that underpinning the gains made by those markets in the past year is a global economic cycle buoyed by Chinese stimulus and by hopes that we will see expansionary fiscal policies coupled with highly favourable monetary policies. It also reminds us that cyclical upswings don't last forever, and that we need at this stage to keep our eyes peeled for any signs of inflection.



## Investment strategy

### Equities

The rally in European equities has continued virtually unabated since the end of the French presidential election. It is worth noting, however, that all major global stock indices are still climbing at the same pace, with the result that the valuation gap between Europe and the rest of the world shows no change. Asia can accordingly claim the top performance in May – in the Indian, Chinese and South Korean equity markets.

Our performance in May was lifted by our move at the start of the year to step up our exposure to those markets through investments in Indian banking names like Indusind and Korean tech stocks like Samsung. We also continued to diversify our tech holdings, purchasing stocks that were cheaper or less well-known than the major US internet names. We accordingly initiated a position in Zayo Group, an American bandwidth and internet service provider. Lastly, we focused our energy positions on US shale oil producers, who stand to benefit from the ongoing commitment by Saudi Arabia and the other OPEC members to support crude oil prices. However, we sold off our holdings in oil service companies, because we believe they will be hurt by the oil cartel's sustained output freeze.

### Fixed income

The Federal Reserve has resolutely set its sights on normalisation, while the ECB has shown extreme caution regarding the timetable and specifics of any future move away from unconventional monetary policy. The result of that approach could be to keep European interest rates low, even as the economic recovery gathers momentum and inflation stabilises in the eurozone.

That outlook led us to step up our carry-trade strategy through a mild increase in our Italian debt holdings. We also took tactical advantage of the abrupt hike in Brazil's interest rates to temporarily increase our exposure to Brazilian bonds, which we have hedged for currency risk. Although political uncertainty may delay pension reform and other similar measures, the country's fundamentals, including its current account balance and rate of inflation, are extremely sound – and they are inadequately reflected in what is currently one of the highest real interest rates anywhere in the world.

### Currencies

The euro has continued to gain ground, appreciating by more than 4% against the dollar in the last two months. We have taken full advantage of that trend with a currency strategy centred on the euro. And with the outcome of the June UK general election increasingly up in the air, our British pound hedges have also paid off. Finally, thanks to our cautious stance on emerging-market currencies, we have taken in stride the surge in volatility that hit the Brazilian real in the wake of the latest political scandal.

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