

MANAGEMENT REPORT – 3RD QUARTER 2017

Q3 2017

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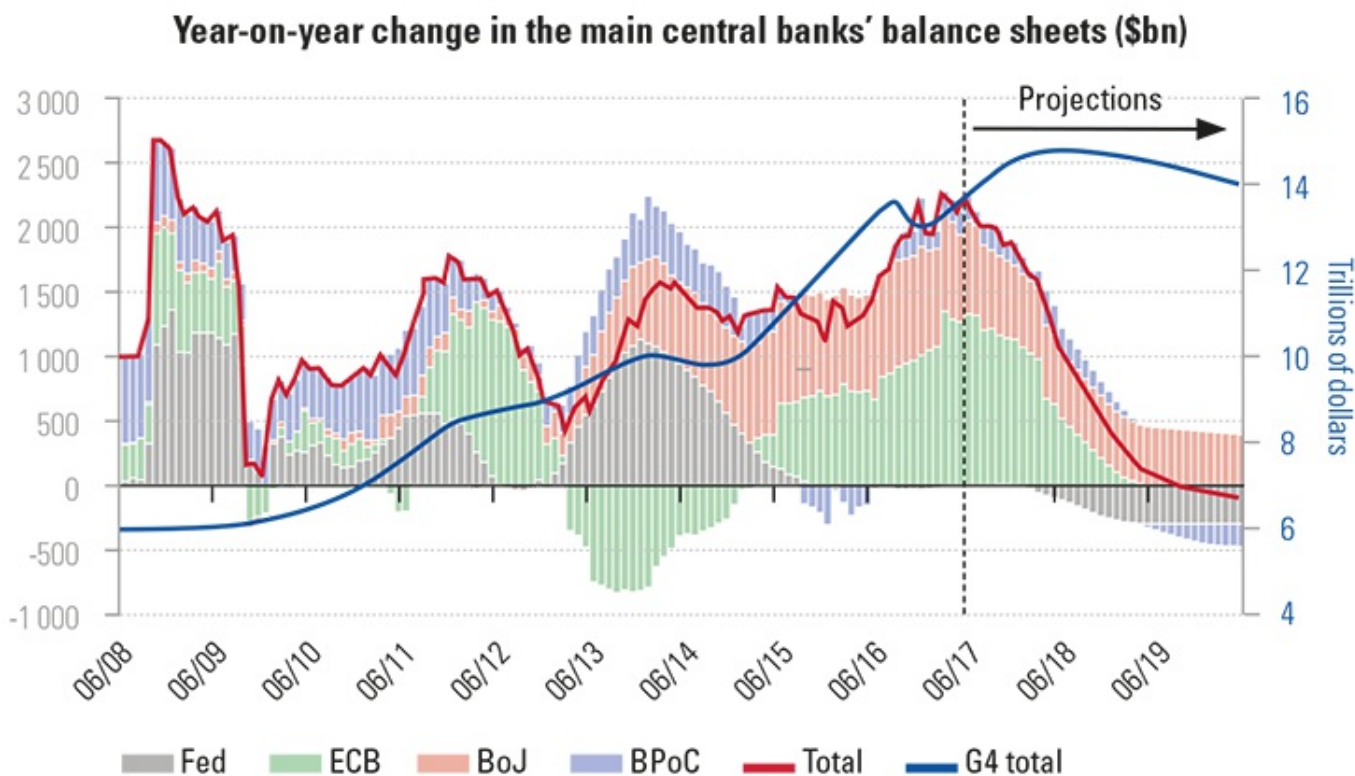
Global economic growth has continued to gain traction, with Europe and the emerging world powering the process. Despite persistently weak inflation, central banks in the United States and Europe will soon initiate monetary policy normalisation, enabling them to manage down the amount of cash in the system. We are unquestionably in the midst of a global economic upswing, one bolstered not only by market expectations of monetary policy normalisation, but also by the fact that political uncertainty hasn't even mildly dented market performance or the resilience of the US economy.

The global outlook

Elaborating on our analysis of the first quarter, we wrote three months ago: *"Virtually coordinated announcements of policy normalisation by central banks, combined with strong recent US leading indicators and a global economy growing moderately but in relative sync, tend to validate our non-consensus expectation for a return to cyclical trends, including an expansionary phase that will be vigorous enough to force central banks to step in and apply the brakes."* We also identified the flagging business cycle in the United States as *"the best bulwark against a sharp contraction in global liquidity"* while adding that *"the days when the Fed deliberately pursued policies that lagged behind the cycle out of fear of deflation and of stifling the recovery are over and done"*.

In our view, that perception of the economic environment still holds true on all essential counts. Global economic growth has continued to gain traction, with Europe and the emerging world powering the process. Despite persistently weak inflation, central banks in the United States and Europe will soon initiate monetary policy normalisation, enabling them to manage down the amount of cash in the system. We feel that the Fed's growing perplexity over the absence of inflation bears out that view, but we are still keeping a watchful eye out for any pick-up in prices that the current business cycle might generate. We are unquestionably in the midst of a global economic upswing, one bolstered not only by market expectations of monetary policy normalisation, but also by the fact that political uncertainty hasn't even mildly dented market performance or the resilience of the US economy.

Soaking up liquidity (normalising) is putting it mildly



Source: Carmignac, 30/06/2017

Sovereign bond yields show little change, while stock markets have been buoyed, as expected, by continuing signs of GDP growth and ongoing monetary policy easing. In the third quarter, our cyclical stocks (e.g., in the energy sector) partially made up for their weak performance early in the year and our stocks with good earnings visibility sustained their momentum, particularly those with continuing growth prospects like our tech stocks. Strengthened by a steadily improving global economic outlook, the euro tested a \$1.21 exchange rate – that is, 17% above the low it hit in January – before retreating slightly.

The next few weeks will be decisive for the global economy and markets. The Fed will start scaling back the reinvestment of coupons and maturing securities on its balance sheet, while the ECB will specify the pace at which it plans to trim its asset purchases. Over a 30-month period, the combined effect of those two shifts towards monetary policy normalisation could cut annual cash injections into the world economy from \$2.5 trillion to zero. Over the past decade, central banks have unconventionally ploughed seemingly unlimited amounts of liquidity into the system, creating a serious and widespread cash addiction – at a time when the ongoing deleveraging of the global economy has continued to hold down long-term economic growth and inflation.

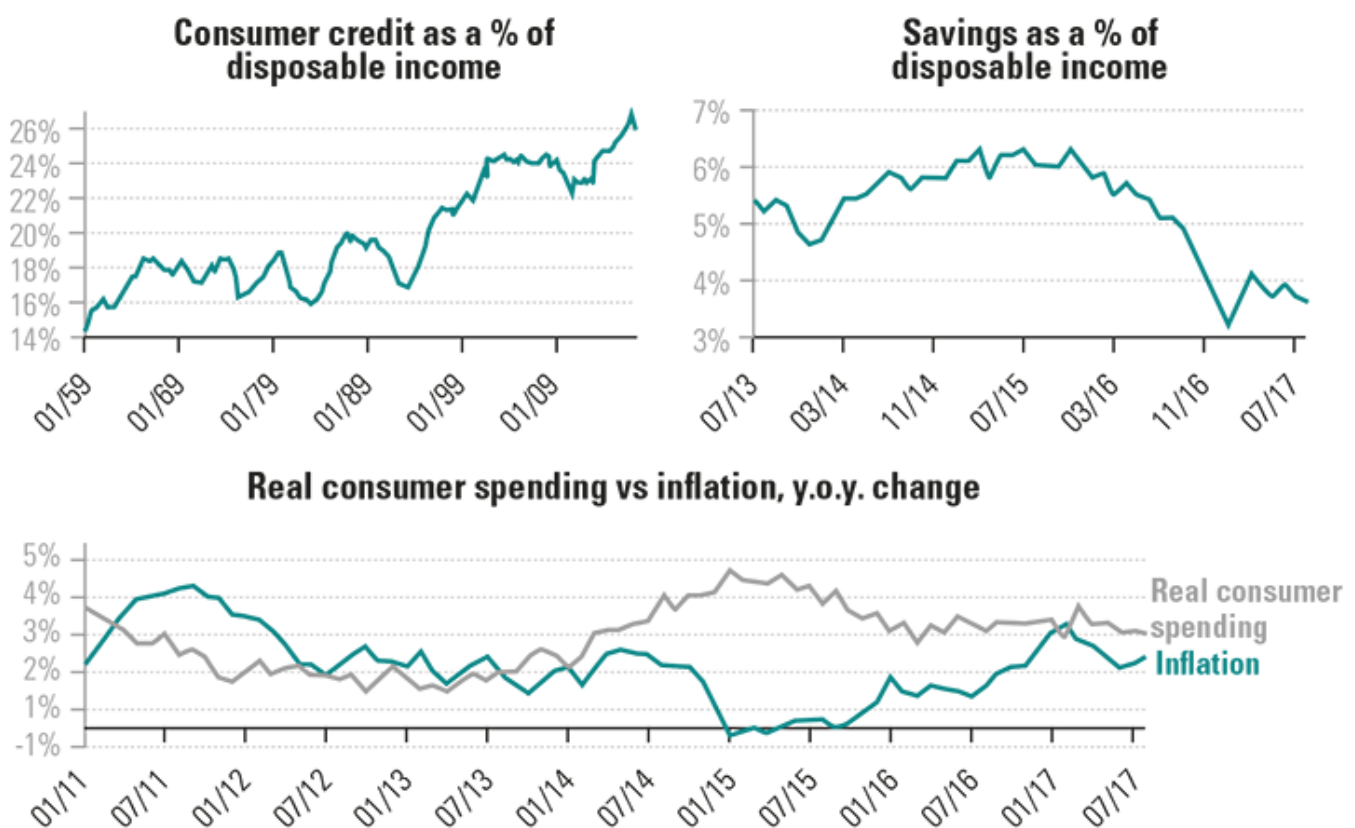
We are therefore inclined to doubt that the central banks will move as fast as they have promised. But even a partial return to “normal” monetary policies will necessarily affect the economy. The main arguments advanced for such a return are the threat of inflation in the United States – which could be sparked by wage

increases, given that the unemployment rate is barely over 4% – and the sense that the world’s regions are growing largely in sync, as evidenced by the vast majority of leading economic indicators. But does that apparent synchronisation, combined with a lull in the European crisis, really offer central banks the opportunity they’ve been awaiting for so long? Or does the announced shift in monetary policy stem rather from a misperception, with the Fed overestimating the strength of GDP growth in the United States?

United States

Even though the Trump administration has yet to implement a single measure to boost growth, the US economy has continued to power ahead at an annual rate of roughly 2.5%. Consumer spending has been boosted by a declining savings rate, which currently stands at 3.6% of disposable income, by further growth in consumer credit, which has climbed to a record 27% of disposable income, and by the lagged effect of the disinflation seen since March. Capital investment too has increased by 3.6% year-on-year, but growth in new orders for durable goods – a harbinger of capital spending – weakened from an annualised rate of 10% to 5% over a six-month period. US export growth followed a similar course over the same time-span, falling to zero. In fact, that situation is shared today by a good many export economies around the world.

United States: consumer spending is partially “spent”, but disinflation will still help



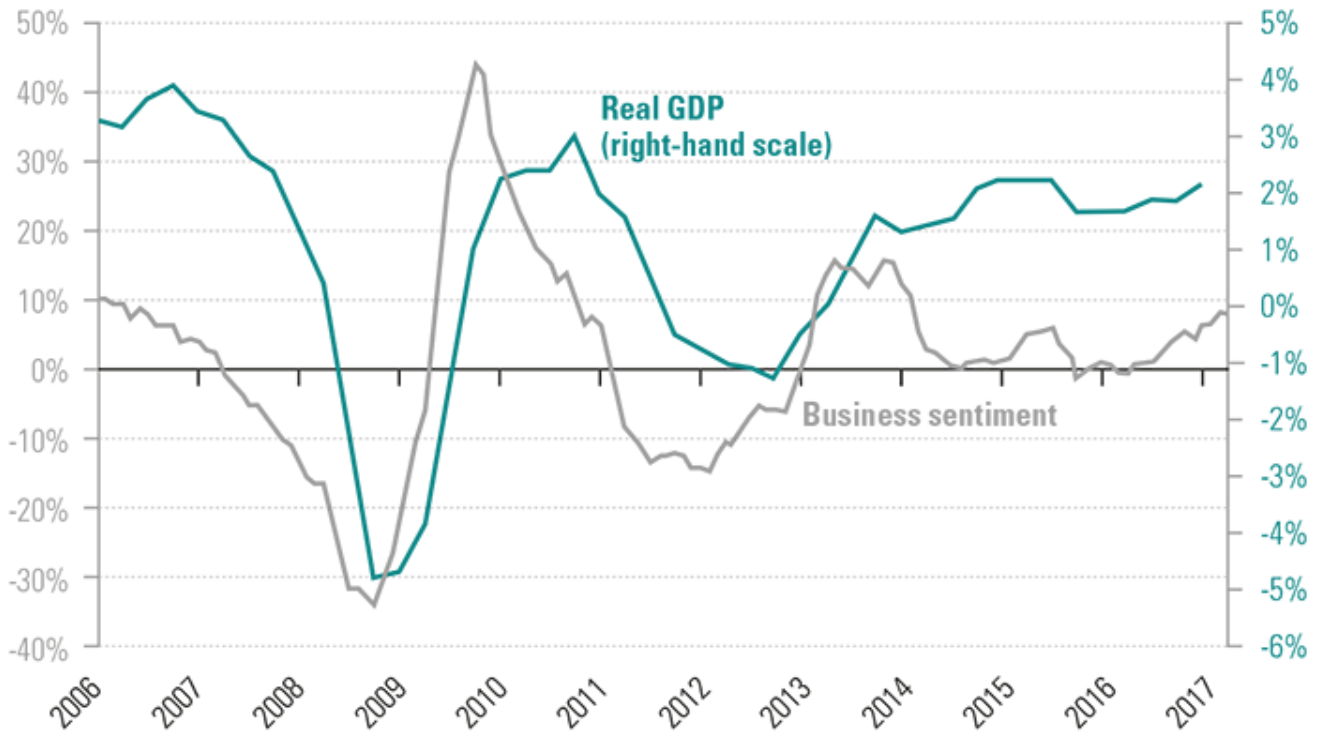
Source: Carmignac, CEIC, 31/08/2017

However, there is substantial divergence on leading indicators for manufacturing activity, making it hard to analyse trends with any degree of certainty. The ISM Manufacturing Index recently hit a 20-year high of 60.8 in September, for example, whereas the US Markit Manufacturing PMI was flirting with its lows of recent years. Be that as it may, our take on the US economy is that consumer spending as a growth driver is largely “spent” and capital investment is gradually running out of steam. The only thing likely to keep GDP growth up in the 2.0% to 2.5% range (its average for the past decade) is the prospect of tax reform. The withdrawal of liquidity orchestrated by the Fed – at a monthly clip of \$10 billion initially and then \$20 billion from next January onwards – is bound to have a negative impact on growth. The resulting slowdown may be offset for a while by further expansion in Europe and the emerging world, but this is still no time for complacency. Global economic growth is increasingly dependent on how adroitly the Fed manages the shift.

Europe

Europe today has the benefit of extremely clear economic skies ahead. The continent enjoys high and rising consumer and business confidence. The German locomotive continues to produce robust manufacturing data. And the election of a resolutely pro-business president has given the French economy new wings. According to the IMF’s latest forecasts, eurozone output should increase by 2.1% this year and by 1.9% next year. France, Italy and Spain are the leading contributors to what is a broad-based upgrade. With industrial production advancing at a 5.7% annual rate in August, Italy has corroborated even the most upbeat predictions. This expansionary phase in the eurozone’s cycle could well hold up and even gain momentum if the Fed administers the right dose of monetary policy normalisation. The region’s vibrant economy lends even more weight to expectations that the ECB will soon trim its asset purchase programme to €30 billion a month. When that happens, yields of below 0.5% on German 10-year paper will be decried as an anomaly and rising bond yields across the currency bloc will become a tangible component of a normalisation process that might put a strain on GDP growth.

Eurozone: GDP and business sentiment, y.o.y. change



Source: Carmignac, CEIC, 29/09/2017

The eurozone, then, is the engine driving the current expansionary phase. The same can hardly be said of the United Kingdom. The 17% slide in the pound against the euro since the Brexit vote, together with inflation that reached 2.9% in August, may be the start of a vicious circle. Such a circle would be intensified by a worsening capital account deficit that could lead to a currency crisis of the kind that emerging economies are all too familiar with. The ultimate specifics of Brexit will have a crucial impact on the British economy, so much so that the risk of a bleak political and economic climate can't be ruled out at this point. What can be, however, is the idea of serious economic spillover to the euro area.

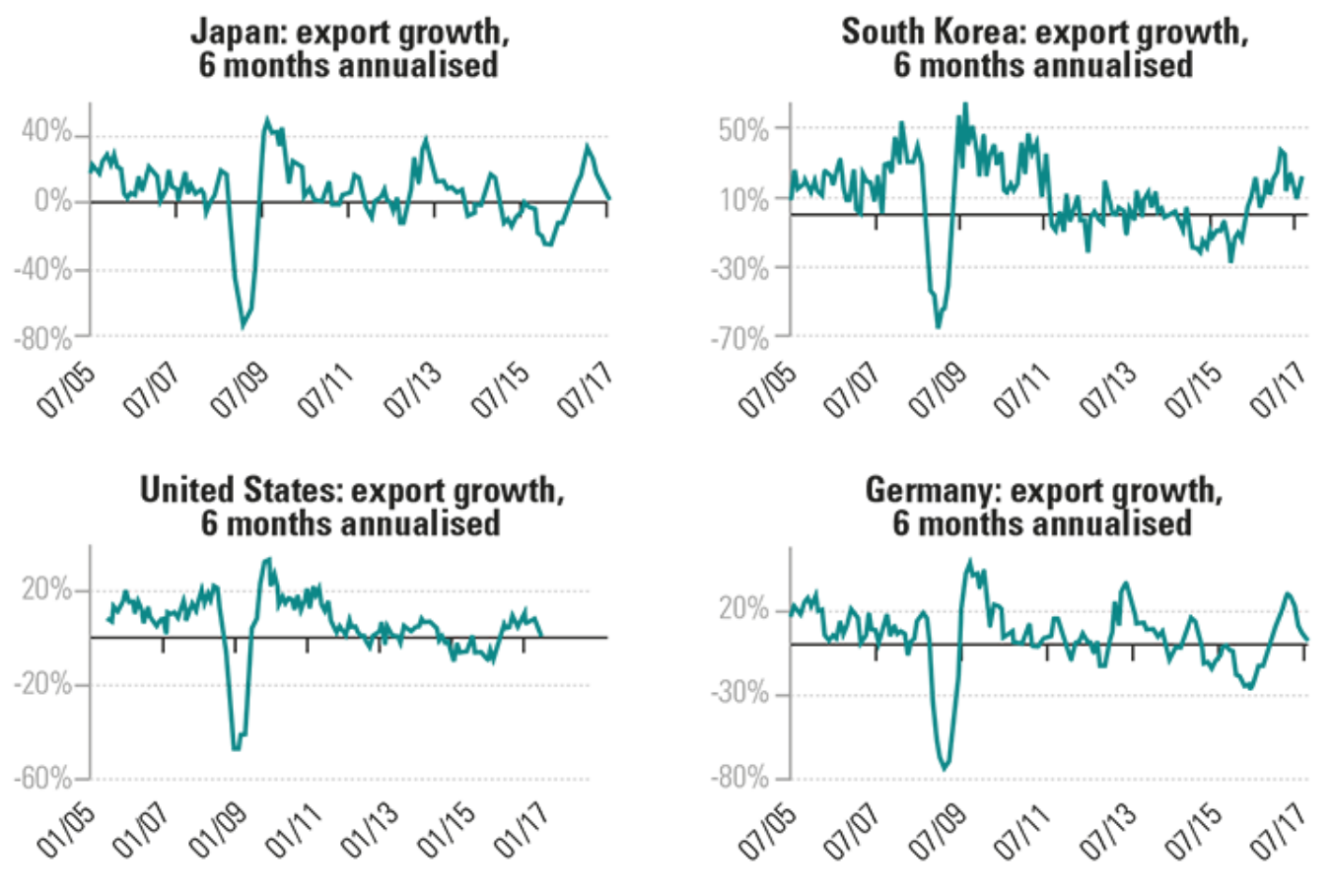
Emerging markets and Japan

The emerging world has been buoyed by a weaker US dollar, low interest rates, the upswing in Europe, the ongoing strength of the US expansion and – so far – a policy mix in China that works to the advantage of emerging markets as a whole. In broader terms, those markets are benefiting from the inertia that characterises the current growth cycle. This is strikingly true of Brazil, the quintessential link at the far end of the production chain. GDP shrank by 3.6% in 2016; it is forecast to grow 2% in 2018. In our previous report, we voiced the expectation that the Chinese Communist Party Congress in October would ensure economic stability, and it did. But the mild monetary tightening engineered by the People's Bank of China to cut excess

capacity has also hurt retail sales and industrial output in the country.

In addition, as we mentioned above, world trade has lost a fair amount of momentum in recent months. Like the US, China (as well as Japan and Germany) has seen annualised growth in its exports plummet to zero in the past six months, after rising substantially in the preceding quarters. If that trend were to become firmly entrenched, it would be very bad news for global growth, which is underpinned to a large extent by world trade. The outlook for global trade is therefore a key focus for us. The recent, impressive 35% rebound in South Korea's highly volatile export figures, a result well in advance of the current global cycle, is in that regard a heartening sign. But in any event, the ongoing improvement in emerging-world current account balances and a return in many cases to greater monetary policy freedom strongly increase the likelihood that, after six disappointing years, equities in those countries will go on outperforming as they have in 2017.

Cyclical slowdown propagated by world trade



Source: Carmignac, CEIC, 29/09/2017

Investment strategy

The question at this stage is whether upcoming action by the Fed and, to a lesser extent, the ECB will shrink global liquidity to the point of spoiling the party in equity markets. We doubt it will. Though the risk of monetary policy misfires can't be ruled out entirely, there are such powerful deflationary forces at work on both sides of the Atlantic that both central banks' inflation targets have become unattainable. And that makes

the prospects of substantial hikes in their key rates seem highly unlikely. Needless to say, we would be worried about the US economy overheating in response to large-scale fiscal stimulus – if we actually believed the Trump administration stood a decent chance of carrying out its tax reform plan.

We have therefore maintained high exposure to equities, striking a balance between stocks and sectors with good earnings visibility, which are less dependent on the business cycle (e.g., tech stocks), and more cyclical holdings like energy stocks, which also serve as an effective hedge against geopolitical risk in the Middle East and the risk of resurgent inflation. As regards the bonds in our portfolios, the start of monetary policy normalisation at a time of synchronised global growth, as we have described, can be expected to push up yields on benchmark sovereign bonds – a good reason to keep our modified duration low. Only local-currency emerging market debt and bank shares still offer enough value in our view to warrant sizable positions or renewed exposure in our portfolios. In the forex market, the steady propagation of growth across the globe will continue to give non-US currencies an advantage over the dollar – and to justify maintaining our extremely low exposure to the greenback.

Source of data: Carmignac, CEIC, 30/9/2017

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