

MANAGEMENT REPORT – FIRST QUARTER OF 2019

Q1 2019

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MACROECONOMIC ANALYSIS

The first signs of a slowing US economy, faltering output in Europe and the elusive goal of maintaining even a modest rate of inflation have spooked central bankers to such an extent that they have reverted to ultra-loose monetary policies. As a result, the amount of available liquidity – whose contraction had upended financial markets in 2018 – has risen virtually over night to a more encouraging level. Investors have wasted no time in taking advantage of the protection pledged by central banks against an economic slowdown. But is this trend reversal likely to last? Fiscal stimulus in China, signs of steadying growth rates in Europe and a moderate US economic slowdown can together be expected to put the world economy on the road to a cyclical upturn that should be supportive of equity markets, particularly if accompanied by a weaker US dollar.

The global outlook

Our previous report was largely downbeat on the global economic outlook and the chances that stock markets could sustain the rally that took hold at the start of the year. “We can therefore expect the prospects of a sharply slowing US economy to provoke fresh bouts of investor jitters, even though the Fed will be working further to prevent risk assets and the dollar from suffering excessive swings by hewing to its recently adopted policy of taking its lead from the financial markets rather than from macroeconomic trends,” we wrote. However, we went on to comment: “Full employment and the attendant rise in wages have kept the Fed from changing its tack, and it will be some time before the US central bank can deliver the monetary policy reversal that investors are so eagerly awaiting.”

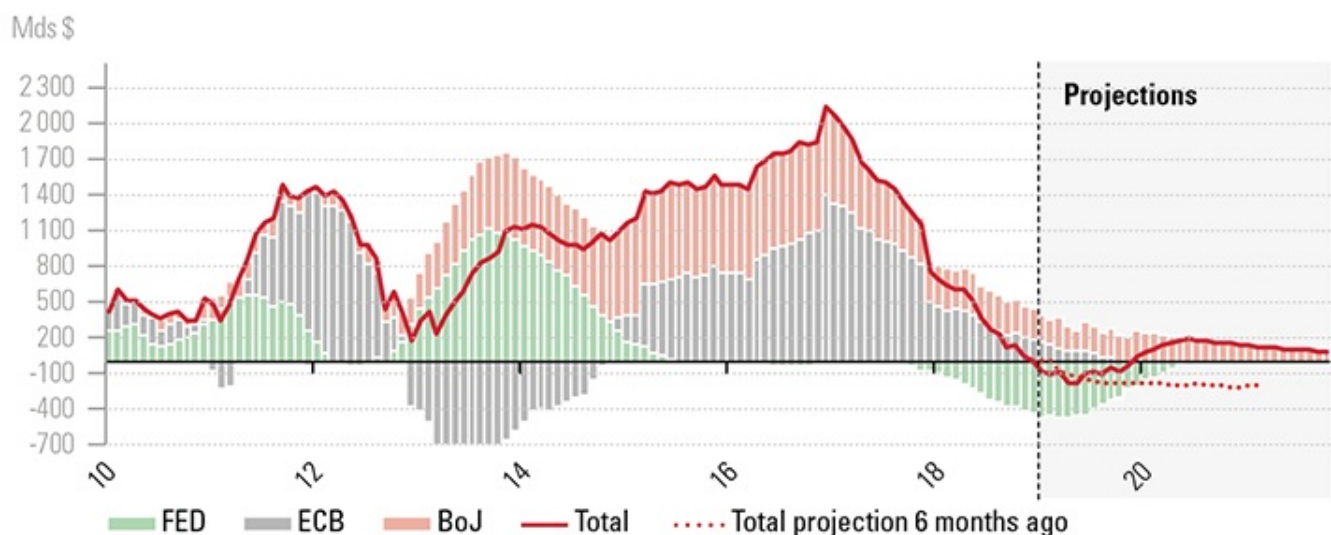
It turns out we were overly cautious. Throughout the first quarter, the Federal Reserve Chairman demonstrated that he had indeed executed a genuine about-face at the beginning of 2019. A few signs of waning business investment and mildly disappointing US employment figures, along with a negative perception of the economic climate in China and Europe – compounded by the uncertainty surrounding the international trade talks under way – were enough to convince the Fed to shift to a much more dovish stance. US monetary policy has become avowedly data-dependent and the pace of balance-sheet trimming at the central bank is set to slow as of May. More importantly, the Fed is now targeting a 2.5% inflation rate as measured by the Personal Consumption Expenditures (PCE) price index – a level not exceeded for 25 years.

The change of tone is so striking that investors are now pricing in a cut in key rates some time in 2019, whereas two hikes were still on the agenda at the start of the year. The US Treasury yield curve even inverted briefly in March, with 10-year yields slipping below their 3-month counterparts.

Simultaneously, a persistently sluggish eurozone economy and disturbingly weak readings in Germany and Italy led the European Central Bank to signal that it would do whatever it took to keep rates across the yield curve as low as possible. Partly in reaction to that statement, the yield on 10-year Bunds fell into negative territory for the first time since October 2016. Softer inflation on both sides of the Atlantic likewise made it easier for central bankers to shift to an ultra-loose monetary policy stance. The amount of available liquidity, whose contraction had meant hardship for risk assets in the second half of 2018, has risen virtually overnight to a more encouraging level. Meanwhile, China's stimulus programmes are apparently starting to pay off, creating a more upbeat short- and medium-term outlook for the country's contribution to global economic growth.

Central bankers spooked by poor growth and inflation readings

Balance sheets of the leading central banks, annual change (\$bn)



Source : Carmignac, Bloomberg, 04/2019

The global economic climate has thus undergone a major change over the past three months. But are the first signs of a slowing US economy, faltering output in Europe and the elusive goal of maintaining even a modest rate of inflation really sufficient grounds for the current central-bank angst or the International Monetary Fund's showing of concern at a time when equity markets the world over are surging impressively?

United States

After being pushed back by President Trump's procyclical policies, the oft-predicted slowdown in the US economy now appears to be materialising – though an unusually cold winter in the north and east of the country and a partial government shutdown for a few weeks suggest we should take the Q1 data with a grain of salt. That said, business investment has emerged, objectively speaking, as the "poor cousin" in the GDP growth family these past few months. The labour market has also sent out the first signals of waning momentum, with fewer jobs being created and growth in hourly earnings sliding from 3.4% to 3.2%. But that rate is still high enough to exert downward pressure on corporate profit margins and potentially discourage investment.

Things could worsen if the greenback gets further support from an excessively high interest-rate differential or from the perception that structural weakness was holding down other major currencies, thereby giving the dollar default leadership status. Our feeling about the US, however, is that with the economy softening, the current-account deficit increasing and the Fed sticking to its proactive stance, the dollar will eventually depreciate – much to the benefit of the United States and everyone else. The swift first-quarter decline in nominal bond yields relative to the inflation rate has led real yields in the US to sag over a five-month period from 1.15% to 0.50%. This has meant greater liquidity for the market and brought about a commensurate decrease in the real cost of financing capital investment. The Fed's vigorous response to the first blips on the US economy radar, combined with President Trump's determination to avoid disappointing his constituency as new electoral contests loom up, should reassure investors that there will be no abrupt halt to GDP growth between now and the end of 2020, though we believe the current deceleration is likely to continue in the meantime.

United States: a dip in leading indicators for employment and investment

The Fed ready once again to step into the breach

United States: planned redundancies and demand for capital goods



Source : Carmignac, Datastream, 04/2019

Europe

In Europe, the most noteworthy economic development of late has been flagging growth in Germany. In addition to ominous winter weather expectations, the country was hurt by a contraction in world trade and the uphill battle of its carmakers to adapt to changing demand. The latter also had to contend with damaging fallout from the carbon emissions-cheating scandal. Taking a longer-term view, some economists argue that the sweeping labour-market reform initiated in the early 2000s by Gerhard Schroeder has done all the good it can for German industrial productivity, and that new reforms are now required. The latest economic data shows more of a mixed bag, however, and our take is that the country's manufacturing recession is not as deep as suggested by leading economic indicators like the manufacturing PMI survey, which has dropped to

a low last seen in 2012. The subdued manufacturing readings are chiefly attributable in our view to weaker foreign demand, above all from the emerging world, whereas Germany's domestic orders, retail sales and property market have been heading in a more positive direction. We expect the German economy to bottom out some time between the beginning and the end of the third quarter.

France and Spain have meanwhile enjoyed greater momentum, as shown by a rebound in the more reliable leading economic indicators. In contrast, Italy remains a source of serious concern. Many observers wonder whether the national debt is sustainable in a country with only limited ability to rekindle GDP growth as long as much-needed reforms haven't been enacted.

The upcoming EU parliamentary elections may well heighten the skittish mood among investors from outside the Union. If the mainstream parties don't lose too much ground to their pro-national sovereignty rivals, Europe's economies and financial markets will stand a better chance of perking up. Cyclical industries are already outperforming the stock market as a whole, reflecting investor expectations for a broader economic upturn. And going forward, economic growth and financial markets in the eurozone can count on support from monetary policy, although the ECB has less room to manoeuvre than the Fed.

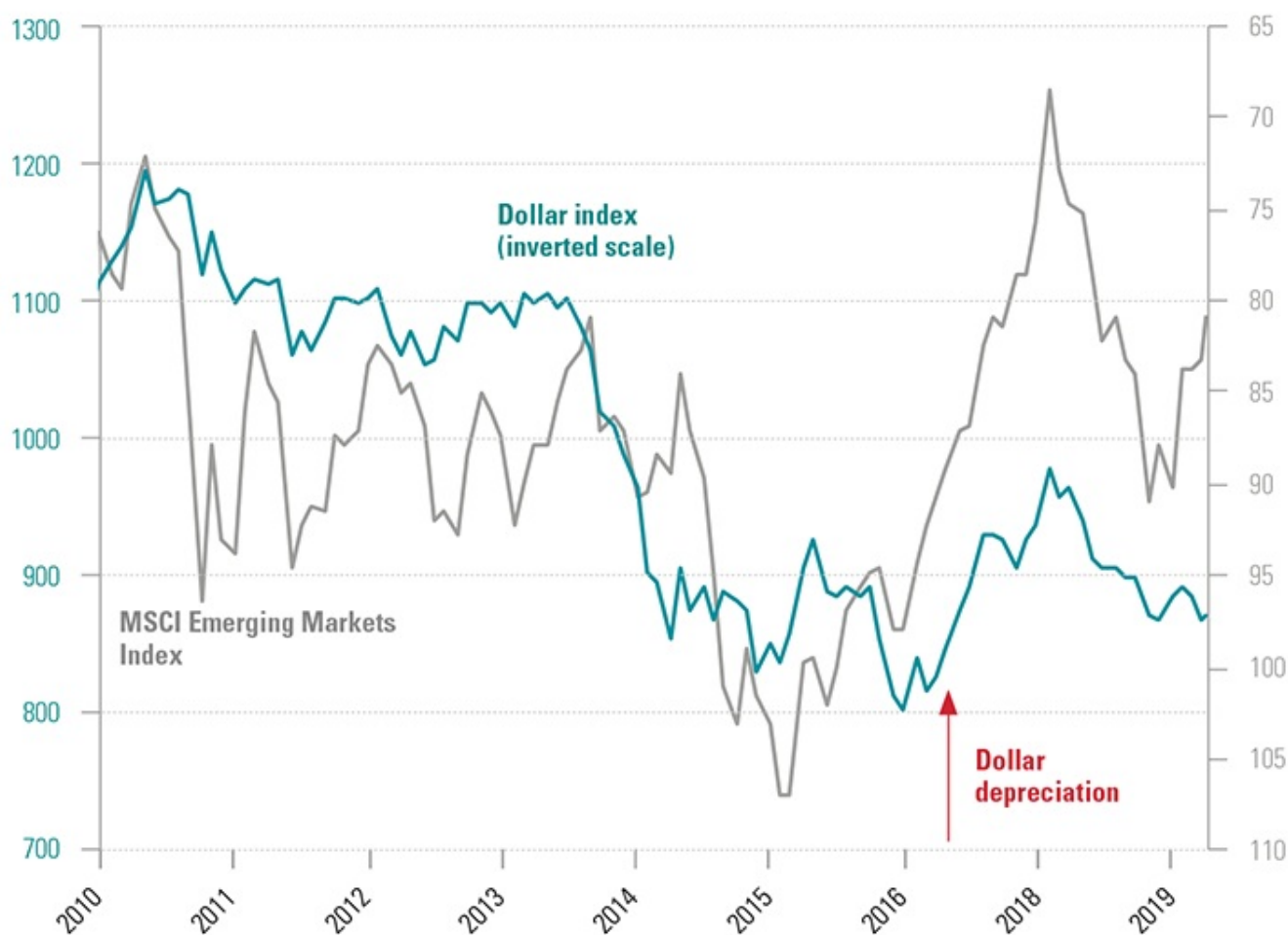
Emerging markets

Emerging economies are meanwhile grappling with clearly identified headwinds. One of them involves the tough US-China trade negotiations under way. The first casualties of the prevailing wait-and-see approach – ahead of a deal widely expected to be reached in May or June – are the usual beneficiaries of expanding global trade, many of them in the developing world. A trade agreement between Washington and Beijing will likely give the global economy a welcome boost, particularly as it could gradually nudge the greenback downwards by allowing US growth to feed through into other geographies. A strong dollar is the second headwind facing emerging markets in that it constrains their monetary policies. It has significantly undermined the ability of those countries to take countercyclical action: they can't cut interest rates because their currencies are already weak relative to the dollar, and that weakness magnifies the external constraints weighing on them while also eroding fiscal room to manoeuvre. Argentina illustrates in over-the-top fashion how much harm a strong greenback can do to insufficiently "virtuous" emerging markets. Make no mistake about it: dollar depreciation has become a vital necessity for a broad revival of the emerging world.

China's economy shows the first encouraging signs of steadying thanks to a string of single-minded fiscal stimulus policies, although sub-par performance in several sectors still bears witness to inadequate domestic demand – which is even affecting exporters in the developed world. Those policies are designed primarily to juice domestic growth. And while their impact on the rest of the world will be of second-order importance, it may well reinforce the effects of the expected trade deal and a decline in the value of the US currency, which we consider both likely and necessary.

The emerging world still highly dependent on a weak dollar and an upswing in China

US dollar index (DXY) and EM equities



Source : Carmignac, Bloomberg, 11/04/2019

The most striking development in the past three months has been the U-turn executed by the US and EU central bankers. In their public statements, they are now drawing attention to the possibility of a cyclical slowdown. We agree that the slowdown is broad-based, but still consider it modest in scope. The protection pledged by central banks against the effects of a slowing economy has made risk assets less risky – a change that investors wasted no time in taking advantage of during the first quarter. The promise by these central banks to keep interest rates low for an extended period has also substantially driven down the entire yield curve. Moreover, we believe that the dollar will weaken and as a result help fuel the cyclical upswing we expect China and Europe to lead. A narrowing interest-rate gap between the United States and the rest of the world would pave the way to such a weakening, which would prove beneficial across the board. In our

view, then, equity markets still have a fair amount to offer.

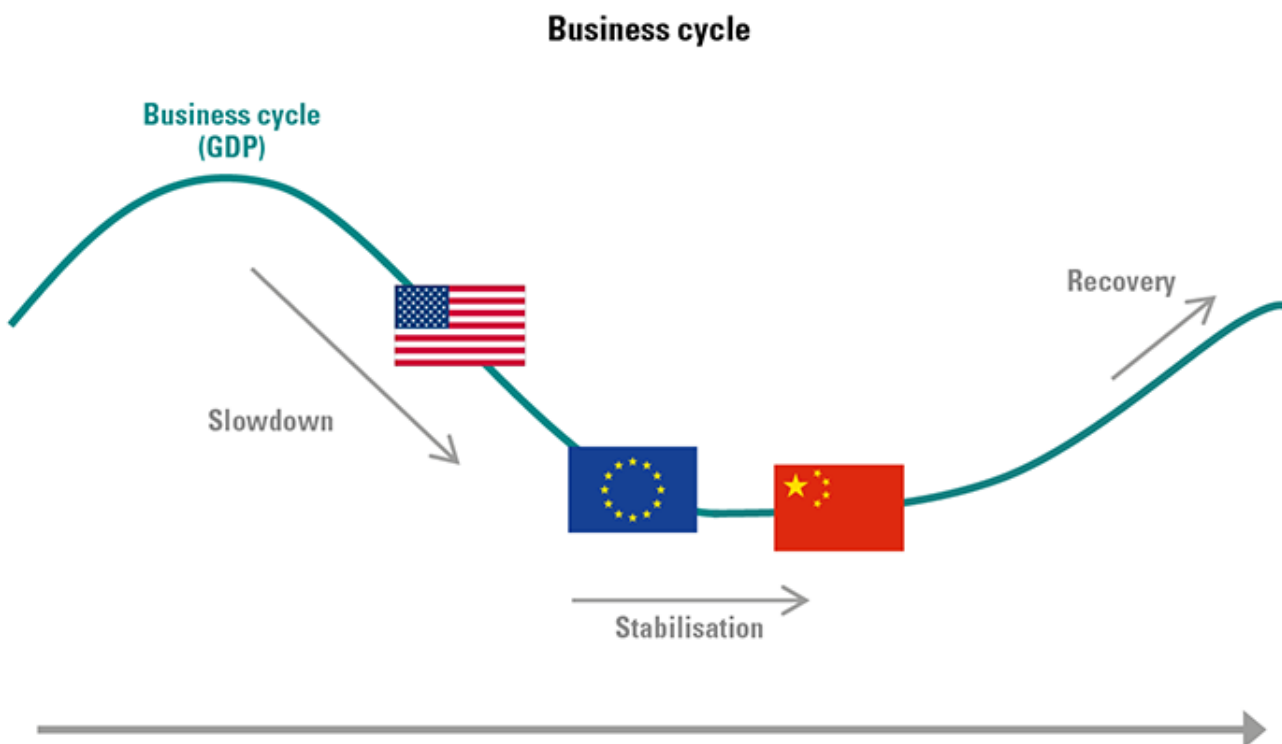
Investment strategy

Even after reaching record heights in the first quarter (following a disastrous fourth quarter of 2018), equity markets may well continue upwards. Companies with a predictable outlook and the ability to increase their earnings consistently and vigorously should see further strong share-price appreciation in the low-growth environment that is still with us. From a more tactical standpoint, we also feel that a smaller group of firms with greater dependency on the state of the economy could regain lost ground – provided that the US economic slowdown proves to be as moderate as we expect, the upturn in China continues and Europe surprises investors with a recovery of its own. A weaker greenback would spur that kind of reverse momentum as the rest of the world replaces the United States as the driving force behind global economic growth. If the dollar were to depreciate, the emerging market complex would recover its status – across all asset classes – as the destination of choice for international investment flows.

Bond markets are still reaping the benefits of monetary policy easing. For now, the prospect of an economic upswing in the United States is too remote to warrant a defensive fixed-income strategy. We rather expect to see a further, substantial decline across the entire US yield curve, with the short end moving first and leading to an overall steepening. By way of contrast, our impression of unanchored inflation expectations in Europe points to a flattening yield curve in the currency bloc. At the same time, the ECB's policy is conducive to carry trades.

In the forex market, we are awaiting the forces that will catalyse dollar depreciation, which is likely to occur when the global economy surprises investors with greater resiliency than is commonly assumed today. A weaker greenback will create major opportunities in the emerging world.

How far along in the growth cycle are we?



Source : Carmignac

Based on our macroeconomic outlook and our examination of how various markets are interacting, we have raised the exposure of our global portfolios to high-risk stocks, but that exposure is offset by our underweight positioning in cyclical themes. In the sovereign debt market, the surprisingly dovish line taken by central banks has encouraged us to maintain our exposure to duration risk, particularly in the United States. We have substantially scaled back our currency risk through limited exposure to foreign currencies, above all in our portfolios focused on preserving long-term wealth.

Sources: Carmignac, Bloomberg, Datastream, 29/3/2019.

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