

CARMIGNAC'S NOTE

A NEW WORLD ORDER, INFLATION, AND MARKET OPPORTUNITIES

21/11/2022 | FRÉDÉRIC LEROUX

The days of cheap financing for the US are drawing to a close, and with them the Pax Americana that had reigned over the globe since 1945.

Inflation, in terms of both its absolute level and fluctuations thereof, will be the key issue shaping the global economy, financial markets, and our investments in the coming years. Inflation looks set to remain high, albeit with periods of acceleration and deceleration, now that the world order which the US had constructed since 1945 – a world order based on a US-centric financial system – is rapidly coming undone. The US dollar had served as the benchmark currency for international transactions; it could be converted freely and its dominance was both backed and justified by America's diplomatic, military, and economic might. US Treasury bonds were seen as the ultimate safe-haven asset and provided a channel for the rest of the world to reinvest the dollars it had accumulated by exporting its wares to America. These bonds gave investors an assured source of fixed income at acceptable returns. The US-centric system also provided a way for oil-exporting nations to recycle their petrodollars and fund the deficit that Washington had run up to pay for America's dependence on foreign production. The system survived the end of the convertibility of the US dollar to gold in 1971, and grew even stronger after the fall of the Berlin wall in 1989 and China's entry into the World Trade Organization in 2001. Following these events, Europe was able to purchase cheap energy from Russia and pay for it in euros, while China found it could export its low-cost goods to the US and the rest of the world at a highly favourable exchange rate. This allowed China to start catching up with industrialized countries (both technologically and economically) at an impressive pace while helping to keep inflation low in the developed world. In return, China (like the Gulf states) recycled the dollars from its trade surplus into US Treasuries – further securing America's status as the world's consumer of last resort, the global policeman, and, through NATO, the protector of Europe.

But today, the US-centric world order appears to be falling apart at the seams. Under the Trump administration, the US started to see China as a potentially dangerous competitor.

The measures Washington introduced in response have reduced China's appetite for paper issued by Uncle Sam. Instead, China is investing heavily in its Belt and Road Initiative, which will open up new opportunities for trade and energy procurement. Meanwhile, Saudi Arabia has shed its role as America's faithful ally; the OPEC member no longer automatically implements Washington's requests for adjustments to production output, given that the US is seeking to achieve greater economic and political balance among Middle Eastern states as a result of its reduced dependence on Saudi Arabian oil. The war in Ukraine and the ensuing jump in energy prices is eating away at Japan's and Europe's trade surpluses, thus reducing their capacity to fund US spending by purchasing Treasury bonds. And perhaps most significantly, the sanctions introduced against Russia – in

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particular the seizure of its US dollar-denominated assets and its exclusion from the main international settlement systems – have undermined the safe-haven status previously enjoyed by the US dollar and Treasury bonds. Assets are no longer considered safe havens if they can be confiscated from one day to the next. The days of cheap financing for the US are drawing to a close, and with them the Pax Americana that had reigned over the globe since 1945 and that had given rise to expanding global trade coupled with disinflation. Now, we're likely to see greater economic nationalism; this in turn will fuel inflation, encourage bellicose policies, and result in a less-efficient global economy. These factors, combined

with demographic trends and the other inflationary societal shifts we discussed in a previous Note, will usher in a new economic world order. All this will require investors to make deep-seated changes to their investment strategies – a process we've already begun in our diversified funds.



Swings in inflation should be taken as assurance of sound returns for active investment approaches



One such change will be to start tactically reinvesting in risk assets, a move we don't believe is inconsistent with the new state of play. Bond yields are now closer in line with inflation expectations and better reflect the greater difficulty the US will have in funding its public debt. As yields stabilise, that will push up stock prices. For the near term, good news could soon be headed our way: we're starting to see the first real signs of an upcoming respite in the war in Ukraine, and chances are growing that Beijing will put an end to its zero-Covid policy – a policy that had been putting the brakes on the country's GDP growth. These two developments, if they materialise, would initially be inflationary since they would boost global demand, but they would also push down energy prices and clear up bottlenecks in supply chains. Above all, they would stem the slowdown in US and European GDP growth being caused by the high energy prices and monetary-policy tightening under way.

With the business cycle returning to normal, we can expect to see more accentuated swings in inflation. For now it looks like inflation will slow for several quarters, lifting the prices of financial assets in the process. Asset prices will also be buoyed in the coming months by a switch in investors' outlook for the trajectory of monetary policy. Those stocks that, owing to their lofty valuations, had suffered the most from rate hikes could be given a break from the sell-off. If so, we intend to take advantage of this in order to rotate our portfolio towards undervalued "old economy" companies that have been shunned by investors for too long. The tactical recovery we've seen in equity markets over the past few weeks should therefore continue, propelled in part by these companies, and confirm a new pecking order in terms

of sector performance. However, any renewed stock-market vigour shouldn't be interpreted as a sign that inflation will return to lastingly low levels. One consequence of the new world order and its many inefficiencies will be structurally higher inflation.

For us at Carmignac, it will be essential to be among the first to correctly anticipate the next upturn in inflation, so that we can position our portfolios effectively in all asset classes: equities, fixed income, and currencies. Swings in inflation, which reflect a return to a more normal business cycle after over a decade of stagnation, should be taken as an opportunity for active investment approaches – the kind of approach we fully embrace – to show their merits.

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