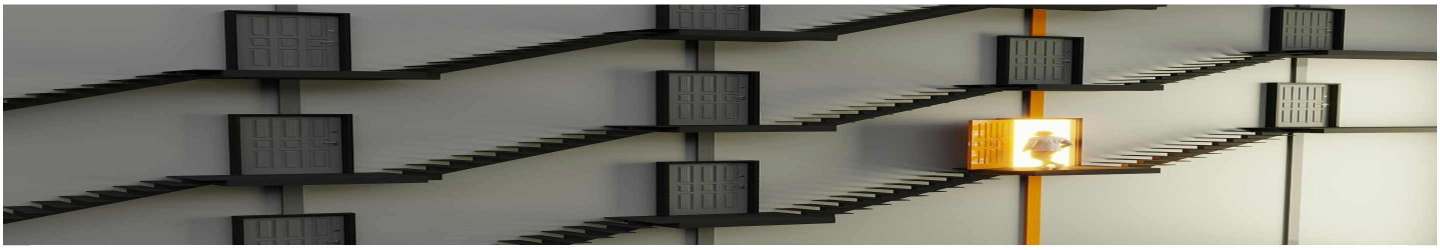

A new world order, inflation, and market opportunities

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The war in Ukraine, tensions between the US and China, and Saudi Arabia's recent cold shoulder to Washington are signs of a new economic world order that's emerging – one that's no longer focused on the US and that will give rise to structurally higher inflation. The upshot is, this will also open up new opportunities for investors, explains Frédéric Leroux, a member of Carmignac's strategic investment committee.

What's the biggest challenge investors will face in the coming years?

Frédéric Leroux: Inflation, and fluctuations in the rate thereof, will be the key issue shaping the global economy, financial markets, and our savings. Inflation looks set to remain high, albeit with ups and downs, 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.

You mean the famous Pax Americana?

F.L.: Exactly. Under that system, the US dollar 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. America bought up products made by other countries, which in turn used their dollars to invest in US Treasury bonds – thus funding America's fiscal deficit – and receive an assured source of fixed income at acceptable returns.

Is this the same mechanism used to recycle petrodollars, for example?

F.L.: Yes. The US-centric system also provided a way for oil-exporting nations to recycle the dollars they received from selling petroleum and fund America's fiscal deficit. This system survived the end of the convertibility of the US dollar to gold in 1971, and grew even stronger after China's entry into the World Trade Organization in 2001.

How is that?

F.L.: Because China, like the Gulf states, recycled the dollars from its trade surplus into US Treasury bonds – further securing America's status as the world's consumer of last resort, the global policeman, and, through NATO, the protector of Europe.

You refer to this system in the past tense.

F.L.: That's because the US-centric world order appears to be falling apart at the seams. For instance, 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 to keep buying Treasury bonds and fund America's fiscal spending. Instead, China is investing heavily in its Belt and Road Initiative, which will open up new opportunities for trade and energy procurement.

Saudi Arabia also appears to have changed its attitude towards the US

F.L.: True, the OPEC member has shed its role as America's faithful ally – it's no longer automatically implementing 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 oil. But there are even more signs that the US-centric system is coming to an end.

Like what?

F.L.: 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 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.

So the Pax Americana will soon be over?

F.L.: 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 slow consumer-price growth. Now, we're likely to see greater economic nationalism, which in turn will fuel inflation and encourage bellicose policies.

And this will usher in a new economic world order.

F.L.: It looks that way. These factors will result in a less-efficient global economy which, combined with demographic trends and other inflationary societal shifts, will bring about a new economic world order. This will require investors to make deep-seated changes to their investment strategies – a process we've already begun in our diversified funds.

Is there any good news on the horizon?

F.L.: For the near term, yes. 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, clear up bottlenecks in supply chains, and stem the slowdown in the US and European economies.

How will all this affect your investment strategies?

F.L.: With the return to a more normal business cycle – i.e., the cycle of economic expansion, contraction, recession (or depression), and recovery – 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.

What does that mean for stock markets?

F.L.: It will give some relief to growth stocks, or the stocks of companies whose revenue and earnings grow faster than the market average. We plan to take advantage of this by rotating our portfolios towards undervalued "old economy" companies that have been shunned by investors for too long. The tactical recovery we've seen in stock markets over the past few weeks should continue and confirm a new pecking order in terms of sector performance.

So there's reason to be optimistic?

F.L.: Well, this doesn't mean we can stop worrying about inflation. One consequence of the new economic world order will be structurally higher inflation. And fluctuations in the rate of 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 to fully show their merits.

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