EDOUARD CARMIGNAC'S LETTER

Edouard Carmignac writes on current economic, political and social issues each quarter.

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Dear Investor,

It's taken just one quarter for expectations to swing from a high-growth scenario with a temporary inflation pickup to one based on a serious threat of stagflation. In other words, slow growth accompanied by sustained inflationary pressure.

Is this concern devastating for equity markets legitimate? The downgrade to GDP growth forecasts does not surprise us. As you may recall, this was foreshadowed in my previous letter. What we find more troubling is the growing number of different factors fuelling inflation and how much staying-power they may have. The inflationary pressure being caused by pandemic-induced bottlenecks in supply chains will not last. As such, the semiconductor shortage that is partially stalling the automotive and other industries should soon be alleviated once operations fully resume at chip-testing centres in Malaysia – which have sizeable stockpiles of chips awaiting certification. The same goes for port congestion created by shortages of spare parts that are forcing many manufacturers to rely too heavily on just-in-time deliveries.

In contrast, we suspect the upward pressure on energy prices won't go away any time soon. While the higher prices of these past few weeks reflect a unique confluence of drought, weak winds in Europe and seasonal shutdowns of gas production facilities, it's actually the underinvestment in fossil-fuel extraction over the past several years – compounded by the move to prioritise green energy – which is inevitably driving up energy prices. On the brighter side, rising prices for conventional energy sources will at least make alternative energies more competitive. It's less clear how upward pressures on labour costs will play out. As governments from the United States to China aim to tackle inequality, we can expect wages on the lower end of the spectrum to continue rising. Moreover, after discovering the advantages of being "locked down", some workers seem in no hurry to look for jobs. Will the gradual withdrawal of pandemic-related income subsidies be enough to reverse this trend?

A reasonable case can thus be made for the idea that post-Covid inflation will prove resilient. That said, we still believe that secular deflationary forces (demographics, technology) will partially offset these inflationary pressures. So, should the prospect of moderate inflation – in the vicinity of 2% – be grounds for concern? Mild inflation would lighten debt burdens, while encouraging both consumer spending and corporate investment. It would also be a boon to equity investing.

Yours truly,

Edouard Carmignac