

LETTER FROM EDOUARD CARMIGNAC

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EDOUARD CARMIGNAC'S LETTER

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

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Dear investor,

The extreme volatility in financial markets we have seen this year may have left many of you feeling bewildered, along the lines of what Bob Dylan described so eloquently:

"It's getting dark, too dark to see,
I feel like I'm knockin' on heaven's door"

In light of the many uncertainties now facing us, it is understandable to be alarmed. However, upon closer analysis, these uncertainties stem from three factors that could end up being less disruptive than feared:

• **Central banks' efforts to curb inflation.** By bringing business and consumer activity to a virtual standstill, the pandemic created an unprecedented increase in global liquidity and gave rise to a similarly unprecedented array of fiscal stimulus measures. Back in January, it was reasonable to assume that central banks would gradually start tightening their monetary policies. But then came the invasion of Ukraine. Food and energy prices skyrocketed, pushing inflation to nearly 10% in both Europe and the US and leading central banks to introduce highly contractionary monetary policies, to the point where Fed Chairman Jerome Powell now claims he is not uncomfortable with running the risk of a US recession. How big will that recession need to be in order to produce a meaningful reduction in inflation expectations and tame the overheating US job market? It is hard to say, since the pandemic has made employment generally less appealing. But many couch potatoes will probably soon be back in the workforce, as their fears of catching Covid-19 ease, as they run down the savings they had built up during the lockdown, and as the cost of living marches steadily upwards. However, gone are the days of the 1980s when Paul Volcker was steering US monetary policy. Today's significantly lower tolerance for a sharp slowdown in economic growth eliminates the risk of a severe recession in our view. But for now, given that the Fed has a clear mandate to keep inflation under control, the US will continue to mop up global liquidity, thus driving down asset prices across the board and further inflating the US dollar.

• **Europe's energy crisis.** Here we're facing a major shock. Higher energy costs will push up Europe's total bill by some 10% of GNP, but this will largely be covered by fiscal buffers. Furthermore, the chances of a significant energy shortage this winter have been reduced by major inventory-building of natural gas, by stop-gap energy solutions, and by enticements for businesses and consumers to cut their power use. But such measures cannot last, meaning Europe's economic competitiveness is under serious threat. That said, the collapse of Russia's army, which seemed to us a likely prospect back in April, should severely shorten Putin's term in office. While this prospect increases the chance of an escalation, it also makes a regime change in the Kremlin more likely.

• **China's economic slowdown.** Beijing was already grappling with a property bubble when it experienced a second, self-inflicted wound: the zero-Covid policy. This policy has paralysed swathes of the economy and nearly 20% of Chinese under 25 now find themselves unemployed. The Chinese government could change its policy after the Party Congress later this month, which will see Xi Jinping reappointed to another term, or after the National People's Congress next March. But sooner or later this policy will have to be amended – which should provide a powerful shot in the arm to China's flagging economy.

In conclusion, do investors have good reason to be so bearish? Our analysis of the three factors above reveals numerous silver linings. But we will have to wait until these uncertainties dissipate, at least in part. In the meantime, we will continue to be particularly diligent in the risk management of our portfolios.

Yours truly,



Edouard Carnignac

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