EDOUARD CARMIGNAC'S LETTER

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

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Dear investor,

What a first half! Over the past six months, financial markets experienced some of the sharpest swings in the post-war period. Yields on 10-year government bonds jumped 1.5% on both sides of the Atlantic, causing the prices of these reputedly "low-risk" assets to drop by nearly 12%. At the same time, global stock markets plunged 13.2% and the price of oil shot up 36%.

The roots of this severe turbulence lie in rampant inflation, which forces central banks to adopt contractionary monetary policies that weigh on global growth – at a time when economies are already under pressure from hefty increases in the cost of living. Unlike most business cycles, where central banks seek to tame inflation by cooling an economy that's overheating as a result of excessive demand, this time around, it's the lack of supply that's driving up prices and causing central bankers to tighten the screws.

In my previous letters, I detailed my concerns about the tensions being caused by the pandemic – whether temporary, such as those on supply chains, or longer-lasting, such as those on the job market. These tensions have been compounded by the soaring energy costs resulting from both an underinvestment in fossil-fuel extraction in recent years and the growing use of renewable energy. Russia's invasion of Ukraine exacerbated these tensions through a dual food and energy shock. Three months ago, I wrote that given the fragile state of Russia's economy it was highly unlikely V. Putin would embark on a lengthy military conflict unless he was willing to risk the collapse of the Russian economy and his regime. I underestimated his determination and drive to restore Russia's historical borders.

What do we expect for the months ahead? It's likely that V. Putin will carry through on his threat to further reduce gas supplies to Europe, inevitably throwing our continent into a recession. The spotlight on Europe's vulnerability would trigger a depreciation in the prices of European assets, naturally including the euro. Germany is already feeling the effects; it recorded its first trade deficit in 30 years. The prospects for China, however, are brighter. The country's economy has seen lower inflation and is gathering the support from a flurry of stimulus measures. The US is less threatened by the food and energy shocks but must grapple with restrictive policy moves from the Fed, whose stance should become less hawkish as GDP growth slows. This backdrop should favour companies with good earnings visibility that have been shunned for the past year, as they come back into favour once investors again appreciate the robust nature of their growth.

In this challenging market outlook, which nevertheless harbours opportunities, we'll be particularly diligent in managing risk in our portfolios. Hoping to bring you more effectively some peace of mind in these stressful times, I wish you a relaxing summer.

Yours truly,

Edouard Carmignac

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