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CARMIGNAC'S NOTE

NEW INVESTMENT THEMES FOR A NEW ECONOMIC LANDSCAPE

20/12/2022 | FRÉDÉRIC LEROUX

As 2022 draws to a close and 2023 begins, we'd like to share with you our investment outlook for the coming year.

As we've mentioned several times in the past few quarters, the business cycle is returning to normal now that inflation is back on the scene – meaning investors will need to adjust their mindsets to the new global economic landscape. We've explained before why we believe inflation will remain structurally higher; the reasons include demographically fewer savers in the countries whose economies matter, a probable decline in the share of international trade in global GDP in the coming years, efforts to speed the pace of the energy transition, the end of Pax Americana, and policymakers' refusal to watch their economies suffer a contraction. These are all structural forces that look set to cause a lasting increase in global inflation and fuel a trend towards higher nominal interest rates. In the light of these factors, we've been gradually orienting our investment portfolios towards themes that should outperform over time in an inflationary environment, while also factoring in the swings we'll see in the business cycle in the near term – swings that can, for example, give rise to a period of marked disinflation in the coming quarters. A newly cyclical economy requires both vision and proactive management skills from investors.

Our fixed income portfolio was impacted by the war in Ukraine, but has since recovered thanks to the active way in which we managed our investments. We positioned our portfolio for the prospect of higher bond yields and to take advantage of investors' extremely bearish stance towards corporate bonds; the yields on these bonds factor in default rates that we feel are too high relative to the economic fundamentals. Our assessment of the fundamentals incorporates the fact that policymakers have become less willing to endure an economic slowdown, meaning that considerable fiscal stimulus will likely be rolled out in tandem with the tighter monetary policies. This implies that, according to us, real bond yields will soon slide back into negative territory.

The US dollar will probably weaken during the next cyclical upswing as a consequence of the new equilibrium that will take hold in the economy in the medium term. This will make emerging-market debt more attractive, as central banks in these regions will be better able to implement more dovish polices.

> *"Investors need to adjust their mindsets to the new global landscape"*

In equities, the prospect of recurring waves of inflation has prompted us to reconsider investment themes which have been set aside in recent years. For instance, considering just how much the energy transition is exacerbating inflationary pressure, we understand that the transition can't take place effectively without the involvement of today's oil and gas majors. These companies will have a significant role to play and are some of the biggest investors in renewables. We have therefore decided to work judiciously with those "transitioners" that are firmly committed to promoting clean energy. These much-maligned fossil-fuel producers are now trading at attractive prices and have adopted policies that are in line with our environment, social, and governance (ESG) criteria. As responsible investors, we see this as an opportunity to profitably combine our duty as asset managers with our environmental aims.

In the same contrarian bent, we've taken a renewed interest in Japanese stocks. These stocks have consistently fallen short of their potential to deliver strong returns, and foreign investors have been shying away from them for years.

Today, Japanese companies are underpriced according to all standard valuation methods. Ironically, the factor that could trigger a rally in these stocks is inflation – or more specifically, the monetary-policy reversal that the Bank of Japan will have to effect in response to inflation, which is structurally higher there, too. Higher interest rates in Japan could spark a sustained appreciation in the yen, which would be a big draw for foreign investors who have been put off by the country's feeble currency for the past 12 years. In this regard, Japanese banks could be an attractive way to regain exposure to the country, through investments made as part of a comprehensive portfolio allocation.

> "*A more cyclical economy confirms the added value of an active, flexible approach to asset management*"

Another focus area for our equity investments will be manufacturing, or "old economy" companies that are now back in favour. These firms are getting a boost from efforts to step up the transition to clean energy and to reshore production capacity in strategic industries after the pandemic made it painfully clear how dependent many countries are on distant trading partners. These factors will create attractive long-term opportunities in the manufacturing sector, which we intend to seize ahead of the next cyclical upswing. Europe in particular should offer many promising investments in the manufacturing theme. Looking ahead to the new global economic landscape, we intend to take advantage of the opportunities it offers by capturing the revival of entire segments of the manufacturing sector and honing our market timing so as to position our portfolios for the return of the business cycle.

These renewed cyclical swings against a backdrop of structurally higher inflation will prompt a reshuffle in financial markets. Many companies and sectors that, owing to the long period of anaemic GDP growth, have been underpriced and have taken a back seat to growth stocks – to the point of nearly being forgotten – stand to gain from the next cyclical upswing, which we believe will occur after the impending economic slowdown and disinflation. The upswing will also create attractive opportunities for fund managers capable of achieving negative exposure to rising interest rates and positive exposure to emerging countries. A more cyclical economy will accelerate the pace at which investors rotate their portfolios among different investment themes and asset classes, and confirm the added value of an active, flexible approach to managing global investment portfolios.

Report finalised on 20/12/2022

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