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Strategy Update

Global markets have been whipsawing, and are experiencing high levels of volatility, after Russia invaded Ukraine. Investors are gauging the impact on commodity supplies, and potentially a delay in the supply chain recovery. Amid a mounting humanitarian catastrophe, the West has been increasing its sanctions on Russia, trying to force it to the negotiating table.

Despite the tragic events on the ground, we do not want to hastily reduce risk assets, and must carefully watch the effects on the global economy and potential financial changes: On a medium-term horizon, the economy always trumped geo-political events, be it in September 2001, or after the two Iraq wars.

Potential Economic Impacts

The effect on the global economy: to put this into context, Russia and Ukraine account for barely 2% of the world's gross domestic product, and therefore are unlikely to derail global economic growth significantly.

Higher commodity prices, particularly energy, could lead to two outcomes:

- Increase the risk of future stagflation, whereby central banks would face a conundrum facing a slowing economy with high future inflation, or –
- Significantly decelerate the economy in the short term, in which case central banks would opt for a slower path of policy normalisation

Markets are currently favouring the second option:

- The US market is now implying less than 5 rate hikes in 2022 by the US Federal Reserve, versus 7 before the invasion, and 2-year notes are sharply lower
- In Europe, the first rate hike by the ECB is now expected to be in 2023, while the market previously was expecting 2 hikes in 2022, and zero rates by the end of the year

The war threatens to delay the normalisation of supply chains. As we wrote in the past, Russia is not only an energy exporter, but also an exporter of key precious metals, such as palladium used for electronics and catalytic converters. As mentioned in the past, Russia and Ukraine together account for 25% of world trade in wheat and 20% of corn. This is a particular problem for developing countries, such as Egypt. Ukraine wheat harvest takes place in June and July, so peace negotiations could still avert a disaster scenario.

The Pandemic accelerated decarbonization and deglobalization of value chains. The current crisis in Ukraine will accelerate the trend of energy diversification. Those elements are potentially all a source of higher structural inflation. Several countries are already having second thoughts on exiting coal-fired plants and nuclear energy too early.

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Potential financial impacts

The exclusion of several Russian banks, along with the central bank of Russia from SWIFT, the global payment system, could lead to dislocations in the financial system: unpaid bond redemptions or coupons, claims on transfers, worries on counterparty risk, particularly in the USD funding system. The US Federal Reserve might be forced to intervene as the lender of last resort, in a similar way to March 2020, when the funding market dried up. In such a context it would be impossible for the bank to increase rates.

As a note, energy and commodities are currently not targeted by Western sanctions, yet.

We could also see the emergence of a parallel SWIFT system, likely developed by China, as the country is likely to replace Europe as a destination of choice for Russian energy. In fact, such a system already exists in China: it is called CIPS, (Cross-border Interbank Payment System), which facilitates transactions settled in Yuan. This system has already been used by North Korea and Iran. It obviously doesn’t solve the issue of accessing its reserves by the Russian central bank. However, if other nations joined, the financial world would effectively be split in two.

Summing up

Since the threat, and then the invasion of Ukraine, stock markets have experienced huge intraday volatility, sharp sector rotations, with daily reversals almost becoming the norm. On the one hand, the effect on the global economy, and particularly the action of major central banks is uncertain. A re-appearance of the ‘central bank put’ is also a possibility. On the other hand, strong earnings results, dividend increases, and share buybacks are strongly supportive of equity prices. Current market and sector dislocations likely offer opportunities. In terms of valuations, in Europe the forward PE of the STOXX 600, at 13.65 is at its cheapest level since February 2019. In the US, the forward PE of small capitalisation companies, (Russell 2000), is at its cheapest level, compared to the S&P 500, since 2001. In terms of Equity Risk Premia, while certainly higher than pre-war, they are more complicated to calculate: the Risk Free component, the 10 year government bond yield, has been extremely volatile over the last few days.We are therefore leaving the equity asset allocation unchanged, with a small overweight, partial protections at the index levels, until we have more clarity on the above. In terms of currency exposure, while conscious that the USD is attracting some safe heaven flows, we didn’t want to add more risk to the portfolios by unwinding some of the foreign exchange hedges we currently have: we therefore keep our non-USD portfolios fully hedged.

In the meantime, our thoughts are with the victims of the war, and let us hope that wisdom will prevail.

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