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Investment Insights

Powell, and now Putin, adding to volatility and uncertainty: Thoughts on the Russian-Ukraine Crisis

Russia's invasion of Ukraine has added another dimension to a volatile start to equity markets in 2022. There is significant uncertainty around how the conflict could unfold. The coming days and weeks will be critical in gaining a better appreciation of the international community's response and broader economic, market and geopolitical implications. In this note, we offer some initial thoughts and observations, we do not wish to overlook the humanitarian catastrophe of war and likely loss of life but have restricted our thoughts to the impacts on equity markets, as we see them.

Whilst no two situations are the same, a key message for investors is geopolitical events tend to result in sharp sell offs, but also rebound quite quickly if economic growth is largely unaffected. This suggests being too reactionary and making sudden portfolio moves may, in hindsight, not necessarily be the right thing to do.

Observations on Russian-Ukraine conflict

- **Further evidence of geopolitical realignment:** The rhetoric and force exercised by Russia in invading Ukraine represents a significant historical moment. It is the first major conflict between two European nations since WWII and represents a coercive move by Russia to redefine its territory and power. In doing so it further threatens the international rules-based order that has existed for more than 70 years since the signing of the Bretton Woods Agreement. Along with the recently announced Aukus alliance (between the US, Australia, and UK) and the "no limits" strategic partnership between China and Russia it provides further evidence that a new international order is emerging based on 'spheres of interest' with the Sinophere (China and Russia), Anglosphere (US, UK, Australia, India, Japan) and European Union emerging as major blocks. As parties to these blocks work more closely together in areas of trade, security, supply chain resilience and other strategic issues, it suggests a changing world order with longer term geopolitical and economic implications.

- **Further inflation impulse and risk to growth:** After two years battling a pandemic, the Russia-Ukraine conflict adds to the complexity and concerns around inflation and the economic recovery. Ukraine represents the largest area of arable land in Europe and is a key supplier of barley, wheat, potatoes, and sunflowers as well as being Europe's largest producer of ammonia (a key fertiliser input), whilst Russia is a major source of energy. Together they produce 15-20% of global output of main grains and Russia supplies 35% of Europe's gas demand.

  In recent days, we have already seen a spike in food and energy prices on fear of supply chain disruptions, economic sanctions, and protectionist policies. Oil has broken through $100 per barrel, European gas spiked more than 50% and wheat up 16%. Soft and hard commodity prices were already trading at decade highs on the back of Covid supply chain disruptions. The risk is, if food and energy inflation prove to be stickier and more persistent it could start to change consumer behavior and weigh on economic growth. There is also the question of how central banks can fight food and energy inflation? Traditional monetary policy tools tend to have little permanent sway over food and energy prices given their essential nature.

- **Supportive for energy and commodities:** Recent steep inventory draw downs, recovering demand from COVID and supply side under investment have left energy and commodities markets more exposed to geopolitical shocks. In the short term, the Ukraine crisis provides additional impetus to prices and supports our positive energy and commodities view, providing tailwinds for oil and gas stocks. However, the latest move in oil prices is also a signal to the market to raise supply and curtail demand, while the latest move in inflation is a signal to central bankers to curtail the supply for money and raise rates. This set-up is likely to lead to ongoing volatility.

- **Sanctions - where and how?** Western policymakers have begun to roll out sanctions on Russia including restrictions on Russian banks, foreign trading in Russian sovereign debt. Over the weekend it was announced Russia will be cut off from the SWIFT international payment network used by 11,000 banks in 200 countries. In addition, Germany has announced a halting of the start-up approval of the Nord Stream 2 gas pipeline which is intended to supply gas from Siberia to Europe via Germany.

  The impact of the initial sanctions remains uncertain, and the fact they didn't deter Russia from invading in the first place, raises questions about their efficacy. We expect where sanctions go from here depends on how the Ukraine situation evolves.

  The most severe and obvious way to hurt the Russian economy would be energy sanctions, given oil and gas exports represent roughly two-thirds of Russia's budget revenues. But this comes with the risk of hurting other economies dependent on Russian exports and indirectly the oil price and global growth, still recovering from the pandemic. Imposing restrictions on supplying financing, technology, and services to Russian companies in the energy, defence and financial sectors may be more palatable first steps.

  The introduction of meaningful sanctions will require the West to accept significantly higher costs and potential spill over effects. A risk in banning Russia from using the SWIFT system is it increases the risk of politicising the platform and the use of alternative platforms like CIPS, China's rival to SWIFT for the cross-border payments in yuan. The other consideration is how will Russia respond to sanctions? Whilst it has little incentive to curtail major commodities like oil and gas, the disruption of industrial metals like nickel or palladium could cause problems for international supply chains, and add to inflation risks.

- **Australia more insulated, Europe more exposed**: Australia has relatively little direct economic and financial exposure to Russia and Ukraine. In 2020 Australia's two way trade was only 0.2% of our total trade. It also has little direct exposure in terms of debt and equities. The greatest impact is likely to be felt indirectly through any impact on higher oil and petrol prices and over time, food prices if the situation becomes protracted.

  The conflict has greater risk of weighing on European growth given the dependence on Russian energy and Ukraine's soft commodity position. Any sanctions or disruption to European gas supply and prices remains the greatest obvious risk. There are incentives on both sides of the conflict to suggest large disruptions in commodity flows are unlikely, but this cannot be dismissed.

Investment considerations

The impact and timing of geopolitical events are usually very hard to anticipate, and position around. As we have witnessed in recent days, they can drive a sharp decline in risk appetite and markets as investors are gripped by fear and seek flight to safety. This favours sectors like Healthcare, Staples, Telcos and Gold and sovereign bonds.

The rebound can also be quite fast, and is generally faster than when geopolitical tensions are not the main driver. This is consistent with geopolitical shocks often being short-lived and driving a higher risk premium without leading to a material change to long-term growth expectations. We are therefore cautious about being too reactionary and making sudden portfolio changes.

Still, the impact can linger, especially if economic conditions worsen as a function of the geopolitical shock adding to uncertainty around future growth. It will be particularly important to monitor economic data and conditions over coming weeks and months.

Since the beginning of the year, and before the escalation of events in Ukraine, there had already been an increase in volatility as markets grappled with the tug of war between rising inflation concerns, monetary tightening, and post covid economic recovery. This has seen strong relative outperformance of more cyclical and value stocks leveraged to higher inflation and underperformance in growth and long duration companies (those with more of their earnings in the future). As Figure 1 shows, this has been most evident in the unprofitable technology stocks which in the US and Australia at an Index level have erased all their gains of the last 18 months.

The sharp correction in some parts of the market, and impending rise in central bank interest rates has raised concerns of a broader market sell off. The Ukraine situation only adds to this fear. Higher inflation concerns support calls for higher rates. However, if it results in lower economic growth it could also see the recent sharp rise in interest rate expectations revised down, and central banks delay or reduce the number of hikes as they seek to cushion their respective economies.

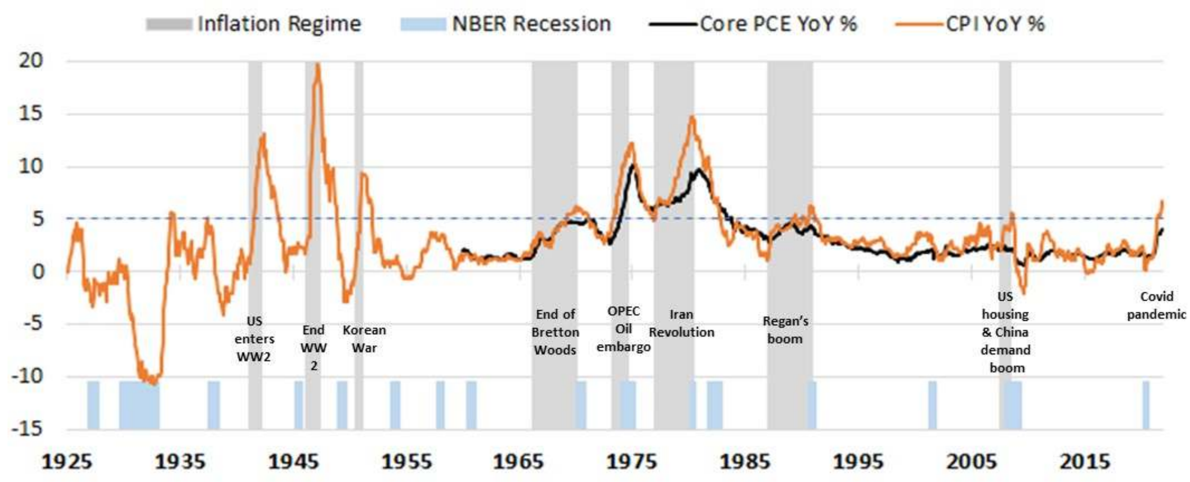
The timing of the Ukrainian conflict, and sharp rise in commodity prices, also raises the question whether we are currently seeing peak inflation, and potential for the inflation narrative to take a breather. This is due in part to the high base effect already in place, but also potential peaking of Covid supply chain bottlenecks and problems exacerbated by the back-to-back effects of the Delta and Omicron waves. In the near term, any fading inflation expectations would likely be positive for growth stocks given their sharp sell-off, whilst reopening will continue to provide tailwinds for cyclicals such as travel and energy stocks. Both scenarios are plausible, and support the argument for maintaining a diversified portfolio.

Beyond this we see increasing evidence why inflation could prove more persistent and structurally higher. As Figure 2 shows, looking back over the last 100 years rising inflation regime episodes mostly coincide with unexpected supply shocks. Covid has arguably resulted in the biggest supply shock in history with the effective lockdown of all economies. This has been an 'event-driven' shock which should alleviate as the pandemic recedes. However, the Russian-Ukraine conflict provides further credence to a changing world order and geopolitical and economic realignment of supply chains and trade, with greater sanctions, tariffs, and sovereignty restrictions. This points to broader structural change afoot, a potentially higher inflation regime and the coming of the end of the 30-year deflationary cycle!

Figure 1: Last 18 months unprofitable US Tech sector and ASX200 Tech Sector have materially underperformed
Index price performance last 18 months (from 1-Sep-2020 to 25-Feb-2021)

Source: Bloomberg

Figure 2: In the last 100-years rising inflation rate episodes have been mostly due to unexpected supply-side shocks
US YoY CPI and Core PCP overlaid with inflation regimes and recessions



Source: Bloomberg, NBER, 'The Best Strategies for Inflationary Times', April 2021 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3813202

Notes:

1. *Core PCE data history starts in 1960*
2. *Inflation regimes are time periods when the year-on-year realised inflation rates rise materially above 2% (i.e reaching 5% or more). This level is often targeted by central banks, and even when not explicit, is often considered a psychologically important threshold. The regime end is the point at which CPI year-on-year reaches its peak without having fallen below 50% of its maximum annual rate in rolling 24-month observation windows. Episodes shorter than 6 months are excluded and considered too short to constitute a regime change.*
3. *NBER recession periods are periods where the US economy was in recession as defined by the National Bureau of Economic Research*

Hamish Tadgell
Portfolio Manager
SGH High Conviction Fund
SG Hiscock & Company

28 February 2022