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Reflections & Insights

"One will rarely err by ascribing extreme actions to vanity, ordinary actions to habit and mean actions to fear."

– FRIEDRICH NIETZSCHE

Over the past decade and a half, the difficulty in putting together reviews like this has been in thinking up something new to say. Despite COVID, BREXIT, Trump and all kinds of noise, the best advice over the past fourteen years has been simple: 'Invest in risky assets, particularly US equities. The financial system has your back.' Of course, the commentariat has found many ways to say the same thing in increasingly nuanced terms, while also warning you of speed bumps or even car crashes around every corner. Most of the financial world relies on activity and sloth doesn't generate revenue, even when it is precisely the right sin to indulge.

That was the past. Today, things have changed. The Russian invasion of Ukraine has revealed, rather starkly, the deterioration in the underlying governance of the global economy, which has resulted from the policies in place since the global financial crisis.

Very loose monetary and fiscal policy, combined with a political worsening of conditions for growth in trade, have run into two catalysts for fundamental change – COVID and now Ukraine. Both of these have underlined the need for greater autarky, that is, economic independence and resilience, which is completely counter to the outsourcing/offshoring trend of the last three decades. The 'wealthy' world has been able, over that period, to export the low value-added 'manufacturing' component of activity to low wage economies, while keeping the high value-added component of intellectual property at home. This was a 'win-win-win'. Consumers benefitted from lower prices, companies saw fatter margins and the developing world started to build prosperous societies. Without getting too philosophical, this was made possible by the demise of communism in Europe and the change of policy in China, which came with Deng Xiaoping.

That now seems to have gone wrong. As China has become wealthier, it has become more assertive and less tolerant of dissent, triggering an aggressive response from the US, most visibly in trade policy. Companies and markets were beginning to adjust to the idea that a different economic model would be needed to ensure that supply chains were not disrupted, but nobody was in a great rush. COVID was the second wake-up call, demonstrating that thinly stretched supply logistics, which depended on

global cooperation were not well suited to countries each dealing with the pandemic in their own ways. We may not yet be out of this thicket, but it does not require a genius to imagine that better resilience in supply chains is needed.

And then along comes Putin...

Whatever the original plan was, it has not survived contact with reality. It has shown, though, that reliance for key energy and resource supplies on an unpredictable autocracy is not the best idea. It has also blown away the peace dividend that followed the end of the Cold War. Military spending is set to accelerate in Europe, and in one of the most dramatic policy reversals of recent years, Germany has abandoned its post-war defence stance. Whether this makes any sense is beside the point – a new Iron Curtain has fallen and it will lead to increased defence spending.

All of this has happened against a background where the generous monetary tap, which has sustained the developed world for many years, is gradually being turned off in response to high inflation. This inflation may have its roots in the disruption to markets caused by COVID, but the situation in Ukraine is exacerbating the trend. While shipping bottlenecks are likely to ease in the next few months, the tightness in labour markets is beginning to feed through into higher wages and the question of how to deal with interruptions in energy supply is just coming to the surface.

Investment in natural resource exploitation has collapsed over the last seven years, as lower prices and a near-universal drive towards more investment in renewable resources have tightened available supply without fully replacing what has been lost. Sustained higher prices now seem likely as countries seek to replace Russian gas and oil. There will be new investment in the oil patch and in infrastructure to move LNG and oil around the world. There will also be accelerated investment in renewables, although the current situation has illustrated how the transition from fossil fuels needs to be gradual rather than sharp. There will also be new investment in weaponry and defensive capability.

The consequences of change

The consequences of these changes are not just important in geopolitics, but also for financial markets.

Stating with energy, the old saw says that the cure for high oil prices is high oil prices. This is because

the impact of price rises is akin to a tax rise and so hurts the consumer. To some extent, consumers are protected by the build-up of savings that follows the fiscal impulse of the pandemic, but prices generally are going to have an impact on demand. This is the short-term effect.

In the longer run, higher prices lead to an increase in supply as new investment picks up. The effect is likely to be differentiated by region. The US is more or less self-sufficient in energy, and with a pickup in investment, is in a good position. Europe and Japan are in a bind as major importers. European consumers will be squeezed by energy prices and will feel the more direct costs of the war through issues such as migration. A recession in the EU is quite likely over the next year. The US may avoid that fate, although is still likely to slow considerably. The EU's position could also worsen if the Euro weakens against the dollar, a possibility as the trajectory of rate rises in the US is steeper than in the Eurozone – this raises the Euro cost of imports and keeps upward pressure on inflation.

The UK sits somewhere between the EU and the US but is going through the pain of adjustment to a post-BREXIT world. This is visible in a number of areas, in particular in trade flows, which have been very poor, and labour shortages in a number of industries.

This is an environment where China is likely to attempt to purchase Russian energy at a discount, but without overtly falling in behind the Russian position. It is a delicate position, but it is in China's interest to act as a conduit for Russian economic activity to the rest of the world.

A more hawkish rhetoric

Bond markets have seen a dramatic rise in yields, as the US Federal Reserve (Fed) rhetoric has become more hawkish. The risks of increasing interest rates and the shrinking of the Fed's balance sheet have had a dramatic effect on bond prices. Still, they have not spilled over (until very recently) into riskier assets like equities. Those who follow such matters explain that only certain types of interest rate rises at certain points of the cycle are bad for equity markets, and the arguments behind the theory, that all is well, are so strong that we should all relax.

In practice, risky assets are generally not cheap, either in bond or equity markets, and the amount of money sloshing around the global financial system is about to shrink, which would usually be bad for asset prices. In bond markets, this is likely to lead to spreads widening – which is code for saying that riskier bonds are going to get cheaper. If risks are

rising, the usual 'safe haven' assets are government bonds. The problem here is that real interest rates are still negative despite the rises in yields. Nevertheless, given the corrections that have taken place, and given the need to seek safety for some parts of a portfolio, the highest quality bonds offer an interesting option, although, as yet, with only one toe in the water.

Equity markets have mostly been able to shake off all bad news. Whether it be COVID, Ukraine, inflation, or rising rates, equities have delivered a decent return. Could that change?

Thus far, corporate earnings have remained robust. It is only as economies slow and profit forecasts are revised that markets will begin to worry about the rising interest rate picture. In practice, many companies are able to deal with higher prices by passing increased costs through to consumers, although this can only go so far in a world where real earnings are falling. Other companies benefit directly from higher prices – witness the windfall profits being made by energy companies (and the accompanying demands for a special tax). Equity investment should focus on those areas where companies operate globally, have pricing power and where they provide something essential or where they are well-positioned to benefit from the rather different investing environment in which we find ourselves. Of the major markets, the US is best positioned (albeit expensive), although there is clear value in China and other emerging markets.

Turning to gold

Portfolios need to be as diversified as possible. Gold remains an asset that could benefit from the current conditions as Russia is looking to price oil in gold and link that to the Rouble as a means of defending its currency from sanctions. It has also had its dollar

reserve balances effectively sequestered, which may mean that other large 'illiberal' holders of dollars may need to consider their positions – a positive for alternatives such as gold.

Geopolitical risks

For the first time in many years, this review posits that the market environment has changed significantly. There is obviously a lot that we do not yet know or understand. It seems clear, though, that the risks associated with geopolitics have risen sharply at a time when central banks are looking to revert to a more normal monetary policy. The Fed, for example, seems likely to pursue its policy of quantitative tightening until something breaks, in other words, until the economy stutters or inflation comes under control.

In any case, the interest rate environment is likely to remain difficult for some time, putting upward pressure on the dollar. This could in turn create problems for economies like the UK and EU, which will either see currencies slip or have to follow the Fed with rate rises, ensuring poor economic performance.

Politics is also uncertain. Rising prices, especially for food, could cause trouble in Africa and the Middle East (as they did during the Arab Spring) while rising inequality in the developed world could lead to populist responses or even regime change.

The Ukraine war means that what might have been temporary rises in inflation will be longer-lasting, and the global economy weaker than seemed possible two months ago. The risks of conflict spilling over into other Russian satraps should also not be underestimated.

This is a time for caution, not bravado.