ISGAM

Manager's Report

QUARTER TO 31 MARCH 2022

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The first quarter of 2022 has seen a dramatic escalation of geopolitical risk with the shocking invasion by Putin's Russia of its neighbour, Ukraine.

We are all appalled by the brutal images of devastation and human suffering. An estimated 4 million Ukrainians have fled to neighbouring countries and an additional 6 million are displaced within Ukraine. Sadly, wars and refugee crises are constantly ongoing in many parts of the world, but it seems our awareness tends to be more acutely shaken by what is close to home, and for Europeans Ukraine is right on our doorstep.

At the time of writing (29 March) there appears to be some hope of a de-escalation of hostilities and a scope for negotiations, though an end to this war could be some way off. Still, Putin seems to have underestimated the force and courage of Ukrainian resistance, as well as the extent and unanimity of sanctions imposed by the US and Europe. He also probably overestimated the battle-readiness and morale of his own army.

We are by no means military experts, just as we were no epidemiologists during the pandemic. However what we can do is to estimate the probabilities of a range of economic outcomes, their respective effect on asset prices, and to manage your portfolio accordingly, constantly monitoring changes but staying within the framework of a medium to long term investment strategy.

At the start of the year, the main challenge facing markets appeared to be the imminent normalization of monetary policy, while growth was expected to remain strong as we were exiting the Omicron wave of the pandemic.

As markets digested the sudden hawkish pivot by Central Banks to incorporate expectations of a steeper rate hike path, January and February saw a correction in "long duration" asset prices and a dramatic rotation from so called "growth stocks" to "value stocks". The war then added a major disruption to the supply of energy and other key commodities (wheat, aluminium, key minerals for the car and semiconductor industries) and a large rise in their prices.

This "stagflationary" shock (a shock that increases inflation and depresses growth) makes the already difficult job of Central Banks even more complicated.

Chart 1) Russia's share in global commodity production (percent)

	2018	2019	2020
Oil	12.2	12.3	12.1
Natural gas	17.4	17.1	16.6
Coal	5.6	5.5	5.2
Copper	4.3	4.3	4.3
Aluminium	5.9	6.2	6.1
Nickel	6.8	6.3	6.1
Zinc	1.9	1.5	1.5
Gold	8.1	9.1	9.5
Silver	5.1	5.3	5.4
Platinum	10.8	11.7	14.1
Palladium	39.4	41.0	43.9
Wheat	9.8	9.7	11.0

Source: Aviva Investors

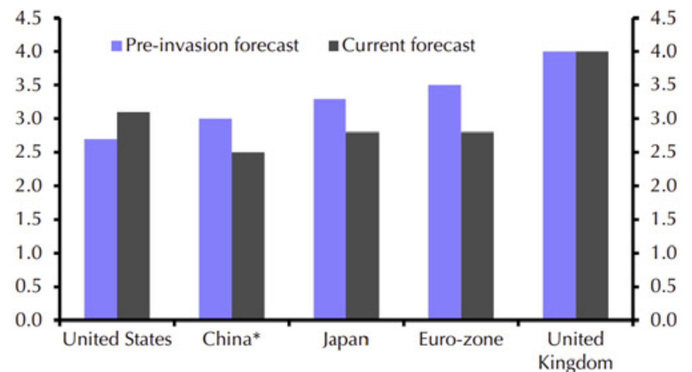
For 2022 up to the outbreak of the war the US (after years of outperformance) had been the worst performing market, as the Fed was expected to need to be more aggressive in raising rates than European, Chinese or Japanese central banks. In addition, US stock indices have a large exposure to "growth stocks" (which tend to suffer in a rising interest rate environment due to their "long duration" factor) and had a rich valuation. The war is likely to affect European economies and Asian energy importing economies negatively, and more so than the economy of the US, which is a net oil and gas exporter. Therefore, since 24 February the US market is once again outperforming and has, along with the dollar, enjoyed a "safe haven" status. Also, the "growth vs value" stock dichotomy becomes more nuanced in a scenario where high inflation is caused by supply disruption rather than strong demand, and economic growth and profit margins come under pressure – this is an environment in which quality growth stocks tend to outperform.

As a rule of thumb, every 10% increase in energy prices decreases global GDP by 0.15 to 0.2%. Oil prices are up roughly 25% year to date at the time of writing (at around USD 100 a barrel for WTI) – implying a potential hit to global GDP of 0.5%.

Capital Economics currently bases its GDP and inflation forecasts for this year on an average oil price of $120 a barrel in a "central" scenario (based on existing Western sanctions) and up to $160 a barrel in an "extreme" scenario of the West placing a complete embargo on Russian energy exports or Russia completely halting its energy exports.

Under the "central" scenario they have scaled back their estimate for global GDP growth this year to 3.2% – with different effects on different countries, as per the chart below. So far this "central" scenario does not foresee a recession in the US or even in the Eurozone, although admittedly the risk of a technical, one or two quarters recession happening in the Eurozone has risen, especially under an "extreme" scenario for energy prices.

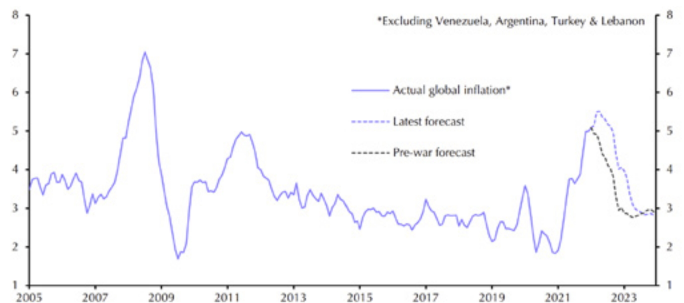
Chart 2) 2022 GDP Forecast Changes since Ukraine War



Source: Capital Economics

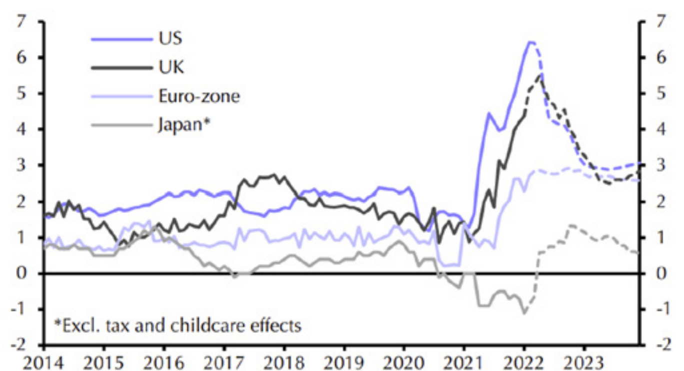
Inflation forecasts have been adjusted to account for higher energy and commodity prices as well; the expected "peak" in consumer prices, and their subsequent normalisation as the energy price increase falls out of the year-on-year equation, has shifted into the future.

Chart 3) Shift in inflation expectations due to the war



Source: Capital Economics

Chart 4) Actual and Expected Core CPI inflation in major Developed Markets



Source: Capital Economics

Prior to the invasion of Ukraine, the US Federal Reserve was already increasingly judged as being "behind the curve" and too slow to remove the extraordinary monetary stimulus put in place during the COVID pandemic.

The recent FOMC meeting of 16 March validated this view as FED members significantly increased their own projections for US interest rates (the "DOTS" on the dot plot) - see graph 5).

Chart 5) The "Dot Plot" resulting from the most recent US Federal Reserve meeting, compared to the previous (December) Dot Plot

Source: Credit Suisse

The side-by-side comparison of Fed Chairman Powell's March 16 and December press statements show a marked change in emphasis – talk of growth worries due to COVID 19 was dropped entirely, the US jobs market was now characterized as "strong", and though a potential negative effect on GDP growth from the war was mentioned, the emphasis was on its potential to push up inflation.

Our economic forecasters have increased their estimate of the Fed funds' rate to 1.75%-2% at the end of 2022, towards a peak of 2.75-3% in 2023-2024. Their expectation for the US Government bond yield is to peak at around 2.6% to 3%. The ECB is expected to start raising rates in Q4 of this year but move very cautiously due to the EU's proximity to the war and its potential negative effects on industrial production and consumer demand.

Of course, estimating inflation and GDP growth at this moment remains tentative as no one knows how long the current hostilities and its effect on commodity prices will last.

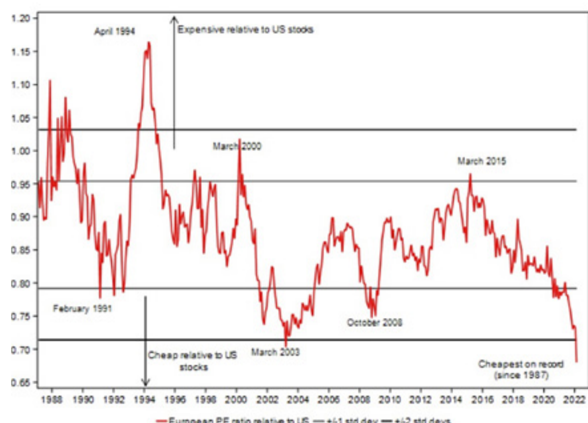
The extensive sanctions put in place on Russian companies, banks and its Central Bank have been designed to "carve out" the supply of energy according to existing long-term contracts, to protect energy flows to the West. However, many companies are now "self-sanctioning" by voluntarily pulling out of the Russian market or boycotting supplies from Russia. The US and UK have already announced a halt to all oil imports from Russia, but their share of Russian oil in their energy mix was already very small. For Europe this is a different story – 40% of its gas, and about 25% of its oil, came from Russia in 2021. Especially gas, much of it supplied via pipelines, is not easy to replace (or easy for Russia to re-direct).

Importing LNG is not a simple solution; firstly, the global LNG market is already quite tight, and Europe will be competing with Asia for global supplies. In addition, LNG is shipped by sea which takes time. It also needs special terminals in the receiving country to convert the LNG to useable energy.

European countries differ in terms of where their energy supplies are sourced – Germany has been dependent on Russian gas, whereas France always retained a high share of nuclear power. For this reason, EU discussions of how to speed up the reduction of energy imports from Russia, and how to cushion the price shock to consumers and companies in the process, is ongoing and complicated. So far, the EU has pledged to reduce its gas imports from Russia by two thirds by the end of this year; this looks feasible, but ambitious.

Based on current earnings estimates European stocks look cheap compared to US stocks – the cheapest since 1987, as per the chart below:

Chart 6) European (Stoxx 600) PE Ratio Relative to US (S&P 500)



Source: Bloomberg Finance L.P., Longview Economics

Of course, should Europe enter a recession this year under an "extreme" energy price scenario, European company earnings estimates could be cut dramatically.

Emerging economies vary in their resilience to high commodity prices. Commodity exporters will fare better than commodity importers.

Of special consideration is the price of wheat, grain and sunflower oil, of which the Ukraine is a major exporter. Prices of these food staples have soared, and for example, supply to Middle Eastern countries, much of which is shipped via the Black Sea, has been seriously disrupted. The UN World Food Program, which sources 50% of its wheat from Ukraine, is warning of a catastrophic food shortage. For many developing countries food makes up a significant percentage of the consumption basket.

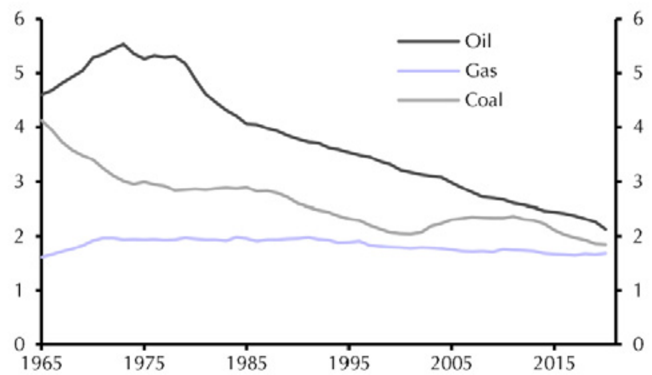
The Chinese stock market, which forms around 30% of Emerging market indices and was in free fall until recently, has now stabilized and made a bit of a come-back, as Chinese authorities have now pledged to end their relentless regulatory crackdown on the Technology sector. In terms of valuation, the broad Emerging Market index looks the most undervalued compared to developed markets in over 20 years.

At the same time many Developing Market Central Banks have already been quite aggressive in hiking interest rates as the effects of the Pandemic are wearing off – their need to maintain stable exchange rates to the Dollar does not afford them the luxury of being "behind the curve".

Some comparisons are being drawn to the current economic outlook with that of the "stagflation" period of the 1970's and early 1980's, which was not a good period for asset prices.

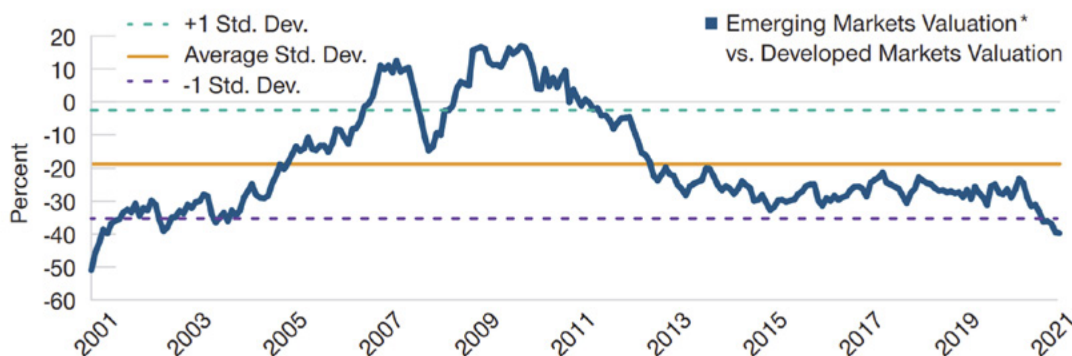
At first glance, there are many worrying similarities between the early 1970's and today. In 1973 many Arab countries stopped exporting oil to the West as punishment for its support of Israel in the Yom Kippur War, which caused a supply shock and a sharp price increase. Then, as now, inflation was already accelerating before the commodity price shock. However, we are of the view that we are not necessarily living a 1970's re-run when inflation became entrenched, and a price-wage spiral developed; labour unions have lost much of their power since that time. The share of fossil fuels (especially oil and coal) of global GDP back then was considerably higher than today, as illustrated by chart 8 below:

Chart 8) The Energy Intensity of Global GDP



Source: Capital Economics

Chart 7) Emerging Markets More Cheaply Valued Relative to Developed Markets since 2001



Source: T Rowe Price, HSBC

Also, Central Banks in the 1970's were slow to react to spiralling inflation expectations. It took Fed chairman Volcker hiking US rates to 20% in the early 1980's to finally quell inflation, causing a deep recession in the process. Admittedly the US Federal Reserve can currently be seen to be a bit "behind the curve", but it has now placed its total focus on normalizing interest rates and preventing inflation expectations from becoming entrenched. As always, a more aggressive Central Bank carries the risk of going too far and causing a recession in the process. But we still think a soft landing can be achieved, though the path to this has clearly narrowed. Firstly, a large part of current inflationary pressures is due to supply shortages (still lingering from the Covid pandemic plus now added to by the war) rather than from red hot demand and will eventually work their way out of the equation. The "neutral" rate of interest for the US (i.e., the rate at which supply and demand in the economy are thought to be balanced) is currently estimated to be around 2.4%. At the Fed's current projection, it will need to raise rates to a bit above this neutral rate, (to a peak of 2.75 to 3%), to bring inflation back in line with its long run target. This is quite different from the 20% peak in rates of the 1980's.

For the UK, where the Bank of England has also started normalizing policy, the peak rate is expected to be 1.75% next year. The ECB is expected to remain cautious, given the larger expected economic fallout from energy disruptions and remaining slack in the jobs market. The Euro Central Bank rate is expected to peak at 0.5%.

As a final thought, it is likely that the world order has changed for good, in some respects for worse, in some for better. Some of the longer run trends we see that need to be incorporated in positioning portfolios for decent returns over the coming decade are:

- The change from globalization to increased fragmentation and the emergence of a "multi-polar" world has been accelerated by this war. This will have implications for changes in the global supply chain and an impact on inflation. There will be two or more centres of power each of which will try to control the flow of information, technical know-how, and other vital supplies within its own sphere of influence. How will China and India position themselves within this multi-polar world? And will current US-European unity survive differing economic needs?
- The "Peace Dividend" which has kept risk premiums low since the end of the cold war, is now probably a thing of the past – geopolitical risk is back in the equation. This also means there will be an increase in defence spending, including on cybersecurity. Germany has already pledged it will increase its contribution to NATO to 2% of GDP, dramatically reversing decades of post-cold war foreign policy.
- The global financial system, with the USD as the leading currency, has been "weaponized" in this war as never before. In the past, smaller economies such as Iran and North Korea have had their Central Banks sanctioned, but never an economy as large as Russia. What will be the (unintended) consequences of this? An increase in the use of Crypto currencies? The growth of alternative financial systems, away from the dollar-centric one? China already has its own SWIFT-type system, and both China and India have allowed payments in Chinese currency for oil and commodities, whilst remaining careful not to violate blatantly Western sanctions.
- Clean Energy stocks have done well in recent weeks; in particular the EU will be ramping up its development of clean energy adoption in order to wean itself off Russian oil and gas. This accelerated adoption of alternatives will cost money and cause "greenflation" i.e. it will add to inflation in the short term, but will be beneficial to both the climate and the economy in the longer term.
- In the current "value stock vs growth stock" debate, it is important to remember that, once value stocks have regained a certain valuation-multiple relative to growth stocks, the underlying current investment climate is one where true growth will be increasingly scarce and pricing power is therefore of vital importance to profit margins. The type of stocks to which we want to maintain exposure will be quality growth stocks with solid cash flows and pricing power.

We are mindful of incorporating the above factors in portfolio strategies.

Furthermore:

- We retain a “neutral” exposure to stocks. The regional allocation of Equity portfolios is also neutral; higher risk premiums on offer in European and Emerging Markets stocks are offset by US markets’ “safe haven” appeal.
- We remain underweight government bonds as interest rates are rising. Global broad based government bond indices are down 7% since the start of the year, failing to perform their traditional hedging role during a period of geopolitical upheaval.
- While we underweight bonds, we remain overweight “alternatives” which now include gold and commodities as an additional inflation hedge.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general. We hope you are safe, and well, and managing to keep your hope alive in these turbulent times.

Portfolio Management, Team ISGAM AG

Marianne Rameau ASIP

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