

Understanding the Implications of War

I am sure that all our readers are as appalled as we are by the unfolding events in Ukraine. Few expected Russia to actually follow through with a full-scale invasion of the country. Two weeks into the conflict, we are horrified by the indiscriminate shelling and brutality of the attack, with what appears to be very little regard for the consequences. Events are moving so quickly that any commentary thereon risks being out of date before it is even published. Nonetheless, we try to summarise the key economic consequences below and the impact on your investments.



**Michael
Porter**

It is hard to believe how much has changed in the space of just two weeks. For the first time in living memory (for most of us), the prospect of a wider war across Europe is becoming a distinct possibility. That has enormous consequences. Since the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union a year later, the World has reaped a “peace dividend” where globalization has ushered in

strong growth, low inflation and steadily rising GDP per capita. Those halcyon days appear to be disappearing fast. We now face the possibility of the opposite, although this crisis has reunited the West.

Sanctions on Russia have been more widespread and damaging than initially anticipated, especially the freezing of assets belonging to Russia’s Central bank, and the ban on SWIFT payments. This is on top of sanctions spanning a raft of politically connected people and their assets. In addition, western reaction to the conflict has been so damning that corporations are rushing to distance themselves from Russia, if at all possible. In a move that will cause widespread implications for ordinary Russians, Visa and Mastercard have shut down their payment networks inside the country. The stock market remains closed and foreigners invested in Russian equities have effectively seen their investments written down to zero. There is no doubt that the Russian economy will enter a severe recession over the next month or two but that is relatively inconsequential for the global economy. Between Russia and Ukraine, they account for just 3% of global GDP.

The primary implication of this unfolding conflict is the impact on commodity markets. 85% of all Russian exports are commodities and it accounts for well over 10% of

SPEED READ

- The response from the West has been more coordinated than expected. Sanctions have targeted critical infrastructure. More are likely to follow.
- The key channel through which the crisis is being manifested is commodity markets – oil, gas and increasingly agriculture.
- These price shocks are reverberating across the global economy, adding substantial fuel to the inflationary spiral that was already causing jitters.
- The path ahead is impossible to predict, but age-old investment principles remain valid. Do not panic during times of crisis.

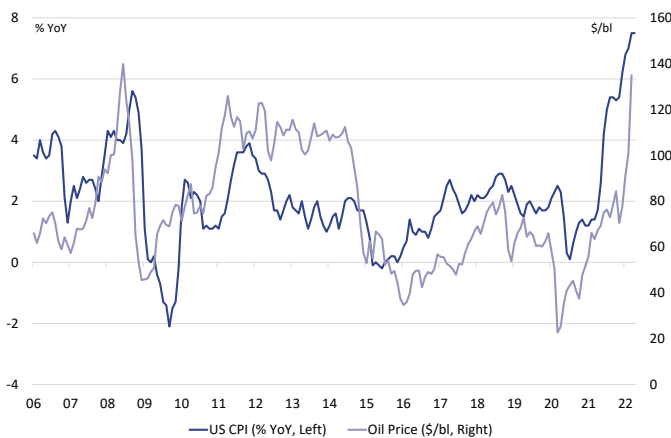
global oil and natural gas production. Europe’s reliance on Russian energy is much higher – estimated to be 20% of Europe’s combined energy requirement.

Russia's Share of Global Commodity Production (%)

Commodity	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	43.9
Wheat	9.8	9.7	11

At the time of writing, oil prices were spiking over \$130 per barrel given the rumours that the West would impose an oil embargo on Russian exports. This was unthinkable just a few days ago, but in many ways was already occurring naturally. After just a week of conflict 70% of Russian oil was struggling to find a buyer as traders shunned the country. Whether from a fear of reprisal or just a moral stand on the situation, it matters not. The implication is the same – higher prices and the consequent damage to global purchasing power. The chart below highlights the close correlation between US inflation (used here as a proxy for global inflation) and the price of oil. What is frightening is that the current oil price shock of the last few days has yet to manifest itself in inflation. Unfortunately, it is not just oil prices that are rising. Agricultural commodities – especially wheat, corn and sunflower oil – are all surging as well. To add insult to injury, surging natural gas prices are making it cost-prohibitive to produce ammonia (prices are up 420% over the past 18 months) and potash exports from Russia have plummeted. Both are crucial in the production of fertilisers. This has the potential to severely dent crops and yields. Expect global inflation to rise much higher in the months ahead. The risk is that it stays elevated for far longer than initially assumed.

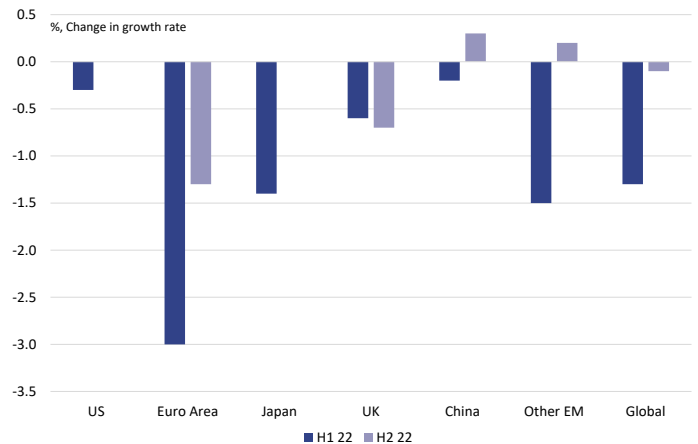
INFLATION & OIL PRICES



Inflation is surging, yet the impact of recent events has yet to manifest itself. Expect inflation to rise higher in the months ahead.

Long before this conflict erupted, investors were already worried about inflation and the response thereto. Interest rates were forecast to rise aggressively across the world. Now we face a situation where inflation will rise further, yet demand and growth are already being revised downwards – a typical “stagflation” scenario. It is unclear how authorities will react or whether interest rate increases will be tempered. Nonetheless, global growth forecasts are being revised lower, especially for Europe. The risks to global growth are very much to the downside.

REVISIONS TO GLOBAL GROWTH



Since 18 February, forecasts for global growth have been revised down by 0.8%. These downgrades have been concentrated in H1 of this year, and in Europe. The risk is that they spread more widely.

The future is always scary when faced with wild unknowns and President Putin has shown himself to be extremely unpredictable. Yet amidst the gloom and the pressure from oil prices, we should not forget that markets do respond. At elevated oil prices, it is highly likely that between OPEC, the US and global strategic reserves, sufficient oil will find its way to the market to balance demand and supply.

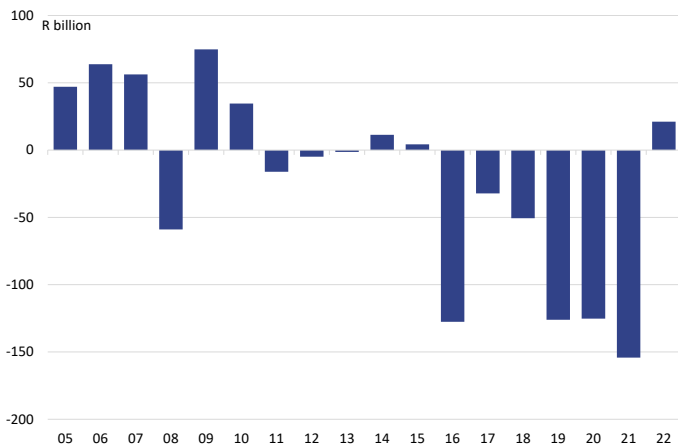
“The future is always scary when faced with wild unknowns and President Putin has shown himself to be extremely unpredictable.”

This will not happen immediately, but the best cure for high commodity prices is high commodity prices. They encourage a ramp up in production that ultimately brings the market into oversupply. Already US production is rising rapidly, so we should always be mindful not to extrapolate recent trends.

Where does this leave SA? In the near term that is not an easy question to answer as SA is caught in various cross-currents, not all of which are unfavourable. On the one hand, we will not be immune to higher oil prices. Local petrol prices are already at record highs and will rise further. That in turn will push up prices across the economy, draining discretionary spending. Like elsewhere, we must also expect the Reserve Bank to react with higher interest rates, adding a further brake to our fledgling recovery.

However, we stand to benefit from this Crisis as well. Like Russia, we are large exporters of platinum group metals. Prices have spiked in the last two weeks as Russian supplies dwindle, which plays directly into our hands. Gold too is trading near record highs as investors rush for safe havens. Taken together, these trends are very supportive for our terms of trade – and is one reason for the relative strength of the currency so far. Last year Treasury collected a substantial amount of extra tax from the commodity windfall. That might be repeated this year, which would release pressure from slower GDP growth.

FOREIGN TRANSACTIONS IN SA EQUITIES



Foreigners have been net buyers of our shares for the first time in 12 months. It is too early to call a decisive change in the net outward trend of the past 6 years, but Russia's expulsion from notable indices stands us in good stead.

In conclusion, some of these points may well be moot by the time this is published. Events are moving that quickly. There will be consequences and times might get a little

tougher. A bicycle might be a good investment rather than a new car. But experience and history have taught us time and time again that times of crisis are seldom the best times to panic. Some SA companies do have Russian operations

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– Barloworld, Mondi and Naspers to name a few – and share prices have tanked. But the reaction is already looking overdone. Far from rushing for the exit, these are times when opportunities present themselves. That applies to both local and offshore portfolios. In closing, be prudent and understand that some belt-tightening may be required, but most of all, let us all pray that wisdom and sense prevail to prevent a wider conflict and further unnecessary human suffering. Furthermore, I alluded earlier to the fact that Russian stock markets were closed and foreigners have essentially been banned. This week, Russia will be removed from key MSCI and FTSE indices. Together with Turkey, which faces its own domestic issues, two of our largest peers are largely uninvestable. For those investors looking for emerging market exposure, SA is standing out. That may not last forever, but it's hard to see investors flocking back to Russia any time soon. In the meantime, SA has an opportunity to remind foreign investors that we have world-class companies trading at very reasonable valuations. It is early days but the trend has turned far more favourable.



The war in Ukraine has unleashed devastating commodity volatility, but, sadly, war also creates investment opportunity.



Topic: **Taming Inflation**

Natal Midlands

Date:	17th March 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg

Date:	15 March 2022 (<i>Revised Date</i>)
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am



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