Economic Update

Ukraine

March 2022 edition, By Chris Boag

Last month we noted that the year had commenced as expected with a higher level of volatility as markets adjust for anticipated interest rate increases and inflationary pressures. Russia was building its troop numbers on the boarder of Ukraine with clear intention to invade. Russia has now invaded Ukraine and the 'West' has reacted by imposing significant sanctions while trying to avoid direct conflict with Russia.

The escalation of geopolitical tensions including the Russian invasion of Ukraine is indicative of the end of the stable geopolitical period we have enjoyed recently. The immediate impacts from the invasion have caused some concern that the US Fed may delay the first anticipated interest rate hike. Certainly, expectations of the magnitude have reduced, a 25bpt rate increase is widely anticipated based on recent testimony from Jerome Powell.

The Russian invasion is likely to have a meaningful impact on the European economy. The Eurozone represents 23% of global GDP and the US economy has close to a 90% correlation with Eurozone economy, indicating the two economies rarely decouple. What we are witnessing at present is a rapid shift in supply and demand for key commodities that could lead to a period of supply constrained commodity prices, stubbornly high inflation and weakening economic growth. Overnight we have seen the price of nickel rise by 90% due to the short squeeze and inability of some customers to make payment, the London metals exchange (LME) has taken the unprecedented action of suspending trade. Other commodities are also in focus as the US and its allies seek to effectively ban Russian oil, coal, and LNG imports. This is creating a commodity crisis across metals, hydrocarbons, and grain that could rival the oil crisis of the 1970's. The West is not just adjusting supply chains but are in-effect raising the Iron Curtain on Russia's behalf.

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It's important to take a moment, step back, and reflect. The Pandemic has accelerated the sift to greener economies, looking at the high prices for oil and gas, one can see that this could also lead to a further acceleration of the adoption of clean energy and battery technology. Someone once said that the best cure for high oil prices is higher oil prices. Figure 1 is from the Allken Half Yearly report (prior to the invasion of Ukraine) and it clearly highlights the growing demand for lithium and the lack of new mine investment to fill the supply gap. More broadly when looking at other commodities, and as previously noted, the miners are in no mood to invest in new mines even with these high prices, so we are not expecting a supply led response to the current situation.

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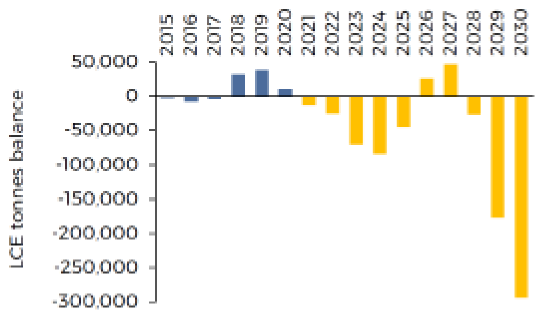

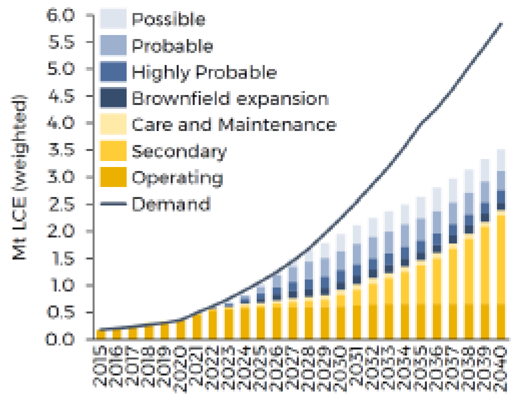

Back home in Australia the RBA has, to no one's surprise, kept the benchmark interest rate at 0.10%. The RBA continues to wait for sustained wages growth to support any rate increase. Inflation is currently running at about 3.2%pa with the next reading to be the March quarter (released in late April). Economists suggest annual headline readings of 4% plus and non-discretionary (household necessities) at 5% plus are likely.

As we have mentioned in previous updates, Australian's have built up significant surplus savings from Government handouts and the inability to spend it due to Pandemic induced restrictions. This surplus is expected to be spent in the economy as restrictions are eased both in Australia and overseas. This anticipated increase in spending will not only support economic activity but is likely to add to inflationary pressures. Once prices for goods and services have risen there is little chance of them falling regardless of interest rates.

In stock markets we have seen heightened volatility due to the Russian invasion of Ukraine. We have seen the Nasdaq Composite fall 3.4% only to recover and close 3.3% higher for the day. The last occasion this occurred was back in April 2000. A bear market followed. The suggestion hear is to be careful. Despite this, Australian reporting season was largely positive. Given the uncertainty of the Pandemic, Australian companies have by and large done a fantastic job. Shareholders have been rewarded with total dividends for 2021 estimated to be $87b. BHP and friends were key contributors but banks and recovering oil companies have also joined the party.

The Russian invasion of Ukraine has now entered its 2nd week and the situation for geopolitics and investment markets remains very fluid. Uncertainty is elevated and investors are generally in a risk-off mode. Volatility is likely to remain highly elevated this month and there is potential for investment markets to fall further. Looking through the short-term noise, equities continue to offer an attractive return outlook in the medium term as robust economic growth should continue to support corporate earnings. Central Banks including the US Federal Reserve are expected to increase interest rates this year with the US Fed expected to move 25bpts in March. Potential triggers for a renewed setback in equities include ongoing geopolitical risks including a protracted conflict in Ukraine and further surges in inflation. One must keep their focus during such times and remember the powerful forces still driving global growth; extremely accommodative monetary policy, very high household savings, and strong employment growth.

Post reporting season and considering current investment and geopolitical issues, we believe our portfolios are well positioned. We are not taking interest rate risk within our Interest-bearing Securities portfolios, our Australian equities portfolio is well diversified and international equities remain 75% hedged back to the AUD$.

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Sources: RBA, Morningstar, Credit Suisse, Allkem