



BREWIN DOLPHIN

The Weekly Round-up

Friday 25 February 2022

In his latest note to the Brewin Dolphin wealth community, Guy Foster, our Chief Strategist, discusses Russia's invasion of Ukraine, the potential response from the West, and the impact on global markets.

The approaching weekend will come as a relief to a lot of investors after a tough few days prompted by Russia's invasion of Ukraine. It will, however, provide no real relief to those most directly impacted. One of the unusual features of the invasion is that even as government leaders warned of a full-scale invasion, private sector analysts felt, on balance, this was unlikely. The rationale for that misplaced scepticism is that it would seem a very poor cost-benefit trade-off for Russia's President Vladimir Putin.

Despite deploying similar numbers of forces, Russia seems capable of largely overpowering Ukraine, with its superior military hardware. However, if Ukrainians continue to resist, then even a conventional combat phase can reap a huge financial and human cost. The war-scarred territory gained would require enormous economic support, which we can only assume Russia would be prepared to shoulder. Putin's explicit aim is to instil a puppet government, which is likely to meet ongoing resistance. As for the benefits, the stated justification is to avoid an expansion of NATO, although that modest objective could be achieved with the mere threat of force. It may ultimately add some heft to Russia's NATO rival, the Collective Security Treaty Organisation (CSTO). De facto control of Ukraine would strengthen the already formidable dependency on Russia that Europe suffers through imports of food and energy.

That dependency has no doubt been behind the reluctance of Western powers to impose the harshest sanctions on Russia. Whilst measures will impact Russia, they stop short of striking at the heart of its current strength, which is the substantial role Russia plays in providing energy to a market that is currently undersupplied. Instead, sanctions have focused on individuals and financial institutions. Governments have gone for some of the harshest restrictions on banks and we will wait to see how these pan out. Having been excluded from some capital markets,

Russian banks will need to keep confidence among their depositors and other counterparties. Failure to do so could have dire implications for the Russian economy, where average citizens will suffer from the economic burden of this conflict and the sanctions that come in response.

Windows of opportunity

This dispute has been rumbling on for more than eight years, when the ousting of the pro-Russian Ukrainian President Viktor Yanukovich triggered a political crisis in the region. It would appear that this latest escalation reflects a potential window of opportunity for Putin when the potential pushback is likely to be particularly low. Right now, Western government cohesion is close to a generational low. The last two decades have seen some very unfortunate foreign policy campaigns, which have hugely diminished the appetite among electorates to be more assertive abroad. Finance ministers would echo the need for non-interventionist policy, as they count the cost of fighting the pandemic. And the West is dependent upon Russia in a way which will hopefully diminish in proportion to its reliance on fossil fuels as the world pursues decarbonisation.

Even as the battle rages in Ukraine, China's President Xi Jinping will have considered whether similar dynamics should dictate the timetable for his life goal of reunifying Taiwan into the People's Republic of China. A foreign ministry spokesperson was clear to distance the situation in Ukraine from that in Taiwan, but the distinction being made was that Taiwan "has always been an inalienable part of China. This is an indisputable legal and historical fact." A statement which doesn't seem to rule out any future actions. Just as the aim of decarbonisation may have pressed the hand of Putin, could Western desire to reduce reliance on China represent a shrinking window for Xi? Fortunately, all is currently quiet on that front.

Energy markets

Oil was the topic du jour before this week's escalation. Even reasonably bullish scenarios for oil should see year-on-year inflation effects begin to ease. There are lots of high inflation numbers waiting to drop out of that historical calculation, and it's easier for oil to double from a low price than the current high one.

Currently, prices are escalated because of the war and the geopolitical premium that prices incorporate. For what it's worth, our estimate is that the undisturbed price of oil would be around \$90, but tensions have lifted it above \$100.

"The best cure for a high oil price is a high oil price," or so the saying goes. High prices dissuade some marginal travelling and activity, but also prompt greater supply. Both of these will be intensified by the current elevated price.

We have started to see a greater response from US shale oil. If the US government controlled its energy sector in the same way that China or Russia control theirs, then shale would be the ultimate sanction. As we saw in 2015, shale can collapse the oil price to a level that would leave Russia reliant once more on borrowing from global markets. Instead, shale producers are reliant upon market forces and the trust of their investors who are desperate to avoid a repeat of the oversupply that has destroyed profits in previous shale surges. That kind of oversupply is the reason for the establishment of OPEC (OPEC+ since the involvement of Russia).

Currently, the market is undersupplied and prices are rising. OPEC countries have been unable to fill their quotas (most notably Nigeria and Angola). However, in response to the current very high prices, it seems likely that quotas will be reallocated. The US Energy Information Administration anticipates the market moving back into balance by around April, and the oil price normally peaks a couple of months after that happens.

Looking forwards

Although hardly in the news this week, it is important to recognise that while historically the oil price has been, and will continue to be, a big driver of headline inflation, the current inflationary anxiety is elevated precisely because it has become much broader than that. The Ukraine crisis may have shown that bonds can serve a role in reducing risk during sudden events like this.

So how do we take into account these horrific and tragic events? There can be no question that sometimes markets' reactions to tragic events can be uncomfortable. They are discounting economic outcomes rather than human or political outcomes. That is part of the reason for what can be unintuitive reactions to deeply troubling events. The other reason is that they are forward-looking, trying to anticipate what will change more than react to it. So they have been weak ahead of the invasion, but investors often seem to 'buy on the sound of gunfire'. This is because it often marks the point of maximum uncertainty, after which the picture starts to clear.

The anxiety has prompted something of a bid for bonds. That contributed to the outperformance of the Nasdaq on the day of the invasion, with its high weighting in interest-rate-sensitive technology stocks. It also contributed to underperformance from the banking sector, which will earn a lower 'net interest margin' from the flatter yield curve. This has not, however, taken interest rate increases off the table. The Federal Reserve and the Bank of England are both expected to raise rates at their forthcoming March meetings and to keep raising rates thereafter.

Such matters might seem trivial when such tragic events are taking place in Eastern Europe. It does not, however, diminish our desire or responsibility to serve clients. So, we need to consider all risks and opportunities. Markets sometimes seem disconcertingly dispassionate about events like these and, based upon the sanctions currently deployed and Russia's response to them, it seems likely that investors' concerns will drift back towards the current inflation and interest rate environment and away from the human tragedy. But, of course, there are still many potential twists and turns that might keep the matter in focus.

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy. Information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness.