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"We need to increase oil and gas output immediately."
Elon Musk, 5 March 2022

Just as the world economy was emerging from the Covid crisis it was overtaken by another crisis when Russia invaded Ukraine. Apart from the human trauma there are multiple economic impacts from this act. The main one is that it has made an energy crisis even more acute, but a string of other commodities' supply have been affected. Russia is a commodity superpower producing 11% of the world's oil, 17% of its natural gas, 40% of palladium, 15% of platinum and rhodium, 15% of aluminium, significant volumes of battery grade nickel, and 65% of neon (a rare gas used for semiconductor production). Russia and Ukraine account for 28% of global wheat trade. Belarus has 40% of the world's potash, and Russia supplies 66% of ammonium nitrate (used for fertilizer). Many of these markets were already tight, and the loss of such a large provider will create huge upheaval as the world tries to reorganise its supplies. The inflationary pressures are clear, and they add to a situation which was already experiencing the highest inflation for forty years. On top of these pressures will be increased defence spending, which will further constrain government budgets and add to inflation. Wars are always inflationary. Before the invasion several areas of financial markets were struggling as Central Banks indicated that interest rates would rise through the rest of the year. Bonds had fallen as inflation rose, and profitless technology companies in the US fell precipitously. Most dramatic was the profit warning on 3rd February by Meta (formerly Facebook) which resulted in it losing $250bn of value that day. It is a measure of how concentrated the market is that its loss represented the combined total value of all but the top twenty companies in the S&P500. Yet this feature of the market also offers opportunity. The obsession with technology in the last decade means that large swathes of the market have been ignored, leaving plenty of decent companies on sensible valuations. Nonetheless the strong inflationary environment, with a super imposed geopolitical and commodity shock, has left all markets in an uncertain state. Longer term the most damaging consequence may be to the US dollar's reserve currency status. The unilateral freezing of Russian reserves will make countries with large surpluses think twice about parking their reserves in the US bond market. The US has benefited from trillions of deposits from countries such as China, India, Saudi Arabia, UAE, and Kuwait. These reserves have allowed the US to run huge deficits at low cost, but if the inviolability of these reserves is questioned they may leave. That will put upward pressure on US interest rates, and downward pressure on the dollar.

The emergence from Covid was always going to be an uneven progress given the mutations of the virus and the different levels of deployment of the vaccines among various populations. However, at the start of 2022 the economic reopening was moving steadily ahead. This was bound to lead to some inflation given the gigantic stimulus applied by the authorities and the disrupted supply chains, but it was hoped that this inflation would be transitory. It has turned out to be more persistent, and in the US is running at close to 8%, while Germany has recorded producer price inflation of 25%, and Italy over 40%. Western inflation (it is much less of a problem in Asia) has broken out of a forty-year downtrend. Food and energy are the main drivers, but wage inflation is also rising. Strong employment and fewer workers, due to many people taking early retirement or staying at home for Covid related health issues, have driven up wage rates. There has been further pressure from supply chain disruption, and environmental factors such as China reducing its use of cheap thermal coal to reduce pollution. When inflation last surged up to the current level of 7.5% in 1978 the US government debt to GDP ratio was 32%. Now it is 130%, or $30 trillion. With tax receipts of only $2 trillion danger looms if interest rates rise much further, but the more inflation presses the harder it will be to keep interest rates down. In simple terms if rates rise 1.5% that adds $450 billion to the US interest bill. Even before inflation was a problem the unattractive level of real yields meant that bonds issued by the Government have had to be bought by the Federal Reserve. This process of quantitative easing has clearly benefited asset prices. At the start of 2009 when the QE program commenced the US stock market was valued at 60% of US GDP. By the end of 2021 it was over 200% of GDP, while the Fed's balance sheet had expanded by $8 trillion. Both the bond and stock markets look stretched relative to inflation, and if inflation persists both are vulnerable to significant falls. In this context the Russian/Ukraine disaster couldn't come at a worse time, as it is likely to generate significant wage demands as consumers struggle to meet their rising cost of living. There are estimates that the average European household energy bill may rise by 50-100% as energy prices are forced higher. The probable loss of the Ukrainian harvest will push food prices higher. Most Ukrainian wheat goes to the Middle East and North Africa. The Arab Spring uprising a decade ago was caused by food shortages, which then threated the security of Middle East energy supplies. There is clear potential for an ugly spiral to develop. Governments will be praying for good harvests this year. They may try to intervene to ease the financial pain for low incomes households, but that will exacerbate the problem because subsidies muffle the price signal, so demand for oil above $100 will be greater than it should be.

The energy and commodity crises have been worsened by the environmental movement. Net zero policies has demonised the oil and gas industry. As a result the budget to replace fossil fuel reserves have been cut by a cumulative $1 trillion over the last decade. As an illustration Rystad estimate that the discovery of oil and gas in 2021 was the lowest since 1946, with the result that reserves are not being replaced. Equally damaging, the skilled labour pool necessary for operating the industry has slumped as fewer young people have entered the sector. Inadvertently the green lobby has constructed a moat around the commodity sector rendering it hugely profitable. Even before the Ukraine disaster the world faced a rolling energy crisis over the next five years, as we become increasingly dependent on countries unsympathetic to the West for our energy supplies. The current problem with renewable energy is that it cannot be stored. When the sun sets or the wind drops supply stops. This is what caused so many electricity grids to crash last year. The resulting effects of higher energy prices are widespread. Energy intensive products such as urea, which is used in fertilisers, have tripled in price during the last year. Farmers must either decide to pay those prices or cut their usage in which case grain yields will collapse. This problem cannot be solved by Central Banks; they cannot print energy or food. The lack of supply of these fundamental commodities may drive inflation yet higher.

Against this grim backdrop one should not lose sight of the opportunities. The key question is can growth hold up. The pandemic showed that policy makers can support growth if they choose to, and they are likely to try to shield consumers, at least at lower income levels. If they support growth, stock markets will benefit because they love any stimulus. Moreover, consumers entered this crisis in good shape with big savings from the pandemic so they have a buffer. Employment is strong and wages are rising. China has started to stimulate its economy, so as long as there is not a deep western recession it should do well. In terms of sectors the clear beneficiary of recent events is the energy sector, whether fossil fuels, or renewable energy. The vague target to achieve clean energy by 2050 has been changed to the need to do everything possible to achieve energy security and independence by winter 2022. This is relevant, particularly for Europe. An enormous amount of resources will be thrown at the issue. The longer-term solution to energy security and climate change is to build nuclear plants, and more renewable infrastructure which will benefit areas like machine tools and semiconductors, and metals like copper, lithium and cobalt. Short term fossil fuel producers will benefit as the absolute commitment to net zero will be impractical, and the world will be forced to return to these producers to plug the gap left by Russia. To finance this the €750 billion EU Recovery fund is available, as is the EU plan to deploy over €1 trillion in an EU Green Deal. There will be a massive ramp up in investment. This should lead to a prolonged period of elevated commodity demand. It will benefit companies that have been ignored in the technology obsessed bull market of the last decade. These companies have not been in the spotlight but they have solid operations and reasonable valuations. Higher wage inflation will also force firms to invest more to increase productivity, and this should spur a multi-year pick up in investment spending from today's low levels. With strong wage inflation companies will need to grow sales fast enough to offset cost increases. Many companies won't manage this, but those that do will flourish. Stock selection is therefore crucial, and following indexes may be less rewarding. A stark illustration of this is the last reorganisation of the Dow Jones Index in August 2020. The evicted companies performed as follows to March 31st 2022: Exxon +106%, Pfizer +44%, and Raytheon +62%. The replacement companies' performance was Salesforce -22%, Amgen -5%, and Honeywell +17%.

Geographically one of the most interesting markets is Japan. Japan hosts many of the companies that will benefit from this new environment, and the stock market is experiencing a corporate revolution in which the shareholder is receiving far better treatment. Return on equity for Japanese companies with a market capitalisation above $500 million has improved to close to American levels. Over the last twenty years Japanese companies have increased dividends by seven times from $20 billion to $140 billion. Since 2012 when the market bottomed it has risen 240% while earnings have risen 300%, so it has de-rated at a time when most markets have seen their valuations expand. By contrast, the US market has risen 500% over the same period while earnings grew only 200%. The market is under-owned by global investors, has strong earnings, record cash generation, and improving corporate governance. Private equity companies have also become active in the market and this is pushing companies to perform better.

The shocking events in Ukraine have left markets fragile and there is considerable uncertainty. It is unlikely that this anxiety will lessen, and it may increase. Besides the political issues the main economic tension is likely to focus on how Central Banks resolve the rising inflationary expectations while maintaining absurdly low interest rates. However, crisis always bring opportunities. While the majority of the stock market is likely to struggle there will be selective opportunities in areas like commodities, Japan and those companies which can enhance productivity, and those that enable the world to achieve more efficient energy supplies. Bonds remain uninteresting, and it is notable that since the war started they have been weaker while most equities have recovered the ground they lost on the news of the invasion. It is rare that equities prove to be more of a safe haven than bonds, but this illustrates the confidence that investors have in the reliability of earnings in the largest technology companies as well as the new opportunities. These equities can probably continue to do well, so long as bond yields don't rise too far. In currencies the US dollar is likely to remain a safe haven, as the war in Europe weighs on European growth.