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Geopolitical crisis

Market Comment, March 2022

Geopolitical uncertainty remains high by historical standards. Russia's attack on Ukraine is not only increasing nervousness and reducing risk appetite in the short term; higher energy costs and, should inflation remain elevated, higher financing costs via interest rate hikes could also see record-high corporate profit margins fall again. What's more, the so-called "peace dividend" of the past 30 years is in danger.

We have written about geopolitical issues a few times in recent years. This time, the geopolitical crisis is a little closer to home. Russia's invasion of Ukraine increases the risk of stagflation, i.e. the risk of lower or stagnant economic growth and greater inflation owing to high energy prices, more than the Crimean annexation of 2014.

As far as the economic impact is concerned this time, a few facts are of importance: In Europe, it is the Eastern European states that are most economically intertwined with Russia. Across the whole of the European Union (EU), just shy of 1.5% of economic activity is directly dependent on Russia, with this figure standing at around 2% in Germany. Within the European sectors, Russia accounts for a higher share of demand in cyclical sectors than in defensive sectors. However, it is set to be the indirect impact of the economic sanctions against Russia that will be more important than any direct economic interdependencies.

Russia is not only a leading military power, but also most notably an important supplier of raw materials. Around 40% of Russian oil exports and 70% of Russian gas exports go to Europe. Of all European raw materials imports, almost 40% come from Russia in the case of natural gas, and approximately 30% in the case of oil. Viewed over a period of several years, gas deliveries from Russia to Europe have been very low this winter. This fact, together with the historically low stocks of oil and gas, means that Russia has a political "lever" to protect its geopolitical interests in the event of really tough sanctions.

The following figures reveal just how important Russia is for raw materials: In terms of total global production, Russia accounts for around 40% of palladium, which is important for catalytic converters in petrol cars, about 25% of grain (the main customers being Turkey and Arab countries) as well as 17% of gas, 10% of oil and 9% of gold.

> "Defensive approaches are more popular once more – in terms of equity focus and in the political sphere."
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> Gérard Piasko, Chief Investment Officer

What is the situation with the so-called "peace dividend", i.e. the military expenditure saved due to the end of the Cold War? Gradual rearmament in Europe is now becoming more likely. There is likewise an increased likelihood of a renewed phase in the arms race between East and West, similar to that seen in the 1980s between the US under Ronald Reagan and the Soviet Union, which ultimately did not have the economic means and collapsed economically. Russia has an advantage this time around, at least in the short term, as it spends around 4% of its gross domestic product on the military. The EU countries, on the other hand, which had been investing 3% in their military at the end of the Cold War, have only been investing 1.5% until now. The money saved as a result has so far been used in Europe for other economically important expenditure such as the support offered to the countries of Southern Europe. These funds thus represent a "peace dividend" that could soon shrink again.

In recent years, the US has pointed out to other NATO countries that their contribution to common military defence is too small. The chess player Putin feels that he has to seize the initiative before rearmament in Europe and a new arms race cost Russia too much economically. It is precisely this, however, that could provoke an arms race. At present, Russia is still benefiting from its invasion of Ukraine due to higher commodity prices, especially for gas and oil, which are allowing for additional revenues.

Conclusion: The geopolitical unrest following Russia's attack on Ukraine is not only impacting Western equity markets due to nervousness (reduced risk appetite) among investors, but also through its economic effects. And it is set to be the indirect effects that are more important than any direct interdependencies: An increase in energy costs could lead to a fall in corporate profit margins. Profitability, which has climbed to record levels, could fall once more. This is also due to the higher financing costs owing to interest rate hikes implemented in light of persistently high inflation driven by developments in oil and gas prices. Furthermore, the money that has so far been saved in the economy thanks to historically low military spending could decrease again if the "peace dividend" is diminished. A more defensive approach is once more the order of the day in every sense, including with respect to equity focus through a lower level of cyclical sensitivity. This is why we have established an overweight position in the less cyclical Swiss equity market relative to other regions, while we already moved to reduce equities overall months ago.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche

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