February 2022 — Over the Horizon Market Commentary by David Offer

Despite some large daily market swings, the month of February saw little overall movement, with the All-Ordinaries Index gaining just 55 points to close at 7,323 points. For the month of March to date, the market is up a further 93 points or 1.3%.

A reasonable interim reporting season was overshadowed by ongoing news relating to Russia's shock invasion of Ukraine and in particular the terrible impact the invasion is having on Ukrainian civilians caught within besieged towns and cities. Russia appears to have started the conflict assuming the sheer scale of its mechanised army would overwhelm Ukrainian resistance. This has not eventuated. A protracted war now appears likely, particularly given Western countries intend to re-arm Ukrainian ground forces.

Time will tell if Russia will be able to successfully fund this war to deliver a satisfactory conclusion for Russia. From an economic perspective, Russia is a relatively small country. Its gross domestic product of $1,648 billion represents approximately 10% of the Economic Union's GDP and 2% of the world economy. This is on par with the combined economies of Belgium and the Netherlands. To win this war and maintain its armed forces, it appears Russia will have to drastically increase its military spending. In doing so, consumption in other areas will need to be cut and this will further impoverish Russia's population of 146 million, which is more than 5 times the size of the combined population of Belgium and the Netherlands.

Russia's exports as a share of global GDP represent just 0.3%. Russia's top exports are crude petroleum ($123B), refined petroleum ($66.2B), petroleum gas ($26.3B), coal briquettes ($17.6B), and wheat ($8.14B), exporting mostly to China ($58.1B), Netherlands ($41.7B), Belarus ($20.5B), Germany ($18.9B), and Italy ($16.7B). At this time, oil and gas sales are not part of global sanctions and perversely Russia is benefiting from the high energy prices occurring because of the conflict. However, there are a number of longer-term negative implications for Russia that include;

- Countries are presently stockpiling oil and gas due to the uncertainty of the war so there is the potential for oil and gas prices to soften once this concludes. In addition, the northern hemisphere is moving into summer, a season of lower oil and gas consumption.
- While it will take time, the European Union is now actively moving away from its reliance on Russian oil and gas making Russia increasingly reliant on China to receive its exports.
- The current volatility in oil and gas prices will likely speed up the transition towards low carbon energy generation and reduce the long-term demand for oil and gas.

The economic consequences of the war are already being felt in Russia. Interest rates have rocketed to 20% from a record low of 4.25% in July 2020, the stock market has closed and Russia's currency (the Ruble) has crashed 42% to its lowest level ever. There is an unprecedented exodus of Western business from Russia, extensive sanctions have been applied and half of Russian's foreign reserves of $600 billion have been seized. It is estimated that the Russian economy will shrink by between 7% and 15% in the year ahead. A severe recession looms and it is likely Russia will default on upcoming debt obligations making access to future international funding much more difficult and expensive.

Further, if Russia does take control of Ukraine, it will need to take some responsibility for rebuilding destroyed infrastructure. With Ukrainian citizens increasingly pro-European, maintaining peace in such a hostile environment will force Putin to divert significant resources from Russia. It appears inevitable that successful or not, the Russian people will pay a huge economic price for Putin's attempt to achieve his apparent goal of re-establishing the former Soviet Union.

In Australia, we have been adversely impacted by the war primarily through having to pay higher prices at the petrol pump. However, this is likely to be more than offset by higher export income as Australia is a net exporter of oil, gas and agricultural products. However, perhaps how Australia will benefit the most is the education the Ukrainian population is presently providing to utilitarianism regimes. Functioning democracies do not take kindly to the forced removal of freedoms! Hopefully, China will be taking note with respect to its future intentions with Taiwan. Any future possible Taiwanese conflict would almost certainly draw in Australia and our most significant export market (where we enjoy a significant trade surplus) would likely disappear overnight as part of targeted sanctions. This would devastate the Australian economy.

The spike in energy prices appears to be cementing the outlook for inflation. In America, inflation in 2022 is now forecast to be 4.3% (up from 3.6%) versus GDP growth of 3.7%. In Europe inflation is now expected to be 5.5% versus GDP grown of 2.8%. In both. In both Europe and America, inflation is eroding people's standard of living. In Australia, the outlook is a little more favourable, with core inflation predicted to be 3.25%, while GDP growth is expected to exceed 4%.

Covid has unexpectedly proven to be the catylist to move the world from a deflationary environment back to a more conventional one with inflation. The Russian Ukraine war has aided this outlook with rising energy and food prices. Central Bank policy globally is yet to reflect this as evidenced by Australia's RBA continuing to retain Australia's interest rate setting at 0.1%. At a recent address, RBA Governor Philip Lowe stated that while a rate rise in 2022 was 'plausible', he believes the market's expectation of 4 rate rises this year was highly unlikely. We feel it is increasingly inevitable that interest rate rises are on the way but to a lesser degree than assumed by investment markets at this time.

Against this difficult investment backdrop we have been pleasently surprised with how well investment portfolios have been holding up. Value investments (along with resource shares) have strongly outperformed growth shares for the financial year to date and this is where we have the majority of client portfolio's invested. We see the outperformance in value shares as likely to continue until interest rates at least start to normalise.

Equally important is for investors is to continue to maintain a reasonable cash balance for unexpected market opportunities. We expect plenty of further market volatility ahead and it is unlikely we have seen the worst of this war. For example, on Friday 4 March, our market briefly plummetted 100 points on news a Ukrainian nuclear power plant was under attack. Thankfully no sustained damage was incurred. However, a nuclear disaster (power plant or otherwise), the destruction of pipelines supplying oil and gas into Europe (and the energy crises that would eventuate) or escalation of the conflict to involve more countries (with the increased risk this would bring), would all be reasons for market sentiment to be adversely impacted.

If you have any queries with respect to your investment portfolio, please do not hesitate to contact our office.

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