CARTLIDGE MORLAND
INDIVIDUAL WEALTH MANAGEMENT

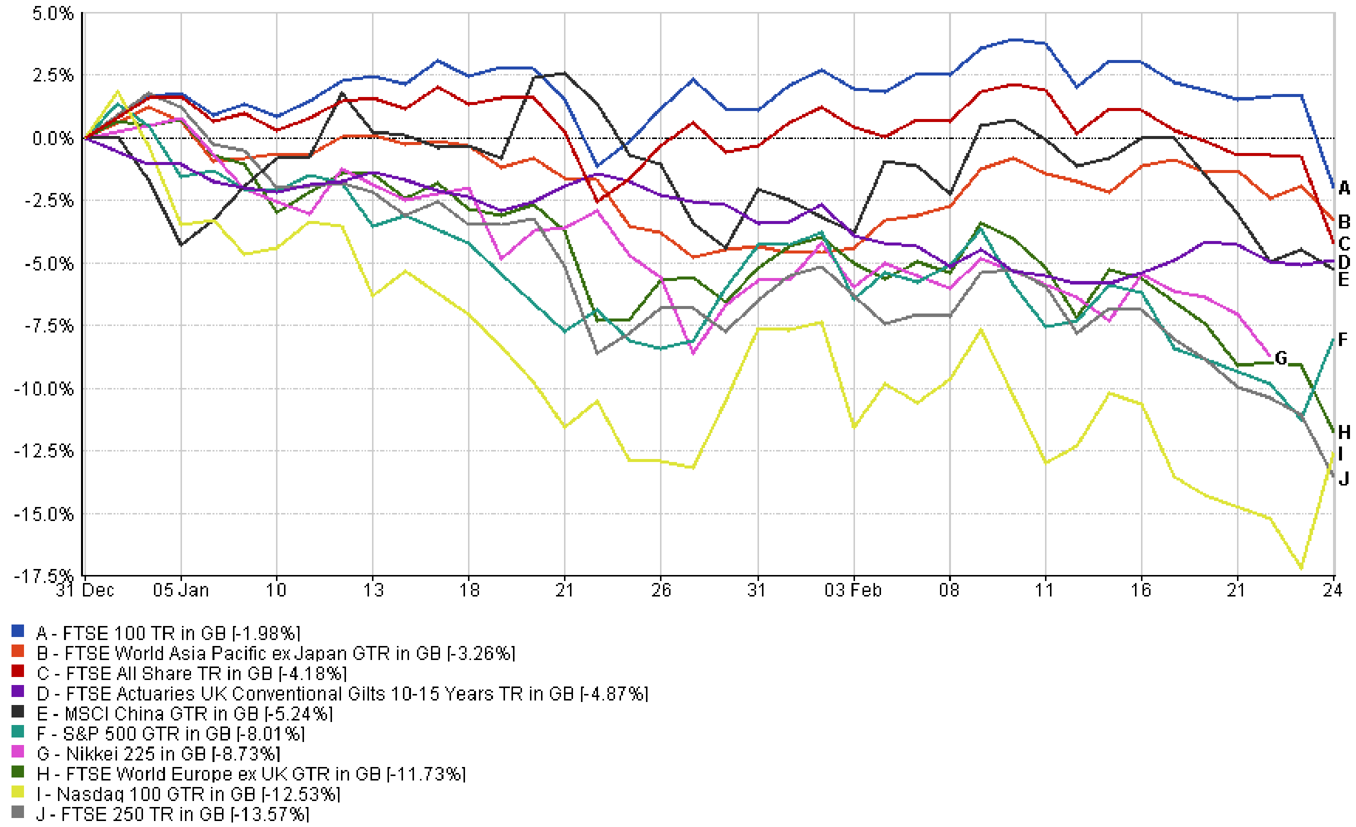
INVESTMENT COMMENTARY

25 FEBRUARY 2022

OVERVIEW

The Russian invasion of Ukraine has led to investor confidence weakening and equity markets falling. Investors have sought safer assets including gold and other commodities, high quality government bonds and the US dollar at the expense of more risky equities. Investors and commentators alike had not expected the scale of Russian invasion with markets originally seeming to be pricing in military action in two of the Russian-leaning Eastern Ukrainian provinces rather than a war escalating further westwards. Whilst Russia and Ukraine comprise a minimal part of the overall global equity market, it is the impact of the war on the prices of oil, gas and wheat in particular which is of concern together with possible disruption of energy supplies to Europe. Rising inflation as a result of pandemic-related supply chain bottlenecks, rising energy prices and increasing demand as economies were restarted after pandemic-related lockdowns was already a worry for investors. Russia is the second largest producer of oil and gas globally so any interruption in these supplies is likely to increase inflation further. Persistent higher levels of inflation can also negatively affect economic growth in the longer term.

INVESTMENT MARKET STERLING RETURNS YEAR TO DATE TO 24 FEBRUARY 2022



31/12/2021 - 24/02/2022 Data from FE fundinfo2022

The Russian equity market lost 33% of its value in the wake of the Russian invasion of Ukraine – one of the worst collapses in history. Russia's central bank had to spend significant levels of its foreign reserves to support the rouble which also sunk to record lows as Western powers imposed sanctions. The Russian equity market is a very small proportion of the global equity market – it comprises 2% of the emerging markets equity index and of the funds we use (mainly emerging markets funds), so this seismic fall has little direct impact. Of more concern is the uncertainty that the conflict brings and the effect on values of companies quoted on other stockmarkets with exposure to Russia. For example Austrian, French and Italian banks are the most exposed to Russia in terms of lending, with US/UK banks having very minor exposure whilst BP holds a 20% stake in Roseneft, the massive Russian energy company.

Equity market returns had already been weak since the turn of the year in the face of rising inflation with growth areas of the market, such as technology, suffering as central banks began to tighten monetary policy, with interest rates increased or set to rise over the year. The value of future earnings of growth companies are based on interest rates so as rates increase, the value of earnings decreases. The performance of the NASDAQ indicates the correction seen in the technology sector. The Russian invasion of Ukraine is likely to stoke inflation further. As a key supplier of oil and gas and with sanctions being imposed by the West, energy prices are likely to rise steeply if Russian energy supplies are limited. Russia may weaponise its natural resources by withdrawing them from global markets or Western sanctions (such as the cancellation of the Russo/German Nordstream 2 gas pipeline) may have the same effect. The oil price has risen to around $100 per barrel following the Russian invasion. Ukraine is a key supplier of wheat to Europe so food prices could also be impacted. Central banks now face a dilemma - would raising interest rates more aggressively to control higher inflation then curtail economic growth? Would the global economy then be facing stagflation (minimal growth and high inflation)?

It is important to recognise that the nature of energy security has changed. The US was once the largest global importer of oil and gas, running an enormous financial deficit on its energy supplies. In the past, the current situation would have led to the ballooning of that deficit, potentially to pressure the dollar, a resultant rise in US interest rates and then to global recession. Due to fracking, the US is now the world's largest oil producer (2020) and the fourth largest exporter of oil. In other words it now runs a huge trade surplus in oil and oil related products – very different to the position which applied only a few years ago. By some considerable margin, the US is also the world's largest producer of natural gas and its exports of liquified natural gas (LNG) by ship are rising. The US dollar's role as the world's reserve currency – spurred by the increasing value of US energy exports – may result in a rise in the value of the dollar becoming a global problem. Given the US Federal Reserve (the Fed) has been trying to control surging domestic US inflation through tightening monetary policy and signalling interest rate rises in March, these rises may well be delayed against this currency backdrop. A rising dollar would hamper non-energy US exporters and potentially cause considerable problems for governments and countries in emerging markets whose debts are often priced in dollars. Conversely, a higher dollar will cut the price of US imports and assist the Fed in taming inflation. In overall terms however, it is difficult to believe the Russian action in the Ukraine presents serious economic challenges for the US beyond controlling domestic inflation. The implications for European and Central Asian security are immense and not ideal for the US during a period in which China presents an increasing challenge to US global interests.

For Europe, the implications of the Russian invasion are far more serious. Reliance on comparatively inexpensive Russian gas, through an increasingly integrated international pipework system has long been viewed as a cleaner energy solution than the traditional coal -fired power stations, with their more obvious environmental impact. Whilst France has wholeheartedly embraced nuclear energy/electricity and Italy has increasingly relied on gas piped from Libya, most of Europe has become increasingly reliant on Russian and Norwegian gas. In fact 40% of the EU's gas consumption is piped from Russia. Now it seems that even if the Russians keep the tap turned on, European sanctions against Russia are likely to lead to it being turned off. Added to this, a considerable amount of Russian gas is piped through Ukraine which could intervene to prevent Russian exports. The Nordstream 2 pipeline intentionally offered a different route for Russian gas exports – but the German government has ruled out using it. Whilst none of this sounds encouraging, it is thought Europe can gather sufficient gas from other sources to meet its needs. The Norwegians are able to supply more gas and the Dutch North Sea gasfields can pipe more too – for all production there is comparatively modest. The UK is by now a net importer of gas so it will in principle require its North Sea production to meet domestic needs. However, the UK has built massive port handling facilities for the import of LNG, so there is thought the UK may switch to reliance on increased LNG imports temporarily, whilst piping its North Sea gas to continental Europe to ease supply shortages there. The EU nations exported €79bn to Russia in 2020 – so it is not an insignificant export market that may now be closed. Conversely, total EU exports in 2020 were around €1900bn - meaning that Russia accounted for only about 4%.

The UK government taxes oil and gas exceptionally highly in order to encourage a switch by consumers to more environmentally friendly alternatives. Whilst considerable strides have been made in this direction, the UK is still a huge consumer of gas and oil, remaining heavily reliant on both. Supply shortages of gas appear unlikely but further price rises are inevitable as a result of market conditions and taxation policy. The UK does not source very much of its gas or oil imports (around 5%) from Russia and it is thought alternative supplies are readily obtainable, given UK port handling capacity for LNG and its close relationship with Norway, including pipeline infrastructure. Very little oil is imported from Russia and Russia accounts for only 1.30% of total UK trade.

History points to short-lived equity market volatility around geo-political events as the table below showing S&P 500 index sell offs around key events illustrates.

Event	Start of Sell off	Duration of Sell Off (Trading days)	Duration to Recover Prior Level (Trading day)	Size of Sell Off (%)
Israel Arab War/Oil embargo	29 October 1973	27	1475	-17.1
Soviet Invasion of Afghanistan	17 December 1979	12	6	-3.8
First Gulf War	1 January 1991	6	8	-5.7%
9/11 Attacks	10 September 2001	6	15	-11.6
Iraq War	21 March2003	7	16	-5.3%
Ukraine Conflict	7 March 2014	6	13	-2.0%
Intervention in Syria	18 September 2014	21	12	-7.4%

Source: Deutsche Bank, Refinitive Datastream, Standard and Poors, JP Morgan Asset Management Data as at 21/02/2022

Unless a full-scale war were to break out between NATO and Russia (which still seems highly unlikely) any direct economic impact on UK/US appears likely to remain slight. This said, global financial markets are correlated and any major impact on the French, Italian or Austrian banking systems would be very unwelcome.

A global wind rarely blows absolutely no good and those economies which are large exporters of energy and other natural resources are likely to benefit significantly from the demise of supplies from Russia, assuming Russia is largely excluded from Western markets. For certain emerging market economies this may well outweigh any adverse effect from a rising US dollar. Countries such as the US, Australia, Qatar/UAE, Malaysia, Nigeria and Brazil will almost certainly benefit.

The CM Investment Commentary is compiled by Angela Cooper, Managing Director of Cartlidge Morland's Investment Services team.

Angela runs the firms' investment management propositions, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance Practitioner.

OUR VIEW

Geo-political risks are permanent features of the investment landscape and making a judgement as to the degree of importance to attach to them is a continuing challenge. Threats turn into military action on a major scale comparatively rarely, whilst resulting economic damage is often localised and of limited importance, outside the financial markets of the countries or region concerned.

Our portfolios are well diversified across geographic and industrial sectors and as mentioned above direct exposure to Russian equities is largely restricted to any holdings in emerging market equity funds. Cash, government bonds, property and protected funds are included in portfolios, where appropriate, to limit the downside risk in times of equity market volatility. Equity income funds investing in well financed, income producing companies should also provide some protection for returns through their dividend streams. With the exception of ESG portfolios, our portfolios do include some funds which can invest in companies in producing oil and other commodities which are likely to benefit from the current situation. Unless there is a serious escalation of the Russian/Ukraine conflict into which NATO enters, markets are likely to begin to look ahead and through these events as the geo-political events table above shows. Attention will return to the global economy, to the prospects for growth and inflation expectations. Central banks continue to face the challenges of managing interest rates to control inflation whilst maintaining economic growth. The interest rate hiking cycle may be less aggressive for fear of choking off economic growth. European countries will need to seek alternative energy sources for the future to move away from reliance on Russian sources. The transition from the use of fossil fuels to renewable sources will be accelerated.

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