Russian Ukrainian War – Possible implications for investors

March 2022

Preamble

As we write this article, the Russian Ukrainian conflict is into its thirteenth day. Many experts are surprised that the war has lasted so long. Most commentators had expected that Russia would be able to install a puppet government in Kyiv within three to five days.

War, in any form, is terrible and reflects the worst of humanity. Consideration of its long term geopolitical and economic implications is secondary to the suffering and hardship experienced by those affected by the bloodshed.

Naturally, much has been written about the war and how it may end. Our view is that any expert is unlikely to have an edge in predicting the final outcome; the system is simply too adaptive and complex. One can, of course, develop scenarios but the probabilities assigned to these scenarios will involve a good dose of guesswork.

With this as background this note focuses on the possible economic and geopolitical consequences.

High probability events

We can be certain that the war will put pressure on energy prices as Russia holds an estimated 5% of the world's oil reserves. In addition Russia and Ukraine supply about 1/3rd of global wheat exports and, as a consequence, wheat prices have soared to record highs.

The obvious implication is additional inflationary pressure in an environment that is already experiencing the highest inflation since the 1970s. The market consensus is that whilst these higher inflation rates may last for a few years, ultimately inflation will be reined back into the 2% p.a. range.

The market may be too sanguine on how soon inflation will be tamed. Whilst the policy tools required to reduce inflation are well-known, we believe that central banks will be cautious to raise interest rates quickly as this would almost certainly result in a recession and materially increase the interest burden of many developed world governments. We have previously commented that low interest rates and high levels of government indebtedness may curtail the ability of central banks to deal with higher inflation effectively. We are about to see whether this is the case or not.

The consequence of possibly higher inflation for longer than the market expects is that our client portfolios need to have good inflation-hedging characteristics. Investments such inflation linked bonds and infrastructure assets have direct inflation linked returns and higher commodity prices sometimes result in outsize profits for commodity companies. In addition, listed equities generally have reasonable inflation hedging characteristics, particularly if the company is able to pass on the higher inflation to its customers.

The second thing we can predict with high confidence is that investment markets will be more volatile, as the progress of the war is incorporated into market pricing. Such volatility is typically a friend of long-term investors, as it may provide investment managers the opportunity to acquire sought-after companies at attractive prices. Some will argue that it is an opportunity to buy Russian stocks because the prices are so low and there is the possibility of an asymmetric payoff. Aside from the ESG issues associated with buying Russian equities at this time, we would caution against such an approach, as we would classify such a strategy as speculative.

Nevertheless, we accept that there is option value and managers who still own Russian counters in their portfolios may wish to retain these for this option value. In our view, this makes sense provided that the allocation is less than 1% of their portfolio.

More likely events

Slowdown in globalisation

We believe that a key consequence of the conflict is that the developed world countries will aggressively seek to become more self-sufficient for their energy, food, and health care supply lines.

A lot of capital has already been allocated to finding alternative energy sources, and we take the view that this funding will only increase. The key investment opportunities seem to be in energy storage (batteries), with the possibility of cost-effective nuclear fusion being the ultimate prize. Since the late 1950s scientists have believed that successful fusion was only 20 years away, but delivering this solution has, to date, proved to be elusive.

In effect, developed world countries will seek to structure their economies around resilience rather than efficiency. We believe they will be prepared to do this provided that the cost of resilience is low, an outcome we consider likely because technology will play a key role. The implication of the above is that our clients' portfolios should include some exposure to innovation.

This drive for increased self-sufficiency may also represent a step backwards in globalisation. This scenario could have material negative consequences for less developed and smaller countries that depend on global trade to grow their economies. Such countries may need to specialise and develop niche products or services if they are to grow their economies. We would posit that this trend towards less globalisation was already in place ahead of the conflict, but the Russian Ukrainian war may accelerate it.

ESG considerations

The war has already demonstrated the importance of ESG factors. It is noteworthy that the BP Board made the decision to write off its $14 billion interest in Russian energy company Rosneft just days after the conflict started. There will be some shareholders who will be disquieted, but the decision was clearly taken on the basis of putting wider societal interests ahead of financial considerations. Nevertheless, in the short term, rising energy prices are likely to lead to a reduced focus on climate change and compromises being made to ensure energy security.

We posit that the conflict also highlights the naivety of some ESG thinking. A widely held view is that investing in defence companies is "bad" and so should be excluded. This view arises because of the long track record of such companies indiscriminately selling military hardware to any tyrant or warmonger who can pay for it. However, the other side of the coin is that the ability to defend democratic and free enterprise principles depends on the institution of a strong military capability to do so. This observation also highlights one of our beliefs, that seemingly simple things (like ESG) are far more complex than appear at first blush.

Nevertheless, we take the view that, as with the likely slowdown in globalisation, the war will have the effect of accelerating the focus on ESG, and increasingly companies will be held to account against the standard of "doing the right thing". In addition, we believe that having a deep understanding of the nuances of ESG considerations will contribute to an "edge" in investing, which creates the opportunity to exploit the errors embedded in a narrative based view. For example, some managers have increased their allocation to fossil fuel companies on the thesis that there will be an energy supply shortage as alternative sources of energy come on stream at a slower pace than expected.

Possible events

There is a possibility that the conflict leads to a re-alignment of power blocs, which we speculate is more likely to result in an icy truce (the globe is large enough to accommodate two superpowers) or heightened economic confrontation, than in a second Cold War.

The obvious alignment would be the Western World against Russia and China, with the latter bloc possibly extended to countries run by autocrats, including those of the Middle East. As observed during the Cold War, countries that do not belong to either bloc are vulnerable to being reduced to pawns in the power struggle unless they hold valuable commodities or skills. We point out that such a superpower battle can be positive for economic growth, as significant amounts of capital are invested in innovation and staying ahead of the competition.

Many commentators have written on the likely demise of the Western World, and point to the history of empires declining as evidence supporting their arguments. However, what we have seen over the past few weeks in Ukraine is that liberal democracy and its institutions of secure property rights, freedom of speech, judicial independence and accountability are highly valued by many.

At times, liberal democracy may appear weak as it struggles to deal with the conflicting demands of its right and left wings. Nevertheless, in our opinion, it remains a system which is supportive of long term prosperity because of its respect for human freedom, property rights and transparency (all of which also support innovation).

In essence, we posit that a possible outcome of the war may be a resurgence in the value assigned to liberal democratic principles. For this reason, we would be hesitant to write off the western world - the challenge for countries like China will be to show that their system can deliver long term prosperity in the absence of clear property rights, human freedoms and transparency.

Very unlikely events

There is a negligible chance that the conflict triggers a nuclear war. We conclude this because of the wide recognition that nuclear war will bring "mutually assured destruction", i.e., that there can be no winner from a nuclear war. There is always the possibility of an error or a madman's decision, but one would like to believe that there are enough checks and balances in the system to make this a very low probability outcome.

Impact on the client portfolios

The natural client question will be, "What is the impact on my portfolio?" Of course, this can be answered, but the answer will depend on the day chosen, making it a rather meaningless exercise. Arguably, it is more helpful to consider investments where a permanent loss of capital is possible. This would primarily relate to any investment in Russian, Ukrainian and Belarusian companies. A typical client "growth portfolio" would have had less than 0.25% direct exposure to these counters. Obviously multi-national companies like Visa, Coke and Apple will also have exposure to the Russian market, but this is likely to be a small part of their revenues as Russia is not a very large part of the overall global economy.

On the other hand, some companies will "benefit" from the war, such as energy companies that have little or no exposure to Russian oil or gas fields. South African platinum group metals ("PGM") producers are also clear beneficiaries, as Russia is the world's second largest supplier of platinum.

Summary and conclusion

The Russian Ukrainian war has caused a great deal of suffering and hardship at a human level. However, the impact on market returns for our South African clients (and most global investors) has been muted so far, although this could change quickly.

This is because the local stock market is a beneficiary of higher metal prices, particularly for the PGMs. There are, of course, also large companies with more material exposure to Russia whose share price is down significantly, notably Naspers/Prosus and Mondi.

However, the conflict does, in our opinion, change a number of trajectories. We assign the highest probability to inflation remaining higher for longer than most investors expect. The war will undoubtedly cause inflation to rise in the short term, and we are concerned that central bankers are hamstrung by high government debt levels and fears of a deep recession from raising interest rates aggressively to combat inflation.

Furthermore, we believe that a key consequence will be that developed-world countries will focus on increasing the resilience of their supply chains, rather than the efficiency thereof. This is likely to lead to a reduction in globalisation, which may have adverse consequences for smaller (and "left behind") countries.

We also think the focus on ESG is likely to be accelerated, and the investors who have a deep understanding of the nuances of ESG investing will have the opportunity to exploit the errors embedded in a narrative based view.

In addition, the conflict may result in a re-alignment of power blocs which is likely to lead to an icy truce or heightened economic confrontation. This, of course, will have long-term geopolitical implications. We also highlight that such a superpower battle can be positive for economic growth, as significant amounts of capital are invested in innovation and staying ahead of the competition.

Much of what we have written above will have the effect of accelerating existing trajectories which are already in place. The one trajectory that may be reversed is the narrative that the Western World is in structural decline, in line with the fall of empires as observed throughout history. A possible consequence of the war may be a resurgence in the value that society assigns to liberal democratic principles, with a renewed conviction that these are worth upholding. However, consistent with the Annie Duke principle (see our latest "Perspectives"), we would only bet a small amount of money on this view!

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WTW-ZA-2022-18089. March 2022.

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