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Economic Impact of Russia-Ukraine Conflict

Russia's invasion of Ukraine is first and foremost a humanitarian crisis. While the situation is rapidly developing, concerns are also rising about the economic impact of the invasion on the production and export of important commodities such as oil, wheat, and metals. What will this mean for investors? In this episode of Choate's Family Office Podcast Series, Tamer Alamuddin, managing director of ChoateIA, and Harrison Odaniell, Choate's senior investment analyst, discuss the economic consequences that are unfolding as a result of the Russia-Ukraine conflict.

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Welcome to the Choate Family Office Podcast Series. On this show, we explore important topics related to wealth management, investing and managing risk across generations.

Diana Beaudet: Hello, I'm Diana Beaudet and with me today is Choate Investment Advisors' Managing Director, Tamer Alamuddin, and Senior Investment Analyst Harrison Odaniell to discuss the global economic impact from Russia's invasion of Ukraine. Thank you both for joining me. So, we'll get started right away. Tamer how have the recent developments in Ukraine changed your focus?

Tamer Alamuddin: Yes, first and foremost, you know, the situation is changing all the time. It's first a humanitarian crisis. Right now we understand more than 2.7 million refugees have fled Ukraine to neighboring countries and that's going to cause a lot of disruption. In addition, we entered this crisis with a supply chain that had not yet fully recovered from the global pandemic. So we already were seeing cost pressures in a number of industries. Now we are seeing commodity prices rise as a result of further disruptions from both Ukraine and Russia.

DB: Let's zoom in on that last point regarding commodity prices. Harrison, can you talk about a bit of what you're seeing the global commodity markets today.

Harrison Odaniell: Yes, so first and foremost, we've seen a significant increase in the price of crude oil for one and natural gas prices have soared across Europe too. While global oil prices had already risen some 40% this year, Russia's invasion of Ukraine

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catalized frankly further price pressures there. Russia is the world's second largest oil exporter, and is also the world's largest exporter of natural gas. European natural gas prices have just recently come off an all-time high, but still are nearly 10x higher than where they are in the US today. With 40% or so of Europe's natural gas coming from Russia, there's real potential for an energy crisis. There's not just energy that has social ramifications though, agricultural commodities like corn and wheat are moving up in part due to higher input costs from fertilizers and fuel etc. Corn prices are up 30%, wheat up nearly 50%. Russia and Ukraine combined – they account for nearly 30% of global wheat exports. It's not just US and European imports either, one-third of Chinese corn imports have historically come from Ukraine, so that's a big factor there and we've read recently that China's winter wheat crop has been described as one of the worst in history. So, it's entirely likely that grain supplies are going be stressed there as well. I think food security is becoming a much greater concern in many countries around the world. Lastly, on the metals front, we're seeing some pretty crazy changes in the prices there as well. Aluminum prices globally have increased some 25%. Russia produces about 40% of the world's palladium, which is the key material for auto emission controls. The prices there are up about 50%. Also, Russia's the world's largest nickel producer and it is integral to battery technology. Nickel prices rose so quickly after Russia's invasion of Ukraine that the London Metal Exchange was actually forced to temporarily suspend trading in nickel futures. It's up at the time like 130%. So, although the Russian economy is just 7% the size of the US, it's output is highly concentrated in natural resources and I think the same can be said of Ukraine as well. That's partly, why this conflict is having outsized impact on the global economy because of the concentration of their economies.

DB: The effects are widespread. Tamer, what kind of impact do you expect these changes to have on the global economy?

TA: So, one of the issues here is we just don't know the scope of the impact from the Ukraine crisis. With regards specifically to natural resources, we're coming after a period of 5 to 7 years where companies in both energy producing companies, as well in industrial metals were incentivized to cut back on capital expenditures, to cut back on production, and respond very aggressively to investor demands that they show capital discipline. Therefore, what we're seeing right now is windfall profits from these companies, but CEOs and management teams promising investors that they're going to increase their dividends or increase their share repurchases and not yet commit to more aggressive capital spending, which would offset some of the supply issues coming from Ukraine and Russia. So there is no quick fix. Our assessment is that the harm to European economies is clearly going to be greater than either the US or China. First off, the US is self-sufficient in energy and we're self-sufficient in agriculture as well. We also don't really export or import much directly from Russia. Whereas Europe is highly reliant on Russian energy, but is also the largest trading partner with Russia, and so there are some other goods that will be impacted. China could well be a beneficiary from this, given that they're the only outlet for Russia right now in terms of selling their energy products. Specifically within Europe, natural gas is used primarily for home heating, but is also critical in a lot of heavy industry manufacturing, chemical and other refineries. Therefore, Europeans have to find a solution, an energy solution, and they are reverting back to coal to meet the near term energy demand. We think that Europe has about 6 to 9 months to figure out something before we enter the next winter heating season. It's not sure what they'll do. We hope that it will be more aggressive investment in clean energy, purchasing of liquid natural gas from the US, but it's going to be a struggle either way for Europe to wean itself from Russia in the short term.

DB: Okay, this is maybe catching you a little bit off guard, but in today's news they mentioned that Russia has reduced the price of oil and India is willing to purchase it. Does that have any additional impact on the landscape?

TA: Yes, so one of the things that's interesting is oil is typically traded at a global commodity and at a price that's set, it's called the Brent crude price, and it's set at the London Market, but various oil subcontracts are on delivery can trade at a discount or a premium to that price. So, what you are seeing is that Russian oil is trading at a very significant discount, so the price of oil today is, let's say, $100 a barrel, but Russia can sell its oil at $80 a barrel and that's basically incentivizing countries like India to try and source that oil. It shows how porous some of the sanctions can be with regards to energy though the sanctions of manufactured products are really going to bite the Russian economy a lot more. It also highlights how difficult it is for us to access the impact on earnings and corporations here in the US, because we again don't know exactly what the long term price will be.

DB: Okay. So even though we might be just in the early stages of this conflict, suffice it to say, the economic disruption could be significant. Harrison, what kind of response are you seeing from policy makers?

HO: That's an excellent question. Thus far, policy makers are coming at the conflict from a variety of angles. First, financially with the majority of Russian banks cut off from the SWIFT messaging system for settling cross-border financial transactions, there's been significant disruption to Russia's financial system. US, Japan, Europe and other trading partners have frozen the majority of Russian

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Central Bank assets outside of Russia too. As far as sanctions, from trade go, energy trade is gotten a little hairy with the EU's reliance on Russian fuel as Tamer eluded to. But the US and the UK are banning imports of Russian oil and natural gas. Many countries have actually suspended exports to Russia of everything from auto parts to shoes to computer chips. The G7 countries collectively agreed to strip Russia of its "most favored nation" trading partner status within the WTO, the World Trade Organization, and that amounts to putting up pretty significant barriers to future trade as well, not just today. Businesses are joining in solidarity too. You see Visa, MasterCard and American Express all blocking Russian banks from their various networks. UPS and FedEx are no longer delivering in Russia. Apple stopped selling phones in Russia. McDonalds is closing its Russian restaurants. So there's been a lot of quick movement from both policy makers and from companies. I think one thing we're focused on is the various monetary and fiscal policies challenges that this conflict presents. You know western governments may have some ability to cushion the downside risks with increased fiscal spending. Germany and other European countries have significant fiscal flexibility right now. We're actually hearing some reports that EU members are mulling some sort of joint debt issuance. Ironically, that could be the catalyst that truly unites all the EU countries in that regard, which we think is really interesting. Within the US, the Federal Reserve might delay or at the very least slow the pace of interest rate hikes later this year, but it and other central banks frankly are stuck between a rock and a hard place. On one hand with tightening policy at a time like this, risking undermining the fragile global economic recovery from COVID, and on the other hand, high inflation and price instability is also disruptive to the economy. So, we expect that policy response is going to be a lot less predictable and frankly, much more data-dependent than it might otherwise be. One key unanswered question, even if this conflict is ended quickly, how do you go about removing the various sanctions that are going into place. There has to be some sort of victory by someone even if it's symbolic. Now is Putin really just going to walk away from the situation right now? Unlikely. Let's say a path to peace is found quickly. It's not as though the war will be forgotten and it will take time for western governments to actually dial back the sanctions in practice. So, we expect that, at least from an economic standpoint, this will drag on a lot longer than many anticipated.

DB: Tamer, what does this all mean for investors? What changes are you making for Choate clients in responding to these developments?

TA: Yes, that's a great question. So first and foremost, for us from an equity investment standpoint and that's really what's most volatile right now, stocks and stock market, what we really track is company earnings. Ultimately that's what drives investment returns, it's how much money companies make and what we're seeing is a reassessment by investors on company earnings for 2022 and beyond given the rising commodity prices. So, outside of the energy sector, which is the obvious beneficiary of higher prices, other sectors are going to be negatively impacted. And it's really important to note that companies are very sensitive to changes in margins. So, a company margin is the difference between what the price is that they can sell a product and the price that it costs them to manufacture that product. And for the S&P 500, which the 500 largest companies in the US, that company margin is about 12.3% in aggregate. So a 1% shift doesn't sound like a lot, but it actually can reduce company earnings by almost 8.5% and that's quite a big deal for investors. And the challenge that companies are facing is, though they find a way to pass those cost increases to their consumer, in the end to households, or their margins go down. And if they pass that price increase to households, what do households do? At some point households have to discriminate between their discretionary purchases and ultimately someone is going to be left with lower demand, and this is the challenge we're facing. So what are we doing? We started off saying that we think Europe is more exposed to all these factors than the US. So, the first step we reduced our international exposure to stocks. In addition, we did add selectively to some US large cap securities, increasing our exposure to some energy companies as well as some material companies and financial firms. In the long run, we're keeping our strategy unchanged in terms of the shape of the mix of companies we invest in. We do favor resilient companies that can grow their earnings over time. But in the near term, we think we need to have a little more exposure to companies that are benefiting in this environment. Lastly, we also reduced our equity exposure in aggregate and bought short-term bonds in the US. This increases our optionality. As we said, we don't know how this conflict will end and we're hoping for a quick solution, but either way, we want to be sure that we can react if there is a change, we are going to responding just like everyone else to the news of the day.

DB: Absolutely. Well, thank you both for joining me today. This have been very helpful and the information you've provided will definitely be useful for our listeners.

TA: Thank you.

HO: Thank you.

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