THE GLOBAL CIO OFFICE

March 7th 2022

Harsh Reality Dawns

- **Economists start to cut global growth forecasts but are still very much in the dark to downside risks.**
- **Oil continues to send jitters. While $150 looked a remote possibility even a few weeks earlier, rising spot prices make $200 a not-so-distant reality.**
- **As the uncertainty prevails, financial markets are struggling to find a level that appropriately factors in the current geopolitical conditions.**
- **We believe that policymakers will eventually have to react.**
- **The new reality could be no rate increases from central banks and a new wave of quantitative easing.**
- **Equities have more downside, and bonds struggle between fearing inflation and hoping for central bank intervention.**

The downgrades to global growth – not quite anticipated even a few weeks earlier – have started becoming a reality. Several investments banks have pared their growth forecasts, with the cuts stretching from a modest 20-50bps off global growth to downright slashing of European growth forecasts by half. Although Ukraine – and its aftermath – remains foremost in investors' minds, it's easy to forget that the crisis itself is less than two weeks old. The sanctions are only just starting to be implemented and we have yet to see the full force of the shock to the global economic system. Until then, it's a guessing game for both economists and policymakers alike.

The uncertainty alone seems to be wreaking some early damage. We participated in a number of forums of small and medium-size businesses last week. The practicalities of not wanting to run afoul of the sanctions was causing much angst among managements.

Surging oil price forecasts continue to give jitters. Just a week ago, these forecasts stretched to a maximum of $150. But as spot prices continued to rise through the week, analysts upped their projections to as high as $200. The dynamics in the oil market are particularly complex. Sanctions on Russian oil could remove 1mbpd from the market, but then OPEC has some spare capacity to make good the shortfall. Several countries have the option to release strategic reserves, although there may be some reluctance to release too much oil, as global inventories are quite low by historical standards. There are hopes for a rapprochement with Iran to permit 500,000mbpd back onto the market relatively soon, and even Venezuela may be allowed a little more capacity in the coming months.

Recent rises in food prices are most worrying. Russia and Ukraine are key suppliers of grains, with Russia and Belarus accounting for a major chunk of global fertiliser supplies. A Bloomberg report cited the example of a corn farmer in the United States receiving around $80 a hectare for corn, but the fertiliser alone now costs $240 per hectare. All the major cereal and rice prices have risen sharply in the past week.

As one economist put it, a householder may have baulked at seeing their monthly energy bill rising to $1000, but how would they like to counter a monthly food bill of $1000.

Financial markets are struggling to find levels that investors might consider appropriate for current volatile geopolitical conditions. The 'buy the dip' recommendations of investment houses, which, quite frankly, should have known better if not entirely foreseen the crisis, have been overwhelmed by further significant falls in equity markets. European equities have been at the epicentre of the selloff. While the markets are starting to look cheap on some metrics, analysts have yet to reflect the crisis in cutting their corporate profit forecasts. The risk of a phase of severe cuts to projections will come in April when companies announce their first-quarter results and make their first estimate of the future impact of the crisis on their earnings outlook.

Bond markets are pulled in many directions by several different events influencing yields. Higher inflation and government deficits would usually push yields higher, however the downgrades to global growth and the prospect of central banks stepping in again and forcing bond yields lower with quantitative easing may keep government bond yields in check. Emerging market debt has been hurt by investors getting stuck with Russian debt. Meanwhile, investors in the corporate debt markets are fretting as much as equities investors about the likely impact on growth and hence the risk of default.

Are there any positives?
Where could the positives come from? We doubt that in the near term a solution will be found in Ukraine. Although the market has at times rallied for a day or two on hopes of talks between the two sides, they are starting to realise that the two perspectives of the situation leave little room for a negotiated solution. Even ceasefires have proved to be fleeting.

Policymakers will soon have to turn to supporting their economies as the broader economic impact of the crisis takes hold. We suspect that in time there will be targeted increases in government spending and potentially another round of quantitative easing. We also expect that central banks will be (eventually) loathe to increase interest rates. The inflation we see today has been increasingly driven by supply issues and not demand. Higher interest rates don’t solve supply issues. Central banks may have to sit out the higher inflation and instead prop up their respective economies by anchoring long-term interest rates at a lower level.

In summary, we see more downside to equities as investors realise the scale of the hit to growth and corporate profits. Bonds can only perform if central banks start to revert to the textbook, they used during the COVID crisis. We continue to believe that gold will prove to be a safe haven for investors with upside beyond $2000.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)