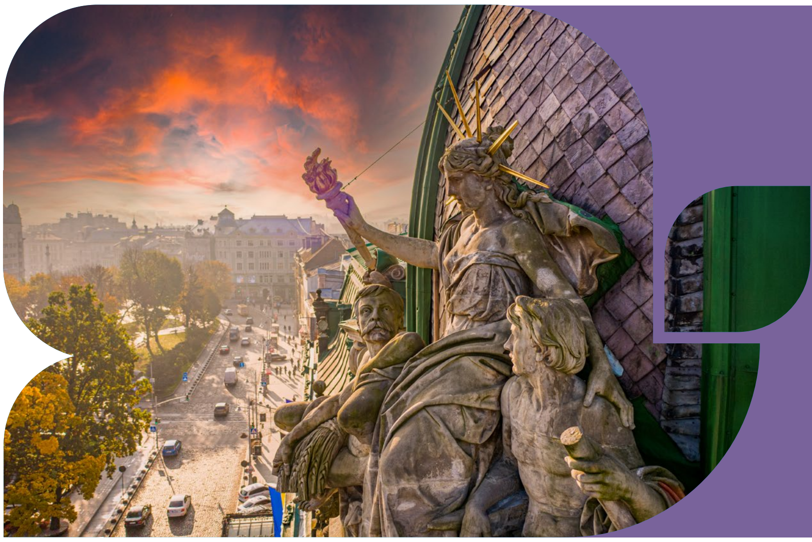

Rathbones
Look forward

Review of the week

20 February 2023

One year on

The war in Ukraine has caused misery in Eastern Europe, upended global trade and sharpened world politics. An era of cheap hydrocarbons is now behind us, and further energy shocks could be on the horizon.

It seems much longer than just one year since Russian tanks rolled over the Ukrainian border. The invasion devastated the lives of millions, upended markets for food, energy and metals, and galvanised Europe to invest more in alternative energy and their armies. It has also intensified growing rifts in geopolitics, the global financial system and world trade.

At the outset, the Russian army was expected to take Kyiv and topple Volodymyr Zelensky's government in a matter of days. Instead, Ukraine summoned a stubborn resistance, halting the Russian advance roughly 90 miles in. Then, they started to push the invaders back. When the war began, we said that time was the most important resource for both sides. Russia needed a swift victory; Ukraine needed to slow the war down. One year on, the war has settled into a period of stasis as spring approaches. Following on from a 300,000 conscription in October, Russia is reportedly considering widening its draft to a further half a million kids.

The war looks set to drag on for months and perhaps years. Russian President Vladimir Putin seems bound to the war he started. If he is toppled, it will be because of the war; and if he is no longer president, the path to ending the war seems wide open. But, for now, Putin appears secure and the fighting grinds on. The sheer scale of the Russian military means they will be able to persevere for a very long time. Yet Ukraine has been supported by NATO nations with training and better-quality gear than their adversaries. From cautious and limited beginnings, as the war continued this support has widened and deepened. First it was small amounts of training and donations of helmets. Then there were high-tech anti-tank and aircraft missiles, followed by precision-guided missiles. Top-of-the-line Western tanks will now be dispatched to Ukraine and the conversation has moved on to whether or not to deliver fighter jets.

One of the most important tools provided to Ukraine is SpaceX's Starlink internet service. Using thousands of small satellites flying around the globe at much lower altitudes than conventional satellites, Starlink offers reliable, high-speed internet that can be accessed anywhere in the world with only a small receiver dish. An internet connection seems a small thing, yet this technology gives Ukrainian troops a technological advantage, better communications and intelligence, and increased flexibility and autonomy for detachments in the field. It's a good example of how effective digital technology is for our societies - whether individuals, nations or businesses.

If Ukraine continues to receive more superior technology from the West as the war rolls on, Russia's size will count for less. That is, unless Russia gains support from another quarter, from one that can provide it with better-quality weaponry and technology.

A different world?

China has offered political support to Russia since before the war, yet it has steered clear of supplying arms. That may be changing, given US Secretary of State Antony Blinken's warning that any material support for Russia would have serious consequences for Sino-American relations.

China and the US have been jockeying for global status for years, but it has really ramped up recently. Since the fall of the Soviet Union, America alone has dominated the world order. However, the rapid rise of China means that phase of geopolitics is coming to an end. Way before the invasion of Ukraine, China and the US have been in a trade war. After years of mutually beneficial exchange - offering Americans cheaper goods and higher profits, and Chinese people greater wealth - the relationship soured in the mid-2010s. The US Congress continues to pass anti-Chinese policies, aimed at restricting cross-border flows of capital and technology. This joins a surge in protectionist measures the world over.

Globalisation was never perfect, yet it made businesses much more efficient. It led to cheaper and better-quality food, cars and televisions. It also improved cross-border transfers of energy and raw materials. It meant less money tied up in warehouses full of unnecessary stock or in oil and gas deposits sitting unused in tankers and silos. Less money required for that sort of thing – for those contingencies – means every pound of investment can go that bit further, can be that much more profitable. That's not just good for businesses and investors, it benefits everyone because it allows cheaper prices for virtually everything. We may have lived through a golden age of cheap food, energy, goods and air travel without actually realising it. As they say, sometimes you don't know what you've got till it's gone.

Still, for all the rhetoric, businesses haven't taken much notice to date: global trade as a percentage of GDP is roughly where it was 15 years ago, as are flows of cross-border direct investment. Rather than a reduction in globalisation, we're seeing globalisation ***reoriented***: a shift from more-hostile trading partners to those who are perceived to be more friendly. For the West, this means less China and more Vietnam, Thailand and South Korea. We expect this to continue. Analysis of earnings calls with company management teams in 2023 reveals an exponential increase in the number of companies discussing 'near-shoring' (jargon for the shifting of supply chains to more friendly neighbours closer to home). There is much less evidence of the repatriation of supply chains entirely.

This new trend didn't begin with the war in Ukraine, but it has certainly been catalysed by it. Russia is such a large supplier of everything from grains, energy, timber and metals, that Western sanctions against it caused wrenching hikes in the costs of virtually all types of commodities. Most prices have since fallen back from their stratospheric peaks, but they remain significantly higher than before. There is now much more uncertainty about trade, especially in raw materials and most crucially energy. This is most visible in the higher cost of oil, gas and power worldwide. This is, essentially, the result of a higher risk premium on the world's energy. And because energy fuels the technology that boost our efforts and productivity, it means a higher risk premium on virtually everything – including stocks and bonds.

One of the more worrying developments of this year is Russia's announcement that it intends to cut its oil production by 500,000 barrels per day from March. Global oil consumption is approximately 100 million barrels per day, so this is a consequential announcement. There may be an innocent explanation: Siberian temperatures mean Russia's extraction and refining infrastructure require huge maintenance costs, which Moscow may be choosing to deprioritise, especially given access to high-tech components is difficult under Western sanctions. Or, it may be the start of further escalation of the weaponisation of energy supplies. Another energy price spike this year would be politically painful for many Western governments – inflation strongly influences election outcomes. More importantly for investors, it would likely send a shockwave through financial markets, given widespread expectations of sharp falls in consumer price indices. We will closely monitor for signs of further escalation.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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