OPINION

BOTTOM LINE

SHANE WATKINS: There is a time to make money and there is a time to curb losses

Stagflation is a real possibility in the current global climate and investors should just sit tight

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All Weather Capital are stock-pickers, so it is with some humility that we write offering a macro opinion. There are many reasons for equity investors to adopt an attitude of caution right now. We are in uncharted territory economically and geopolitically.

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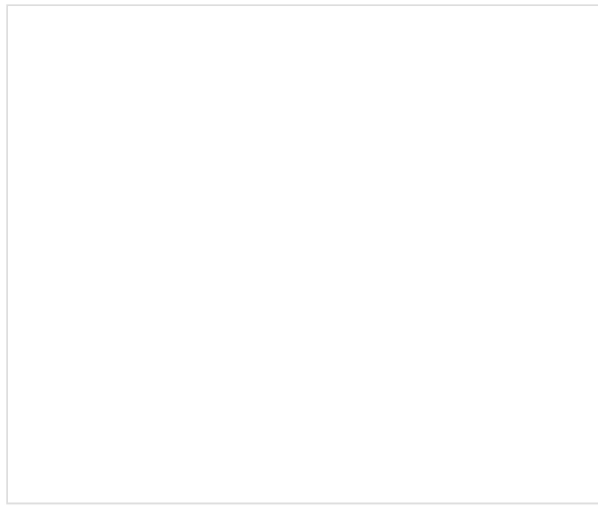

So, how should investors position their portfolios in this environment? Charles Gave from Gavekal says there is a time to make money and a time to lose as little as possible. He suggests that we have entered the latter phase. We concur. There are two proximate causes for our caution: rising inflation and likely rising interest rates, and the widespread global effect of the Russian invasion of Ukraine.

First to interest rates, which have been falling globally for more than 40 years, albeit with occasional blips upwards. Few people will recall that rates on US government bonds peaked in the 1980s at almost 16%. Since then, these yields have been declining, a trend that was accelerated by the global financial crisis and then the Covid-19 pandemic.

Interest rates are to financial analysts what gravity is to the physicist. An asset's value is the discounted present value of its future earnings. Falling rates reduce the discount rate applied to future earnings, thereby increasing their value.

Lower interest rates reduce the cost of debt, increasing the earnings of indebted companies and encouraging them to borrow and invest more: a virtuous cycle upwards when rates are declining, but unfortunately very valuation-destructive when rates rise.

The Russian invasion of Ukraine has now added enormously to the overall risk for investors. The premium investors in shares require over risk-free assets is called the "equity risk premium". War is clearly a condition that elevates that premium: as it escalates, equity values decline. So, the first-round effects of the war are simply higher discount rates and lower valuations.

The second-round effects are related to much higher inflation. Due to the pandemic, the global supply chain was already stressed, a situation war has worsened. Ukraine has shut their Black Sea ports from where over one-fifth of the world's wheat is shipped, airspaces are being closed and there are sanctions on many important materials from Russia.

For obvious reasons, most Ukrainian manufacturing and agriculture facilities are now closed. Russia and Ukraine produce more than half of the world's sunflower and cotton seed oil, one quarter of wheat, 20% of barley and 13% of fertiliser.

Russia is the world's largest supplier of palladium and one of the world's top exporters of oil, natural gas and coal. The resulting supply constraints from the war have pushed prices of these commodities through the roof.

These price moves will add to an inflationary cycle that was already well entrenched before the Russian invasion. Inflation in the West is at 40-year highs and will likely trend higher, while growth expectations are falling, which, combined cause stagflation, absent for many decades, but now probable.

Two other factors are prejudicial to growth. The oil price was already rising rapidly before the Russian invasion. It is up 80% in the past 12 months, and on Thursday reached $115 a barrel.

The Fukushima disaster in 2011 and the rise of environmental, social and governance considerations has resulted in the closure of many nuclear and coal-fired power stations. This has left the world, and especially Europe, short of energy, resulting in Europe's increased reliance on natural gas, over 30% of which comes from Russia.

Without cheap energy, economic growth will slow as household budgets are redirected to higher electricity and fuel costs. A second factor to ponder is the reversal of the decade-long decline in global spend on military equipment.

Globally, defence spending has been declining since the 1960s, when it peaked at 6% of global GDP. It's currently at about 2% and rising for reasons that are obvious. Governments will fund part of this increased spending with debt and this will cause higher interest rates. Spending on armaments, while necessary to secure a country's borders, is

generally unproductive and will further reduce future economic growth.

It does seem that SA equities could see some passive inflows if Russia (3% weighting pre-crisis) is down-weighted or eliminated from global MSCI indices. Furthermore, except in the instance of oil, SA does benefit from the significantly higher commodity prices. And when viewed in the context of the risks facing other emerging markets such as Russia, China, Brazil or Turkey, SA looks relatively more attractive. And SA equity valuations seem reasonable.

Equity valuations are higher globally, with the US market particularly expensive on almost any measure. The price-to-earnings ratio on the S&P 500 is almost 23 times. The market capitalisation of US listed equities is about 60% of the global total, while the US economy accounts for about 25% of global GDP.

Furthermore, US financial assets are almost 5.6 times US GDP. Neither ratio has been sustainably higher. So, at the very moment that global valuations are most stretched, we are suddenly confronted with adverse and deteriorating macro conditions.

Because of elevated inflation, central banks will be constrained in their ability to counteract any negative shocks. An obvious left tail risk is that a war that is currently confined to the Ukraine spreads into other countries in Europe. Equity investors have a predisposition to try to make money no matter what the conditions. This is not a time to focus on gains. Avoiding capital losses should be the aim for 2022.

• Watkins is chief investment officer of All Weather Capital.