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Market Synopsis – March 2022

The consequences of the Ukrainian war

In our February newsletter, we discussed the initiation of the Russian invasion of Ukraine and how we believed it would impact global markets. We surmised that while general volatility would persist in the short term, equity and commodity markets should normalise towards the end of 2022. Unfortunately, the situation has developed further and our optimism has been tempered. The fallout of this conflict is likely to persist into 2023.

Regional conflict or the start of the next European war?

The current conflict in Ukraine is actually the reignition and continuation of Russian hostility dating back to their annexation of Crimea in 2014. While the persecution of Russian citizens in Donetsk and Luhansk (Donbas region), as well as the apparent need to "de-nazify" the Ukrainian parliament were used as excuses to invade, the true motivation behind this aggression is purely strategic. Ukraine, a former Soviet state, has always been an important buffer zone between the main body of Russia and NATO countries. Over the past few decades, Ukrainian relations with the West have steadily improved, mounting to a point where joining the EU or NATO seemed inevitable. For the Kremlin, this was an unacceptable proposition. Having Western weapons on its doorstep was too great a threat to national security – an invasion now may be challenging, but one in the future would be impossible. Thus, on 24 February 2022, Vladimir Putin announced to the world that he would invade Ukraine, where Russian forces still remain over a month later – see Figure 1.

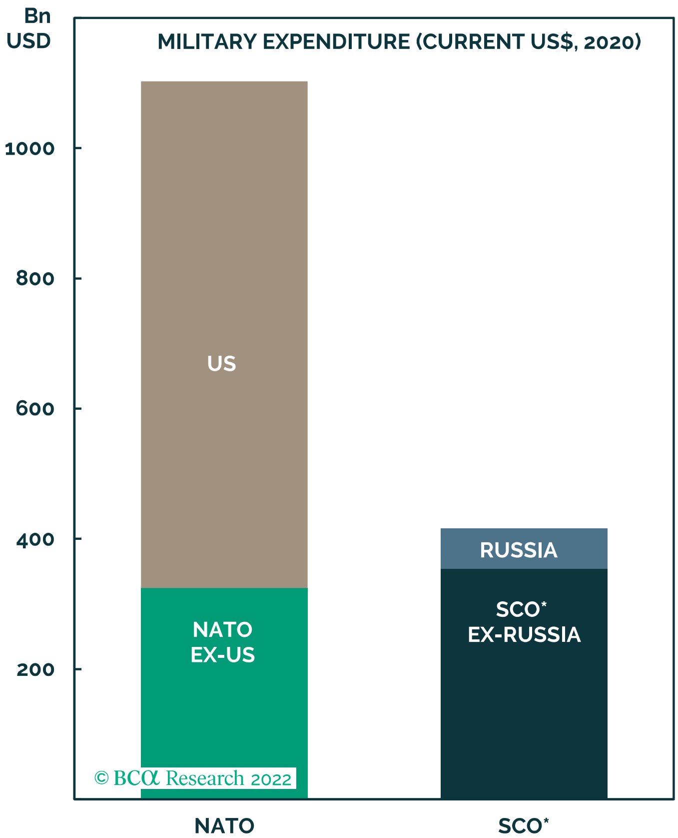
Putin cannot afford to accept defeat or the current stalemate with Ukrainian forces. This will likely lead to further escalation and the use of increasingly deadly weapons and civilian casualties. A ceasefire may be possible if Ukraine agrees to de-militarise, formally declare to never join NATO, and recognise Donbas and Crimea as part of Russia. The Ukrainian government has so far deemed these demands unacceptable.

SOURCE: EVAN CENTANNI AND DJORDJE DJUKIC, WWW.POLGEONOW.COM.

Figure 1 – The current state of the Russian invasion

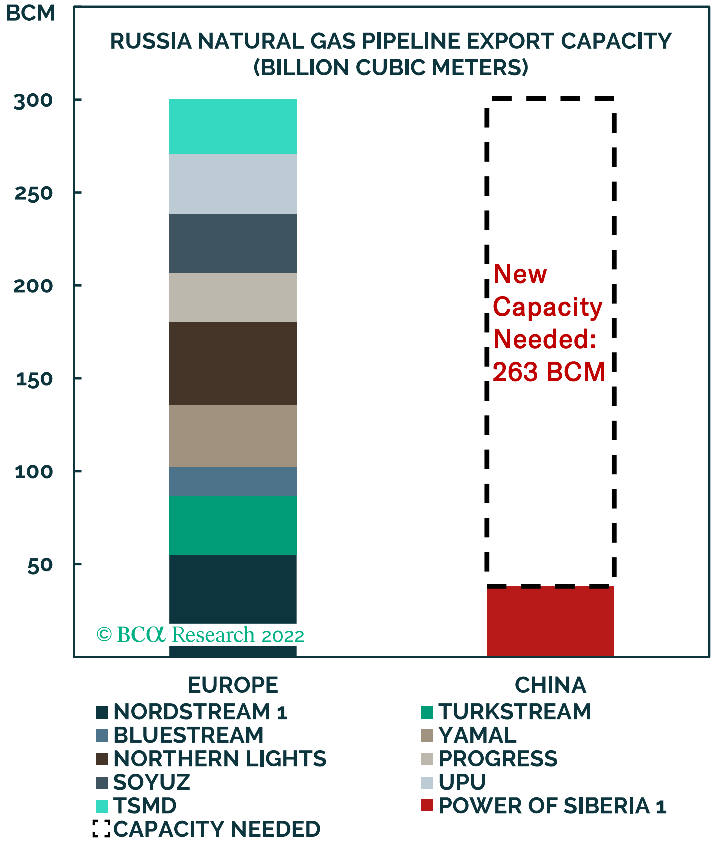
Thankfully, it seems unlikely that this conflict will spill into surrounding regions. While the current invasion is largely an exercise in improving Russian national security, a larger war would ultimately weaken it. NATO forces would utterly overwhelm Russia, even if we were generous and thought China and the rest of the Shanghai Cooperation Organisation (SCO) would offer its full military support – see Figure 2.

If it was Russia's aim to expand its aggression to NATO members following the Ukrainian skirmish, it would have started laying the groundwork a while ago. This would have included improving relations with China to buy its oil reserves and building the necessary infrastructure, while simultaneously cutting these exports off from Europe to induce a recession and hamper their ability to ramp up military expenditure. While 60% of Russian oil is currently at sea and could be redirected, its natural gas production are moved through pipelines and its current infrastructure to the East is miserably lacking – see Figure 3. This indicates that Russia is not economically preparing for a world war, but rather limiting it to East and South Ukraine.



* SHANGHAI COOPERATION ORGANIZATION. INCLUDES FOUR OBSERVER STATES: AFGHANISTAN, IRAN, BELARUS, AND MONGOLIA.
SOURCE: WORLD BANK AND SIPRI.

Figure 2 – Military expenditure, NATO vs Russian alliance



SOURCE: REUTERS AND GLOBAL ENERGY MONITOR.

Figure 3 – Russia gas pipeline capacity

None of the Western powers are pushing for escalating conflict with Russia either. While the UK and US have been the most aggressive in supplying Ukraine with aid, they have avoided becoming directly involved – they have no intention of deploying troops on the ground or imposing a no-fly zone above Ukraine. Countries closer to the conflict are even less excited about the concept of escalation, as France and Germany have maintained a semblance of economic integration with Russia. China may seem like Russia's best hope, but they are unlikely to get further involved to avoid potential sanctions from the West. While the potential for escalations seems unlikely, investors should be keenly aware of unintended consequences.

Ultimately, this conflict will end in a way that is preferable for either Russia or Ukraine. A win for Russia would include the formal annexation of Crimea and Donbass, the destruction of the majority of Ukraine's military infrastructure, and the installation of a pro-Russian government in Kyiv. Similar to Taiwan, Western Ukraine would become the seat of the government in exile. Given the country's current military capacity it is difficult to believe that Ukraine can "win" this conflict, so the best outcome for the nation would be a ceasefire. This would likely occur when Russia's commodity revenues dry up, or if the pressure of sanctions becomes unbearable. Russia could withdraw and use Ukraine's infrastructure losses as proof of their success in de-militarising the country. While multiple factors are influencing the chance of either of these outcomes occurring, arguably the most important are the decisions that Western Europe makes in the coming weeks.

The future of Germany

The continued trade of oil and natural gas between Western Europe and Russia is a crucial factor in limiting the impact of economic sanctions. If Russia or Europe cut off ties completely, it will result in an economic implosion in both regions which will severely increase the likelihood of escalating conflict. On 23 March, the German Chancellor, Olaf Scholz, again rejected a boycott of Russian energy during President Biden's visit to promote sanctions. Scholz argued that no sanctions could be put in place that would hurt European citizens more than the Kremlin. Other European nations closer to Russia are even more dependent on the Kremlin for their energy supplies, and it only takes a single member to veto EU sanctions – see Figure 4.

Germany sustaining a basic level of economic integration with Russia stems from protecting national interests. The German political and economic structure was decimated after WW2, but has risen to the power house of Europe through promoting collective interests. A recession in several European nations could divide the EU and a war in neighbouring countries could once again put German citizens on the front line. While Germany and many of its neighbours are dependant on Russia for energy generation, its export revenue generation is largely to other Western nations – see Figure 5. However, those exports are dependent on Germany maintaining a stable level of power generation, which its own government unfortunately hamstrung by decommissioning several nuclear power plants and becoming more reliant on foreign gas imports. In the short term, Putin has a critical bargaining chip keeping most European nations relatively in line, but has handicapped Russia's future. Holding energy supply hostage has caused many nations to instead invest large sums on money into developing their own power supply, or striking new trade deals to get access from elsewhere. Western Europe will strive to become more energy independent, or rely on the US more for supply.

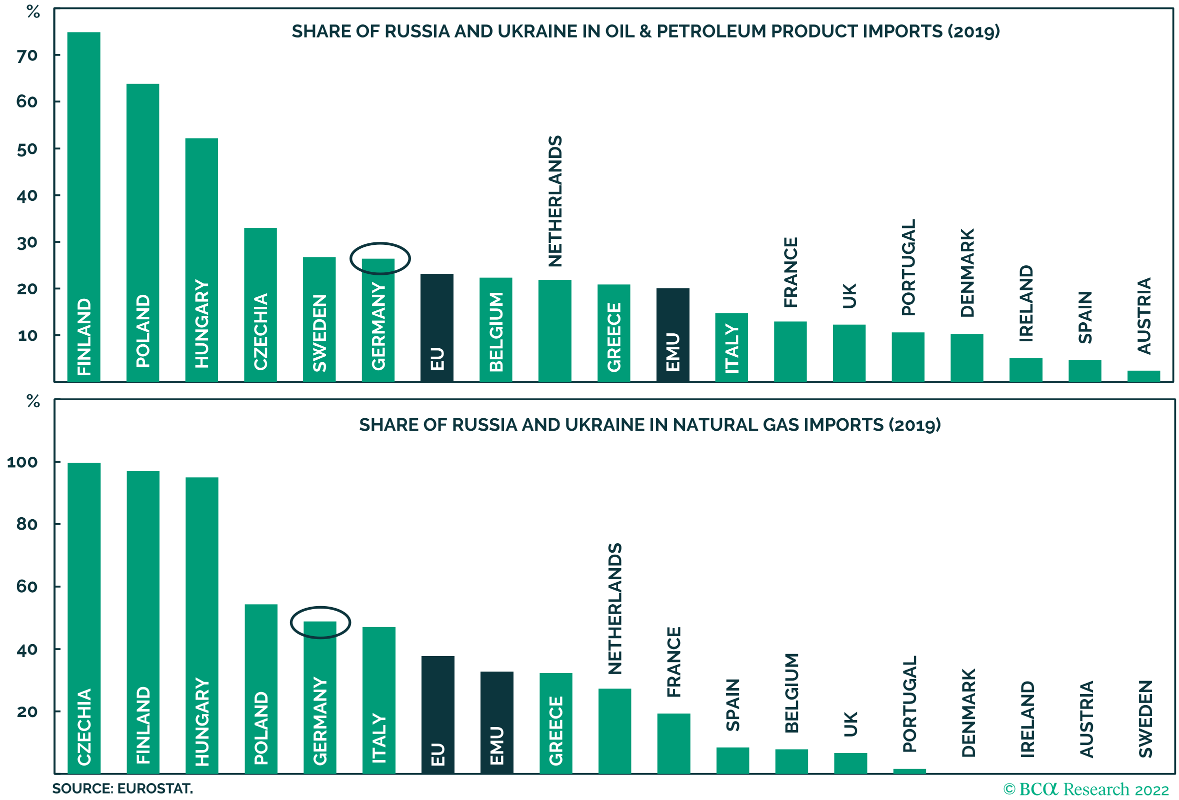


Figure 4 – Russian & Ukrainian energy exports by country

How has the conflict changed and what does it mean for your portfolio

The war has raged on for longer than some may have suspected, and Russia's military superiority has been put into question. While the threat of nuclear action looms over the world's head, it and a spill over of the war into neighbouring countries remains a distinctly low possibility. However, the risk of a protracted conflict has increased, as well as the impact it will have on global inflation. Expect increased volatility across the board, as well as the potential for further interest rate hikes. Cautious investors may wish to diversify more to safe haven assets such as cash and treasuries. Germany and other Western European nations will try to maintain their trade relationship with Russia in the short term to protect their energy generation, but over the longer term will become more self-reliant or turn to the US for their power needs. Renewable energy companies and infrastructure will likely receive massive stimulus in the coming years. Investors should be aware of foreign policy changes, and how any developing news stories, good or bad, will wildly impact market sentiment. The coming months could prove challenging for both growth and value investors, but the volatility will create attractive opportunities for skilled value managers to capitalise on.

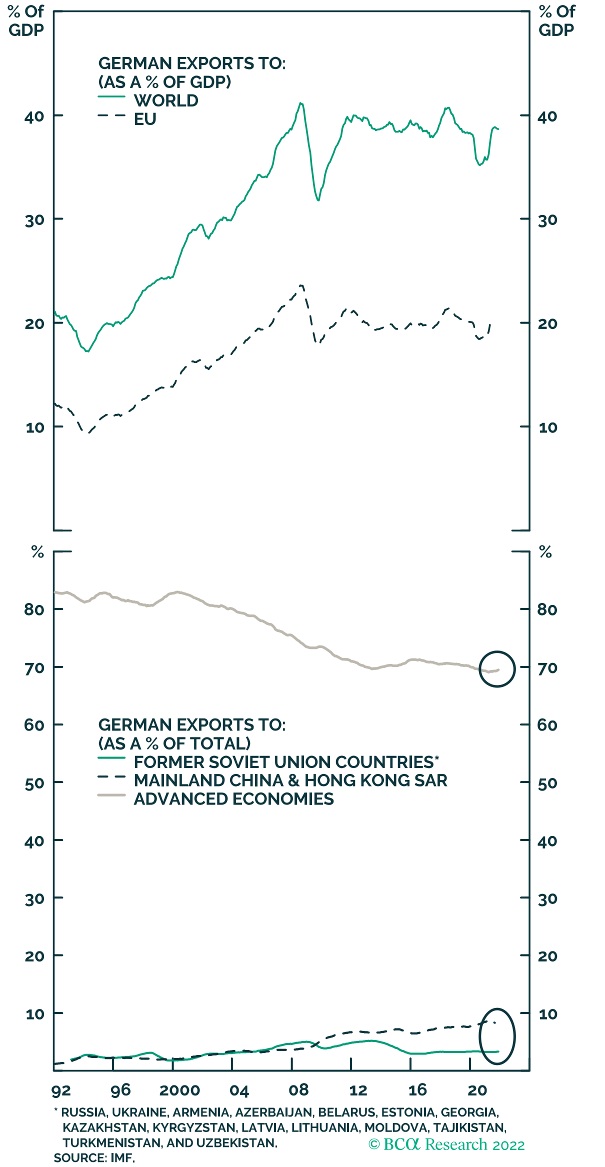


Figure 5 – Germany's export breakdown

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 937,44	1,5%	5,9%	13,5%
Brent Crude	107,91	6,9%	38,7%	69,8%
USDZAR	14,6115	-5,0%	-8,3%	-1,1%
EURZAR	16,1685	-6,3%	-10,8%	-6,7%
GBPZAR	19,2001	-6,9%	-11,0%	-5,7%
JSE All Share TRI	12 435,43	0,0%	3,8%	18,6%
JSE Resources TRI	6 391,91	-2,0%	18,2%	31,7%
JSE Industrials TRI	16 870,89	-4,9%	-13,9%	-4,7%
JSE Financials TRI	11 558,50	12,2%	20,2%	49,7%
JSE Listed Property TRI	1 662,37	5,1%	-1,3%	27,1%
S&P 500	4 530,41	3,6%	-4,9%	14,0%
Euro STOXX 50	8 641,45	-0,5%	-9,0%	1,5%
FTSE 100	7 524,08	1,4%	2,9%	16,1%
Nikkei 225	47 173,86	5,8%	-2,5%	-2,8%
Hang Seng	67 727,53	-2,8%	-5,7%	-20,4%

Source: Bloomberg, as at 31 March 2022

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