Ukraine/Russia Update: Uncertainty Reigns

A few weeks into the war in Ukraine, the West has remained steadfast in its commitment to avoid putting boots on the ground in eastern Europe. Instead, it has chosen to wield its economic might to isolate Russia from the global economy.

Russia—including its banks, businesses and select individuals—has been targeted with unprecedented sanctions intended to cripple both the war effort and morale on the home front. Meanwhile, billions of dollars, euros, pounds, kroner and other currencies have been allocated to the Ukrainian defense effort and to provide humanitarian aid for its people.

Though Ukraine and Russia remain the sole adversaries on the battlefield, the world is at war right now, and the reverberations of this conflict necessitate a reassessment of potential investment outcomes. The Washington-led consensus that characterized the late 1990s has given way to a far more complex geopolitical tapestry and introduced the type of byzantine uncertainty that we believe reflects the "true" risk of investing. The periodic emergence of such uncertainty is among the reason First Eagle's Global Value team prioritizes diversification across economic sectors and geographies and holds portfolio ballast in assets like gold.

KEY TAKEAWAYS

- While first-order consequences of the war can be forecast and managed to some degree, its second- and third-order consequences may be far more impactful and present significant long-term uncertainty to economies and financial markets.
- The supply-chain disruptions resulting from the war in Ukraine and sanctions against Russia are far-reaching and likely to have inflationary consequences in a world already struggling to contain price pressures. Stagflation—weak economic output and high inflation—is a potential result.
- Geopolitical discord is a reminder that oil, the world's most consumed commodity, has value as a potential geopolitical hedge and that energy security is paramount to government interest.
- In an uncertain world, we believe it's important to consider investments simultaneously for opportunity and for ballast.

Views expressed are as of March 14, 2022.

For our immediate reaction to war's outbreak, please see our February 24, 2022, paper "Initial Thoughts on Russia's Invasion of Ukraine."

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Sanctions Bite Quickly, on Both Sides

In response to its invasion of Ukraine, unprecedented sanctions have been imposed on Russia by more than 30 countries representing over half of the global economy.[1] These measures have severely restricted the financial activities and operations of Russia's politicians and oligarchs, its central bank and its prominent commercial banks, and critical state-owned and private-sector companies.

The punitive impacts on Russia have been swift and severe. Consider the following:

- The Russian ruble has dropped about 40% against the dollar since the February 24 invasion. With access to its ample foreign-currency reserves severely restricted, the Central Bank of Russia has been unable to intervene in foreign-exchange markets to stabilize its currency and has doubled its benchmark interest rate to 20%.[2]
- Trading on the Moscow stock market was halted on February 25, and the bourse remains closed. Russian equities traded on foreign exchanges saw their market capitalizations plummet to pennies on the dollar. Prominent index providers like MSCI dropped Russian assets from their global benchmarks, deeming them to be uninvestable.[3]
- Russia's sovereign debt has been downgraded to junk status by major ratings agencies. Fitch Ratings has cut the deepest, slashing the country's debt rating by six notches and referring to the country's default as "imminent."[4] Credit-default swaps on five-year Russian sovereigns soared to nearly 3,000 basis points from the 100-ish level at which they ended 2021.[5]
- The Institute for International Finance, a global financial industry association, has forecast the Russian economy will contract by 15% in 2022—about double the country's decline during the global financial crisis.[6]

These measures have not been without blowback. The supply-chain disruptions resulting from the sanctions and the war itself are far-reaching and likely to have inflationary consequences in a world already struggling to contain price pressures. Surging prices threaten to dampen consumer spending and business confidence and ultimately weigh on economic growth, increasing the potential for stagflationary conditions to emerge.

The third largest producer globally after the US and Saudi Arabia, Russia provides about 10% of the world's oil supply.[7] Though the initial round of sanctions imposed on Russia avoided oil and gas exports, both the US and the UK quickly instituted embargoes on Russian fossil fuels. Given its high level of dependence on Russia for its energy needs, Europe is treading more carefully on this issue; the EU spends as much as $1 billion a day for its imports of coal, gas and oil from the country. Regardless, energy prices have spiked on the Continent. Natural gas in Europe currently trades at the oil equivalent of $240/barrel, almost 10 times the American benchmark.[8]

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Russia also is a major supplier of metals used to make everything from airplanes to cars to batteries. Russia and Ukraine together account for about one-third of global wheat exports and are a key source of the rare gasses used in semiconductor productions. The road to war is among the reasons the S&P GSCI Index of commodities has climbed nearly 60% since the beginning of December.[9]

Distinguishing Risk from Uncertainty

At First Eagle, we've been speaking about heightened geopolitical risk for the better part of a decade; the emergence of a tail event didn't come as a surprise to us. Even so, the crystallization of risk from concept to reality introduces a new form of path dependence of unpredictable complexity. For example, while a Russian victory in Ukraine could cement Putin's ambitions and encourage other leaders of similar inclinations, a Russian defeat could be preceded by untold escalation and followed by the emergence of a totally new regime of indeterminate political leanings. There's also a scenario in which diplomacy prevails—perhaps with China helping to broker an accord[10]—and sanctions are eased, an outcome that would blunt some of the more severe global macroeconomic and financial market consequences we describe in this paper.

1. Source: The White House; as of March 8, 2022.
2. Source: Reuters; data as of March 9, 2022.
3. Source: Bloomberg; as of March 2, 2022.
4. Source: Bloomberg; as of March 8, 2022.
5. Source: *The Wall Street Journal*; data as of March 7, 2022.
6. Source: Reuters; as of March 10, 2022.
7. Source: *The New York Times*; as of March 10, 2022.
8. Source: *Barron's*; data as of March 12, 2022.
9. Source: Bloomberg; data as of March 8, 2022.
10. Source: Greenmantle; as of March 13, 2022.

Current events highlight the fact that most professional investors view risk through the lens of backward-looking quantifiable models that have normal outcome distributions. In his 1921 classic *Risk, Uncertainty and Profit*, economist Frank Knight explored the distinction between "risk" and "uncertainty." One takeaway from his book is that there is a notable difference between the quantifiable risk portfolios face—which can be modeled and, thus, managed—and the freeform uncertainty that represents the true "risk" of investing.

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War, in our view, falls in the latter category. When considering the potential impacts on global output, it's easy to provide stylized illustrations that understate the risk; Russia's GDP is smaller than New York's, for example, while Ukraine's is similar to Nevada.[11] But such reductiveness reveals little about the potential second-order—and third-order—consequences of this war, which in our view could dwarf the first-order consequences and lay at the root of long-term uncertainty.

For example, the war has already begun to shape foreign and domestic policy among noncombatants, including the European Union, which has long been highly dependent on Russia for its energy needs. The winds of change have been illustrated most dramatically in Germany, which gets more than half of its natural gas imports from Russia. As armed hostilities loomed, Germany halted its $11 billion Nord Stream 2 pipeline project intended to deliver natural gas from Russia to Germany directly under the Baltic Sea. Soon after, it announced plans to quickly build two liquefied natural gas (LNG) terminals while also bolstering gas and coal storage and promoting renewables.[12] And after years of resisting pressure from NATO allies, Germany also announced plans to increase its defense spending to 2% or more of its economic output.[13]

Looking at the US, American officials reportedly have been in discussions with Venezuela about lifting the sanctions the oil-producing country has been under since 2019.[14] And it's not hard to imagine that Iran's oil reserves may serve as an important bargaining chip in the ongoing talks to revive that country's 2015 nuclear accord. It's also possible that Ukraine/Russia conflict may represent a non-linear tipping point for the US dollar as the global reserve currency, especially if a favorable resolution remains elusive. The freeze on Russia's ample foreign currency reserves must have other central banks questioning the value of holding their reserves in financial assets to which access can be blocked when needed most—and perhaps have them considering greater diversification of their reserve assets, including more substantial allocations to real assets like gold.

Tighter Financial Conditions May Weigh on Some Industries More than Others

Despite the potential impact of the war on US economic output, unabating price pressures suggest the Fed is likely to follow through on its pre-war tightening plans, with a rate hike coming as soon as its March 15–16 meeting.

We've been concerned for some time that the Fed had fallen behind the curve with respect to inflation, putting the central bank on a complex path as it seeks to normalize policy. Inflation prints were expected to ease in the coming months due to higher 2021 comparison points, but the incremental supply shock resulting from the outbreak of war makes this unlikely, further complicating the Fed's efforts.

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11. Source: Bureau of Economic Analysis, World Bank; data as of December 31, 2021.
12. Source: Bloomberg; as of March 5, 2022.
13. Source: Reuters; as of February 27, 2022.
14. Source: *The New York Times*; as of March 8, 2022.

The US consumer price index in February reached another four-decade high at 7.9%.[15] Commodity-related input-price pressures are concurrent with accelerating wage pressures. Hits to corporate margins are a likely first-order impact associated with these supply shocks, as it will take time for companies to pass along their increased costs to their customers through price increases. As a potential second-order consequence, geopolitical and market uncertainty likely will weigh on corporate confidence and capital expenditures, serving as a negative growth impulse. Additionally, in the US, tighter financial conditions with no policy respite from the Fed or federal government may augur a corporate refinancing challenge and negative credit events down the road.

Earnings expectations remain a wildcard, with the effect likely to vary across industries. The US exited the worst of the Covid lockdowns with pretty sound economic momentum, and, as such, consensus expectations call for upper-single-digit earnings growth in 2022.[16] Businesses in certain sub-sectors of the market that experienced rapid growth during the pandemic may be a particular cause for concern, as many of these companies had especially elevated sales-growth assumptions built into their consensus earnings forecast. Now, however, they face a wall of headwinds related to policy, labor and commodity supply, and have seen pretty substantial derating as a result—and the potential for more should a more structural deceleration in growth rates emerge.

Energy Companies as a Potential Geopolitical Hedge

As we've noted for the past several years, there has been substantial underinvestment in the energy patch—partly due to the ESG-related pressures on the oil and gas industry, and partly due to the demand shock and low prices that emerged with the onset of Covid-19 in early 2020. The current sanctions against Russia have resulted in a real supply shock, even if the market is expecting it to be somewhat transitory; the two-year forward price for oil, for example, is about 30% below the spot price.[17]

That said, the two-year forward price is at its highest since October 2014 and it's doubled from its pandemic trough, suggesting the energy markets are signaling higher prices for longer, even if below current spot levels.[18] Moreover, the two-year forward curve remains below its 30-year averages relative to gold, global equities, US nominal GDP and US money supply. We may need to consider the possibility that oil prices do not soon revert to pre-war norms. The current discord is a reminder that oil, the world's most consumed commodity, has value as a potential geopolitical hedge and that energy security is paramount to government interest.

That said, there are factors beyond a resolution to the Ukraine/Russia conflict that could explain the lower level of the forward oil price curve, including spare capacity among OPEC members, latent capacity in the US Permian Basin, and the potential for oil from Iran or Venezuela to come back to the market. We humbly recognize the challenges to forecasting the price of oil, which is among the reasons we've owned energy companies in Global Value team portfolios over the years. Ownership of energy companies also serves as a potential hedge against rising input costs for the vast majority of companies in our portfolios whose operations are impacted by the price of oil.

Sustainability and Uncertainty

We view our energy position in the context of our aggregate carbon footprint. We are concerned about the impacts of climate change, just as we are concerned about the practical reality that the cost of carbon is likely to escalate independent of oil prices due to carbon taxes and voluntary carbon offset pledges made by companies. Even though we believe our energy sector positioning to be sound and we've benefited from its value as a potential geopolitical hedge during the current disruption, our carbon footprint as a whole is less than that of the MSCI World Index.*

Wanting to be ahead of the curve on carbon exposure does not have to mean disavowing energy stocks in an uncertain world; this is the difficult judgment we've had to make as fiduciaries.

* Source: FactSet MSCI ESG Research; data as of December 31, 2021.

15. Source: US Bureau of Labor Statistics; data as of March 10, 2022.
16. Source: I/B/E/S data from Refinitiv; data as of March 11, 2022.
17. Source: Bloomberg; data as of March 11, 2022.
18. Source: Bloomberg; data as of March 11, 2022.

Environmental, social and governance (ESG) issues may be factors, among many, that are considered as part of our fundamental research process. However, we do not seek to invest in companies based on performance on ESG criteria.

Always Time for Resilience

In our view, war is among the conditions that moves us out of the comfort zone of quantifiable risk and into the domain of uncertainty. In his fifth century BC book *The History of the Peloponnesian War*, Thucydides noted that "For war of all things proceeds least upon definite rules." It is wisdom such as this that reinforces our belief in the fundamental role of humility in investing and drives us to build resilient portfolios from the bottom up.

In an uncertain world, we believe it's important to view investments simultaneously for opportunity and for ballast. Because we don't know the future, we're positioned to maintain diversified bottom-up exposure to what we see as constructive tailwinds across a range of industries and geographies. We own companies—in insurance, consumer staples and freight brokerage, for example—that are exposed to potential improvements in net pricing. We also own companies that historically have shown positive sensitivity to rising interest rates, such as regional banks, niche insurers and custody services. We have a number of idiosyncratic Covid recovery stories in the portfolio, be it in the payment space, Latin American beverages, restaurant equipment, commercial real estate in business districts, hospitals or dental supplies. We own automation equipment businesses we believe could potentially benefit from the long-term trend toward onshoring manufacturing. We own stakes in gatekeepers to the transition online, whether it's cloud software, broadband, search, social media or e-commerce platforms.

The Global Value team's exposure to the combatants in the Ukrainian conflict is negligible. But looking at our European positions more broadly, the spike in natural gas prices and headwind to confidence it represents could push some economies close to recession, though fiscal easing could forestall that. Regardless, European equity markets have derated substantially. Our exposures in Europe are eclectic and diversified, and we believe their valuations to be modest. They include, for example, holding companies that in our view trade at large discounts to their sum-of-the-parts value; consumer staples names whose strong market positions should help them withstand higher input prices; and businesses with unique expertise in certain industrial spaces.

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As a complement to our equity holdings, we want consistent exposure to an asset that may mitigate the impacts of a tail state of the world. Gold's reputation as a potential hedge has been validated thus far in the crisis. As long-dated inflation expectations picked up, real yields have fallen and the gold price has risen. Meanwhile, Russian gold refineries have been suspended from London's gold market, the world's largest, suggesting that the supply of gold may become more constrained just as demand for it is increasing. We believe gold's proven ability to maintain its purchasing power over the long term combined with its counter-cyclical price dynamics, versatility, resilience and long duration make it the most compelling form of potential hedge against both the seen and unseen risks facing portfolios.

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All investments involve the risk of loss of principal.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates.

Investment in gold and gold-related investments present certain risks and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

Definitions

One cannot invest directly in an index. Indexes do not incur management fees or other operating expenses.

MSCI World Index is a widely followed, unmanaged group of stocks from 23 developed markets and is not available for purchase. The index provides total returns in US dollars with net dividends reinvested.

S&P GSCI is typically recognized as the leading measure of commodity prices. It is one of the most widely recognized benchmarks that is broad-based and production-weighted to represent the global commodity market beta.

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