INFORMATION FOR INVESTMENT PROFESSIONALS

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3D vision: decarbonisation, defence and deglobalisation

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Peace is like cement: you don't necessarily see its benefits but it holds everything together. It is the foundation of geopolitics and markets that have been shaken to their core by the unexpected events of the past few weeks, the reverberations of which may well be felt for years to come.

The economic sanctions recently imposed on Russia have relatively limited direct impact on our global equity portfolios and markets – as of the end of 2021 our flagship Global Select strategy had no direct Russia holdings and less than 1% of revenues were derived from Russia, while the country made up only 0.4% of our world equity benchmark.[1] However, we are seeing many second order impacts flow through global equity portfolios.

Much has been said about oil, natural gas and wheat, but there are other commodities for which the world is reliant on Russia: palladium and neon, which are key materials in the production of semiconductors and cars; and titanium, which is needed within the aerospace industry. We had been starting to see signs that the semiconductor chip shortage that plagued the auto industry last year was starting to ease; this latest supply shock may well delay the recovery in chip production yet again with knock-on effects for every product that requires them. Long waiting list times for new cars are beginning to seem like the norm.

Markets are moving to price in the impact on earnings of higher inflation and commodity costs. Against this backdrop, one of the strategy's holdings, Ecolab, which makes cleaning and hygiene products, has put through a temporary price increase to help cover higher input costs. It is these types of companies – with strong pricing power and flexible production capabilities – that we believe are best placed to navigate inflationary challenges, and on which the global equities team will focus as potential investments.

As long-term investors we are always trying to look through the noise to see what kind of a world we may emerge into. Besides a renewed bout of supply chain and commodity driven inflation, there are three themes that will likely endure beyond the initial inflation spike: decarbonisation, defence and deglobalisation.

[1] Bloomberg, Russia weight = 0.39% of MSCI ACWI, as at 31 December 2021

The war in Ukraine may well do for energy transition what Covid did for cloud computing. Necessity is the mother of invention and we would expect to see the pace of decarbonisation become supercharged, especially in Europe which relies heavily on Russian energy imports. The European Commission recently released the REPowerEU[2] plan in response to the energy security problem, which shows the scale of the EU's ambitions as it looks to reduce its dependency on Russian gas by two-thirds before the end of the year. Accelerating the buildout of renewables such as wind, solar and green hydrogen will do a lot of the heavy lifting in achieving these targets. Orsted, a leading offshore wind developer, is one of the strategy's holdings that gives us exposure to this theme.

Defence spending is another area we believe will see an uptick for years to come. Not only will we see this on a governmental level, but private companies will also likely spend more on cybersecurity. Cyberwarfare is a relatively new facet of broader physical conflict, but it is not inconceivable that it may increasingly be unleashed on private companies given how they have been brought into the conflict via boycotts of Russia. Shoring up the protection of firms' digital assets is likely to be another trend accelerated by the war and cybersecurity service providers will play a key role.

The final theme is deglobalisation, a trend that started with former US president Donald Trump's trade war with China in 2018. This was exacerbated by the pandemic and likely cemented by the war in Ukraine. In the near term, continuing supply chain difficulties will likely mean further diversification of suppliers and production facilities and better matching production and demand locations. Over a much longer timescale, the use of economic sanctions against Russia, and notably weaponising the dollar against a G20 member state for the first time by freezing Russia's access to $630 billion of foreign currency reserves, will likely have ramifications for the global economy. It is difficult to imagine China, which currently has $3.2 trillion of forex reserves[3], a large percentage of which is likely to be dollar denominated[4], not wanting to extract itself from this dollar exposure given its own geopolitical tensions with the US. Along with inflation, this has the potential to create a scenario where the nominal cost of capital continues to edge higher.

As markets look to price in change, there will always be opportunities. The benefits of active management allow us to pivot towards stocks where we believe too much risk has been discounted, and we remain focused on these opportunities, finding companies that are best suited to adapt to the new landscape.

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[2] European Commission, REPowerEU: Joint European action for more affordable, secure and sustainable energy, 8 March 2022

[3] State Administration of Foreign Exchange (SAFE), https://www.safe.gov.cn/en/ForexReserves/index.html

[4] The last published statement by SAFE indicated USD composition was 58% of China's FX reserves as of 2014. State Administration of Foreign Exchange (2019): Annual Report of the State Administration of Foreign Exchange 2018. https://www.safe.gov.cn/en/file/file/20190905/8bed0ab4a8f74ef08b0b3553c5d66ac3.pdf?n=Annual%20Report%20of%20the%20State%20Administration%20of%20Foreign%20Exchange%20(2018)

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