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By the Way

Monthly commentary from Jack Way

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""An evil enemy, will burn his own nation to the ground… to rule over the ashes."

War is irrational. War is unpredictable. War is destabilizing. None of which matters to stock markets until a negative economic outcome becomes consensus. It's a harsh fact that despite one country invading another, if the perception is that the conflict will be neat and over quickly (i.e. Russia takes over Ukraine in days) without a major disruption to growth, markets will hold their own. History has shown that with a few exceptions (most notably the 1973 Israeli / Arab war and subsequent oil embargo) stocks quickly recover any lost ground and are higher within six months to a year. Hence the cold-blooded recommendation I've seen in several places; "Buy the Invasion". I want to interject how much sympathy and empathy I feel for the unbelievably brave citizens of Ukraine. Equity markets have no such emotions or a moral compass and so while there has been a great deal of volatility and concern that a huge decline was in the offing, such was not the case. Several events have seemed to me to be counterintuitive or counterproductive. Global stock markets were down around 3% as President Biden prepared to announce sanctions against Russia, but when the sanctions were interpreted as weaker than expected, and thus less harmful to the economy, stocks rebounded to up 3%. Now sanctions have been stiffened significantly, and defenders are resisting the Russian advance; which sounds like good news but has served to raise the prospect of a protracted conflict with more casualties, more destructive weapons and more time to weigh on economic growth. Putin ordering Russia's nuclear forces onto high alert is the epitome of such risks. It's too easy to become hysterical right now, but Sun Tzu, the author of "The Art of War" (considered a definitive work on the subject), wrote; "An evil enemy, will burn his own nation to the ground… to rule over the ashes." Putin is being backed into a corner as more and more countries turn against him and he begins to realize the new harsher sanctions are a real threat to the country and him personally. In particular the threat that global central banks will freeze Russian central bank assets on deposit would have a huge impact on his ability to wage this war for any length of time. Putin seems a man who needs to "save face" before he will back off. I don't know what can be offered to him, but we need him to stand down before the situation get markedly worse. New negotiations are possible as we hope for more rational leadership in Russia.

Even if the "hot war" can be defused it will not automatically mean business as usual. Violence is only one source of power it is said. I would expect Russia to use its power as a commodity supplier to exact concessions from Europe, the U.S. and NATO. Russia and Ukraine control 25% of the world's trade in wheat and 12% of corn. Europe is dependent on Russian natural gas for heating. (Natural gas prices were up 60% in Europe as the war lowered supply.) Gasoline supplies count on Russian oil. Modern technologies need commodities like nickel, lithium and other elements which Russia supplies.

If, as one would expect, Russia chooses to limit supply of any or all of these commodities there would be a significant negative impact on both inflation and the rate of global economic growth. Higher prices and limited supplies would add to an already complicated trade-off between controlling inflation, but not causing a recession. There is the risk of a double-whammy if the economy is in decline at the same time as governments and central banks, led by the U.S. Federal Reserve, are tightening policy to combat inflation. The decisions and outcomes that take place over the rest of this year are likely to have a much more meaningful effect on financial markets than the current situation. It is worth keeping in mind that inflation levels in April, May and June of last year were in the 5% area. Given the nature of the "base effect" comparisons will become easier and should at least provide the appearance of better and lower results.

The S&P 500 has been holding above an area of support for the past three months, but now is not the time to relax. A break below that support would suggest a further decline of 10-15% from here, and there is the potential for bad news on the inflation or geopolitical front. There are reasons to be encouraged by internal measures of market strength, such as new lows, which are acting better than at the previous index lows in January. For those contrarians who want to go against consensus: short selling is the highest since last March; call options on individual stocks are the lowest since April 2020; put options, on the other hand, have recently had 3 of the 5 most active days in history; and the AAII survey of retail investors is at the lowest level of bullishness since 2016. All in all I remain cautiously optimistic despite the war.

This conflict has again forced us to confront the future of the United States as a superpower, or any kind of power for that matter. It is an existential question but should be asked given the rate at which the world changes. In many ways the superpower designation is not that old. World War II and Pearl Harbour brought the U.S. out of an economic depression and a policy of isolationism; a policy that appears to be making a comeback. The WWII victory was not to be enjoyed for very long; Korea was a standoff; Vietnam was a loss (despite what Kevin Kline said in "A Fish Called Wanda"); the U.S. attempt to be the "world's policeman" almost exclusively led to unpleasant results (Serbia, Iraq and Somalia would be examples). As the body bags piled up and September 11th proved retribution was a reality, the retreat inward has become more obvious. President Obama promised to intervene in Syria if Assad used chemical weapons against his own people, but reneged on the promise. President Trump rallied around "America First" and turned his back on long-time friends and allies. President Biden made the embarrassing exit from Afghanistan, and now his words and actions in the Ukraine can be challenging to interpret. The apparent change in policy has not been lost on countries around the world as they realize that depending on U.S. to keep its promises is not assured. Only today former Prime Minister of Japan, Shinzo Abe, was quoted as saying that the U.S. should abandon its policy of "strategic ambiguity" and announce it would provide unequivocable support for Taiwan should China attack. I don't know what might happen in the short term, but it certainly appears the world and America's role in it are evolving rapidly. I found it somewhat ironic the U.S. hosted the "Summit for Democracy" in December as authoritarian regimes are flexing their muscles, and the U.S. provides no pushback.

I enjoyed an answer by the CEO of luxury goods company LMVH, Bernard Arnault. When asked about Apple stock, he replied that while he had no idea about the iPhone in 20 years, he was sure people will still be drinking his product Remy Martin. Which fits with the revelation, to me anyway, that in 2000 Palm stock (you kids can Google it) was worth more than Apple, Google and Amazon combined.

Finally, I was mystified to read that Russia sells sulphurous crude from the Urals to the U.S., but our neighbour to the south won't do more business with Alberta.

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