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The Longer-Term Investment Consequences of the War in Ukraine

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As we try to assess the longer-term implications of Russia's vicious attack on Ukraine some conclusions come quickly and are hard to dispute. These are the known knowns. Others are more speculative but also often more important to get right. These are the known unknowns. Of course, getting the unknown-unknown right would be fantastic, but that would be getting into the business of fortunetellers and respecting their monopoly business, we won't venture into this.

The known knowns

War is the most extreme and violent expression of **Big Government**. We defined the theme of "Big Government" back at the time of the Great Financial Crisis, and the theme has grown ever more dominant since. However, the Russian attack on Ukraine and the response to the attacks take this to a new level, where you now can start talking about a new "war economy" in Europe. Germany



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“...there are known knowns; these are things we know we know. We also know there are known unknowns; that is to say, we know these are things we do not know. But there are also unknown unknowns – the ones we don't know we don't know ...”
 — Donald Rumsfeld.

has, under new leadership, done the only right thing and recognized its position as the European superpower and will start a new rearmament program like we have not seen since the 1930s. Most if not all of Europe is following Germany. Priorities have been rearranged; security – both sovereign and in energy terms – supersedes anything else as we reconnect with Maslow's basic needs, see also our recent paper [here](#). President Macron even talks about nationalizing energy companies – somehow, the former liberal Macron thinks the state is better positioned to provide energy than the private sector... We are also starting to hear talk about fixing energy and utility prices and introducing subsidies for poorer segments of the population, which was not even considered during the energy crisis in the 1970s.

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The EU is working on issuing joint EU debt to finance subsidies for high energy prices. The current challenging times allow the EU to emerge with a more extended mandate. The region is leveraging its experiences from other crises, like the recent Covid-19 pandemic, to make more robust and faster decisions. “Europe will be forged in crises and will be the sum of the solutions adopted for those crises,” said Jean Monnet back in the 1950s, one of the founding fathers of the European Union. EU develops through crises. The rising debt/GDP ratios due to the war will lead to the issue of joint EU debt to protect against a sovereign or euro crisis. In this context, the ECB should once again be called to the rescue granting low financing costs and maintaining stability of sovereign spreads: i.e., more quantitative easing is more likely than not. Raising interest rates within a geopolitical crisis overlapping with an energy crisis would seem counterproductive.

Issuance of more common EU debt and the centralized purchase of weapons are all bottom-up initiatives calling for a new institutional framework toward **fiscal and**

political union. With “barbarians” at the gates of Europe, it becomes a lot more challenging to argue against deeper political integration in Europe.

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Europe will be forged in crises and will be the sum of the solutions adopted for those crises — Jean Monnet

The world has underinvested in primary energy at least since 2014. This has resulted from the **energy transition** agenda and our shared desire to phase-out fossil fuels. Spare capacity is close to non-existent today. This was evident long before the Russian invasion of Ukraine but putting sanctions on the largest commodity producer in the world and saying Europe wants to get-off Russian gas – with the implicit threat from Russia of cutting-off supplies to the continent – has of course created even more havoc. Energy prices will stay secularly high – mainly European gas prices as we transition away from Russian energy dependence over the coming decade. It will be very difficult to do it faster – unless the Russians decide for us.

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The “European Business model” for the last 30 years was based on outsourcing its energy requirements to Russia and its defense to the US, while Europe manufactured for the world and developed world-class welfare states for its citizens. Ukraine changes that. Europe will have to become much more self-reliant on almost everything. Energy will be sourced from US LNG and a massive expansion of domestic **renewable energy**. Nuclear could become part of the solution, but this is getting into the known unknowns. New defense investments will take their toll on public sector budgets.

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The financialization of the economy with ever-growing debt, both public and private, and rising asset values has been the modus operandi for a generation. This will be accelerated as the public sector faces even more significant areas of expenditure in the form of subsidizing the populations for high energy costs, energy independence, and defense. Realistically, monetary policies will probably never normalize, and real interest rates will have to stay very negative. The impetus for this has only grown bigger as national security now has taken center stage and will eventually be secured by financial regulation and yield curve control if needed. Negative real yields guarantee poor bonds returns and lowers the

hurdles for equities and other real assets, which should be favored in this environment.

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The desire to insulate our economy from the outside world

It is a phenomenon that has been growing since the Great Financial Crisis and amplified by the Covid-19 pandemic. **Supply chains** have taken center stage. Covid-19 taught us that we were overly dependent on supplies from far away. Efficiency, just in time inventory, and profit maximization have been taken too far. There will now be even more focus on creating resilient supply chains isolated from potential geopolitical concerns. With its inability to source computer chips, the auto sector is a case in point. The EU



and the US have decided to subsidize the localization of semiconductor chip manufacturing, each initially at around USD 50 bn. This is a beginning, but it will have to grow multiple times if both continents are serious about shifting global manufacturing of semiconductors back to Europe and the US. The predicament of the US is especially critical. It can be compared to Europe's energy dependency on a hostile Russia since the US military is dependent on supply chains in China. China is viewed as a strategic adversary, and therefore it will be a situation of doing whatever is necessary to remove the dependency. Our view - which is shared by Morris Chang, founder of Taiwan Semiconductor - is that it's unrealistic to try to localize a very globalized industry like semiconductors. Still, in any case, it's good for the equipment suppliers with more localized production sites. In general, we expect the trend toward localization of supply chains to lead to much higher manufacturing investments in the future.

The known unknowns

The Russian invasion has met a resolute response from western countries. Most Russian banks have been kicked-out of the Swift payments system. Still, and more importantly for this discussion, the reserve assets of Russia's central bank have been frozen, which in essence means Russia only can access the part of those assets that are either denominated in Renminbi (Rmb) or domestically stored gold.

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If your dollar-based central bank reserves can be frozen when you need them most, then what is the use in holding them?

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The US has previously frozen the foreign exchange reserves of Iran, Syria, Afghanistan and Venezuela. Yet, none of the previous targets of sanctions were as powerful as Russia. This has opened a pandora's box of uncertainty about the future system for reserve assets.

If your dollar-based central bank reserves can be frozen when you need them most, then what is the use in holding them? Could it be that the central bank freeze marks the death of the post-Bretton Woods system, born after Richard Nixon took the US off the gold standard in 1971, and the start of a new monetary order centered around some neutral reserve assets to be determined in the coming years? If your dollar assets can vanish at the whim of the debtor, the logic follows that a reserve system must exist outside the dollar-based financial system. Especially now that many creditor nations have minimal trust in and, in many cases, quarrels with the reserve issuer, the US.

Break-up of the Petro-dollar system?

Following the asset freeze, India first announced they were working with Russia to import Russian crude oil and pay for it in Rupees. The following day Saudi Arabia announced they were willing to sell crude oil to China and get paid in Rmb. Up until today, the oil market has been a dollar market, formalized in 1974 in the aftermath of the first energy crisis. The US was desperate to get Saudi Arabia to compensate for falling US oil production, which had peaked in 1970. The US would buy oil from Saudi Arabia and provide the kingdom with military aid and equipment. The Saudis in return would plough billions of their petrodollar revenue back into US Treasuries and in so doing finance America's deficit spending. This was the birth of the Petro-dollar system which has been with us ever since. It now seems to be breaking up.

Another reason for the growing unwillingness to hold US reserve assets could also be that, given the indebtedness of the US and other western economies, real interest rates will have to be kept negative for many years. Why sell your crude oil and get paid in reserve assets with a negative real yield?

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Significant changes to the international reserve system

Finally, and despite the obvious historical benefits of being the reserve issuer, the US might also have reasons to change the system. The US has deindustrialized and outsourced its manufacturing base primarily to China. This is the flip side of being the reserve currency issuer. This in turn has hollowed-out the US middle class and shifted the US to a service-oriented economy. Looking out over the coming decades, the power struggle will be between the US and China. Is it possible to be a superpower without a manufacturing base and being highly dependent on China for the sourcing of critical components for its military? Over the coming decades, the US economy needs to re-shore manufacturing from China,

produce more and import less. The current currency system structurally overvalues the US dollar because the outside world recycles the trade account deficit back to the US by buying US assets, thereby pushing up the value of the USD. What we are seeing is the start of significant changes to the international reserve system.

Conclusion

The picture painted is an inflationary one. And one needs to remember that periods of war are inflationary. This is a clear break from the previous 30 years. However, the underlying structural drivers of the last few decades of disinflation are still present: debt, demographics, and technology. In the “good old days” central banks created recessions by hiking interest rates too much to cool the economy. In the 2020s, it will be commodities doing the job of the central banks; high commodity prices – primarily energy – will eventually lead to demand destruction and recession, where falling commodity prices will lead to recovery. As commodities oscillate, investors will witness inflationary spikes followed by collapses, abundance replaced by shortages. Avoiding whiplashes by identifying strong companies with pricing power exposed to longer-term trend and thematic tailwinds and building resilient secular growth portfolios seems the only rational answer to an irrational world.

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