Authored by:

Michelle Cluver, CFA

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Russia Ukraine Conflict: Commodities, Inflation and Portfolio Positioning

Inflation and its implications for real economic growth are the main portfolio positioning consideration of the conflict in Ukraine. The Bloomberg Commodity Index has increased 33.7% year-to-date (YTD) with a 15.1% increase occurring since the invasion. Energy and basic food related commodities have increased sharply with WTI crude rising above $120 / barrel and wheat hitting all-time highs, increasing 85% YTD with substitute grains also increasing sharply, pushing the Bloomberg Grains Index up 13.6% since the invasion.[1] Food and energy prices are important for setting inflation expectations as they are some of the most visible prices in everyday life.

Commodity Prices Increases Consumer Prices

On the 8th of March, the U.S. sanctioned Russian energy imports, giving companies 45 days to comply. This led to a short-term spike in WTI crude prices to almost $130 / barrel.[2] Unless all western countries cut off Russian oil, U.S. sanctions will not have a meaningful impact on Russia as the U.S. only represents around 1.3% of Russia's oil exports.[3] U.K. and European restrictions on Russian energy imports are being phased in over the year, thus reducing the immediate impact on crude supplies and giving the market time to adjust. Prior to the U.S. sanctioning Russian energy, companies had already started self-sanctioning to avoid reputational risks or running afoul of sanctions. As such, some of this price impact had already occurred.

Disruption in Energy supply agreements led to short term contracts for WTI and Brent crude rising faster than longer dated contracts – or backwardation. The difference between active WTI crude contracts and August 2022 contracts is currently $16.9 / barrel, up from $2.1 / barrel at the start of the year.[4] This reflects a short-term supply squeeze due to shifting away from Russian Ural oil, which is currently trading at a steep discount to WTI and Brent crude oil.

This week's increase in crude prices drove a sharp rise in gasoline prices for U.S. consumers. Gasoline prices increased $0.50 / gallon nationally bringing the national average gasoline price above $4.00 / gallon.[5] This directly impacts consumption choices, dampening discretionary travel and consumption.

Add higher staple food prices into the mix, and the situation becomes more concerning. According to 2020 U.S. expenditure survey, food and energy averaged of 11.9% and 3.4% of expenditure, respectively.[6] Unless wages keep pace with inflation, which they likely will not, purchasing power will be eroded. We are concerned about the potential impact on lower income consumption as this consumer segment are most exposed to higher food and energy prices with less of a saving cushion.

Further Supply Chain Disruption Increasing Inflation Expectations

Higher commodity prices are not the only factor increasing inflation expectations. Supply chains were expected to normalize in 2022 as COVID-19 restrictions eased. However, the Russia Ukraine war has intensified supply bottlenecks, restricting access to certain commodities (Nickel, Palladium and Titanium) and other key components. Shipping routes are also impacted as oil and gas needs to flow via tankers rather than pipelines and shipping from the Baltic Sea, including grains, has been directly impacted by this war.

Imported Inflation Creates Central Bank Headaches

Russia's invasion of Ukraine is a global inflation shock. U.S. inflation is likely to remain elevated during 2022. 1-year U.S. breakeven inflation started the year at 3.4%, rose to 5.2% in the run up to the invasion and currently stands at 5.9%.[7] February CPI Inflation came in at 7.9% and will likely go higher in March on the back of the spike in energy and commodity prices.

Despite the sharp increase in inflation expectations, interest rate expectations have been scaled back in response to the invasion and reduced growth expectations. Goldman Sachs estimates that a sustained $20 / barrel increase in oil prices will reduce GDP by 0.3% in both the U.S. and China while reducing Euro Area growth by 0.6%. However, cutting off Russian gas to Europe could result in a 2.2% GDP hit for the Euro Area.[8] Europe lacks energy independence from Russia and dollar strength compounds commodity price movements. This could dampen discretionary consumption, increasing Europe's recession risk.

Markets are currently expecting the Federal Reserve (Fed) to commence their interest rate rising cycle with a 25 bp increase at their mid-March FOMC meeting with the ECB expected to end their bond buying early. Central banks continue to walk a tight rope with managing inflationary pressures while striving to avoid a recession.

Positioning for Uncertainty

Market volatility rose during February and into March, with the VIX Index above 30.[9] While volatility is often associated with equity market weakness, some of the best days on the market are during periods of market turmoil.

A more protracted war is likely to amplify the focus on inflation and economic growth while an early end to the conflict could improve the prospects for cyclicals. Overall, we believe it's important to protect against inflation while increasing defensive and quality positioning.

- Commodity exposure and certain key sectors, such as Energy, Materials and Real Estate, can provide some inflation protection.
- Balance value and growth as cyclical sectors that require economic growth may face headwinds while a more cautious Fed is more supportive for growthier segments.
- Defensive sectors such as Consumer Staples, Health Care and Utilities are likely to hold up better in a more protracted conflict.
- Quality tends to outperform late cycle. We believe this is an important focus area in the market currently due to the following factors: elevated volatility, geopolitical uncertainty, more hawkish Fed and corporate earnings growth is slowing down. Corporate guidance is at its weakest level since 2014[10] and companies exiting Russia may adversely impact short-term earnings.

- We believe the U.S. economy and market are likely to weather the turmoil better than Europe. Margin pressure is likely to be higher in Europe than the U.S. due to even greater inflation pressures combined with less wage growth in the preceding years.

Disruption creates opportunities. The current energy crisis may encourage a greater focus on energy independence, increasing investment into renewable and alternative sources of energy. Additionally, this crisis focuses attention on the unaccounted risks of weak cybersecurity systems and processes. This is likely to drive increased adoption and improve interest in cybersecurity.

While markets remain volatile, opportunities remain.

Footnotes:

[1] Bloomberg data as of 3/8/2022
[2] Bloomberg data as of 3/8/2022
[3] Statista, Russia's Most Important Oil Export Partners, 3/7/2022
[4] Bloomberg data as of 3/8/2022
[5] WSJ, Gasoline Price Hits Record High, 3/8/2022
[6] BLS, Consumer Expenditure Survey, 2020
[7] Bloomberg data as of 3/8/2022
[8] Bloomberg, Surging Price of Everything Spells Stagflation, Risks Recession, 3/7/2022
[9] Bloomberg data as of 3/8/2022
[10] BofA Securities, The RIC Report: Peace Through Strength, 3/8/2022

Definitions

Consumer Price Inflation (CPI): CPI measures the average change in prices that consumers pay for a defined basket of goods and services.

VIX: The Chicago Board Options Exchange SPX Volatility Index, commonly referred to as VIX, reflects a market estimate of future volatility, based on the weighted average of the implied volatilities.