Russian Media, De-Linking, Acceleration & 2nd Order Effects

Last weekend, we published "[Що Далі? (What's Next?)]" and came to the sad conclusion that the situation in Ukraine will become worse before it gets better. I've been in San Diego this week attending our first Academy Securities West Coast Summit and while the discussions were active and energized, they did nothing to dissuade me from the view that it will get worse before it gets better especially for the people of Ukraine and the global economy (though there is a glimmer of hope on the war front).

While we attempted some rallies on peace talk headlines and potential help on the oil front (OPEC, Venezuela), we wound up closing near the lows of the week and were down significantly on every equity index. Investment Grade Credit CDX spreads finished unchanged, but bonds were wider (the Bloomberg Corporate Bond OAS went from 130 to 143), and were pushed along by a relatively large calendar given the equity market backdrop. High yield fared worse.

Despite the "risk-off" tone in equities, the **10-year Treasury yield blew out from 1.73% to 2.0%** as inflation across the board took center stage. While commodity markets were roiled and stories of margin calls spread rapidly, it was impossible not to **stare at nickel prices in disbelief** (trading has been halted since Monday).

I remain most concerned about food prices even with wheat prices backing off a little. Prices remain elevated (one wheat futures contract is up 61% from 6 months ago) and while wheat did give up some gains, other agricultural products held firm. I'm hearing stories of fertilizer companies having to raise prices weekly to offset their rising costs, but more on possible "2nd order" effects later.

Russian Media Changing Tune?

Let's start with a potential positive as there has been so little to be positive about. There is reporting (and my social media is filling up with stories) talking about how the Russian media (and some of its most famous pundits) are potentially setting the stage for a "win" for Putin that would allow him to deescalate. Putin and his leaders are masters of misinformation, which in this case might be good for the world. If, and this remains a big if, he is preparing the Russian population for a plausible (to his audience) reason to claim victory and pull back troops, it would be great for Ukraine. It is too early to get excited about this possibility as I type this on Saturday afternoon, but it is interesting. On the other hand, he did announce that he was banning exports of products to the West (seems a bit like a couple who breaks up and each side is rushing to tell everyone they were the one to break it off), but it shows how much effort he puts into controlling the narrative at home. He is constantly elevating actions to "act of war" status when committed by the West, even when they don't meet the Geneva Convention definitions of an act of war. While at the same time, he continues to commit atrocities that go beyond war and are likely in the realm of war crimes.

So, a glimmer of hope, but that is about it for now.

Acceleration and De-Linking

Much like COVID seemed to "accelerate" and give a boost to certain trends (work from home, videoconferencing, etc.), we are seeing the war accelerate certain trends that were already in place. Each of these topics deserves greater detail, which we will touch on in the coming days and weeks, but for now, simply restating them is important and useful enough (I think):

- **ESG as inflationary**. We will build out sustainable energy sources faster than before, while also dedicating more money to traditional energy infrastructure.
- **On-shoring, regionalization, deglobalization, or supply chain repatriation**. It doesn't matter what you call it, but we will see countries and companies work more with partners they feel "close" to. Whether that closeness is geographic, political, or morality based, it will shift with whom, where, and how we do business. There will be huge opportunities and significant risks. More and more it is looking like a Russia/China axis is forming. More of a marriage of convenience (one place has lots of commodities and is trying to get more as they invade Ukraine, and the other has an insatiable appetite for commodities). At our Summit, there was a sense that the relationship between North and South America will grow and will act as a counter-weight to the Russia/China "alliance". I hesitate to use the word "alliance" because most of our GIG would argue that it is far more a marriage of convenience rather than something we would consider an alliance.
- **China's Recentralization and De-Linking**. This has been a constant theme in T-Reports since last summer and there is growing evidence of this. I refer you back to the "thought piece" on China's Olympics as Symbolic Bookends from a couple of weeks ago. **Talk about delisting** fits this model (even though more initiated on our end) and it impacted markets last week as well.
- **The Yuan versus the Dollar as reserve currency**. The dollar is nowhere close to losing reserve currency status (a topic that has come up with increasing frequency), but the removal of some parts of the Russian economy from SWIFT and going directly after the Russian Central Bank will make some less honorable countries or leaders think about the proportion of their reserves that should be held in dollars. China has been pushing to be included to a greater degree in the SDR (IMF's "currency"), is lobbying to get their bonds included in global bond indices (where passive money ensures buyers), and is encouraging trade in commodities like gold and oil to be in their currency. I still think that the Russia/China pipeline deal, denominated in Euros, was extremely telling. China is ahead of the West with the Digital Yuan (though that is more for control of their citizens than for the good of their citizens), but it is up and running nonetheless. I continue to see the long-term trend as one that is for a stronger yuan, especially as I believe that they are more focused internally and the stronger currency allows them to acquire commodities more cheaply.
- **NATO and EU Becoming More Cohesive**. This is one trend that has **reversed course**. We were worried about NATO fracturing along some well-known fissures, but the invasion, the Ukrainian response, and the response of citizens and companies across the West has galvanized political leaders. NATO has not shown this level of resolve, intensity, and cohesion in a long time!!!

Most of these trends are longer-term in nature, but to the extent many doubted them, or thought they had years to adapt to them, **now they must revisit these issues and what it means for their companies or investments**.

2nd Order Effects

Of all the things that I learned at the Summit, one of the most important was that we are highly likely to be heavily underestimating 2nd and 3rd order effects from the invasion and the response to the invasion.

- **Food is a 1st order effect and I re-iterate my view that soon we are more likely to be fixated on food problems than energy problems**. I hope I am wrong, but anecdotal evidence seems to point in that direction.
- On 2nd and 3rd order effects, virtually every attendee at the Summit seemed to have an example that no one else had heard of. Whether it was a car company not getting a critical component, to the production of neon for semiconductors, to food stories, to dealing with bond defaults (or potential bond defaults), the list of things people were looking at or seeing was extremely widespread. As you know, I always argue that Lehman Was NOT a Moment, which I felt was applicable to the China property market, but may also be applicable here. It is the "**Known Unknowns**" which often bite us, and given the fragility of global supply chains BEFORE the invasion, it is not difficult to believe that we will see a more rapid decline in growth, especially in Europe, than is already priced into the market.
- It feels awkward being so vague, but I'm forced to be this vague by the nature of the problem.

Bottom Line

There are some glimmers of hope (I'm trying to be as optimistic as possible) that the combination of the resolve of the Ukrainians and the impact of sanctions (both government and corporate imposed) will be enough to sway Putin to a new and less violent course of action.

I am a bit concerned though, that we remain with the intractable problem:

- **Putin cannot "win"** because much of the world has rallied against him and Ukraine will likely siphon off resources and lives as the insurgency continues even after he captures Kyiv (assuming he does).
- **Putin cannot afford to lose.** He has created an environment in Russia where a "loss" will be very difficult for him to deal with.

So, if he can't win, but he can't lose, what do we get next? Sadly, I'm in the "worse before better for Ukraine" camp right now, though I am desperately looking for signs that I'm wrong. **On the economy and markets, I think that even a resolution to the war will only provide a brief rally.**

- The 2nd and 3rd order effects will still occur and still hit us even if peace is announced (and that is a big if).
- Central banks are tightening and financial conditions are also tightening ahead of any actions, which we should start seeing as early as this week.
- There is a chance that this week the Fed throttles back on tightening rhetoric as the latest surge of inflation is a supply shock which rate hikes won't help and may even make worse as borrowing costs to get new supply on-line will go higher.

While everything is "cheaper" than it was last week, I'm not looking to buy this dip in a meaningful way, though the volatility is so intense that being nimble and taking advantage of opportunities will remain key for investors while **both investors and corporations will need to think fresh about how the world is likely to look a year or two from now to ensure that they are best positioned for that evolution.**

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