

THE KWAMMENTARY

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Kwame Boateng, CFA – Portfolio Manager, Investment Advisor

T 250 861 8173 | Toll Free 1 800 788 5677 | kboateng@odlumbrown.com

Odium Brown Limited | Suite 1500 – 1631 Dickson Avenue | Kelowna, BC V1Y 0B5

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No Sense in Rushing

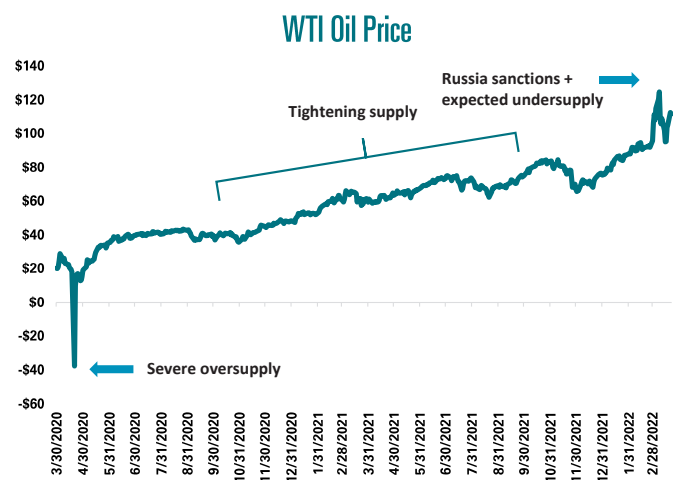
In previous notes, I mentioned that I had hoped to be able to retire “unprecedented” from my vocabulary in 2022. It seems that will not be the case, as the first three months of the year have brought levels of uncertainty and activity that harken back to the beginning of 2020. From the terrible crisis in Ukraine and the second order effects from the ongoing conflict, to rising interest rates across most of the developed world, there has been a confluence of events that have made my murky crystal ball even murkier. Change is afoot, and the ongoing global situation warrants a balanced approach. Let’s review a few topics to get a better sense of our environment.

Russia versus Ukraine

It has been a month since Russian troops officially deployed into Ukraine, with the intent of a blitzkrieg-style incursion that would result in the collapse of the Ukrainian government. On this objective, Russia has failed demonstrably *and* has set global foreign policy back almost 35 years (for them, at least). There have been many surprises from this conflict, ranging from Russia’s miscalculations on a swift victory to Ukraine’s capabilities in withstanding a larger force and their dominance of the narrative via social media and other avenues. What has really surprised me, though, is how quickly NATO nations unified in support against Russia, with varying degrees of sanctions and military aid. This response, coupled with that of corporate entities (more than just lip service), has resulted in a swift and devastating impact on the Russian economy. To complete the trifecta, Western nations will need to get China, India and Pakistan on board, or make them neutral observers, to effectively hedge Russia in. The prospects of this are low, and they give the Russian economy a small lifeline, for now.

Second and Third Order Effects from Ukraine Conflict

Beyond the devastating impact to Ukraine, this conflict has serious implications for countries across the globe as well. Take wheat production, for instance. Russia and Ukraine, combined, accounted for 25% of the global supply of wheat in 2019. At present, Russia has significant sanctions levied against them; meanwhile, Ukraine will likely lose this year’s production and have to limit exports to ensure they can feed their remaining citizens. The [OECD Economic Outlook, Interim Report](#) in March 2022 included a powerful visual of the importance of wheat imports from Russia and Ukraine in certain countries. Considering some countries rely almost exclusively on Russian or Ukrainian supply (e.g., Turkey, Egypt and Israel), this shortage will have drastic effects on pricing and availability. As Turkey and Egypt are historically familiar with, when people cannot afford food, regimes tend to change.



Source: Bloomberg, Odium Brown Limited

Energy prices are also an important factor being directly affected by the continued conflict, mostly on the Russian side of the equation. As mentioned earlier, the sheer size, timing and coordination of sanctions levied against Russia, and Russian interests, have been significant. They have effectively stranded 10% of global oil production during a time when supply/demand dynamics were already trending toward an undersupplied market.

In an environment where most countries are already dealing with mounting inflation pressures, the timing of these necessary sanctions could not be worse. On the topic of mounting inflation pressures...

Inflation shows few signs of letting up

Before the war in Ukraine, I was confident that we would start to see some reprieve from the inflationary pressures that had begun showing up through 2021. The logic goes that as restrictions gradually wind down (whether by prudence or political expediency), the factors that have contributed to supply chain constraints and labour market dynamics would start to reverse course. While we have seen restrictions loosen in certain geographies, the compounding factors of non-COVID-related supply chain issues have put us back closer to square one. I am sure many of you have started contemplating biking or walking to work recently given the price of gas, a natural byproduct of the chaos in the energy market that shows little sign of abating. Pricing for wheat-related staples (bread, pasta, etc.) continues to increase as well because of European developments, which will be bad for wallets. More significantly, the conflict in Ukraine has accelerated the move away from globalization towards favouring local production and closer supply chains that started mid-2020. This trend is inherently inflationary, as local material and labour inputs tend to be more expensive. I am not sure who will absorb this cost yet (corporations versus consumers), but the trend will have long-lasting impacts.

Interest Rate Response

Central banks across most of the developed world have signaled an end to the incredibly accommodative environment that has made up the past decade, in light of inflationary pressures. Many argue that they are behind the curve, and consequently will be forced into more drastic interest rate interventions as time goes on. I have written about this plenty of times before, so you will know my stance: some inflation pressures will disappear and others will not, leading to higher average inflation, but not to an

extreme. To me, there are two high-probability outcomes: either the central banks will overdo their intervention and cause an economic downturn, or they will underdo it and unleash more inflation. Neither outcome is ideal, but the current environment does not leave a whole lot of room for options.

What remains to be seen is how significant an impact these rate changes will have on large developed/developing countries with high levels of consumer debt. After the Financial Crisis of 2007/08, the U.S. consumer was forced to undergo major deleveraging, which has put them in a better position than, say, Canada, going into this rate hike cycle. Although Canada has some of the highest consumer debt levels among developed countries (largely mortgage based), the introduction of stress testing measures for mortgage applications has reduced some of the risk around rates rising. Should rates show significant upward movement, this could become an issue.

Putting it all together – What is the rush?

The number of significant, structural changes happening at once in such a short amount of time is astonishing. Global political and economic spheres of influence are being rewritten, trends that were the underpinning of globalization efforts are reversing and monetary policy that had created tremendous levels of wealth for the past decade are winding down. With all of these long-term changes, there are long-term opportunities. More immediately, they have created a fair amount of volatility, as investors try to sort out how incremental bits of news will influence outcomes. We do not play that game; it is too time consuming and fraught with emotional bias risk, and does not lead to sustainable returns over time. Focusing on the longer term, there are opportunities that have become more attractive, but do not warrant the sense of urgency that the market is emulating. No sense in rushing.

Sincerely,

KWAME BOATENG, CFA

Portfolio Manager, Investment Advisor

Tel 250-861-8173 | Toll Free 1-800-788-5677

kboateng@odlumbrown.com

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