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CIO Viewpoint

Rising inflation and Ukraine's prolonged conflict cool growth prospects

Investment Solutions

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The world's current challenges look more like the plot of a thriller than a reality that fits economic forecasts. Russia's invasion has upturned Europe's energy strategy and slowed the growth outlook worldwide as China's Covid lockdowns add to supply chain disruptions. Faced with such uncertainties, our macroeconomic and investment outlook is more cautious.

The two-month old war in Ukraine has entered a new phase. Russia's military has retreated from the region surrounding Kyiv to focus on an offensive in the eastern Donbas region and southern Ukraine. That creates a 400 kilometre-long eastern front, and gives Russia's forces the opportunity to concentrate, while relying on shorter supply lines and the ability to fight across a more open landscape, less hostile to tanks.

Russian President Vladimir Putin, unable to claim a quick victory, has pounded the port of Mariupol on the Sea of Azov in an attempt to create a land corridor to the Crimean peninsula, and further west along the Black Sea coast. As long as the West continues to support Ukraine by supplying arms and munitions, we see no reason at this stage to change our baseline expectation that the conflict will drag on.

While a broad Ukrainian defeat looks unlikely in the short run, small territorial gains in the east of the country may enable Russia to declare a victory on 9 May, the country's traditionally important celebration of the Nazis' defeat in 1945. A long, 'frozen conflict,' would achieve President Putin's aim of destroying Ukraine's economy and preventing its economic or political success.

Globally, such a stalemate would also cement a geopolitical split between countries supporting economic sanctions on Russia led by the US and European Union, and a series of emerging economies, led by China and India, which are trying to walk a more neutral, non-aligned line.

Sanctions and oil

On 8 April, the EU banned the import of coal, stopped Russian ships from accessing its ports and sanctioned a further group of oligarchs and their families. An additional, sixth package of EU sanctions, is already under discussion that may spread to an oil import embargo. On 20 April, Germany committed to halting Russian oil imports by the end of 2022. With French President Emmanuel Macron

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Our expectation for prolonged conflict in Ukraine is unfolding, as Russia refocuses its offensive on eastern Ukraine
- President Emmanuel Macron's re-election in France strengthens the likelihood of further EU sanctions on Russia
- The war's impact continues to subdue economic activity; we expect the conflict to cut between 0.5% and 1% from global GDP in 2022
- We keep prudent portfolio positioning, with underweight allocations to fixed income, a neutral equity exposure and overweights in cash and broad commodities.

elected to a second five-year term, we therefore expect sanctions imposed by the US, EU and their allies to expand. Any EU move to ban Russian oil imports will be well sign-posted ahead of a European Council summit to discuss such a step, scheduled for 30-31 May.

Worldwide, oil supplies remain tight and prices high. The Organisation of the Petroleum Exporting Countries (OPEC) increased production this month, but is struggling to do more because of supply chain blockages and labour shortages. While the decision by the US and International Energy Agency to release strategic oil reserves should increase supply and stabilise crude prices, the slowing global economy may cut demand. A lower growth outlook, including for China where Covid lockdowns are in place, combined to push Brent crude oil lower, to trade around USD 103 per barrel. Once China's domestic restrictions lift, we would expect to see renewed upward pressure on oil prices. Since Russia's invasion, Brent crude has commanded prices as high as USD 127/barrel, and as low as USD 98/barrel.

Inflation and slowdown

Higher commodity prices from oil to crops and industrial metals following the conflict have undermined the global outlook, especially in Europe which is experiencing a combination of higher inflation and lower growth. Some of the global supply chain improvements seen in late 2021 have now either stalled or are worsening, lengthening delivery times again. We expect this to weigh further on consumer prices, which we see at an annualised 6.7% at the end of 2022 in the US, and 5% across the eurozone. In other words, despite tightening monetary policy, there is still a long road ahead to reach more 'normalised' inflation levels.

The International Monetary Fund (IMF) last week described the economic impact of the Ukraine war as "a clear and present danger." On 19 April, the Fund cut its global growth outlook for the second time this year. It now expects output to rise 3.6% in 2022, from 4.4% in January 2022. War-induced commodity price increases have lifted its inflation forecast to 5.7% in advanced economies and to 8.7% across the developing world. In China, mobility restrictions to tackle Covid in many cities may significantly cut our forecast of 4.7% annualised GDP growth. Our forecasts estimate that a prolonged Ukraine conflict will cut between 0.5 and 1.0% from global growth this year (see chart).

Markets are facing a challenging environment. The impact of the Ukraine war, sustained inflation and central banks' tightening cycles all add to the uncertainties. The war has also increased geopolitical tensions which threaten the rules-based frameworks governing international relations since 1945, notes the IMF. Nor has the Covid threat disappeared, with around 5,000 daily deaths worldwide and economic disruption from lockdowns in Chinese cities.

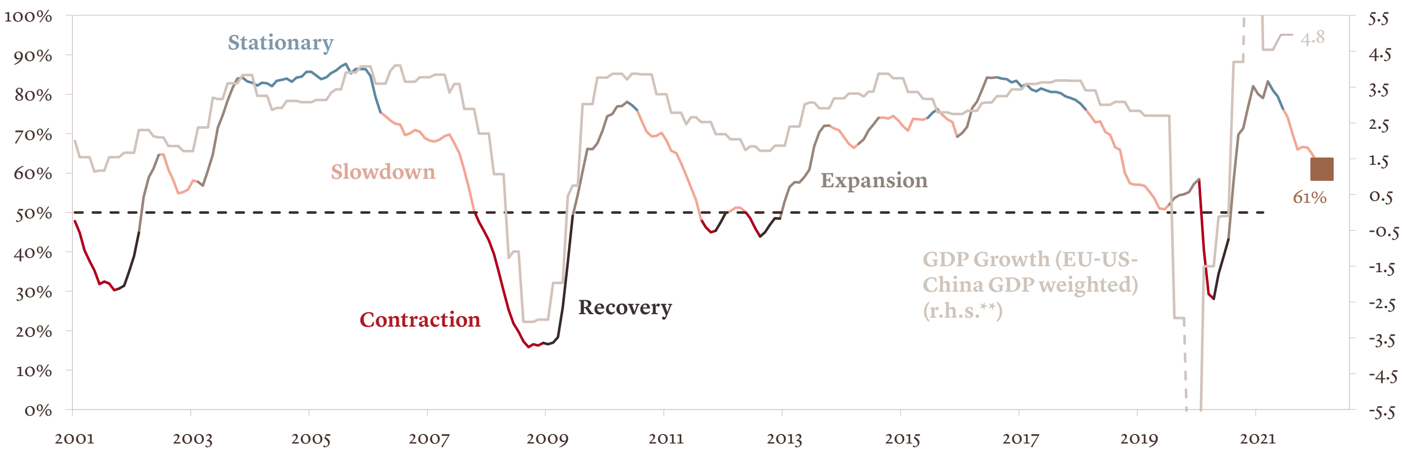
Prudent positioning

As the US Federal Reserve and European Central Bank turned more hawkish, both bonds and equities have fallen year to date. That has challenged traditional diversification strategies and translated into weaker investor sentiment as markets try to price the risks of a monetary policy mistake.

How should investors think about equities in this inflationary and rising rate environment? The good news is that many of the negative drivers are already incorporated into the market narrative and therefore at least partly priced into stock values,

A slowdown phase

Lombard Odier World Economic Indicator*



* Proprietary composite of 74 business indicators, ** right hand scale / Sources: Bloomberg, Lombard Odier

while economic growth is slowing from high levels and still-positive. First quarter earnings reporting has just begun. As a whole, the consensus in both the US and Europe is positive, and for 2022, forecasts point to full-year earnings per share (EPS) growth of 10% in the US and of 11% in Europe.

However, this only tells part of the corporate earnings story. Although the consensus for EPS growth in the first quarter for S&P 500 stocks is 4.5%, that is almost entirely driven by the rising estimates for energy, with materials, industrial, healthcare and the technology sectors also contributing to the increase. Excluding energy, earnings in the first three months of 2022 are expected to fall by 1.1%, with declines forecast in segments from consumer discretionary stocks to financials, utilities, and communication services.

Although many paths for the globe's economies are possible, we believe that it makes sense to stay invested and well diversified with a quality bias. We are maintaining our underweight allocation to fixed income, and a neutral position on equities. Within our equity positions, we have reduced our small capitalisation stocks to underweight, while maintaining a preference for exposures in the UK, value, energy and healthcare segments. We have also raised our US stock exposure, given that market's more defensive characteristics, a greater reliance on the domestic market and lower exposure to the war in Ukraine. We have also kept our overweight holdings in a diverse basket of commodities, as well as an allocation to European real estate and a larger cash buffer. This is key to being able to capitalise on any investment opportunities as they develop.

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