SPOTLIGHT | MARCH 2022

GHOSTS OF THE 1970S

Key points

- Nearly 50 years ago, a long simmering conflict reignited with the Fourth Arab-Israeli War culminating in a global energy shock and kicking off the 1970s stagflationary era.
- More recently, the near decade long battle between Russia and Ukraine has erupted once again, with Russia's invasion of its neighbour bringing a humanitarian crisis and raising stagflationary risks for the global economy.
- The US and Europe have now placed sanctions on the Russian central bank and seek to limit targeted Russian banks from accessing the SWIFT consortium. The potential is growing for the vast majority of Russia's trade with the world to eventually be restricted, leaving Russia potentially in the company of North Korea, Venezuela and Iran looking forward.
- While Venezuela and Iran are, like Russia, major energy producers, they pale in comparison to the over 6-7m bpd in Russian oil and gas exports. Moreover, with Russia dominating the global trade in major grains and industrial metals, sanctions on Russia have the potential to create a more wide-ranging commodity supply shock than seen in 1973.
- Should these sanctions be implemented, Western policymakers will be faced with a stark choice – pursue similar monetary policies as seen in the 1970s which resulted in deep recessions throughout the decade or accommodate the inflation in order to preserve growth.
- While ghosts of the 1970s cast a shadow on markets, a focus on proactive risk management can complement high quality earnings streams in both credit and equity to help investors weather more frequent and extended volatility spikes than seen in the past decade.

Global Investment Committee

UNION BANCAIRE PRIVÉE

Russia-Ukraine: A Global Inflation Threat

The long running regional conflict between Russia and Ukraine, which last erupted in 2014 when Russia seized control of Crimea and backed separatists in Eastern Ukraine, now threatens to create far-reaching commodity shocks for the global economy as Western powers implement sanctions and seek to cut off Russia's central bank and its wider economy from the rest of the world.

Nearly 50 years ago, another smouldering regional conflict reignited, bringing an energy shock to major Western economies as the Fourth Arab-Israeli War resulted in the OPEC crude oil embargo to Western economies in 1973.

Then, like now, the US economy was emerging from a deep recession while US headline inflation was accelerating, reaching nearly 6% in the summer of 1973.

This cyclical resurgence in inflation would soon see an exogenous shock to prices as in October,1973, the Organization of Petroleum Exporting Countries (OPEC) deployed the power of its global oil oligopoly by cutting off exports to the United States and other nations. It did this in retaliation for US support for Israel and unwillingness to pressure Israel to withdraw from lands seized during the war.

As the effects of the OPEC embargo moved through the global economy, crude oil prices nearly tripled to over US$10/bbl, pushing inflation to almost 12% by mid-1974.

Similarly, in 2022, the global economy has been experiencing not just cyclical inflation pressure following pandemic-related reopenings over the past year but also supply-induced pressures following underinvestment in global supply chains since the March, 2020 onset of the global pandemic.

In 2022, the supply shock parallel is emerging in light of the move by Western Europe and the United States rapidly to levy extensive sanctions on Russia, including on its central bank and limiting its access to the SWIFT consortium, which facilitates the vast majority of global trade.

Iran's experience over the past decade provides an illustration of the impact of instituting such wide-ranging sanctions and removing a nation from the SWIFT system on its ability to trade.

In February, 2011, the then US President Barack Obama ordered the freezing of all US assets of the Iranian government, central bank and financial institutions. By March, 2012, the Belgium-based SWIFT consortium complied with European Union sanctions on Iran.

This resulted in Iranian oil exports falling from 2.5m barrels per day to 1m barrels per day. The economic pressure helped spur the negotiations that culminated in the 2015 nuclear agreement which lifted sanctions and restored SWIFT access, allowing Iranian oil exports to resume at 2-2.5m barrels per day.

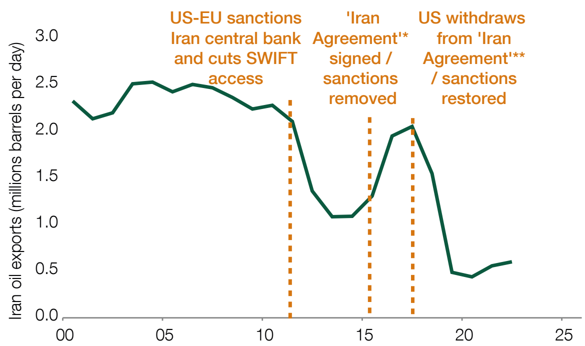
As the US, withdrew from the agreement once again and sanctions were reinstated in 2018, Iranian oil exports slumped once more, this time to <0.5m barrels per day where they sit today, highlighting the speed and impact such sanctions can have once applied.

Though sanctions have not (yet) been applied as broadly as they were in 2011-12 against Iran, with Russian energy exports (~40% of total exports in 2021) still technically outside the scope of sanctions, the impact that anticipation of potential sanctions is having on energy markets as well as on grains and key industrial metals (given Russia's importance as a global supplier in these areas) has been substantial.

Beginning amidst the rising tensions in late-2021 and then further spurred by the broad Russian military offensive launched against Ukraine in February, global crude oil prices have risen by as much as 50% year-to-date with a 20% rise in global agricultural prices and a 15% rise in industrial metals prices over the same period.

Like in 1973, should sanctions harden and be implemented for a prolonged period, as seen in Iran, North Korea, or Venezuela, such an event would pose a significant stagflationary threat to the global economy.

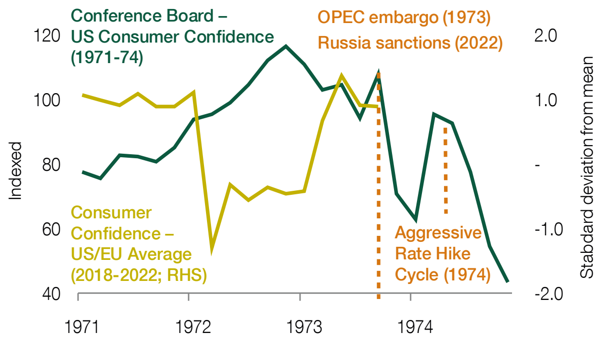
Wide-ranging sanctions proved highly effective at limiting Iranian oil exports since 2011



Sources: Federal Reserve Bank of St. Louis, SWIFT, and UBP

* Iran agreement between the Iran and the US, China, Russia, UK, Germany, France lifts sanctions on Iran including SWIFT ** SWIFT suspends access to Iranian banks following US threats to sanction SWIFT should it not comply with US sanctions

Consumer confidence in the US and Europe had already been waning ahead of supply shocks, just like in 1973



Sources: Conference Board, European Commission, Bloomberg Finance L.P., UBP

Fallout from the 1973 Supply Shock and lessons for 2022

Unsurprisingly, the near fourfold surge in crude oil prices as a result of the embargo, helped trigger a recession in late-1973 which lasted until 1975 in the US economy.

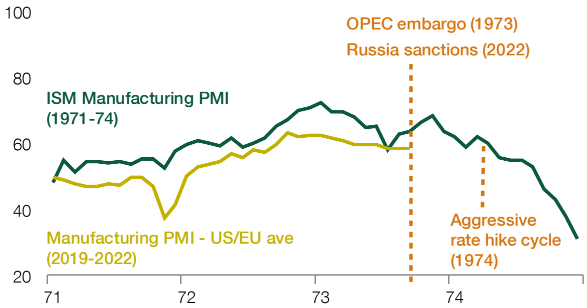
The US consumer was the first to capitulate, with consumer confidence falling almost immediately after the spike in energy costs. Indeed, with the Fed having started their tightening of policy in 1972, consumer confidence had already begun falling from its lofty level in late-1972, only to see it fall sharply again once the embargo was imposed.

Just as in 1973, in 2022, US and European consumer confidence has been waning, driven by rising inflation following the post-pandemic reopening in 2021 leaving households on both continents and around the world exposed to the over 20% rise in crude oil prices since early February.

The 1973 impact on corporate sentiment to the surge in input prices was comparatively slow, as measured by the Institute of Supply Management's Purchasing Managers' Survey. Indeed, the ISM survey remained above the 50 level that typically signals economic contraction until March 1974.

Perhaps uncoincidentally, February, 1974 was also the end of a relatively stable Fed Funds rate going back to June, 1973. In March, 1974, Fed policy tightening raised the Fed Funds rate by 560 bps in four months, bringing about a collapse in US corporate confidence and driving the Purchasing Managers' Survey to its 2nd lowest reading (only outdone by the 1979 oil crisis and the subsequent recession) in the history of the series.

US corporate confidence was more sensitive to Fed policy than to surging oil prices in 1973-74



Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP

The role of monetary policy in the 1970s stagflation

So, investors should not underestimate the importance of policy responses to the 1973 energy embargo as contributors to economic stagnation and the depth of the recession that followed.

Encouragingly, in 2021-22, winter gas shortages in Europe have provided a test bed for the EU fiscal response to high energy prices, highlighting a fiscal appetite to at least cushion the impact of the extra costs faced by European consumers.

In the US, in recent weeks, legislation has been introduced to suspend the US Federal Gasoline Tax (currently appx 5% of average US gasoline prices) signalling a similar fiscal willingness to at least partially cushion the impact on consumption and activity looking ahead, especially with 2022 mid-term elections coming up in November.

This is consistent with the fiscal policy pivot from tight in the early-1970s (with non-defence US government spending contracting from 1971-1973) to loose in 1974 (with non-defence government spending growing by as much as 3% year-on-year in 1974) to try to provide support as consumer and business confidence came under pressure.

Unfortunately, just as fiscal policy was loosening in 1974, Fed policy was tightening dramatically in response to the growing inflationary pressure. Indeed, with a Fed tightening cycle already underway prior to the OPEC embargo, Fed policy tightening accelerated in response, with the US Fed Funds rate seeing its dramatic 560 bps rise by mid-1974 to 14% as the inflationary impact of the embargo took hold.

Consequently, there are challenges ahead for the Fed and other central banks around the world. They need to strike a delicate balance between combating the growing wage pressures and the rapidly rising housing prices in their economies and the potential that the global commodity supply shock that is taking shape results in a 1973-style contraction in confidence. This could, in turn, spur a recession while interest rates remain near the zero bound and balance sheets stay bloated with bond purchases from the global pandemic response.

Complicating the policy outlook for the Fed and the European Central Bank is the fact that their respective pivots to more hawkish language in late-2021 and early-2022 tightened financial conditions back to outright tight.

Over the past decade, US financial conditions near current levels of tightness have spurred a pause or even outright reversal in the Fed tightening agenda rather than the tightening that looks likely to begin in March.

US financial conditions near current tightness triggered a pause in tightening rather than rate hikes

Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP

Beyond this, wide-ranging sanctions on Russia may not only trigger additional supply shocks but also potentially shocks to global liquidity as Russian trade surpluses would no longer be recycled.

Against this backdrop, while the Fed undoubtedly will seek to withdraw excess liquidity to combat cyclical inflationary pressure, it will also need to avoid a rapid withdrawal, as pursued in 1973-74. Getting this balance wrong might not only push the economy into recession but, just as importantly, risk a painful credit cycle in light of elevated debt burdens around the world which could threaten system stability.

In the light of these factors, investors should expect Fed policy to react rapidly to meaningful deterioration in its three policy objectives – inflation, full employment and financial system stability – creating a new, higher volatility backdrop than seen since the Global Financial Crisis.

Investing amidst a global supply shock

For investors, the uncertainty brought about by rising price pressures aggravated by the Russian invasion of Ukraine as well as the uncertain policy path and sanctions trajectory ahead continues to suggest that proactive risk management strategies should remain valuable looking ahead. This is especially true as the Fed begins its tightening cycle and Western sanctions against Russia continue to be deployed in the weeks ahead.

With the threats to growth growing and the prospect of more prolonged and potentially higher headline inflation looking ahead if sanctions remain in place for an extended period, credit spreads have understandably widened even as government bond yields in Europe and the US have retreated from the early-2022 peaks.

However, even with this, global bond investors are left facing similar, though more acute challenges as they encountered at year-end, with elevated inflation resulting in negative 'real' yields across the fixed income risk spectrum.

As a result, we continue to believe that our focus on fixed income-alternative, hedge fund strategies offers an opportunity against a backdrop of rising yields and widening spreads that may lie ahead.

Complementing this, looking to private markets in search of illiquidity premium in private debt and infrastructure should help to mitigate a period of persistent and elevated inflation.

More tactically, active shifts in Fed policy as seen in the 1970s, should create a high and rising volatility scenario which should create tactical opportunities for investors to generate income/return.

In equities, the prospect of a more sustained, elevated inflation environment should keep pressure on PE multiples.

However, should the pattern in corporate earnings in place since 1990 remain intact, investors can focus on high quality, higher visibility, growing earnings streams in an attempt to mitigate potential PE compression that might emerge.

More optimistically, recall the rising inflation of the 1970s translated into a long-term acceleration in earnings growth over the decade, as high inflation supported earnings despite poor real economic growth over the period.

So, a tactical focus on inflation-beneficiaries can complement the strategic, high visibility, quality-focus outlined previously.

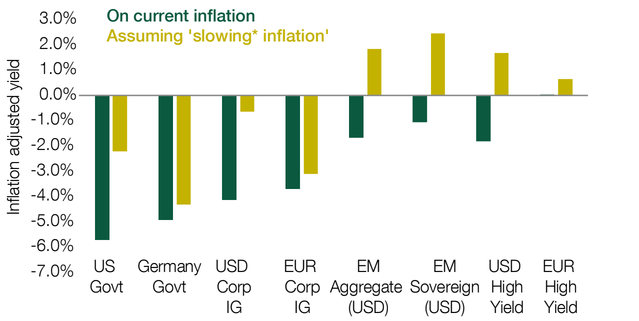
Moreover, though many investors recall that the S&P 500 delivered 1.4% CAGR returns excluding dividends from 1969-1979, few remember the two rallies of 60-70% that coincided with Fed policy easing during the decade.

Therefore, with our expectation that Fed policy shifts may be active, as seen in the 1970s, any signs of a pivot in Fed policy which reverses its inflation fighting focus and instead trains its sights on spurring growth could create meaningful cyclical opportunities for investors as was the case in 1970-1971 and 1974-1977.

While ghosts of the 1970s may cast a shadow on markets, a focus on proactive risk management can complement high-quality earnings streams in both credit and equity to help investors weather more frequent and extended volatility spikes than seen in the past decade.

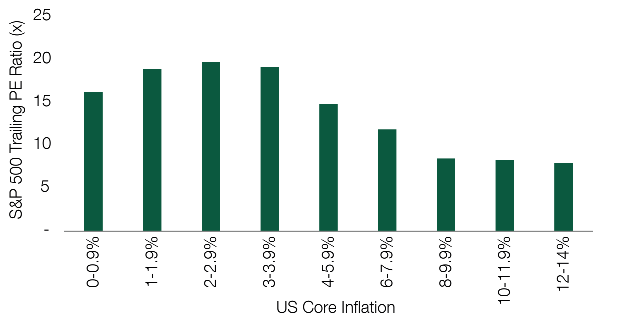
Moreover, positioning around evolving fiscal and monetary policy dynamics should provide tactical opportunities to exploit the prospect of an overall, more modest investment return profile ahead.

Even if inflation slows, fixed income investors need alternatives to generate positive inflation-adjusted yields



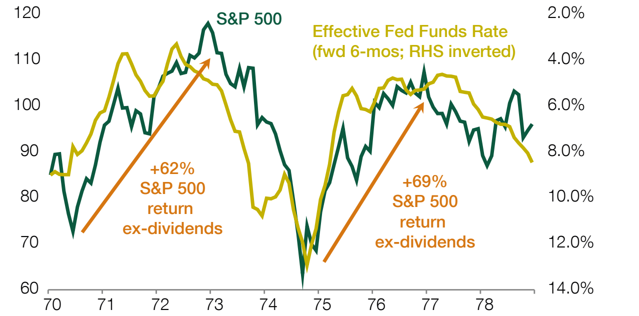
Sources: US Bureau of Labor Statistics, Bloomberg Financial L.P. and UBP
* Awwssuming inflation falls to the level of 2-year USD and Germany inflation swaps

Long-cycle rises in inflation have coincided with lower PE ratios in the S&P 500



Sources: Standard & Poor's; Bloomberg Finance L.P. and UBP

Pivots in Fed policy during the 1970s preceded sharp rallies and sharp declines in the S&P 500



Sources: Standard & Poor's; Bloomberg Finance L.P. and UBP

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