WAR

Three months ago, when I was writing my previous letter to shareholders, I had absolutely no idea that I would be writing today's letter in a situation when war is raging near our borders. Yes, in retrospect, we can say that many things pointed to that. Nevertheless, until the last moment, we refused to believe that anyone would commit to something so barbaric as a full-scale military invasion of another country. Not in Europe, in the 21st century, and essentially without any justification and completely arbitrarily.

War is a very emotional matter, and I can say that sometimes we have no appetite even to think about stocks against its backdrop. But this is our profession and so we have to do so. I openly admit that this is the first time we have been in such a situation. Over the past 30 years of my investment career, there have been multiple wars in various regions as well as several major terrorist attacks and there are lessons for investing that can be drawn from them. Each of these events was nevertheless quite specific, and historical parallels of further developments may therefore not be very relevant. In the following text, I want to describe our thoughts as to the impacts of the war in Ukraine on areas that are important to our investing. All of these considerations are based upon, among other things, two basic assumptions: first that the war in Ukraine will last for quite a long time, and second that it will remain a regional conflict.

Impact of the Russian (and Ukrainian) economy's collapse on the global economy

If Putin has succeeded in anything, it is to completely dismantle a functioning domestic economy virtually overnight. We probably never have seen anything like this before, and we may never see it again. Russia has suffered – and will continue to suffer – from a sharp decline in GDP, high inflation, a plummeting currency, collapse of foreign trade, a semi-dysfunctional banking system, absence of foreign investments, as well as curbs on vital commodity exports and equally vital technology imports. Fortunately, the Russian economy is not very large. It is roughly the same size as economies of the three Benelux countries and accounts only for about 1.3% of the world economy. Even if we add in the Ukrainian economy, which unfortunately also is facing a huge downswing in GDP, we still are looking at less than 2% of the world economy.

So, the direct impact on the global economy might not appear large at first glance. Unfortunately, this is complicated by Russia's out-sized importance in commodity markets, and especially for oil. Even before the war, the oil market was already quite tight due to a combination of long-term growing demand and several years of low investment on the supply side. The spare capacity of producers is absolutely minimal, and so a shortfall in the supply of Russian oil to the market, whether due to sanctions or logistical problems, would plunge the oil market into a more significant deficit and prices could easily surpass not only the 2008 high of USD 145 per barrel but might just as easily reach the inflation-adjusted equivalent of around USD 200 per barrel. One would therefore naturally expect the war to have a global stagflationary effect. It will push inflation up and economic growth down. After all, we can already see this in our everyday lives.

Oil is not the only commodity that will have this effect. Other commodities in which Russia is important will do the same to a greater or lesser extent. Wheat, nickel, fertilisers, platinum, palladium, enriched uranium, coal, aluminium, and above all gas. Because of gas's high price, we can also expect a significant increase in food prices, particularly because of the high price of fertilisers, for which gas is a key feedstock. It is also worth noting that both Ukraine and Russia are large producers and exporters of wheat. Our memories flash back to the Arab Spring of a decade ago. One of the triggers to those events at that time was rapidly rising prices of basic foodstuffs.

Indirect impact on financial institutions and markets

A certain unknown is the exposure of financial institutions, banks, insurance companies, leasing companies, investment funds, and corporations to Russia. At the end of last year, foreign investors held USD 62 billion of Russian sovereign debt, USD 86 billion of stocks, and total foreign debt of Russian entities of USD 381 billion. Foreign banks (led by European banks) have direct Russian exposure alone of USD 90 billion and a much larger indirect exposure. Many of these assets are now in a major price slump, completely illiquid, or in default. Russian banks are under heavy sanctions and their ability to collect their debts and pay their obligations is very limited. Therefore, it cannot be excluded that the markets may experience shock waves caused by liquidity problems. Large movements in commodity prices also put pressure on investors and the traders who transact in these materials. The events surrounding nickel trading on the London Metal Exchange are proof of this.

Further long-term impact

If Putin has succeeded in anything else, it is to unite most of the Western world against him personally and cause it to reconsider some of its previous positions. A number of long-term changes affecting investment can be expected, and some of these can be seen already. This is very well demonstrated, for example, by the attitude of Germany. Until recently, it has embodied relatively pacifist attitudes. Facing the new reality, however, it made a 180-degree turn when Chancellor Scholz announced that Germany will boost its military spending to 2% of GDP and, in addition, it will invest EUR 100 billion in defence at the very beginning to make up for what had been missed. We expect to see similar changes in other NATO members, and particularly in Europe. Many European firms (and not just defense companies) will benefit from this.

Germany has also announced that it is accelerating the construction of liquid gas import terminals in order to gradually switch to suppliers other than Russia. The entire EU energy policy is likely to be reassessed. An immediate positive impact is likely to be seen in the fossil fuel sector, which Europe simply cannot do without. In the long term, we expect a positive effect on nuclear power. We have been predicting its major renaissance in Europe for some time now.

All these steps have one thing in common: more government spending. Thus, we can expect another wave of large government budget deficits, especially in Europe. Politicians have noted well that they got away rather easily with gigantic budget deficits from the 2 years of the Covid-19 pandemic. Now they have another argument for continuing these.

Some of the debts are likely to be financed with newly printed money, and their costs will benefit from record-low negative real interest rates. Large budget deficits will again have a strong inflationary effect, but they also will simultaneously push up corporate profits. Record government deficits may well manifest themselves on the flipside of the same coin as record corporate profits.

How safe are foreign exchange reserves?

I would like to mention one other thing that seems to me very important, although I cannot yet guess where it will lead. Most countries maintain foreign exchange reserves. These are deposits of foreign currencies held by the central bank and by financial institutions. They serve as a reserve to finance imports, to support the domestic currency, as a liquidity cushion in the event of crisis, and also to support investor confidence. Most of the foreign exchange reserves are held in the world's major currencies, which of course means first and foremost US dollars.

When Russia's foreign exchange reserves were frozen as part of the sanctions against it, many countries certainly realised that the ownership and disposition rights of their foreign exchange reserves were no longer sacrosanct. What might this mean for the future? I don't know. Perhaps there will be a rethinking of foreign exchange reserve policy, change in the allocation of reserves, greater emphasis on gold or other commodities, poorer access to debt markets for countries that issue the world's major currencies? I'm curious about that myself. In any case, a Rubicon has been crossed here. I nevertheless do not think that this is something that will have a bigger immediate impact on our investing.

Impact on stock markets

As stock investors, we are of course most interested in the impact of the war on global stock markets. If we look back in history as far as to 1941, when Pearl Harbor was attacked, we can see that the impact of wars and terrorist attacks on stock markets tends to be relatively mild. There have been more than 20 wars and major terrorist attacks since that time. The first reaction of the markets is always negative. This is logical, because emotions dominate in the beginning. However, stock price declines are surprisingly small and also relatively short-lived. In the case of the S&P 500, the average decline has been in single-digit percentages and the time it has taken for the markets to return to previous levels has on average been less than 2 months. The small declines and short recovery times probably relate to the fact that after rational, unemotional reflection, investors have mostly concluded that the impact on the operations and profitability of companies is in general rather minor. In many cases this may be very negative, in many cases positive, but on the whole rather small. Because war and terrorist events usually trigger national response in forms of budgetary and monetary stimuli, investors are quick to reflect this positively into stock prices.

This is what a look into history tells us. We would add two caveats: First, these are figures relating to the US stock index. America has always stood quite a distance from the places wars are waged. Markets that are closer to the conflict tend to react more strongly. And this was the case also now. European stocks fell much more than did American stocks. Second, every conflict is specific in its own way, and the war in Ukraine stands out from previous ones precisely due to the magnitude of its indirect impact on the global economy through high commodity prices. It is also worth noting that we actually are never able to pinpoint exactly why markets rise or fall. Therefore, isolating the impact of a factor such as war is not really possible.

So what to do now? Changes in the portfolio.

This question is probably being asked by every investor. Our approach was based upon two points of departure. First, we recognise that our ability to predict future developments is poor. Second, the default preferred response is to do nothing. Better said, no rash actions. Doing nothing is often the best but also most difficult strategy. We thought it important to think long term, well beyond the horizon of current events, and to remind ourselves of our long-term investment objective. Nothing changes about the goal itself and, in fact, the path leading to it does not change either. We are also well aware that neither abnormally good nor abnormally bad investment environments last forever, and that it is the bad one that usually brings good investment opportunities along with it.

We have analysed very carefully the impact of the war and other possible developments on the individual companies in our portfolio. The result, at least so far, seems to be that for most companies the impacts on their businesses and profitability are small. Sometimes negative, sometimes positive, but small enough such that there is no need significantly to reassess our investment thesis. The one exception consists in the shares of Sberbank.

We have owned Sberbank for a number of years and have made no secret of the fact that we considered it a very well run bank, with good corporate governance, very friendly to shareholders, and extremely profitable. Nonetheless, when Sberbank (through no fault of its own) found itself in a situation that will damage it and even make it impossible for foreign investors to own and trade the shares, we decided to take a profit and sold the shares.

We then used the money freed up to, among other things, open three new positions. The stock price declines during the Russian invasion brought a lot of good prices to the market. Out of all the possibilities we considered, we picked the stocks of Asbury Automotive Group (ABG), Celanese (CE), and KLA Corporation (KLAC).

Asbury Automotive Group is one of the largest car dealership chains in the United States. Its revenues and profits come from new car sales, used car sales, service and parts, and financing and insurance brokerage. This industry is relatively well known to us due to our earlier investment in Autonation (AN). This time, we decided to enter it through ABG. ABG has long been growing very rapidly through a combination of organic growth and acquisitions. It has a very good and efficient asset allocation policy and a lot of room ahead to continue growing due to the great fragmentation of the whole sector. The long-term development puts small sellers at a disadvantage and the whole sector is heading towards further gradual consolidation. We expect ABG to play an important role in this and for its shareholders to benefit accordingly.

Celanese is the world's largest producer of acetic acid and its chemical derivatives, including vinyl acetate monomers and emulsions. Their applications are used in a wide range of industries, such as automotive, tobacco, coatings, construction, energy, telecommunications, food, and medical. Celanese recently closed the acquisition of a large part of DuPont's business, which will make Celanese an even bigger player in the industry while reducing the cyclicality of its business. The acquisition is quite large and should deliver significant value to shareholders that in our view is not at all presently reflected in the share price. Celanese is a business that stands more or less aside from the main interests of most investors, but it is a company with very high returns on capital, strong free cash flow, and historically very efficient resource allocation.

KLA Corporation develops leading-edge equipment and services that enable innovation throughout the electronics industry. It specialises in process management and control in semiconductor manufacturing and the related nanoelectronics industries. During manufacturing processes, products must be inspected for defects and correct critical dimensions in order to identify and eliminate possible sources of problems. As customers continue to enforce Moore's Law, smaller chips must meet more precise specifications, which in turn increases the need for advanced inspection and diagnostic tools. This is a key step within the entire manufacturing process and one in which the company has built a very strong, and in places dominant, global position. We have been watching and waiting for an opportunity to acquire this stock for some time already, and this year's drop in its price finally prompted us to buy.

No one knows how or when the war will end. I firmly believe that Ukraine will eventually prevail and that perhaps it will not take long. While Russia is likely to face continuous tough sanctions and remain politically isolated afterwards, Ukraine is likely to receive a great deal of support from abroad and a welcoming attitude from various political and social organisations. Its recovery will hopefully proceed rapidly and its future could be hopeful, not least thanks to a promise of EU membership. Paradoxically, therefore, it could be stronger in the long term after the war even as Russia will remain weakened in the long term. If that's where Russians want to go, well, that's their business, one might be inclined to say, but no one can bring back the lost lives and broken destinies of the Ukrainians.

If the war ends anytime soon, investors will once again turn their attention to the economic environment that continues to await us. Not much has changed. We continue to expect above-average inflation and significantly negative real interest rates over the long term. High inflation is usually not good for stock prices, mainly because it is accompanied by high interest rates. High interest rates press downwards like gravity on stock valuations. The question is what a historically unprecedented period of high inflation that is this time accompanied by low interest rates will do to share prices. It is in just such a period that we find ourselves today and that we expect to continue into the future. High inflation in itself tends to push up all the numbers in companies' financial reports, be they revenues, costs, profits, assets, capital costs, or what have you. This is not evenly distributed everywhere, but the general direction is upward. And that includes corporate profits. If interest rates remain well below the rate of inflation, however, even their gravitational strength will remain weak and will not push stock valuations down much. Paradoxically, therefore, this environment can be very favourable for share price developments as expressed in nominal terms. We have held this view for quite some time now and there is no need to revisit it just yet. When the price of money is falling rapidly, the value of real assets (which include stocks) as expressed in terms of the very money that is falling in value, should rise. We'll see.

Daniel Gladiš, April 2022

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