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Newsletter

SPEKTRA MAKELAARS

An Energy War Looms

2021 served as an excellent reminder to investors that those who are able to withstand the incessant slew of negative news headlines and bouts of market volatility will in due course be rewarded for their patience. Had you been invested in the average South African high equity balanced fund your portfolio would have returned over 20% for the calendar year, a return figure not seen since 2006.

January has barely passed us by and already there are indications that this year will be discernibly different from the one past. Technology shares, the darlings of 2021 which almost single-handedly took the S&P 500 index in the USA to record-high levels, retracted sharply in the month of January, with the tech-heavy NASDAQ index in the USA down by more than 10%, while the shares of Tesla and Amazon were both down over 15% apiece for the month. Cryptocurrencies too have not managed to escape the market selloff, with bitcoin currently trading below $37 000 from its November 2021 high of $67 000. In the fixed income market US bond yields are up, trading above 1.8% for the first time in two years. Likewise, US inflation has risen sharply to above 7%. The last time it broke this threshold was nearly 40 years ago in February 1982. Looking across to interest rates, investors should by now be well aware of the expected path of interest rate rises in the US, and in the last week of January we saw our own Repo rate increased from 3.75% to 4.00% by the South African Reserve Bank.

Many of these pressures facing financial markets are by no means new, and have been covered ad nauseum by economic news articles as well as by the commentators on any of the television news networks. Two factors which have received somewhat less airtime, but which nonetheless have the potential to materially affect financial markets in 2022 are the Russia-Ukraine geopolitical tensions as well as the escalation of the current European energy crisis.

The European Energy Crisis

Across the Atlantic, our European neighbours are currently facing one of the worst energy crises in modern times. Gas prices across Europe are trading at their highest levels in history on the back of a marked reduction in gas supply throughout the continent. Over the course of 2021 European natural gas prices increased in excess of 800%. There are several factors which coincided to trigger the current energy crisis plaguing the European continent, all of which have contributed to the current supply shortages.
To understand the energy predicament in the UK and Europe, it is important to appreciate the extent to which Europe relies on other countries for its natural gas, and as such is forced to import the vast majority, about 40% of which comes from Russia. As a result, European countries are price takers when it comes to natural gas, meaning they must accept the prevailing prices in the market as they lack the market share to influence the current price.

The current gas shortage was initially provoked by the European continent experiencing a particularly hot summer in 2021 followed by a particularly cold winter, thereby increasing the demand for natural gas initially for air-conditioning and cooling, and subsequently for central heating and increased electricity usage. As a result, natural gas stockpiles were already below average levels when several neighbouring countries, such as the Netherlands, announced that low seasonal wind levels had caused their wind turbines to produce inadequate levels of energy. At roughly the same time Asia substantially increased its demand for natural gas on the back of easing lockdown restrictions and a return to full economic capacity. All these factors, coupled with ongoing maintenance issues experienced at several French Nuclear Power Plants, culminated in a significant increase in Europe's demand for natural gas at both a household and industry level. When all eyes turned to Russia to come to the rescue by providing the additional gas supply that was required, Vladimir Putin, nicknamed the "Gas Godfather", was not willing to increase the supply levels. This led to a surge in gas demand across Europe, resulting in enormous and sustained wholesale price rises.

The knock-on effects of the energy crisis have been far-reaching; in the last six months alone 27 UK energy suppliers have gone bust in the wake of the supply crunch and inordinate gas prices.

This no doubt poses a material problem to domestic customers who, at any moment, could find their energy supplier no longer operational. To date all customers of bust energy suppliers have been moved to alternative providers, however the sustainability of such a process is questionable should more energy suppliers continue to close their doors. Households will not be left untouched by the crisis and have already seen their gas bills soar. Average household gas prices in the UK are expected to be around £2 000 for the current year (an eye-watering R40 000 in rand terms), marking an increase of over £700 from previous levels. Industries too are bearing the brunt, and already several large metal producers have reduced output and mothballed their plants in the wake of the high gas prices.

The Russian supply of natural gas and oil is at a point of heightened volatility and has the potential be disrupted by a much greater degree should the current geopolitical tensions unfolding on the Russia-Ukraine border escalate further…

Russia and the Ukraine

On the Russia-Ukraine border tensions have risen to their highest point in years. Russia has markedly increased its military presence on the Ukrainian border, having deployed over 100 000 troops along with 50 to 60 highly mobile battalion tactical groups.

The hostility between the two countries has been unremitting since the start of the Russo-Ukrainian War in 2014, involving Russia and pro-Russian forces, and Ukraine which has been supported by the European Union along with NATO. In response to Russia's recent increased military presence, the US Pentagon has placed 8 500 troops on standby for an Eastern European deployment and NATO has pledged to send ships and jets to bolster Ukraine's defences.

Notwithstanding the political and humanitarian consequences of a deepening conflict between Russia and Ukraine, the economic and market-related outcomes would likewise prove severe. America, along with several other European nations, has given its support to Ukraine and has threatened to impose sanctions against Russia should they continue to escalate the crisis, whereas Russia, on the other hand, has the power to restrict its outgoing supply of natural gas and oil to Europe, thereby increasing prices and further exacerbating the energy crisis.

It remains uncertain whether a military conflict will indeed break out between the two countries, however Russia has accused the United States of escalating the tensions and has threatened a "military-technical response" if NATO refuses to cease its eastward expansion. NATO Secretary General Jens Stoltenberg has said in response that "There will be a high price to pay for Russia if they once again use force against the independence of the nation, Ukraine." [1]

The Investment Perspective

From an investment point of view, geopolitical risks pose only one of many headwinds investors are faced with for the year ahead. Rising interest rates coupled with persistent inflation will be the source of much market volatility over the coming months, even if a truce is reached between Russia and the Ukraine. Likewise, uncertain energy supply and the resultant price spikes will remain a key concern, particularly across the European continent.

In times of uncertainty, it is always helpful to cut through the noise and be guided by fundamental valuations, as these, not stories, are what ultimately determine investment returns.

Sources:
[1] Chalmers, J. (2021). NATO says Russia will pay 'high price' if uses force against Ukraine. Reuters.