SV Wealth - Newsletter

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Navigating the Bermuda Triangle

Recent events in the financial markets remind us of the Bermuda Triangle, a mythical section of the Atlantic Ocean, where dozens of airplanes and ships vanished, seemingly without a trace or any sign of wreckage. Some historians suggest navigational issues were at play since the region is one of the few where true north and the magnetic north line up, leading to erratic compass readings and potentially dangerous situations.

Source: https://oceanservice.noaa.gov/facts/bermudatri.html

With inflation and the current geopolitical situation in Europe, it sure feels like we're entering the Bermuda Triangle of investing; we need to take stock of the risks ahead to avoid getting blown off-course.

Risks on the Horizon

2022 has been a rough year for the markets so far. Prior to the outbreak of conflict in Europe, rampant inflation caused by supply chain issues and labour shortages means interest rates are on the rise. Rising rates are bad news for the growth stocks that typically lead the markets. The events of Russia and Ukraine this week add a new layer of volatility for the months ahead. Aside from the obvious human tragedy, the sanctions imposed on Russia could have wide-ranging implications on our economy, some unexpected and unpredictable.

Russia & Energy

The most obvious impact of geopolitical strife centers around oil and energy. Russia is the world's third largest oil producer and supplies 40% of Germany and Italy's natural gas needs via pipelines. Europe is rather dependent on Russian energy and as a result, the sanctions levied spared oil and gas. Regardless, some European traders and banks have decided that dealing with Russian oil is not worth the headache, bidding up prices for non-Urals oil.

Oil prices were already high before Russian hostilities began, owing to curtailed production in the US due to Biden's environmental regulations. The removal of even some Russian oil from European markets is bound to push prices higher, especially in the short run. Germany has indicated that it will attempt to reduce this dependency by building new liquid natural gas terminals, but it will be years before the terminals are online.

Supply Chain Disruptions

With Europe, Canada and the US closing their airspace to Russian aircraft, Russia responded in kind. Russia is a big country and its airspace was frequently used by European carriers to get to Asia. As a result of the new restrictions, several airlines canceled flights between Europe and Asia until they can map a new route. The impact of these longer routes will be to raise the cost of air travel and air freight for shipping goods from Asia to Europe. Given that shipping costs are already at records, we can expect costs to rise even further, stoking the flames of inflation.

Another risk to the supply chain is the impact of destroyed factories and infrastructure in Ukraine on other companies relying on Ukrainian parts. For example, Volkswagen had to shut down production in Dresden, Germany since the harnesses used for their cars came from a Ukrainian supplier, who no longer had a way of getting product out of the country.

Ukraine is also the "breadbasket of Europe" on account of its large agricultural production in corn, sunflower seeds, and wheat. With Ukrainian infrastructure in peril, it will be harder to get these goods to market, which means higher food prices. Higher food prices mean inflation could become a lot more global in scope, leading to more geopolitical instability.

The Inflation Beast

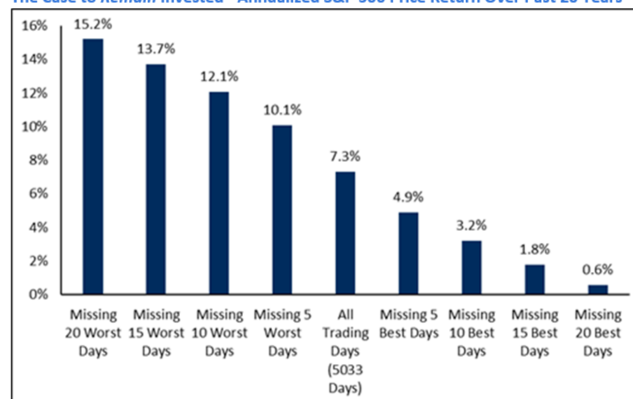
With geopolitical tensions as they are, inflation remains the beast that North American central banks need to slay. The Bank of Canada has begun raising rates on March 2 and the US Federal Reserve is expected to do the same at their meeting later this month. The question is how far interest rates will go, especially as central banks grapple with inflation today versus geopolitical uncertainty overseas. Should the geopolitical strife worsen significantly, central banks might get spooked by the uncertainty and ease off aggressive rate hikes, which could be good news for financial markets.

Points to Ponder

Despite the troubles we're seeing in the market, equities remain the best asset class in which to invest. The key will be to maintain the right balance of risk through asset allocation and diversification.

As demonstrated in a recent piece of research from Raymond James, the importance of staying invested cannot be overstated. Trying to time the market is a difficult game since missing even just a few days of performance can alter long-term results.

In anticipation of higher rates, we're reducing our exposure to rate-sensitive growth stocks and adding more dividend names that can better weather an inflationary environment.



Source: FactSet, Raymond James Ltd.

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