Market2Market

A forward view of the global economy and financial markets

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GHC Capital Markets

Oligarchs

"Both oligarch and tyrant mistrust the people, and therefore deprive them of their arms."
Aristotle

Source: Wikipedia

Since Vladimir Putin's hideous invasion of the Ukraine we have heard the term oligarch so many times that every schoolchild will no doubt now know of the word, if not exactly understanding what it means. The word certainly does not mean someone who owns a premiership football club or has lots of super yachts and lives in a mansion worth a lottery win. A simple definition of an oligarchy is 'a form of power structure in which power rests with a small number of people'.

In 2000 Putin became President of Russia and decided to take control over Russia's oligarchs who were the main shareholders of the largest and most important corporations in Russia. Putin called this "the program of national champions". He likes giving new names to his campaigns. For example, the invasion of Ukraine is a "special military operation". Putin was prepared to make billionaires of the individuals who owned controlling shares in these companies provided they towed the line and fell in with his government. Back then Putin was not so sure of himself as he is today.

When his government began to buy back the huge state industries, which had been privatized by his predecessor President Yeltsin, a small number of these individuals who had bought controlling stakes via rigged auctions became fabulously wealthy. For example, in 1995, Roman Abramovich and Boris Berezovsky purchased a controlling interest in the large Russian oil company, Sibneft for US $200 million (it is now thought that the company was actually worth $2.5 billion at that time). Then, in 2005 the government bought Sibneft back for $13 billion in agreement with these two individuals who became billionaires overnight. Their only discernable talent being that they were friends with Vladimir Putin.

The so-called Russian oligarch's became rich beyond imagination but were removed from executive power. Forbes magazine's rich list shows that the wealthiest of all is steel and mining magnate, Alexei Mordashov who was estimated to be worth $29.1 billion in 2021. Roman Abramovich comes in as the twelfth richest oligarch with a mere $14.5 billion to his name. The list of Russian billionaires is depressingly long. Equally depressing is the fact that so much of this money has found its way into western economies with London being one of the main centres for Russian investment and spending. Legal and financial advisers in the UK have happily shown these billionaires how to hide their money to avoid tax and close scrutiny.

However, all that has changed in the last month as the global community has imposed devastating sanctions not just Russia as a whole but also on individuals who have close connections to Putin. Western governments will now have to decide what they do with assets such as seized super yachts and mansions. New legislation will be needed. If theses assets are sold, what is to be done with the proceeds? One suggestion is that the funds should be given to Ukraine as reparations which will help with the rebuilding of their country. This though depends on Ukraine coming out of this war as a sovereign independent state. Ultimately though I am afraid it is highly unlikely the Russian people will ever see any of the money their own government has effectively stolen from them.

Richard Harper
Head of Asset Allocation
GHC Capital Markets Limited

Asset Allocation

In which **Tim Harris**, the Chair of our Asset Allocation Committee, describes the factors influencing our latest Asset Allocation decisions

War in Ukraine overwhelms asset markets globally

The global economy is on course for lower growth and higher inflation. Changes in economists' forecasts are waning, with analysts hoping that the negotiations between the two warring sides yield results. Things evolved similarly in the wake of the onset of COVID – denial, hope and then resignation. The scale of the geopolitical regime change is the largest since the Berlin Wall went up in August 1961. There are some significant underlying differences in how policymakers face the current crisis compared with COVID. This time governments and central banks have fewer levers to pull. Unlike during COVID when interest rates went down, policymakers will be raising rates in the coming months. Inflation fell sharply when the pandemic was raging. We now face a large increase in inflation. During COVID, governments instituted tax cuts and massively increased spending across industries. Today, governments are spending on defence budgets and supporting forced immigration, and asking the population to take hardships in their stride.

Global bond markets are struggling to get to grips with the war in Ukraine

US 10-year yields are back above 2%, with 7-year and 5-year yields also at that level. German 10-year yields rose to 0.25% from around -0.4% in December, after the ECB made a surprising shift in stance from dovish to hawkish by deciding to accelerate the tapering of bond purchases. The risk of inflation has so spooked the ECB that it is prepared to take a risk with growth. Meanwhile the Federal Reserve and Bank of England continue their strategies to incrementally raise interest rates.

Credit spreads continue to widen, although, in our view, they have yet to reflect the current geopolitical risks fully. The US high yield spread (calculated by JP Morgan) is currently 456 basis points above government yields compared with the long-term average of around 525 basis points. Emerging Market bonds are also under stress. ETF year-to-date returns from JP Morgan (-12.25%) and Invesco (-17.35%) illustrate the problem. While some countries will benefit from higher commodity prices, the overall impact of a supply shock on the global economy is a serious risk for EM, as is the strong performance of the dollar and the rise of US domestic interest rates.

Economists' growth forecasts are on their way down. Governments and central banks will have to remain flexible and tweak policies as matters evolve and as consumer sentiment remains dismally low. The latest US Michigan consumer confidence numbers came in at one of the lowest levels seen in the history of the data set. We suspect that confidence will drop further in a month, given the geopolitical backdrop, a likely further sharp increase in inflation and the announcement of a Fed funds rate increase.

Sentiment in equity markets is at an extreme low, technically speaking

Markets are oversold, so conditions are suitable for a sharp recovery. However, note that the recent 'recoveries' in the S&P500 have been no more than 5-6% over a week. At the same time, realised volatility (risk) is up 43% year on year. In simple terms, we don't believe the trading opportunity in equities looks sufficient for the risk one is likely to take.

It is worth reflecting on how much the global geopolitical scene has changed in these past weeks and their consequences for markets. We would highlight the following:

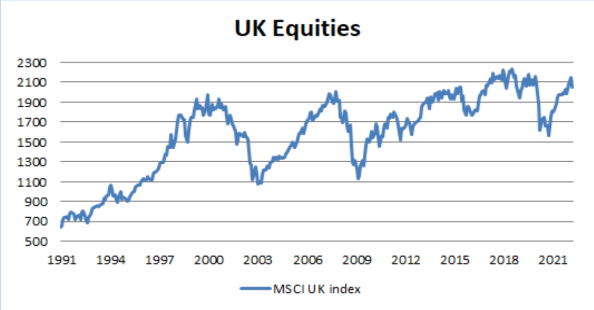
1) This is the end to the post-cold war expansion of markets into nearly every corner of the world. The Ukraine crisis is pitting major blocs against each other once again.
2) The globally integrated financial system has been weaponised. It is now implausible to return to what it was earlier.
3) There will be a price to pay – a potential decline in living standards.
4) Sanctions were previously the domain of governments. Now companies reinforce those sanctions by avoiding associated reputational risks.
5) Heightened geopolitical risk is here to stay. The commitment of many European and some Asian countries to increase defence spending naturally raises the risks between nations.
6) Broken product supply lines and conflict will lead to governments targeting heightened levels of strategic reserves of key energy and food needs.

Technology will be retained in trading blocs and is less likely to be shared. China had already been frozen out of specific technology by the US trade embargoes. Russia now finds itself completely blocked from accessing US technology.

We are backing better value developed market equities and commodity plays

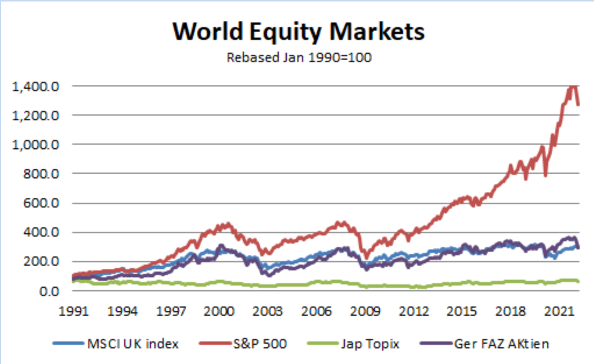
We are minimising emerging market exposure and shortening durations in fixed income and are overweight value relative to growth within equities. Later on, if the situation in Ukraine stabilizes, then cheaper international equities could outperform their US counterparts. However, central banks will be cautious in tightening because of heightened uncertainty. Investors would do well to follow their lead, maintaining very broadly diversified positions in what Fed Chairman Powell has aptly described as "an extraordinarily challenging and uncertain moment."

Markets at a glance



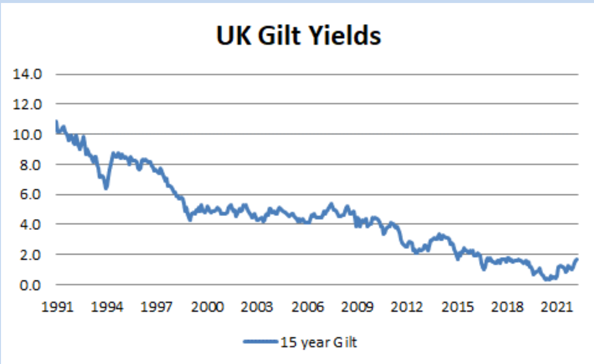
Source: Lipper for Investment Management

The UK equity market started the year well with international investors attracted by its relatively modest valuation and the resilience of leading international companies after a period of post Brexit doldrums. However, implications of war on the eastern edge of Europe including inflation, supply chain disruptions and heightened security risks, have curtailed much of the early year buying. Despite a strong earnings and cashflow recovery from the lows of the COVID crisis, rising inflation pressure implies more tightening of monetary policy this year. We are in a phase of rising domestic interest rates. Nonetheless, we still expect the UK to play catch up to other developed markets.



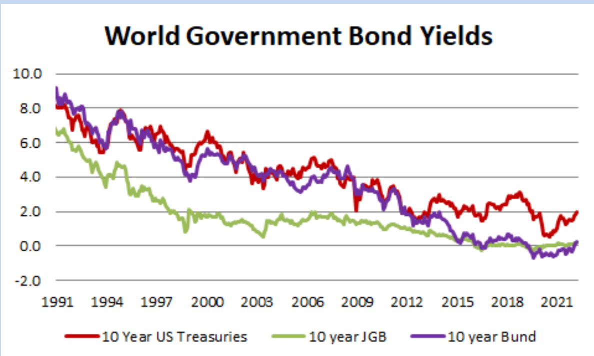
Source: Lipper for Investment Management

The Russian invasion of Ukraine has turned many hopes of ongoing economic recovery across world equity markets on their head. There were already signs of higher inflation across the world – the war adds to commodity prices and supply chain disruptions. In the US, we see robust earnings growth, labour market recovery, consumers remaining flush with cash and the inventory cycle accelerating off historic lows. However, risk appetite has waned in the short term. Central bank policy accommodation in Europe is being moderated in light of inflation risks. Japanese markets may have to encounter inflation for the first time in a generation. EM stocks will have to overcome to logistical disruptions and price pressures, which combine with reduced investor risk appetite.



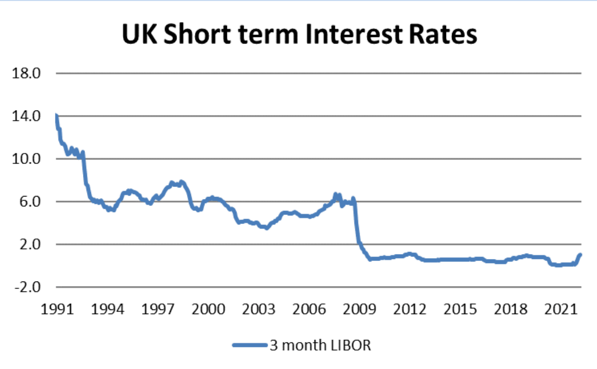
Source: Lipper for Investment Management

Gilt yields have continued to rise at both the short and long end of the curve – the 10-year gilt has risen by 40 basis points over the last two months and currently yields 1.63% to redemption. Despite investors rotating to lower risk government securities in light of geopolitical risks, inflation concerns reflect shortages of materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. Real gilt yields are very negative, given headline and core inflation. Policymakers have started a rate rising phase. Markets will be looking closely at the risks of policy error, given the need to balance economic recovery and housing affordability against significant inflation risk. Any spike in gilt yields could be costly for the economy.



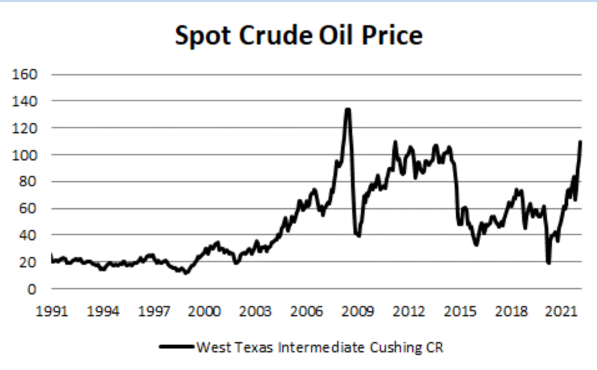
Source: Infront

The Federal Open Market Committee has started to raise repo interest rates in 25 basis point steps and has signalled six such rises this year. We expect Treasury yields to rise, with the intermediate sector (bonds with a maturity of 2-10 years) leading the way. The 10-year treasury now yields 2.15% to redemption. The economic environment may soften through the summer to take pressure off the yield curve. However, given the difference between yields and inflation, there seems to be a risk of policy error to price in. The European Central Bank has changed tack in recent weeks - asset purchase programmes are at an end and we expect a lift-off in rates later in the summer.



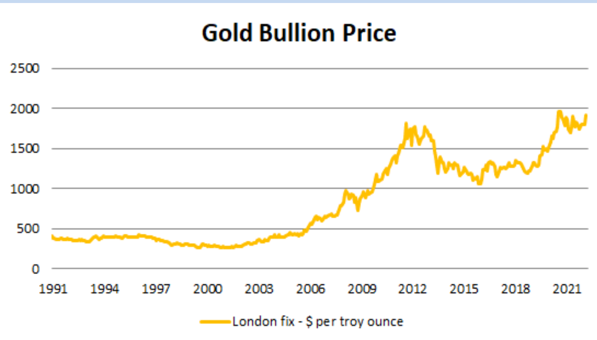
Source: Lipper for Investment Management

Economic growth momentum is expected to soften in the coming months on the back of inflation concerns and geopolitical factors. The good news is that vaccine success and booster deployment will help break the link between the virus and mobility restrictions, with a gradual adjustment on the monetary policy side as central banks focus more on labour markets and wage pressures. The Bank of England has raised interest rates to a current 75 basis points and we expect a series of 3-4 further interest rate rises through 2022 to address inflation.



Source: Lipper for Investment Management

Brent crude oil spot prices have spiked strongly before settling at a current $100/barrel from a low of $36/barrel in August 2020. The Russian invasion of Ukraine and associated sanctions by many western countries imply a tightening of supply in the medium term. The Organization of Petroleum Exporting Countries (OPEC) has not made its intentions on future production volumes clear, although there are signs that Iran might be able to return to some degree of more normal output. The last time prices were this high, US shale drillers were pumping flat out and OPEC countries and allies were locked in a battle for market share.



Source: Lipper for Investment Management

As a real asset, gold is a classic safe haven in times of geopolitical uncertainty and inflation risk. Physical demand for gold has remained strong and investors are looking to this asset for portfolio insurance at a time when risk assets are suffering. ETF buying has picked up. Central banks' gold purchases have remained strong on their view that gold is a valid asset for reserve management of inflation risk. Despite a rebound in India's gold imports, China's gold imports are weak. We expect gold demand to be driven by central bank policy and investor fears of inflation risks.

Note that where an MSCI Index has been used for illustration. This has been sourced with permission from MSCI Inc.

Quick facts

ISA Allowance 2021/2022	Stocks & Shares ISA Cash ISA Junior ISA	£20,000 £20,000 £9,000
Pension Allowance 2021/2022	The limit is the greater of £3,600 and 100% of salary, subject to the annual allowance of £40,000 (unless money has been accessed through flexi drawdown in which case the annual allowance is limited to £4,000).	

Tax facts

Income Tax	Personal Allowance 2021/2022	Up to £12,570
	Basic Rate @ 20%	£12,571 to £50,270
	Higher Rate @ 40%	£50,271 to £150,000
	Additional Rate @ 45%	Over £150,000
	Married couple's allowance:	Minimum £3,530
	Older spouse born before 6 April 1935	Maximum £9,125
		Up to 10% of the appropriate Min/Max
Capital Gains Tax	Annual Exemption - Individuals	£12,300
	Basic Rate tax band (residential property)	18%
	Basic Rate tax band (other assets)	10%
	Higher Rate tax band (residential property)	28%
	Higher Rate tax band (other assets)	20%
	Business Asset Disposal Relief	10%
	Business Asset Disposal Relief limit of gains	£1,000,000
Inheritance Tax	Threshold up to £325,000	Nil
	Over £325,000	40%
Corporation Tax	Full Rate	19%
	Small Companies Rate (SCR)	19%

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