05 May 2022

The price of freedom

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Investment strategy: The sector mix is becoming increasingly important

After the pandemic, the Ukraine war is yet another shock to the global economy – and it reinforces the factor that has the strongest grip on markets in the post pandemic phase: inflationary pressure. But the war's mechanism of action on the economy and markets is fundamentally different from the Covid crisis. In our view, investors should take this into account in their investment strategy. In the following, we compare these mechanisms and derive the consequences for investment strategy.

For the Western economy, the Ukraine war manifests itself essentially as a supply shock for energy and raw materials. Trade sanctions and a possible disruption of energy supplies from Russia, triggered either by a boycott by the West or by countermeasures by Russia, could have far-reaching consequences for companies and citizens. The nature of this shock, however, is fundamentally different from the Covid shock. The latter primarily affected consumer-related service industries such as travel, restaurants, hotels and retail. To be sure, there were also concerns at the beginning of the pandemic about how contact restrictions might affect industrial production processes. And indeed, the lockdown measures affected supply chains worldwide. But the implications for manufacturing quickly turned out to be less dramatic than the consequences for the services sector, particularly consumer-related services. Structurally, this meant that the shock was felt most strongly at the end of production chains. Consumption of certain services was massively impacted, but other sectors, such as online retailing, benefited significantly.

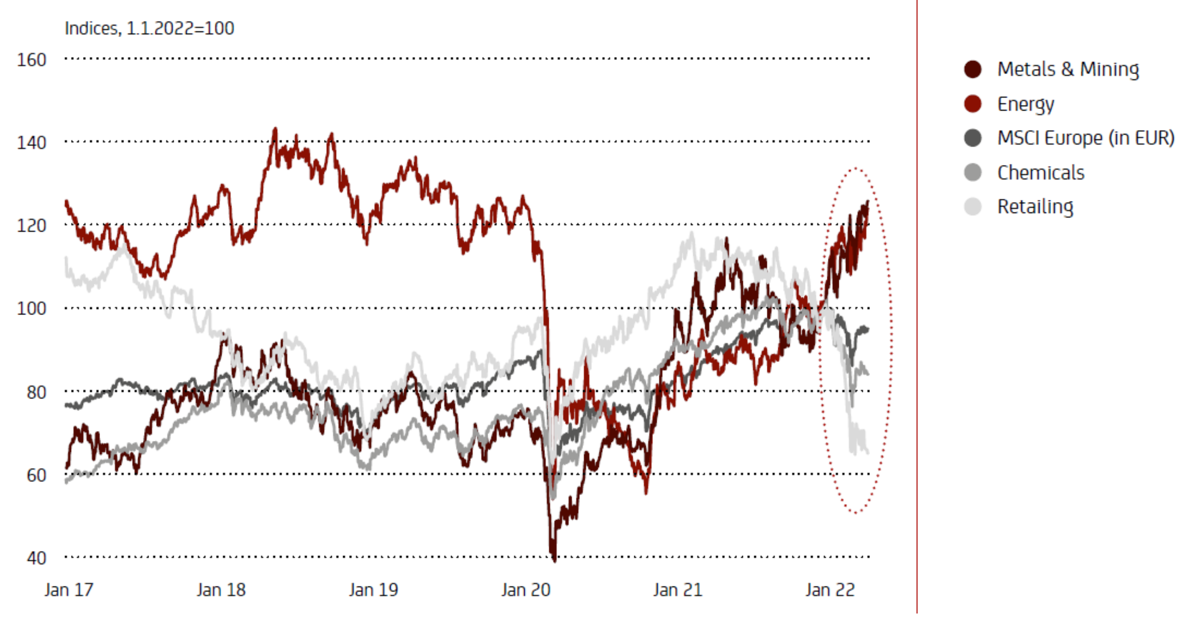
The energy shock as a result of the war differs fundamentally from this because it affects the very beginning of production processes, e.g. in the energy-intensive production of basic materials such as steel and basic chemicals. Much of the uncertainty in the markets stems from the fact that, due to the complexity and strong interconnectedness of production and supply chains, it is unclear how a potential disruption at the very beginning of a production process can affect the overall economy. If certain starting products are missing or become unaffordable for companies, industrial processes dependent on them could come to a standstill. There have even been isolated warnings of the threat of deindustrialisation of the European economy in the event of a boycott of gas supplies. No wonder investors are unsettled by such risks.

Such warnings once again highlight the vulnerability of a globally networked and integrated economy to shock events. This was already the case in the pandemic.
In the current case, however, globally networked and integrated supply chains mean not only risks but also opportunities, because necessary precursors can be procured from different suppliers. If, for example, these are unaffordable on the local market due to a gas boycott, the essential precursors could possibly be procured from another source on the international market. Such developments may pose existential risks for the local producer of these precursors but would keep downstream production processes intact.

The basic economic questions can be traced back to topics such as price elasticity and substitution. Price elasticity is measured as the change in supply or demand as a result of price changes. If price elasticity is high, an increase in the price of a product would cause the corresponding demand to fall sharply. Two examples will illustrate the consequences that can be expected from this for production processes. In both examples, we assume that a company produces a product which is a necessary input product for further processes, and that the price of this product increases sharply. In the first example, we additionally assume that he producing company faces intense competition on the international market, i.e. there are competitors who can offer the product at a competitive price. In this case, the original company's customers will go elsewhere to buy. Existential risks may arise for the company concerned, but downstream production can in principle be maintained. In the second example, we assume that the producing company has a monopoly. Its customers need the upstream product and are also willing to pay higher prices. In this case, downstream production becomes more expensive, but the process also remains intact.

This representation is highly simplified and the relationships will be much more complex in reality. But they do show which principles are at work. For investors, this means that production costs and margin stability are key factors in their investment decisions. These are not trivial issues. A look at the year-to-date performance of individual sectors in the European stock market makes this clear. Unsurprisingly, the energy and raw materials sectors are at the top of the performance table this year, while the retail sector is at the bottom (see chart 1).

1. SECTOR PERFORMANCE 2022: ENERGY, METALS & MINING AHEAD



Please note: *Past performance, simulations and forecasts are not reliable indicators of future performance. The indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. In the case of an investment in foreign currency, the return may also rise or fall as a result of currency fluctuations. Status: 25.4.2022. Source: Refinitiv Datastream, UniCredit Group Investment Strategy*

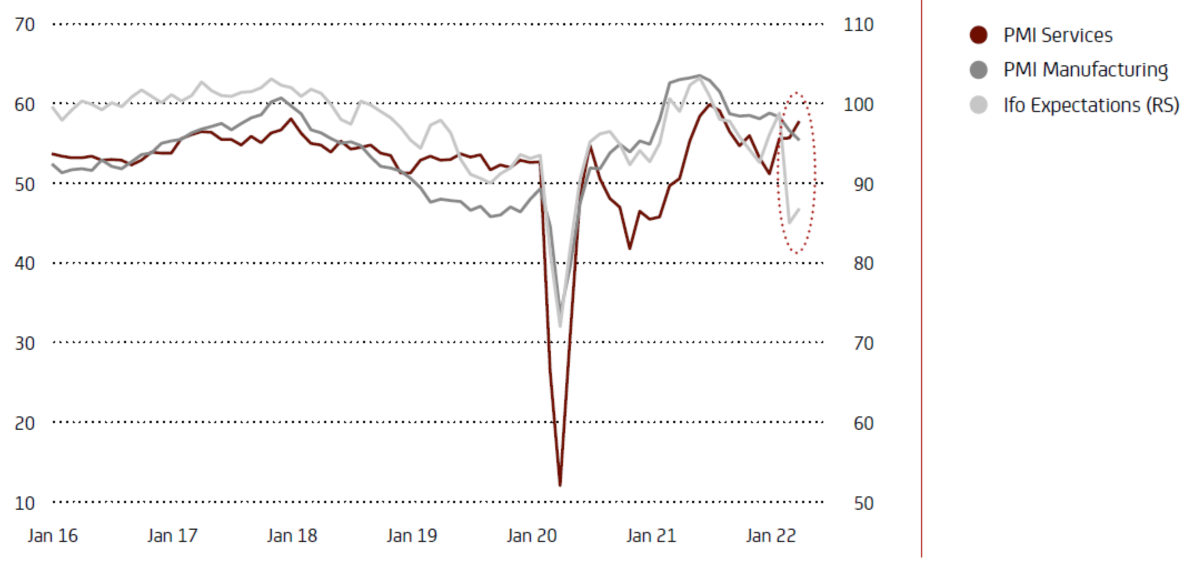
The latter is finding it difficult to pass on the full price pressure to consumers. This means that margins are being eroded. It is also interesting to note that the chemicals sector, which should actually be one of the sufferers of high energy costs, is in the middle of the pack. It has developed more or less in line with the overall market. A look at the share price performance of the sub-sectors shows why. After all, the chemical sector is multi-layered. European fertilizer manufacturers, for example, have been among the big winners this year. Their products are still in demand and trade restrictions on Russian suppliers are reducing competition. Chemical companies, on the other hand, which manufacture substitutable products, are showing substantial share price losses.

What conclusions can be drawn from this for investors? First of all, disruptions such as the pandemic, but also an energy price shock, result in winners and losers. And as the examples from the chemical sector show, the corresponding economic consequences for individual companies are not necessarily trivial. Companies in sectors with strong global competition come under greater pressure in an environment characterised by rising production costs than those whose business are less competitive. Such companies are able to keep their margins stable even in an inflationary environment because they can pass on price increases for intermediate products to their customers.

However, the latter also means that with the right selection of sectors and companies, investors can succeed in positioning themselves stably even in times of high inflation and rising yields – especially since fixed income investments are less attractive overall in view of negative real yields and substantial price losses (due to rising yields). However, investors' return expectations should take into account the current complicated macroeconomic environment and risks.

Despite all the uncertainties in times characterised by war, inflation and countermeasures by central banks, however, business sentiment in Europe is proving surprisingly robust overall. In April, for example, both the EMU-wide Composite Purchasing Managers' Index (albeit solely because of the services component) and the highly regarded German Ifo business climate surprisingly rose (see chart 2). This gives hope for a stabilisation of the markets in the current quarter – followed by a moderate upwards trend in the second half of the year.

2. RELATIVELY ROBUST BUSINESS SENTIMENT INDICATORS



Source: *Refinitiv Datastream, UniCredit Group Investment Strategy*