# INVESTMENT STRATEGY UPDATE

March 31, 2022

**A NEW COLD WAR**

When the Soviet flag was lowered on December 25th, 1991, the world entered a new era. The ideological battle between capitalism and communism was largely set aside and countries turned their attention to expanding their economies. Open borders, cheap labor, and falling transportation costs encouraged companies to invest their capital where it could get the highest return, regardless of the location. Over time, however, the political leadership of China and Russia moved away from international norms and embraced nationalistic goals. Then the COVID pandemic laid bare the risk inherent in long, complicated supply chains.

Russia's invasion of Ukraine may be the straw that breaks the camel's back. Whether this is the start of a broader conflict or just a wake-up call to the realities of today's world, governments and businesses will be rethinking supply chains, sources of raw materials, and defense spending even more urgently. Critical products cannot be held hostage by countries with incompatible political agendas. National security interests will not be subordinate to lower costs. Here, we lay out our thoughts on some of the immediate consequences of the war in Ukraine and the potential longer-term investment implications of a new cold war with Russia and China.

## Energy

Prior to the Ukraine invasion and the subsequent sanctions, Russia was the world's largest exporter of natural gas and the third largest exporter of crude oil. Europe had become dependent on Russia, which was supplying 40% of the natural gas and 24% of the crude oil to those countries. With energy costs sky-high even before the war, Europe is in danger of entering a recession this year. One of our priorities, therefore, is assessing BTR's investment exposure to the European economy. We expect their governments to make a concerted effort to reduce dependency on Russia over the long term. This endeavor will take the form of continued investment in renewable sources of energy, though the inconsistency of wind and solar led in part to Europe's high energy prices prior to the invasion. Our investment interest in this area hinges on valuation.

Liquified natural gas (LNG) from the U.S. or other reliable trading partners is also a good option. LNG can be economically transported by ship or railcar, thereby broadening the availability of natural gas beyond the range of pipelines. It does, however, require substantial investment in facilities at both the shipping and receiving end of the process. Germany has already committed to fast tracking two LNG terminals to supply it with natural gas from around the world, though this will take years to come to fruition.

Major oil companies have been shifting their strategies to recognize a world that will eventually be less reliant on fossil fuels. They have cut back investment in exploration and returned a greater portion of cash flows to investors through dividends and stock buybacks. Increased investment now in exploration is likely to be gradual. In the meantime, shareholders will continue to benefit from high oil prices. All of this argues for maintaining exposure to large integrated energy stocks. We are also interested in companies that manage large infrastructure projects, such as construction of LNG trains.

**Food Inflation**

Another critical area where the Russian economy punches above its weight is the food supply chain. Together with Ukraine, Russia is the world's largest exporter of wheat, supplying 25% of global demand. Eastern Europe is also a crucial supplier of fertilizer: Russia and Belarus account for 20% of all fertilizer exports and 40% of potash exports (the potassium-rich salt used in the majority of fertilizers). China has also historically been a major exporter of fertilizer but has recently restricted exports. Tight supplies and higher prices of fertilizer will force farmers to raise prices and/or reduce the size of their crops, which will lead to significant food inflation.

The average American family spends three times as much on food as gasoline, so the U.S. and its allies understand that a disruption in exports of fertilizer and grain (if a harvest can even be brought in) will send an additional inflationary shock through a world economy that is already grappling with rising prices. Punishing Russia through economic sanctions while maintaining reliable supplies of important commodities may be an impossible task. As such, we need to assess the impact of higher inflation in non-discretionary areas such as food and energy on discretionary spending. There is an interesting conflict between this pressure on Americans' wallets and their desire after two years living with COVID to get out and spend their savings on travel and other discretionary experiences. The impact may be felt most on higher-ticket consumer goods such as cars and electronics.

In contrast, one sector that may be in a position to benefit from rising prices would be consumer staples. The historic ability of companies in this category to pass along price increases gives them defensive characteristics, as do their generally high dividends.

**Interest Rates**

Federal Reserve Chairman Powell testified that inflationary pressures will be the most immediate economic effect of the war in Ukraine. As such, the single most important event for investors remains the Federal Reserve's shifting stance away from easy money to tightening. The war's inflationary shock will only reinforce the Fed's resolve.

Rising interest rates are a headwind for bonds so we continue to keep the average maturities of client bond portfolios relatively short for now, to minimize any decline in values. Keeping a laddered maturity schedule will allow us to reinvest maturing bonds at higher interest rates over the coming two years or so. However, this circumstance will not last forever, and the recent spike in the yield on 10-year Treasury notes has caused us to wonder how soon we may want to push out maturities. This will be an ongoing review.

**Financial Services**

In response to Russia's aggression, the U.S. and its allies took unprecedented steps to starve Russia of capital by cutting it off from the world's financial systems. By stopping bank transactions, halting all international trading in Russian stocks and bonds, and freezing the foreign reserves of Russia's central bank, the hope is to reduce Russia's financial resources to wage war and to spark political unrest as the Russian population pays an economic price for their leaders' actions. However, this "weaponization of finance" may have some unintended consequences. International holders of Russian stocks and bonds have seen the value of their holdings wiped out and businesses owed money by Russian entities will be saddled with bad debts. This sudden destruction of wealth is a shock, but because Russia's economy is only about the size of Brazil's, it's not clear whether this will be a problem for the global financial system. Nonetheless, it is a risk that, due to its unprecedented scope, is difficult to quantify.

Despite this shock, and given the Fed's focus on raising interest rates, U.S. investors should look for stocks that have tended to outperform in a rising interest rate environment. Financial companies fit this description, and we have long viewed them as clear beneficiaries of the post-COVID reopening, which should be a powerful trend. That said, BTR's focus remains on the highest-quality names that have a history of sound management and are very well capitalized.

The freezing of the Bank of Russia's foreign reserves is also unprecedented and central banks around the world will be re-evaluating how they hold their reserves. Several analysts have pointed out that in the future, only reserves held in a country's own currency or in gold will be deemed truly secure assets. This adjustment may lead to a stockpiling of gold by central banks, which is an argument in favor of maintaining exposure to gold producers. On the other hand, such investments have performed best as a hedge against the chaos unleashed by this war, rather than as a hedge against inflation, so we do not want to hold on too long.

## Defense

The largest ground war in Europe since World War II has forced both the U.S. and European governments to rethink their defense strategies and budgets. Even if Russia does not take over Ukraine, there are still several NATO countries (the Baltic states) exposed to invasion. Indeed, the nominally neutral countries of Sweden and Finland are now considering joining NATO.

This military expansion is not confined to NATO, and the desire for territorial expansion is not confined to Russia's leadership. China has been open about its ambition to bring Taiwan back into its political sphere and has been shifting its military from a defensive posture to one that can project its power through its growing navy. Consistent with that threat, Australia has announced an expansion of its plans to build a nuclear submarine base.

During the Cold War, the U.S. spent about 7% of GDP on defense, which has now fallen to 2.8%. Bolstering NATO, arming Taiwan, and revamping the navy to defend international waters will require an increase in defense spending. Even an additional 1% would mean $230 billion of new spending. Although defense stocks have jumped in response to the conflict, we believe a long-term trend has begun, so we are interested in increasing our defense exposure.

## Cybersecurity

Unfortunately, in the digitally connected world, cyberwarfare has become in some ways as dangerous to the home front as bombs and is clearly an important vehicle for countries to project their power against their adversaries. Russia and China are particularly known for their armies of hackers that are either employed by or sympathetic to the goals of their governments.

They target utilities (recall the Colonial Pipeline hack) and other critical infrastructure, pursue proprietary databases to collect information for intelligence purposes or for sale on the black market, and extort money from vulnerable local governments and businesses.

Cybersecurity has been an investment focus of ours for nearly a decade and is an ever-escalating game of attack and defense, with security companies responding to increasingly sophisticated methods of penetrating computer defenses. Sales of security software are expected to grow 10% a year through 2025. The publicly traded cybersecurity companies are a diverse group of stocks with no single leader across all areas. We therefore continue to favor a broad basket to gain exposure to all aspects of cybersecurity.

## Semiconductors

Semiconductors are the basic building block of our automated and connected world. While it has been noted that Ukraine supplies about half of the world's neon gas for semiconductor manufacturing equipment, it is our understanding that the industry had built a good stockpile of supplies and identified alternative sources, so our focus relates less to Ukraine than to Taiwan. Nearly three-quarters of the world's semiconductor manufacturing capacity is in Asia, with Taiwan alone accounting for more than one-fifth. However, only a few companies have the capacity to make the most complex chips and Taiwan has the majority of these more sophisticated plants.

This dependency had already created a rush to build or acquire plants outside of China and Taiwan. The U.S. Congress is trying to pass a $50 billion bill to support domestic expansion of chip manufacturing, while the European Union is committing $150 billion with the goal of capturing 20% of high-end manufacturing. We believe most of the value in the semiconductor industry is in the design function, so our interest remains there, but we are intrigued by the investments in manufacturing capacity being made in the U.S. and will monitor them to see if the geopolitical situation seems likely to lead to a significant increase in their value.

## Conclusion

Geopolitically, the long-term implications of Russia's invasion of Ukraine -- coming as it did with the tacit approval of China -- suggest a return to a bipolar world. The capitalist democracies are banding together against authoritarian governments. Given how many companies have reduced exposure to or abandoned Russia as a market, we must now contemplate a situation in which China was also deemed a pariah nation and its markets closed to the companies in which we do or might invest. In our view, such a development would be disruptive and inflationary in the intermediate-term, but is something to which our economy could adapt.

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