

RISK, NOT CHESS

Wars rarely cause bear markets. Nonetheless, the war in Ukraine could trigger a lengthy phase of disorder for inflation and interest rates. The times are becoming less calculable and more challenging.

“**L**a Conquête du Monde» – this was the name of a board game invented by a French filmmaker in the early years of the Cold War, later to achieve world fame under the name «Risk». Today it still enjoys a top ranking on the lists of favourite board games. Several players attempt to conquer territories on a world map by building up armies, taking strategic decisions, forming alliances, and rolling dice to take turns attacking other players. Not least, there are elements of randomness and luck that make this game unpredictable. Most often, armed factions face each other menacingly across the map for quite some time, until one party dares to risk an attack. The more players around the table, the more complex the diplomatic negotiations and the more opaque the scene.

To most of us over the last 30 years or so, the idea of seizing territory by military means has seemed more apt for a board game, and nothing more than a distant memory of a heavily armed 20th century that was believed to have been left behind. Of course there were terrible armed conflicts in Southeast Europe, Central Asia and Africa, but in

none of these cases was one of the large or small nuclear world powers either the aggressor or a direct combatant. This changed with Russia's brutal invasion of Ukraine on February 24, 2022. For the first time in decades, a nuclear power is waging an open war of aggression against a neighbouring sovereign country. In this respect, it is probably no exaggeration to call this a turning point in history that will occupy us for a long time to come.

The end of predictability

Until the fall of the Berlin Wall in 1989, the world was dominated by two great powers: the USA and USSR. The two countries maintained a balance of terror for decades without coming to open war. World politics resembled a chess game between champions – challenging, but mostly predictable. The political climate became even more predictable after the collapse of the Soviet Union, when the USA began to dominate world affairs. Conditions for companies and entrepreneurs became more stable, and open markets were able to spread globally. In many countries, this created prosperity and reduced poverty – despite all criticism of the undoubtedly serious side effects of globalisation and American dominance.

However, signs of the end of US hegemony were emerging as early as the 2007 financial crisis, according to the well-known political scientist Francis Fukuyama. In 2014, President Barack Obama stated in a speech that the USA no longer wanted to act as the world's policeman. Multipolarity



became the new buzzword in geopolitics. China and Russia, in particular, have been seeking to gain influence ever since. India, officially not a nuclear power because of its failure to sign the Nuclear Non-Proliferation Treaty, has pushed its arms build-up in recent years. Europe is politically confused but economically strong, and includes two smaller nuclear powers, France and the UK.

As with the game «Risk», things get more convoluted the more players there are at the table. Thanks to game theory, economists know that conflict situations with two participants stand a good chance of being resolved – especially when they can exchange information and (must) see each other regularly. With each additional actor, however, the complexity and the (mathematical) optimisation problem increase exponentially. A particularly vivid example from history is the way Europe stumbled into World War I in 1914 – brilliantly documented by Christopher Clark in his 2012 book «The Sleepwalkers».

example, has actually gained some ground since the outbreak of hostilities.

Central banks in a bind

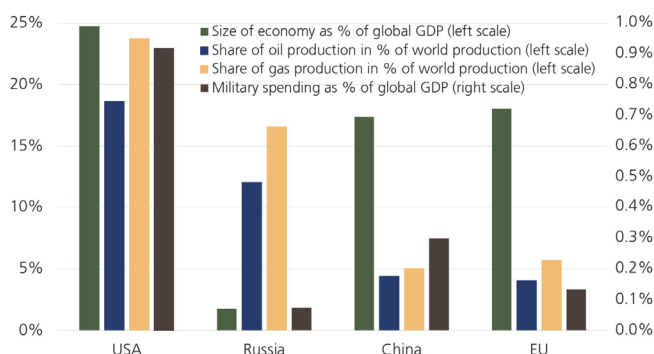
Notwithstanding all the consternation and anger about the war in Ukraine, our impression is that the financial markets have been moved more by other things since the beginning of the year, namely inflation and the potential consequences for interest rates. Since inflation reappeared not quite a year ago, hopes for easing have been dashed month by month. For example, in mid-2021 it was still generally expected that the inflation rate for 2022 would be just above 2% in the USA and around 1% in the euro zone. By the outbreak of war in Ukraine, consensus forecasts for 2022 were already over 6% (USA) and 5% (euro zone), according to Bloomberg. There was another upward surge in the first weeks of 2022, which also explains why the previous market losses were incurred before Russia's invasion of Ukraine, which was surprising at least in its scale.

Experienced investors know that wars and political conflicts generally trigger only brief setbacks on the stock markets, if any. This is also illustrated by our chart on the next page which covers the last 30 years. It is striking that even headline-grabbing and tragic events such as the wars in the Middle East or the September 11, 2001 attacks in the USA have not turned out to be inflection points towards a bear market. And a look further into the past reveals that even during the world wars, there were phases when the equity markets registered significant gains. It may sound cynical, but business cycles, monetary policy and companies have more influence on the markets than wars do.

But how then should we evaluate the situation with regard to the catchphrase «a turning point in history»? Consider first the immediate effects on the global markets, which manifest primarily as price increases on fossil fuels. These confront an economy that is still dealing with the consequences of the corona pandemic (e.g. supply chains) and historically high levels of debt. Those who until recently were hoping for a reprieve for the central banks must now acknowledge that

SIGNIFICANCE OF THE NUCLEAR POWERS

USA STILL IN THE LEAD



Source: World Bank; BP Statistical Review of World Energy 2021; Statista.

Even if it is clear that the geopolitical tectonic plates are shifting and China in particular is catching up: the USA remains – at least for the time being – in the lead, as our chart illustrates. Russia's significance, in contrast, is limited largely to fossil fuels and military nuclear power. This, along with the expectation that the conflict will remain confined to Ukraine, also explains why a major slump on the global financial markets has so far failed to materialise. The MSCI World equity index, for



ongoing price increases are likely. At the same time, the economy has become dependent on cheap money; a withdrawal will be painful. In contrast to recent years (or even decades), central banks are now hardly in a position to react to crises with another flood of cash. They are now in the predicament that they have feared for some time. It is quite possible that the war in Ukraine now becomes the trigger (not the cause!) of a lengthy period of disorder in global monetary policy, in which constantly changing and contradictory signals in inflation and interest rates create uncertainty and volatility. And a trend toward rising inflation is not good news for investors, especially those with bank deposits and bonds.

A more demanding craft

Wealth management is risk management, especially in times of great uncertainty. This includes, not least, avoiding losses that cannot be recovered. We are currently witnessing what this means in Russian and Ukrainian assets: currencies, bonds, equities, shareholdings and real estate have lost huge amounts of value literally overnight – and probably for a very long time, if not forever. Against this backdrop, questions of legal security, respect for private property and the political environment in which investments are legally and geographically located will increasingly arise in the future. Diversification is especially relevant in times of unpredictability, but it must also be implemented with particular care – optimally and mindfully, not maximally or thoughtlessly.

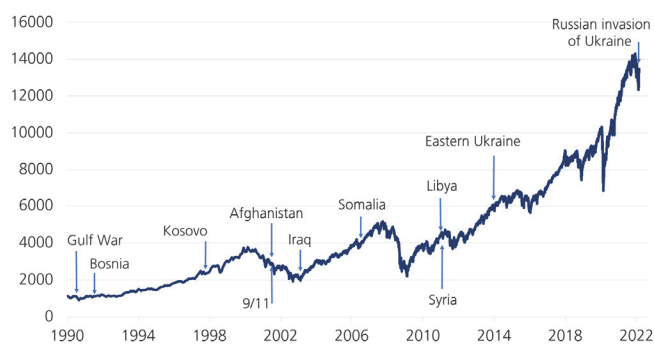
Times of crisis always contain potential opportunities. This should not inspire activism, however, especially since fear can quickly transform into greed. For example, it is at least questionable that now is truly the best time to buy into oil or defence shares. In the long run, it is often the supposedly obvious investments that bring the least satisfaction – just think of the vaccine shares that were once in such high demand. Also, in the face of war and crisis, some may be tempted to enter and exit the markets at the «right» time. Experience teaches that such «market timing» does not work. On the contrary, during a crisis the risk of making bad decisions is actually higher. For this reason, we advise against making major changes to an investment strategy at the moment.

All in all, we maintain that extreme developments, while not very probable, can still not be ruled out completely. In any case, the times are more troubled: chance, luck and potential major risks are increasing, and things are becoming less calculable. So wealth management that is simple, understandable, transparent and flexible is more important than ever. Our task is becoming more demanding – yet it remains a craft, at its best solid and unperturbed.

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IA, 31.03.2022

WARS AND THE GLOBAL EQUITY MARKET SINCE 1990

FORECASTS OFTEN MISSED



Source: Bloomberg, MSCI World. Depicts the beginning of selected wars.

On a longer-term view, we are probably approaching a time in which the world more closely resembles the game of «Risk» described earlier, with numerous uncompromising players. The war in Ukraine is a symptom and a beacon of burgeoning deglobalisation and disregard for international law that has been building for some time. In a world of many potential conflicts with a similar constellation, the most explosive is certainly that over Taiwan – it is no coincidence that China is the greatest unknown to date in the war over Ukraine. Our bank had already put it this way in the 2018 strategic plan: «Geography is becoming more relevant again – assets should be managed in such a way that substance is preserved even in the event of extreme political developments.»



VALUES ARE PRECARIOUS

Yes, we were all mistaken. That «it» would happen again. In Europe. With such brutality. So senseless, devious, cruel. I myself must confess that I was quite specifically wrong in my prediction of a very limited campaign at most. The balance of power was clearly against such an extensive war of aggression by the Russians; the arduous course of events indirectly proves me right. But what good is that?

Clearly, among Putin's admirers there are some nasty characters. But is it justifiable to forego the achievements of the Enlightenment, such as the guarantee of property rights, the right to be heard, or independent judges, for their sake?

We were also mistaken about something else: the resolve of the Ukrainians. It has turned the citizens of this hitherto marginally perceived European nation into admirable heroes. Despite the fact that their relative success makes the European security situation more precarious in the short term, not less. But suddenly it was clear to us all: this is a fight for freedom and the right to self-determination. Not only for the Ukrainians, but for all of us children of the Enlightenment. These are our values that have been so brutally attacked.

However, in that case we should live out these values without ifs, ands or buts. Certainly, we do many things right. We offer shelter to the refugee women and children from the East without too much fuss. Because they were displaced through no fault of their own and because they want eventually to go home again. And we support the Ukrainian resistance to the extent possible.

At the same time, however, boundaries are being overstepped to an alarming degree in cases

where it would not be necessary. Instead of Germany decreeing the only effective sanction – stopping natural gas and oil deliveries from and payments to Russia as quickly as possible, accepting the cost of considerable problems – Russians' foreign exchange reserves have been frozen. The last time this happened, it was done to Afghan reserves to exclude the Taliban from the international banking system. In the past, such a step would have been absolutely taboo, and this gave grounds for confidence in the international financial system and the US dollar as the world's trading currency. This amounts to well-intentioned piracy that could quickly become counterproductive, especially if it became commonplace for all sorts of things and, ultimately, for trifles.

So the knives are out for the «oligarchs». Clearly, among Putin's admirers there are some nasty characters. But is it justifiable to forego the achievements of the Enlightenment, such as the guarantee of property rights, the right to be heard, or independent judges, for their sake? Are we not then betraying precisely the values we accuse the Russian potentate of disregarding?

«Necessity knows no law» has been pronounced rather glibly since the «necessity» of the Covid pandemic, and the sensationalist media naturally enjoys every hunt for the guilty, but unfortunately also for the innocent. This cannot go on.

Let us shed our illusions: what is considered today to be the all so evil «oligarchs», could tomorrow suddenly be the rich or the Swiss or old white men.

The struggle for freedom in Eastern Europe is very important and admirable. The struggle for freedom and fundamental values in the West has yet to begin. It would be terrible to find that we were mistaken about ourselves.

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KH, 31.03.2022

