Economic Snapshot

The Potential Economic Impact of the Conflict in Europe

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Inflation

Inflation risk skewed to the upside with shortage of goods seeming likely to add further price pressure on goods and services. The war in the Ukraine, and retaliatory sanctions placed upon the Russian instigators has removed major suppliers of essential commodities from the global market place.

Russia was a key provider of fossil fuels and its distillates in Europe, and was also a major producer of Aluminium globally. Ukraine was a major provider of agricultural Commodities such as Wheat & Corn in Europe. With both economies effectively removed from the supply chain due the conflict and sanctions, the remaining suppliers of these commodities are likely to experience a windfall of demand from former Russian and Ukrainian trading partners. Consequently, with production expected to lag behind supply, price increases are all but inevitable in the short run causing increasing inflationary pressure which may sustain longer than was previous expected.

Additionally, China has placed approximately 50M people on quarantine as the spread of the COVID-19 virus has regained traction in the country. Speculatively, this move may once again hinder production of goods, negatively impacting the already battered global supply chain.

Optimistically, it is hoped that the conflict will be short lived. If this is the case, it is expected that inflationary pressure associated with the conflict should quickly dissipate.

Jamaican Context

We expect:

- Food cost is likely to increase as wheat and corn are essential parts of food production for humans and livestock.
- Higher cost of fuel and energy as oil prices continues to rally and the global economy braces for any further potential fallout stemming from the possibility of an all-out ban on Russian Oil. This, however, seems very unlikely given Europe's dependence on Russian Oil & natural gas. Nonetheless, the Americans have boycotted Russian oil, putting increasing demand pressure on the remaining (unsanctioned) suppliers.
- Continued slowing of international transhipment.
- Persistently high inflation on essential goods, like food, could trigger economic contraction.

- The Bank of Jamaica to continue to peruse a contractionary monetary policy, gradually raising rates or taking other measures intended to curtail the money supply as Jamaica's point to point CPI at the end of February was 10.7%, well outside of the target range of 4.0% to 6.0%.

Interest Rates

Prior to the most recent geopolitical event, it was a foregone conclusion that many developed economies' respective Central Banks would respond to rising inflationary pressure by deploying their monetary policy arsenal. As to be expected, there was a difference in the timing of actions amongst Central Banks, with some responding swifter than others. However, with the emergence of new geopolitical risks, lagers, such as the United States' Federal Reserve, may be forced to assume a more hawkish posture sooner than previously anticipated. Consequently, it is expected that interest rates are likely to rise globally.

In Jamaica, the Bank of Jamaica has already reacted to the inflationary environment by increasing the benchmark interest rate several times since 2021. Presently, the Bank of Jamaica Policy (Benchmark) Interest Rate stands at 4.0%, up 350 basis point from the 0.5% where it stood a year ago.

Jamaican Context

We expect:

- Risk assets are likely to demonstrate even more volatility in the wake of the uncertainty.
- Long duration assets are likely to be disproportionately negatively affected.
- Credit and default risk is likely to be intensified, especially in the presence of rising interest rates issuers with maturities may find it difficult to raise new capital to refinance old/maturing debt.
- Equity assets fundamental valuation may be negatively affected by truncated growth trajectory and a higher discount rate stemming from rising interest rates.

Expected Investor Reaction:

- Reduce exposure to long duration fixed income instruments in favour of money market instruments which are likely to lose less value as interest rates rises. Additionally, money market instruments, upon their maturity, may allow for investors to reinvest in another money market instrument at a higher interest rate in the future given the rising rate environment.

- Invest in variable rate securities which can take advantage of rising interest rates.

Markets

Global markets were already in the process of reconciling the impact of high inflation into Valuations. However, as previously expressed, the conflict in Ukraine is leading to an even greater expectation of higher inflation which is expected to negatively affect equity valuations by curtailing growth outlook and raising interest rate (risk) expectations/sensitivity.

Currently, commodities including energy, agricultural, and industrial metals are exempt from sanctions. Nonetheless, the price of these commodities have spiked higher as risk premiums have begun to be priced into the assets.

Expected Investor Reaction:

- Exercise a greater degree of prudence when selecting equity securities, paying particular attention to the fundamentals of investment prospects.
- Increase portfolio monitoring and potentially shifting to an active management strategy from a buy and hold strategy.
- Weight the portfolio towards countercyclical companies as they are less likely to experience as large fall of in demand as economic conditions worsen in the near term.
- Grasping growth investment opportunities when they present themselves.

Global Economic Growth

The impact to global economic growth is more complicated to predict. Much of the outcome will be dependent on the inflation outlook. Presently much of the unknown variables relating to inflation are tied to the conflict in Europe. This inflation outlook is likely to inform central bank action (will they peruse an expansionary or contractionary monetary policy?). Regardless, unless the conflict is protracted, the expectation is that the economic fallout from it is expected to be transitory.

Jamaican Context

We expect:

- The economic fate of the country to be directly linked with that of our major trading partners. While the USA may have limited economic exposure to Russia and Ukraine, the same cannot be said about the United Kingdom, Germany and other European nations which rely on Russian energy.

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