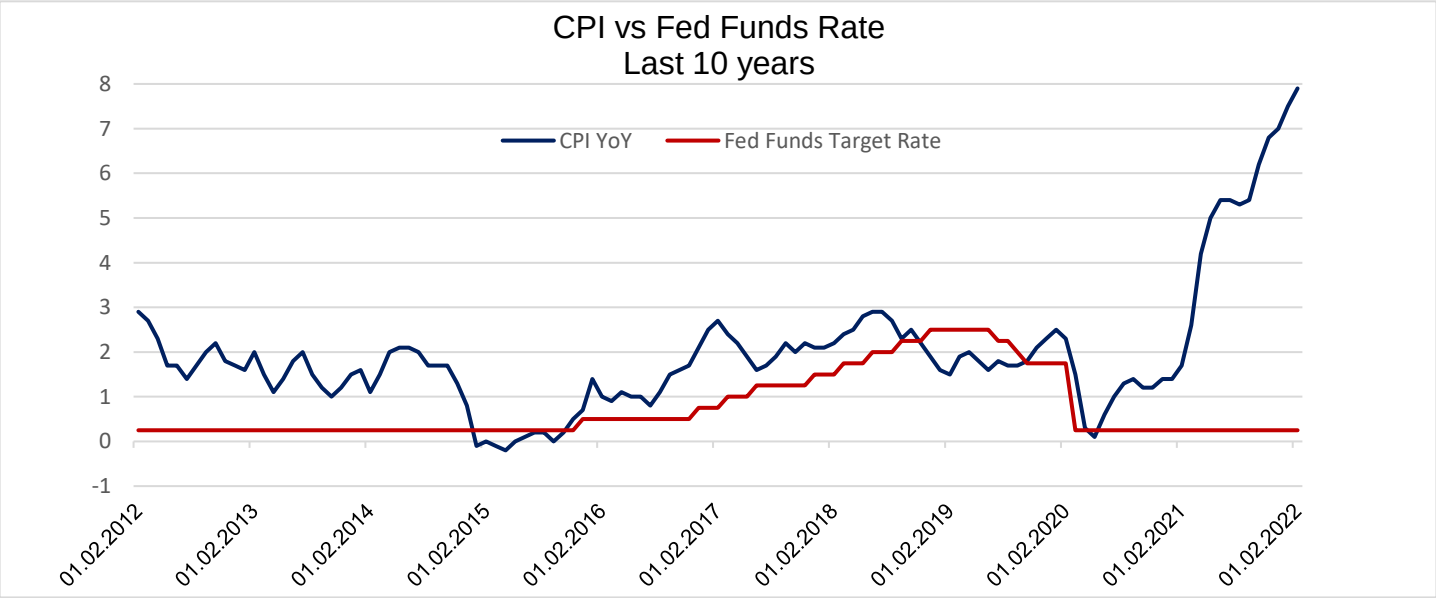
The sound of cannons

Vladimir Putin acted upon his threats, ordering that troops posted at the border between Russia and Ukraine as well as throughout Belorussia invade its neighbouring country. Since February 24th, fighting rages on, propelling the entire world and financial markets into a state of stupor. Concerns for financial tightening quickly took a back seat, making room for fears that the conflict could become global between the West and Russia, possibly involving nuclear weapons. During the month of February, risk assets were therefore strongly affected. Due to the geographic and economic proximity between European countries and Russia, the drop was sharper in the Euro Zone. The Stoxx50 closed the month approximately 6% lower. Conversely the United States, less dependent on Russia, closed on a 3.1% drop. China even managed to pull through with a 3% increase. The big economic "winner" of the current crisis is the defence industry. The announcements from various countries of purchases of military equipment for Ukraine, or the immediate release by the German government of an envelope of 100 billion euros intended to modernize its army, are all clear signs. After years of defence budget cuts across Europe, the conflict has reversed the trend. Europe realized in a few days that the world order is fragile and that it stands under-equipped in the face of a potential menace. A new arms race in Europe is thus launched. American companies in the oil sector also benefit from this armed conflict, having seen their stocks skyrocket since the start of the invasion. The fear of a massive embargo against Russian energy imports has caused gas and oil prices to shoot up, with Brent crude oil trading 50% higher than its January 2022 level. On the other hand, European oil companies have experienced considerable turbulence over the same period, with many of them having part of their activities (and revenues) linked to Russian energy sources. We are talking about oil prices, but it is indeed all raw materials that saw their prices rise. Indeed, Russia is also a major supplier of agricultural and metal raw materials, and the sanctions imposed on the country could disrupt world supplies for an unknown period. Finally, gold also creeped higher, reuniting with its safe-haven attributes. There was also heightened volatility on the foreign exchange front. The rouble collapsed by more than 40% since its February high, while the dollar appreciated 5% against the Euro. The Euro further depreciated strongly against the Swiss Franc, briefly overshooting parity for the first time since 2015.

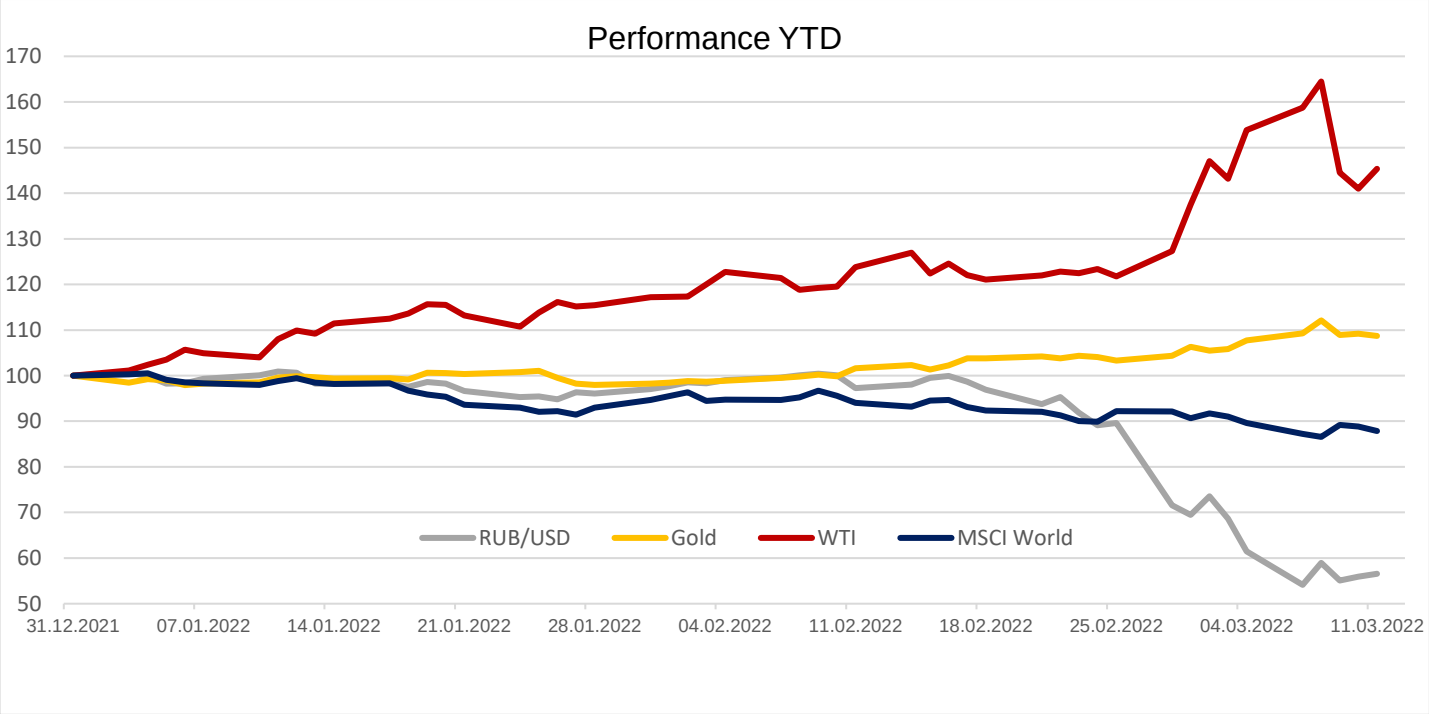


Source: Bloomberg / Banque Heritage

While it is difficult to predict the outcome of this conflict, be it in geopolitical or monetary terms, it is possible to observe its impact on economic variables and thus build a central scenario to help us navigate in the near future. In our mind, raw material costs are the predominant economic vector to consider for the time being. Russian oil exports to Europe are around 4 million barrels a day (Mb/d) while total production stands at around 11Mb/d. Europe further imports 40% of its gas from Russia. The situation is equally preoccupying on the agricultural side. Russia is the world's largest exporter of wheat, while Ukraine accounts for nearly 12% of world wheat exports, 16% of corn exports, and 18% and 19% of barley and rapeseed shipments. It is therefore reasonable to expect that the sanctions taken against Russia and the decrease in the supply of agricultural materials from Ukraine will have a significant impact on the balance in prices and, ultimately, on global demand. While it is difficult to make numerical forecasts, our central scenario is now that of global stagflation, but with strong disparities based on geographical zones.

Europe should without a doubt be more impacted by this crisis due to its dependence on both Russia and Ukraine. Russia is the fifth largest commercial partners of the EU (the trade balance is in deficit). The probability of a negative impact on European companies' earnings in the coming months is therefore high. This could rapidly affect the job creation dynamic, investments and, in fine, consumer confidence. Now, if we add elevated observed and expected inflationary pressures (+5.8% in February year-on-year for the Euro zone), as well as the ECB's monetary policy normalization effects, Europe seems to be the region facing the strongest headwinds.

Looking at the United States, the economic ties between the two countries are much more tenuous as Russia is only the 30th partner of the US in terms of commercial exchanges. "Only" 8% of oil and refined products are imported from Russia, explaining why the United States were the first to declare an embargo on Russia energy. Economically, the country posts a solid growth, and a job market close to full employment. The risk for the US does not lie in its dependence on the belligerents but rather in inflationary pressures in raw materials which could negatively affect household consumption. February data shows an acceleration in price increases (CPI +7.9% over a year), inflation reaching levels never seen since 1982. The FED's monetary policy normalization will therefore prove tricky to manoeuvre. However, our scenario for the United States has not changed since the beginning of the year, i.e., lower growth which should remain within the historical average, coupled with high inflation, at least higher that last quarter's projections.



Source: Bloomberg / Banque Heritage

Within such an environment, we felt it paramount to reposition our asset allocation in order to put a cap on portfolio risk. We reduced our exposure to equity markets and are currently below our neutral points. This reduction focused mainly on European companies with strong exposure to the crisis and its consequences. We further increased our overweight in raw materials as a hedge against a worsening of the armed conflict as well as against increased price pressures. Finally, we increase our cash pocket. It should act as a cushion in case the market correction deepens and will also allow for a rapid repositioning on risk assets should the sky clear in the more or less near future.

Jean-Christophe Rochat, CIIA
Chief Investment Officer