HEMISPHERE
CAPITAL MANAGEMENT INC.
Reflections
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THE GEOPOLITICAL DIVIDE

The Russian invasion of Ukraine shocked the world and triggered a wave of inflationary impacts.

The events of February 24, 2022 shocked the world as Russia launched a large-scale military offensive in Ukraine. The U.S. and its allies responded with sweeping sanctions and boycotts to hamper the Russian economy. They have stopped short of engaging in a direct conflict with Russia at the risk of further escalation. While a resolution may be on the horizon, the impacts of the conflict have been wide-ranging across industries and felt globally. Humanitarian crises are arising in neighbouring countries as almost 4 million refugees have fled Ukraine while commodity shortages from export restrictions have ripped through global supply chains.

Oil exceeded $100 USD/barrel for the first time since 2014 as Russian exports are cut-off and nations begin to prioritize energy security.

Russia is the world's second largest exporter of crude oil and the largest source of natural gas for European Union nations. Restrictions and boycotts on Russian energy exports pushed energy commodity prices to levels not seen since 2014 – with West Texas Intermediate (WTI), a benchmark for North American oil, exceeding $100 USD/barrel. European Union nations are urgently searching for alternative energy supplies as natural gas prices have continued to climb with recent average prices reaching five times more than historical averages. This has prompted Canada and the U.S. to commit to additional oil and gas production in an effort to displace Russian energy exports. Consumers and business alike are paying the price as higher fuel, heating and energy costs eat into household incomes and business margins.

Higher wheat prices and fertilizer costs from lower exports are impacting grocery bills.

Disruptions to the agricultural industry have followed suit and are now starting to show up on grocery bills. Ukraine is a top grain producer and grain production is at risk as Ukrainian farmers are either unable to farm or are short fertilizer, pesticides and fuel to cultivate their crops during the upcoming growing season. Existing grain shipments are also at risk as Russia has cut off access to many shipping ports along the southern coast of the Ukraine. The price of wheat briefly exceeded all-time highs seen in 2008 before retreating to levels well above historical averages. The impact on food production is not only limited to Ukrainian exports. The price of potash - a key ingredient in fertilizer – has risen significantly as both Russia and Belarus have restricted exports. Canada is the only country that produces more potash globally.

Disruptions to the supply of critical rare gases for semiconductor manufacturing…

Unbeknownst to many, Ukraine is also a major exporter of neon and other rare gases, a critical component used in the fabrication of semiconductors. The top two suppliers in Ukraine account for almost half of the world's neon production and both have halted operations as a result of the war. The semiconductor industry has already

…threaten a broad range of industries.

been severely strained from the COVID pandemic and further disruption will only intensify this issue. Couple this with rising metal prices and a broad range of industries from consumer electronics to vehicles are starting to feel the impacts.

The global shipping industry is even more constrained following the COVID pandemic.

The rising prices from production disruptions and export restrictions have been further exacerbated by transportation issues. Boycotts and sanctions have prevented Russian vessels from docking at various ports around the world, restricting the flow of goods. Any vessels looking to transport Russian goods or commodities are being denied insurance by western backers. The global shipping industry, already severely impacted by COVID, is becoming increasingly constrained.

Geopolitical divides will deepen and underpin the development of two geopolitical spheres (East and West).

Given recent developments towards a peace agreement, even if the conflict is short-lived, the impacts will be longstanding. The conflict and sanctions will deepen the geopolitical divide that has existed since China's rise as a superpower. After the military offensive, the West shut-off Russia's access to half of its ~$600 billion in foreign currency reserves. With Russia being barred from its reserves, other nations – notably China – have taken notice. They will look to reduce their foreign currency reserves by stockpiling commodities and hard assets to minimize their risk from potential future sanctions. The development of two separate technological, monetary and military spheres – a "Western Sphere" and an "Eastern Sphere" - will become further entrenched as sanctioned nations turn east to China.

The conflict has accelerated "deglobalization" and the internalization of supply chains.

War is inherently inflationary, especially when compounded by "deglobalizing" sanctions. Over the past few years, rising geopolitical tensions have seen increased use of protectionist measures including tariffs and trade barriers - both of which artificially drive-up prices. Countries will continue to internalize supply chains and move more jobs back home as domestic food and energy security become increasingly dominant headlines. This increases wage costs as labour-bargaining power and competition for limited workers rises. The Russia-Ukraine conflict has accelerated this process.

Inflation will persist for longer even with rising interest rates. We are focused on increasing exposure to hard asset companies over soft asset companies.

Despite the fact numerous central banks (including the Bank of Canada and the U.S. Federal Reserve) are currently raising interest rates in an aggressive approach to combat inflation, we expect higher inflation to persist well into the future. We reiterate our view that companies must have strong pricing power through competitive advantages or constrained supply to succeed in the current inflationary environment. We have focused on increasing exposure to "pro-inflation" stocks by emphasizing hard asset companies (agriculture, industrials, commodities) over soft asset companies (technology). Shorter maturity and less interest-rate-sensitive investments continue to remain the preferred fixed income investments.