

# Pythia's Investment Letter

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## The peace dividend in tatters

The 'rules based' and 'value bound' World order according to Western ideals has been under threat since the United States 'America First' policy was proclaimed. The consequences were not obvious or that dramatic until Russia's actions escalated last week. The most recent events have highlighted deep changes in the perception of Western political elites. Geopolitically, Europe finds itself back in the first half of the 20th century. We are deeply concerned about Russia's invasion of the Ukraine on 24th February and the immeasurable suffering it will inflict on the Ukrainian people.



For Belarus as well as Ukraine, future statehood seems lost. In retrospect, it may have been smarter for the West to negotiate the establishment of formal buffer zones with Russia to prevent a sudden military confrontation. However, this would certainly not have been in line with democratic ideals, especially for the affected areas, if their respective populations had not been offered full suffrage.

The conventional warfare favoured by Putin in the Ukraine, opposed to a hybrid conflict strategy characterised by 'false flag' sabotage groups, disinformation and cyber-attacks makes it clear to us that the Kremlin felt under pressure to act. If it had proceeded piecemeal, the Russians would have probably had to deal with a much stronger foe. The West has been wrong footed in this conflict and is a step behind, whilst Putin prepared for sanctions, built stockpiles of scarcities and capital reserves.

NATO's Eastward expansion can certainly be seen as a prelude for the current conflict and possibly a missed opportunity for the West. The ideals of a rules based and value bound World order, ensured by economic interdependence and cooperation, leading to a 'win-win' situation for the parties involved, seems to be faltering. The current conflict is driving Putin into the welcoming arms of Xi Jinping. However, dependence on China is likely to be far more unpleasant for Russia than any cooperation with Europe. Russia is too weak to support an empire. It may have military might but certainly not sufficient political, economic or cultural strength in its "portfolio". This doesn't of course make the situation any more comfortable for the West and will lead to completely new geopolitical challenges.

The decades that Europe and its current generation of politicians and leaders wallowed in comfort of the peace dividend is now over should they not want to play a subordinate role. As Mrs Merkel emphasized, an influential actor must have 'strategic autonomy'. Accordingly, one will have to think much more in terms of self-interest, not negotiations or balanced arbitration, especially now the US is no longer the world's policeman as it has been for last 80 odd years. The point is, not to be able to wage wars but to build a such a formidable potential deterrence to prevent them.

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1/2

The current conflict in the Ukraine offers a window of opportunity to adjust perceived security policies but this will not be open for long. These conceptions are now undergoing fundamental geopolitical and strategic change.

### **Financial markets on a rollercoaster ride**

2022 had already got off to a shaky start for global stock markets. After an extremely positive 2021 with a year-end rally, 2022 began with a correction. The reasons for this were not only escalating geopolitical tension but also and above all, rising global inflation (7% in The US and over 5% in Europe in January alone) bought about by higher commodity prices and post Corona supply bottlenecks, which although diminishing, are still prevalent. The US Federal Reserve announced tighter monetary policy, balance sheet reduction and higher interest rates. Last year (see Pythia's April 2021 edition), we drew attention to high levels of debt and the possible consequences of ultra-expansive monetary policy. Confidence in monetary authorities and the successful exit from this policy, with the right dosage to fight inflation will be vital.

### **Inflation: Central bank dilemma**

We expect Central Banks to adapt a more

moderate tone due to current events, but they are in a quandary; inflation is in 'special case mode: Russia is an important supplier of raw materials. Existing issues such as supply chain challenges and rocketing commodity prices drive this further. How long this will last is difficult to predict from today's perspective, but inflation is likely to lose steam as the global situation stabilizes. Stagflation must be avoided as it is vital not to stall an economy. Given energy price issues, a near term flattening is unlikely. A turn away from dependence on Russian natural gas and the establishment reliable sources of green energy such as wind and solar power is gaining momentum. In the medium term the focus will return to fighting inflation, albeit at a more moderate pace.

From an economic point of view, The West's dependence on Russia (aside from gas) is very low. Economic data over current weeks will have to be analyzed carefully in order to assess its impact on the economy. Historically, regional armed conflicts have only had temporary negative impacts on financial markets, however, there will be an economic cost to the current conflict leaving much damage in its wake. It is therefore important to stay invested in companies with robust and sustainable business models that will withstand current economic headwinds.

## **Stick with quality**

In the current environment it is vital to remain calm. As long-term investors, we see current geopolitical developments to be of central importance. They are often underestimated in day-to-day business and are strongly neglected in economic models. As early as 2021, Chinese Communist Party state interventions showed investors that our Western achievements such as property rights, independent legal security and a free market economy, which we take utterly for granted are being arbitrarily undermined. We minimize these risks when investing and avoid any direct investment into any allegedly benign autocratic systems.

In the short term we face increased volatility. We continue to favour tangible assets, especially equities. Our overweight stance in Swiss equity markets is an advantage in this environment. The tactical balance between growth stocks and defensive blue chips, which we have been implementing since last year, must be adjusted to current circumstances, depending on given investment profiles. Our Gold exposure has so far proven to be a robust and reliable portfolio diversification during crises, in stark contrast to the much-vaunted cryptocurrencies.

*Geopolitical Analysis: Podcast «die Stunde Null» with Prof. Herfried Münkler; Capital Redaktion, 25.02.2022*

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