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The Rising Economic Costs of a World Rife with Geopolitical Risk

As you may have noticed, we are no longer in a business-as-usual environment.

As the US ratings agency S&P Global recently warned, 'a world ordered for generations by globalisation and geo-economics' has quickly become a world rife with 'geopolitical risk'.

Relations between the two largest nuclear powers, Russia and the United States, are arguably at their most fraught since the 1963 Cuban Missile Crisis. As the Ukraine conflict drags on, with no clear end in sight, the risks of direct conflict between Russia and NATO rise while the economic fallout continues to grow.

Impact on European industrial powerhouses

The EU's two main industrial centres, Germany and Italy, are rapidly losing their competitive edge following the loss of access to cheap Russian gas. The long-term result will be a weaker, smaller, more US-dependent EU economy. The US-EU sanctions were supposed to bring Russia's economy to its knees but instead have hobbled the EU's own economic prospects. Worst of all, the crisis in Germany, Europe's largest economy, appears to be structural rather than cyclical, with Bloomberg recently warning that its days as an industrial superpower may be coming to an end.

The strain on European economies

As the demands of war grow and interest rates remain high, the fiscal health of many European economies, including Germany's, is being pushed to the limit. Central banks' gradual withdrawal of their quantitative easing (QE) programs, which kept government borrowing costs artificially low for over a decade, is imposing fresh constraints on public spending.

The looming fiscal crisis in the us

In the US, a fiscal crisis is also looming after years of ballooning deficits. As interest rates have risen, so too have the interest payments the US government must pay on its debt load, which recently topped $35 trillion.

Savvy investors know what this means: the government will print even more money which leads to generally rising prices across the economy. Investors' inevitable response will be to demand an even higher interest rate, further accelerating the expansion of public debt. Rinse and repeat.

Global commodity prices and geopolitical showdowns

Another risk factor to watch out for is a sudden surge in global commodity prices. As Fitch Ratings cautions, "the wars in the Middle East and Ukraine, upcoming elections in many countries and rising regulatory uncertainty for natural resources in some jurisdictions have renewed the focus on geopolitical and political risks for commodities markets."

US-China tensions and supply chain strains

It is not just the prices of commodities that pose a risk. The world's two largest economies, the US and China, are currently locked in a high-stakes showdown over nanochip development and production. Washington is trying to prevent Chinese companies from accessing the technology needed to develop their own advanced nanochips, Beijing is trying to cut off US and European companies from the raw materials needed to manufacture semiconductors. It is hard to see where this will all end, but one thing is clear: these two countervailing forces will heap yet more strain on global supply chains. And that will probably mean higher prices.

Geopolitical risks encouraging alternative global reserve assets

Two more geopolitical risks worth keeping a close eye on are declining trust in the US-based global system, or rules-based order, and declining global demand for US Treasuries, both of which largely stem from the US-EU's backfiring sanctions on Russia. Russia has already warned of "catastrophic consequences" for the banks and nations involved as well as the EU's broader economy.

The evolving role of cash in portfolios

In light of the complex geopolitical landscape outlined above, it becomes evident that the economic ramifications extend far beyond immediate market fluctuations. The impact of sustained inflation amidst these uncertainties presents a profound challenge requiring a different view of what "risk-free" means in this environment. Liquidity is critical but rapidly devaluing cash piles create a drag on portfolio performance and mean that whilst the cash may be there in nominal terms you cannot afford what you planned to buy with it.

Adapting to new economic realities

In a world where inflation is rampant and unpredictable due to the aforementioned geopolitical risks, traditionally safe investments lose their appeal. Their returns often fail to keep pace with inflation, which means that in real terms, the value of the assets are eroding over time. This erosion is not just a paper loss but translates into a tangible drain on the resources available to companies for investment in new technologies, market expansion, and other growth initiatives. Charities can no longer support their mission as much they once could. Pension schemes have a more difficult job to manage these risks and pensioners lose out when their pension buys them less in retirement.

Strategic implications and the path forward

Moreover, the increased cost of borrowing due to rising interest rates compounds the challenge, as it raises the cost of financing and further squeezes corporate budgets. Companies may find themselves in a vicious cycle where the cost of maintaining liquidity eats into their profit margins, reducing their ability to

invest in future growth and, in some cases, forcing them to cut back on essential services and products. There could then be knock-on implications for corporate debt and equity markets.

Conclusion: Navigating through uncertainty

In conclusion, the world is grappling with governments' preference for easy money policies, escalating geopolitical tensions, and supply chain disruptions. The economic fallout that inevitably follows means that the role of institutional investment is becoming increasingly complex. The imperative now is for these financial nerve centres to innovate and adapt, ensuring they can continue to support and strengthen in the face of sustained inflation and other challenges that lie ahead. This is not easy, and not all traditional investment approaches will continue to work in this new environment which looks very different to the past 40 years. We are at an inflection point, and a willingness to be open-minded and nimble will be seen as key risk management skills.

Sam Roberts, Director of Investment Consulting

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.