WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Monthly Report

EMERGING MARKETS COMMENTARY

Month ending 28 February 2022

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COMMENTARY

Save the series of ethnic conflicts that accompanied the breakup of the former Yugoslavia, conventional warfare in Europe has been vanishingly rare since 1945. Even when the continent stood ideologically and physically divided during the long years of the Cold War, peace held. Russia's invasion of Ukraine has, however, shattered this hard-won period of calm. If images of troops and tanks on the move on European soil carry echoes of some of the darker chapters in the continent's history, they also point to the emergence of a new, more uncertain epoch.

How the current crisis will unfold is impossible to say but it does not risk hyperbole to suggest that it already promises enormous ramifications for the global economy. Most immediately, the conflict and the sanctions designed to hobble the Russian economy are driving a sharp spike in commodity prices, from wheat and corn to oil and gas. In turn, this will feed through to economic activity and aggregate demand. The Federal Reserve will be carefully weighing the potential impact on growth and inflation as it considers how quickly to tighten monetary policy.

> *"The conflict and the sanctions designed to hobble the Russian economy are driving a sharp spike in commodity prices"*

From the perspective of our emerging market strategy, it is through macroeconomic factors such as these, rather than from any material exposure to Russia and Ukraine, that the impact of the crisis is most likely to be felt. The strategy has no direct exposure to either country[1], something that has been true for most of its history. In the case of Russia, this largely relates to our longstanding discomfort with standards of governance and the integrity of its institutional framework. Confidence in both is a prerequisite of our investing in any country. Indirect exposure through our investee companies is also limited. While some companies generate an element of their earnings from Russia and/or Ukraine, in no instances is this material.

Our two Polish investments perhaps invite the most concern, at least from a geographical perspective. As news of the invasion broke, the Warsaw stock exchange, along with other eastern European bourses, sold off sharply. Some of this was linked to economic concerns given the country's proximity to the conflict, but there were also graver fears at work. The current conflict, some speculate, is merely the first step in President Putin's bid to rebuild his country's eastern European sphere of influence that was lost with the collapse of the Soviet Union. Russia's territorial claims, in other words, will not stop with Ukraine. Poland and the Baltic states of Estonia, Latvia and Lithuania have all been touted as potentially at risk from future Russian aggression.

> *"No investment on behalf of our clients is made with the expectation of perpetual political and economic calm"*

Laying no claim to geopolitical prescience, we will avoid the temptation to second guess the Kremlin's long-term strategy. Poland's membership of NATO, however, likely puts a military confrontation with Russia firmly in the 'tail risk' category. For now, the most tangible risks are economic. The Polish economy, growing strongly in the final months of 2021, will face headwinds from a decline in trade with Russia and Ukraine and rising commodity prices. Heightened uncertainty may also weigh on consumer and business confidence. But no investment on behalf of our clients is made with the expectation of perpetual political and economic calm, and nor are many of these challenges unique to Poland. Putting our two Polish investments under the analytical microscope, neither has material exposure to Ukraine and Russia, and both may even stand to benefit from more straitened economic circumstances – one through its value-conscious supermarket offering to Poland's large non-urban population and the other via the country's most competitively priced online retail platform.

One other point worth noting is the potential impact of Russian expansionism on political attitudes in Poland. When we visited both companies late last year as part of our pre-investment due diligence, the possibility of Poland exiting the EU was very much in the headlines. With the country's Constitutional Tribunal having declared certain EU treaty articles incompatible with national legislation, the government was at loggerheads with the European Commission. And although 'Polexit' lacked widespread popular support, it was nevertheless a risk we had to consider when building our investment case for both companies – support for Brexit, after all, had once been a fringe political position here in the UK. We think this risk will now have diminished greatly. For many Poles, the pictures and news reports emerging from across their eastern border will have reaffirmed the benefits of both EU and NATO membership, neither of which is enjoyed by its neighbour.

"The events of recent weeks will likely prove only the start of a prolonged period of geopolitical and economic realignment"

None of this should invite complacency, however. The events of recent weeks will likely prove only the start of a prolonged period of geopolitical and economic realignment. Future developments and their impact on the underlying fundamentals of investee companies will have to be monitored closely. It would be wise to expect the unexpected. But we feel we can say one thing with a degree of confidence: it is in precisely such circumstances that the enduring importance of the attributes we seek in any business are thrown into sharp relief. The companies in which we invest our clients' assets are aligned with structural growth in the global economy, with strong balance sheets, defendable market advantages and resilient business models that we believe will enable them to survive and prosper in even the most testing economic and market conditions.

[1] Shortly after the end of February, MSCI announced it would remove Russia from its emerging markets indices effective from 9th March.

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