



Macroeconomic
Comment



China - Tipping the Scales

March 15, 2022, Peter von Elten

At our last investment committee meeting, the comment was made that Russia's economic output, at about 2%, was insignificant in terms of global GDP. The dwarf in terms of global GDP, however, is a giant as a military power and of utmost importance in global energy supply and food. Since the world was already experiencing shortages, some significant, in these segments of basic services even before the Ukraine war, the impact of the war goes far beyond the incomprehensible human suffering, beyond the brutal destruction of habitat and the compulsion to divert resources to rearmament, and leads to a global distribution crisis.

Even before the war, the world had become significantly poorer as a result of the pandemic, as evidenced by the explosion in government debt to maintain consumption and jobs. Since 2014, the number of people suffering from hunger and malnutrition has risen from about 600 million to an estimated 800 million. War could increase that number by another 10% or more. The distortions caused by ever more state influence on the economy and the undermining of the free-market order will continue to have an impact for some time to come and have proven threatening in the rise in inflation, among other things.

At the latest since the financial and economic crisis of 2007, global growth in the leading economic nations has been fueled by ever higher levels of debt, interest rates at zero and an oversupply of liquidity. Earlier and natural drivers of growth such as productivity and population growth, on the other hand, have been in sharp decline.

At the same time, we are witnessing a sometimes perverse development in the prices of real assets, which has led to major imbalances in the population and poses a threat to social peace, especially in more difficult times. A correction of the clearly visible exaggerations would have been expected even without the war due to the inflation-related need for monetary tightening. The interest rate hikes currently under consideration in the US come too late and can hardly defuse a high negative real interest rate.

It is against this background that we should assess the Ukraine war, which is increasingly developing into a struggle between different social systems and could end in a new cold war. In this context, the bloc formation between Russia and China as an alliance of convenience primarily against the dominance of the USA as the leading representative of democracy is particularly problematic, primarily for Europe.

The search for a face-saving end to the war primarily for Putin, but also for Selenskyj, leads to hectic diplomatic efforts, which in my view could most likely be made successful by China as a mediator. Israel is seen by Russia as more dependent on the US (protecting power) despite a strong Israeli-Russian population.

Relying on a desertion of Russian troops, a military coup, or an assassination from Putin's close circle may be allowed as wishful thinking, but it is not suitable as a convincing strategy.

China, in my view, has an overwhelming interest in an early end to the war and has strong leverage over Russia.

China imported USD 316 billion of oil and gas and USD 190 billion of iron ore last year, according to the Financial Times. The price explosion in these commodities, as well as record grain prices, is driving inflation in China in a year when Chinese leaders, while still targeting growth of around 5.5%, are themselves talking about triple pressures: shrinking demand, partly because of the housing crisis, disrupted supply chains and weakening expectations. At least in the military sector, China wants to grow strongly at a budgeted 7.1%. The agriculture minister fears that the winter grain harvest could be the worst in the country's history due to heavy rains. Ukraine and Russia are responsible for about one-third of world trade in agricultural products. Russia is also the largest exporter of nitrogen fertilizers (13% of total world trade in fertilizer intermediates and 16% of trade in finished fertilizers). These prices have also risen dramatically because production is energy intensive and because Russia recently announced it would halt exports.

China needs a well-functioning global economy and a strong commodity partner like Russia to achieve its goals in the year of Xi's re-election. For the latter, on the other hand, China could be the lifesaver, as a foreign exchange earner, as a financier, but especially as a supplier of technological goods that the US and Europe no longer supply. Since Russia has hardly any friends left, the recently proclaimed "borderless friendship between the two states" and "most comprehensive strategic partnership" could become the lifeline for Russia.

China, moreover, could pose as a bringer of peace, even if it does not see its proximity to Russia as beneficial internationally.

If a ceasefire and peace negotiations cannot be initiated within one to two weeks, I fear a recession in Europe before the end of the year. The war is causing high direct and indirect costs at the expense of normal business operations, entrenching problems in supply chains. The interdependencies in sanctions are becoming more and more visible. The pandemic and climate change have taken a back seat. The latest Covid figures are alarmingly high for countries such as Germany, Switzerland, Austria, the Netherlands, and a new wave is also evident in several Asian countries. Climate change is suffering a setback for the time being, which must be absorbed by additional

efforts. As difficult as it is to make reliable predictions in this environment, it is certain that national debt is about to experience a new surge.

Further destabilization of Europe could be Putin's goal in the brutal destruction of the entire infrastructure in Ukraine, up to 10 million refugees could come to Europe and have to stay longer until Ukraine is viable again. In 2015, we saw in Germany how a great welcoming culture on the occasion of refugees from Syria soon turned into social tensions and the strengthening of the AfD, with just over one million migrants. Initial estimates of the cost of reconstruction in Ukraine are well over EUR 100 billion.

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

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