

## TAM INTERNATIONAL INVESTMENT NOTE



## Walking around the bear

***“There’s nothing like an airport for bringing you down to earth”.* Richard Gordon**

Over the last couple of years, the list of things to worry about has grown ever longer but it’s been interesting to watch stock and bond markets ignore virtually all of them except for brief periods when it suited short term punters to cause a bit of trouble regardless of whether a new drama impacted the economy or not. This was initially true of the unfolding situation in Ukraine. The annexation of Crimea, for example, came and went without any market reaction and the S&P500 went on to a new all-time high. However, developments over the last few weeks appear to have woken markets up to new risks as the scale of potential economic sanctions start to bite. Italy registered -0.2% fall in the second quarter of 2014 against an expectation that it might scrape a +0.1% gain. Unfortunately, the negative -0.1% GDP figure for Q1 means that Italy, Europe’s third largest economy, is now back in recession and battling with an unsavoury mix of failed labour market reforms, austerity and a weakening of economic activity with Germany; itself slowing down as bordering countries struggle to grow. We will see second quarter GDP data for both France and Germany later this week and both are expected to be weak.

But it is Germany that has raised the stakes against Russia with the prospect of sanctions moving from rhetoric to reality. Early sanctions targeted key Russian individuals but have moved on to sector wide blocks as Angela Merkel took over the diplomatic lead from the UK and France taking perhaps a tougher stance than Vladimir Putin was banking on. The threat of cutting off gas supplies to Germany and Eastern Europe hasn’t happened yet, but Russia has banned food imports from the EU and USA and is now mulling the closure of Russian airspace to flights between the EU and Asia. There would be some interesting consequences, not all of them obvious.

Regular readers will know that we are no strangers to Japan and Asia. Indeed, some members of the investment team remember that direct flights to Tokyo were quite an ordeal back in the 1980's. If you wanted to go and visit companies in Japan, you had to fly over the north pole to Anchorage, Alaska (12 hours). This was an adventure, landing as one did on a runway with snow banked up either side as high as the aircraft itself, before disembarking to the terminal while refuelling took place for the second leg to Tokyo (7.5 hours). Unfortunately, there was absolutely nothing to do in Anchorage apart from stretch your legs in the terminal for a couple of hours. This involved joining a cartwheel formation of passengers walking around a stuffed polar bear in a glass case. We understand that you can at least get a doughnut and coffee at Anchorage these days, but it would be an extraordinary way to conduct business between Europe and a vastly bigger pan-Asian economy bearing in mind that commercial airlines are also avoiding states south of Russia: Syria, Iraq and Ukraine. During the Cold War, there were no direct flights to anywhere in Asia. It was necessary to refuel in the Middle East which involved flying directly across the middle of Iraq, for example.

Of course, there was no internet back then, and therefore no video conferencing, which became standard practice for transatlantic meetings in the year or so following the 9/11 attacks. No doubt, quite a few more meetings might happen this way instead of directly, but there would be more at stake than communications in the business world. Globalisation has changed the pan-Asian region beyond all recognition over the last 25 years and also the relationship with the UK, notably London.

There's been a huge rise in the number of British and Asian families having connections between homes and universities on both sides of the world and new London properties are popular with wealthy families from Asia. One European airline has estimated that 12 EU airlines make 900 flights over Russian airspace every week. If the average 777 or 747 comfortably seats at least 350 people, that's around 1,250,000 people a month flying back and forth to Asia on European airlines alone. If flights had to avoid Russia and parts of the Middle East, the impact to the UK and Europe could easily be on a par with the disruption caused by the closure of Northern European airspace during the Icelandic volcanic eruption in April 2010. Estimates put the net loss to UK GDP at £500 million over that 1 month period.

Russia is only considering closure of its airspace for now, and in just the last couple of days there appear to be signs that both sides are looking for a face-saving compromise where everyone gets a bit, but not everything, that they want. To understand what's going on, one really has to delve well beneath the headlines and take the time to understand the complexities of what the powers are up to behind the scenes.

In the last few weeks, we have been speaking to experienced political advisers, published political historians and even an ex-Foreign Secretary to try and see if it is possible to look through the current troubles to better times ahead. On balance, we are encouraged by what we have learned and believe that the West has the will and determination to ensure that the arena of war and the knock on effects to commodities and economies will be contained in the months ahead. Public opinion also demands it. Indeed, President Obama is now under pressure to act rather than maintain an isolationist stance which has been popular post-George W Bush.

Ultimately, we expect the west to step up to find a compromise solution with Russia and to implement various measures to put a stop to the extreme violence in Iraq. President Obama is right that there will be no quick fixes but it is clear that there is a tipping point beyond which the full force of the West's ability to project power is deployed to preserve its own interests and that of its allies. We therefore expect that the market's attention will once again return to looking at the economy and looking forward to third quarter corporate earnings season and forecasts into year end. Geopolitical events may impact the economy but the economic future is still all about jobs and the consumer.

On a day when we listen to the Bank of England factoring in adjustments to its forecasts to take account of geopolitical upheaval, it's a reminder that it's not an exact science; but then neither was stock analysis in Japan. Something often pondered whilst strolling around the Alaskan polar bear.

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