

The Future Beckons - Supply Chain Disruptions - Part 2

Introduction

Rising energy costs threatened to undermine economies just recovering from a two-year pandemic well before Russian tanks moved into Ukraine. As a result of Putin's aggression, that threat may now come to fruition. Fueling the global economy, fossil fuels such as crude oil, diesel, and natural gas are trading at or near record highs, threatening to reshape geopolitical ties between producers and consumers, push up inflation, and even derail efforts to combat climate change. Following the inflationary pressures and war repercussions, we examine the two sectors listed below.

Oil and Natural Gas

Amid a worldwide crisis, President Biden announced he would use up to 180 million barrels of government oil reserves to assist down near-record high gasoline costs. After conferring with friends and partners, the president decided to release oil from the Strategic Petroleum Reserve. Analysts anticipate it to be roughly four times larger than any prior oil discharge from the government's emergency reserve. With midterm elections approaching and his support ratings plummeting, the president's first objective is to lower gasoline costs.

Crude oil prices drive gasoline prices. The U.S. will also need to acquire new crude to replace its reserves, which may cause prices to increase. Analysts say Mr Biden uses a fresh, aggressive approach to push down costs before a scarcity occurs. Rising demand has surpassed supply this year, and although the United States has banned Russian oil, it is still finding its way to the market. According to a Goldman Sachs research note, the extent of the reserve release might have unforeseen effects on oil markets, such as causing logistical bottlenecks at the United States' oil industry's export centres on the Gulf Coast. According to the bank's analysts, it might be more difficult for U.S. shale oil companies to raise their production.

In response to Russia's invasion, B.P. said it would sell roughly 20% of its interest in the state-owned oil company Rosneft. Shell announced it would exit Russian joint ventures and the stalled Nord Stream 2 pipeline to Germany. Exxon said it would stop producing oil and gas on Sakhalin Island in the Russian Far East.

Since 2021, U.S. crude oil prices have risen 43 per cent to \$107.8 a barrel, reaching a high of \$123.7 in early March, the highest level since 2008. Gas prices soared to new highs due to the surge, putting a strain on customers at the pump. Higher energy costs have had knock-on impacts on other commodities. Wheat has increased by 33% this year to its highest level since 2010, while corn has increased by 24%. Many metals, including aluminium, copper, nickel, and palladium, also reached record highs. In the next 12 months, 72 per cent of CEOs of big U.S. corporations anticipate passing on increasing labour and transportation expenses to consumers. Consumer spending, for example, accounts for more than two-thirds of US GDP, and if consumers have to pay more for necessities like food and gasoline, they may be obliged to curtail spending on other products.

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Natural gas might be in the same boat. European gas futures increased 70% to €142 per megawatt-hour in response to the invasion, up from €16 a year ago. After Germany revoked the approval of the controversial Nord Stream 2 gas project, former Russian President Dmitry Medvedev tweeted a warning of a future natural gas price shock: "German Chancellor Olaf Scholz has issued an order to halt the process of certifying the Nord Stream 2 gas pipeline."

Consumer Goods

Those corporations who manufacture products that Russians depend on for an everyday living, from food to infant formula to personal care items, have grappled with whether to remain as Apple has ceased sales and B.P. has quickly announced its leave. Apart from selling basics after the end of the Soviet Union, these businesses, including PepsiCo and Unilever, often have extensive manufacturing facilities in Russia and employ thousands of local workers.

Since the February 24 invasion, more than 300 corporations have ceased operations in Russia, according to Jeffrey Sonnenfeld, a Yale School of Management professor – significantly more than the 200 large companies that left South Africa in the 1980s due to apartheid. Russia accounts for less than 3% of revenues for many consumer goods companies, implying that the effect of suspending operations would be minimal. Danone, Henkel, and Carlsberg are among the most vulnerable, with the latter earning around 10% of its sales in Russia and suspending its annual financial projections due to the consequences.

L'Oréal and Estée Lauder, two cosmetics companies, exemplify the divergent responses of customer segments. L'Oréal, which employs 2,000 people in Russia, has ceased online sales and shuttered its few dozen direct storefronts. However, the overwhelming majority of its goods, such as shampoo and skincare, will continue to be available via local merchants. Estée Lauder took it a step further and halted all commercial operations in the nation, stating that it needed to "take steps aligned with our firm principles."

McDonald's led a fresh exodus of the west's biggest consumer brands from Russia on Tuesday, with Coca-Cola, PepsiCo, Starbucks, and Unilever halting or cutting operations in response to Vladimir Putin's invasion of Ukraine. It was announced that all McDonald's 850 locations in Russia would be closed for a short period, and other activities would be suspended. Several hours afterwards, Starbucks said that the local Russian licensee that manages its 130 cafes would similarly stop operations immediately. Shortly after Coca-Cola declared it was suspending its operations in Russia, PepsiCo stated it would halt manufacturing and sales of its beverage brands, notably Pepsi, but would continue to sell necessary items. In a statement, Unilever said it would halt advertising in Russia but would continue to deliver essential food and hygiene items manufactured in the country.

The Possible or Actual Impact on Corporate Strategies

Many Western businesses have benefitted from the globalization of the economy since the conclusion of World War II. They have gained by selling their goods to customers in China, India, and other far-flung markets while decreasing costs by transferring the manufacture of everything from apparel to digital equipment to low-wage

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nations. Western Mining and oil businesses have mined raw resources in Africa and Latin America, yet large U.S. and European banks have financed most of these operations.

Senior executives must consider factors other than profit margins and compliance with local laws when determining whether to suspend or preserve commercial agreements. Instead, they must assess if their business activities directly or indirectly enable the Russian military and whether they should suspend operations in Russia as part of a more extensive anti-invasion campaign.

Russian President Vladimir Putin signed a directive requiring payment for natural gas in rubles but permitting dollar and euro payments via a specified bank. A cautious welcome from European leaders who say payment would continue in euros and dollars and want to study the decree's fine print. According to a Kremlin regulation released by the state, countries imposing sanctions on Russia for its conflict in Ukraine may continue to pay in foreign currency via a Russian bank. Italy and Germany's leaders claimed Putin had assured them of gas supply. Putin said Russia would accept currency payments, and contracts would be terminated if purchasers did not agree to the new terms, including creating ruble accounts in Russian banks.

With all the attention on Russia's economy, isolation, and western sanctions, its most significant partner, China, is also in jeopardy. No other big nation is in worse economic shape. The Chinese property sector's financial stress has reached record levels in recent weeks, destabilizing an already fragile economy and making it less likely that Beijing would back Russia's invasion of Ukraine. No one knows if the ailing property developers are just illiquid and short on cash or bankrupt and unlikely to survive. Due to a lack of domestic funding, the developers borrowed money at excessive rates. Russia, whose economy is one-tenth that of China, is in a financial crisis, walled off from the rest of the world. Nevertheless, in an often-overlooked way, China is also in danger of damaging its fragile economy if it cancels foreign funding.

What Beckons for the Oil Industry...

Looking ahead, the future of the oil and gas industry seems fragile, as the exclusion of Russia from world trade will have major consequences in this industry. As countries are looking to virtually cut ties with Russia, the question of reliance on Russian oil and gas remains, especially for Europe. To understand this impact, it is useful to consider the case of the EU's economic engine, Germany. Being significantly more reliant on Russian gas than other EU countries, Germany is set to be hit by unprecedented shortages. The German government has formally warned its citizens to ration gas in the coming months, due to the concern that Russia might cut supplies to the country. This comes after Russia announced that it is looking to receive payments for gas in rubles. The German government would also, if necessary, prioritise German households to the detriment of its industry.

Germany's example, while perhaps extreme, does provide an indication of what Europe has to lose from a potential embargo on Russian oil and gas. EU countries suddenly find themselves with a common purpose of finding an alternative to Russian oil and gas, and urgently. This will significantly shift the dynamics in the industry, with other major oil exporters suddenly having the opportunity to supply one of the world's largest markets. For reference, were EU countries to constitute a sort of buyers' cartel, they would collectively represent one-tenth of the world's demand for gas and somewhere between 15-20% of the demand for oil.

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At the moment, the EU has stepped back from an immediate embargo on Russian fossil fuels, but such a move seems very realistic in the near future, provided an alternative is found. One such alternative, in the short run, could be importing crude from the Middle East. The issue with that is that crude is semi-fungible, while refineries are optimised to work with specific types of oil, meaning that a lot of refineries in Europe might not facilitate working with crude oil from the Middle East. While this can be changed, the move would reduce efficiency, while simultaneously raising costs and prices. In the long run, however, an embargo on Russian oil might prove to be a blessing, as it is an added incentive to speed up the move to net-zero emissions in the EU.

Regarding Russia's role in this new oil order, it would most likely shift its exports, of which more than 50% are currently sent to Europe, to emerging markets. China, India, Africa, South America and the rest of Asia are all potential clients. However, it would be almost impossible, at least in the short and medium-term for Russia to preserve oil and gas revenues after losing its biggest client. Therefore the impact on Russia's oil industry might just be fatal.

Not only might Russia's industry be fatally hit, but also the oil industry as a whole. In the second scenario described above, if Russia's actions prove to be an incentive for a faster transition to clean energy in the EU, world demand for oil would plummet. Moreover, if the EU manages to find a way to a faster transition to net-zero, other countries might just follow suit, further decreasing aggregate demand for oil.

From a macroeconomics perspective, the uncertain future of the oil industry complicates the ECB's policy. With the Fed having already announced a first interest rate hike, albeit in the context of a country much less reliant on Russian oil and much less impacted by the war in Ukraine, the general trend of Central Banks seems to be to raise interest rates in the near future. While before this crisis, a change of policy in the US would usually dictate a similar change for the EU, Russia's invasion of Ukraine complicates things.

The only move by the ECB so far was to scale back its bond-buying stimulus plan and make bank funding rules stricter. In regards to interest rates, the ECB said that any changes would come gradually after ending asset purchases. The reason for this uncertainty in the future of ECB policy is the combination of a slowdown in growth caused by supply-chain disruptions as a result of the war in Ukraine and soaring inflation in the Eurozone, sparking a debate on which problem to prioritise.

In the US, the Fed is facing challenges in regard to the monetary policy too as a result of the war in Russia. Even though not as dependent on Russian fossil fuels as the EU, with only 8% of oil imports coming from Russia, US companies do suffer from supply-chain disruptions, as well as from record petrol prices at \$4.25 a gallon.

And for the Consumer Goods Industry

In the consumer goods industry, the impacts of the war in Ukraine have been more direct. The challenges that businesses around the world have been having stem from supply chain-related disruptions and record gas prices, but not only.

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In the long run, it is likely that a challenge that will arise for these companies is making up for lost business in Russia. With stock markets at record levels after the pandemic, the question is whether this scaling-back of business in an emerging market, can be made up for in other markets and if so, how long that will take. Take the case of Carlsberg again, shares of which have fallen 29% this year, climbing 7% after the announcement that it was pulling out from Russia. This hike in stock price comes after Carlsberg executives have declared that the move will mean a substantial hit to their businesses. The question is whether they can justify their current stock price, as losing 9% of business clearly indicates a negative trend in performance, contrary to the trend in the stock market.

The issue of growth prospects extends to other companies in the consumer and retail industry, as companies found themselves in the position of having to make up for lost business elsewhere. But that could take years, and whether investors have that patience remains to be seen. The scenario where Russia is not cut off from world trade is still possible, provided that the invasion of Ukraine stops and damages are paid for by the country. But until then, growth prospects appear to be a matter of concern for large companies in this industry.

TAGS: Supply chain, coronavirus, pandemic, Ukraine, wheat, consumer, goods, oil, gas, industry

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