ODDO BHF

MARKET *view*

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The 73/74 oil crisis: parallels and differences with the Ukraine conflict

> *"In seven out of eight recessions in the US since 1965, the right thing to do was to raise equity ratios again only shortly before the end of the recession. We are not there yet."*

"**History does not repeat itself, but it rhymes.**" Investors have not experienced such a strong supply shock in over 40 years. The current shock, which is increasing production costs, making goods and services scarcer and more expensive, was largely triggered by the Ukraine conflict. Many are trying to compare current market events with the oil crises of the 1970s in order to draw conclusions for their investment strategies. During the Yom Kippur War in October 1973, the Arab OPEC member states led by Saudi Arabia imposed a 6-month oil embargo against countries that supported Israel in the war. **But how comparable are the two supply shocks really, and what conclusions can be drawn for investors to safely navigate the current turbulent market environment?**

Then and now, a regional conflict triggered sanctions and developed into a global economic war. **This led to a drastic shortage of energy supply, accompanied by a sharp rise in energy prices.**

In both cases, rising energy prices fueled inflation in the US and forced the Federal Reserve to substantially raise interest rates, as the table shows. **The result: stagflation. High inflation without growth.** Inflation averaged 9.2% during the 1st oil crisis, and 8.4% during the Ukraine conflict so far. GDP growth fell from 5.7% in 1973 to -0.5% in 1974. For 2022, growth is estimated at 1.5%, down from 6% in the previous year. In the 1970s, stock prices didn't react well to such a mixed situation. The American S&P 500 (total return) only returned to its pre-crisis level after about 3 years. The maximum loss at that time was almost 50%. Since the Russian invasion of Ukraine, the S&P 500 has fallen by almost a quarter so far.

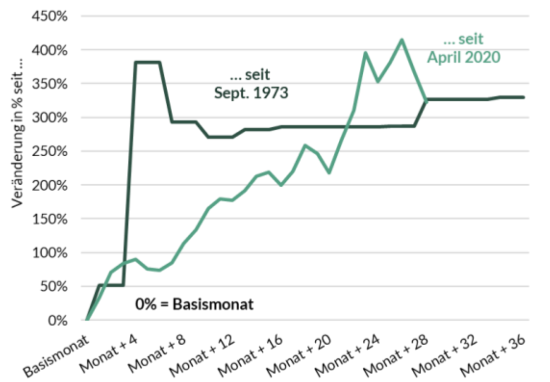
PARALLELS – 1ST OIL CRISIS AND THE UKRAINE CONFLICT

	First Oil Crisis	Ukraine Conflict (so far)
Inflation	9.2%	8.4%
Growth decline	from 5.7% to -0.5%	from 6.0% to 1.5%
US key interest rate	9.5% - 11%	0.25% - 3.25%
Stock prices	-44%	-23%

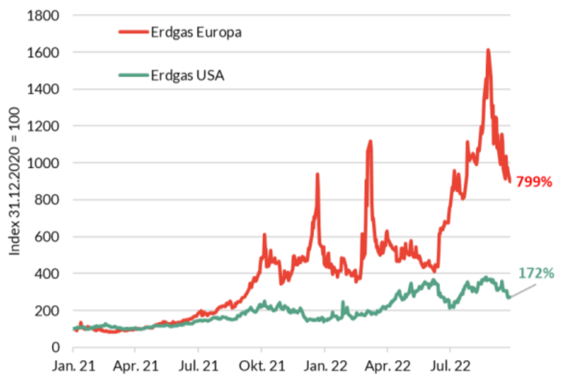
Source: Refinitiv Datastream; 1) US CPI, in % yoy average Oct. 1973 - Mar. 1974 resp. Feb. - Aug. 2022; 2) Difference in US GDP growth rates between 1973 and 1974 resp. 2021 and 2022 (in percentage points); 3) Fed Funds Rate (upper bound); Oct. 1973 - Apr. 1974 resp. Feb. - Sep. 2022; 4) Maximum Drawdown S&P 500 12.10.1973 - 03.10.1974 resp. 29.03.2022 - 30.09.2022

The first graph shows the rise in oil prices during the 1st oil crisis and since the start of the war in Ukraine. **Both price shocks are very similar in magnitude. However, the current rise in energy prices is taking place over a much longer period of time**. It began during the peak of the Covid crisis in April 2020. **The crucial difference is that production was much more energy-intensive at the time**: compared to the 1970s, only half as much oil is needed today to produce the same economic output. In addition, the US's status has changed from a net energy importer in the 1970s to a net exporter. The second graph shows that Europe is far more affected by rising gas prices than the US.

OIL CRISIS IN COMPARISON AND ENERGY PRICE SHOCK (UKRAINE)



Source: World Bank / Bloomberg; period: 01.09.1973-30.09.1976; 01.04.2020-31.08.2022



Source: Refinitiv Datastream; period: 01.01.2021-27.09.2022.

During a stagflation, corporate profits come under pressure from several sides. High energy bills and wage demands increase costs, while a negative consumption and investment climate threatens sales from the demand side. **In such an environment, selecting companies that can pass on increased costs to their customers and show robust sales growth is more important than ever**. Focusing on "crisis-proof" business models with pricing power is, in our view, crucial for investment success. We focus on quality companies with high capital efficiency, clear competitive advantages and pricing power. The crisis has already left its mark: measured by indicators such as price-earnings ratio, price-book ratio or cash flow yield, equities are no longer expensively valued, at least in Europe and in emerging markets. As long-term investors, we ask ourselves, when is the right time to raise equity ratios again. **In seven out of eight recessions in the US since 1965, the right thing to do was to raise equity ratios again only shortly before the end of the recession. We are not there yet.**

We are keeping duration short. The 1970s have shown that supply shocks can last longer, because, unlike a demand shock, the government cannot tackle an economic decline through expansionary fiscal policy or interest rate cuts. If it did, inflation would rise even more. The high inflation of the 1970s did not end in the US until after the 2nd oil crisis, when the Federal Reserve under Paul Volcker raised key interest rates to over 20% in the early 1980s, plunging the economy into recession. **Such high interest rate hikes are unthinkable today, as countries are much more indebted than in the early 1970s.** If the ECB were to raise interest rates too much, a second euro crisis would loom. Given the limited leeway of central banks, especially in Europe, **the phase of high inflation could last longer than the market currently expects.**

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