Investment implications of Russia's Ukraine invasion

Fullerton Market Updates

February 2022

Executive summary

- Equities have suffered the most in Russia (because of the painful impact likely to come from economic sanctions), followed by Ukraine, and thereafter Europe (given its dependence on Russian energy). With lower trade dependencies, equity markets in the US and across Asia have suffered relatively less. The declines in safe-haven bond yields were relatively shallow because global recession risk is still judged to be low.
- What may become more concerning to investors, and a dilemma for central banks, is the risk of stagflation – as the spike in commodity prices, especially energy, will push inflation even higher and may cause significant cuts in industrial production and household spending.
  - But if global growth slumps then wage inflation pressures are likely to correct faster and central banks could slow the normalisation of interest rates.
  - If recession risks appear on the radar, global policymakers may be forced to bring back more stimulus.
- Aside from the adverse impact from this huge geopolitical shock, we have turned negative on global equities because markets appear to be front-running weaker fundamentals to come.
  - Global liquidity will likely continue to tighten, and the market is pricing in significant US Fed rate hikes.
  - With high valuations, especially across Developed Markets, rising yields suggest that equity markets could de-rate further.
- As sharp as corrections have been into this year, it is premature to be too bearish on global risk assets. Investors should still remain active as growth assets have favourable longer-term trends, but be extra cautious and consider taking some money off the table for now, with the aim of being better positioned to take advantage of potential rebounds.
- What may ultimately prove the greatest concern and uncertainty for investors is what will Russia do next if it successfully annexes Ukraine. President Biden has stated that if a NATO member is attacked, then US troops will be committed, which would likely create a much greater conflict across Europe.

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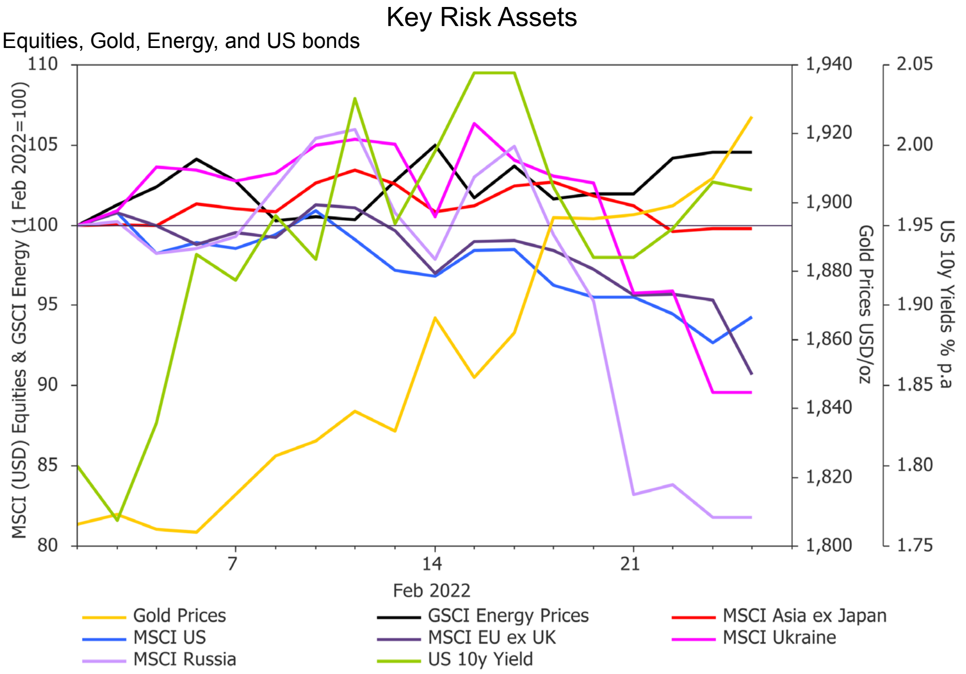
Russia's invasion is a 'risk-off' shock for investors

On 24th February 2022 Russia launched an invasion of Ukraine by land, air and sea, engaging the biggest attack against another country in Europe since World War II (WWII). Russia's annexation attempt is a traditional 'risk-off' geopolitical shock for investors, with equities falling, and commodity and gold prices rising (see Figure 1).

Equities have suffered the most in Russia (because of the painful impact likely to come from economic sanctions), followed by Ukraine, and thereafter Europe (given its dependence on Russian energy). With lower trade dependencies, equity markets in the US and across Asia have suffered relatively less. The declines in safe-haven bond yields were relatively shallow because global recession risk is still judged to be low.

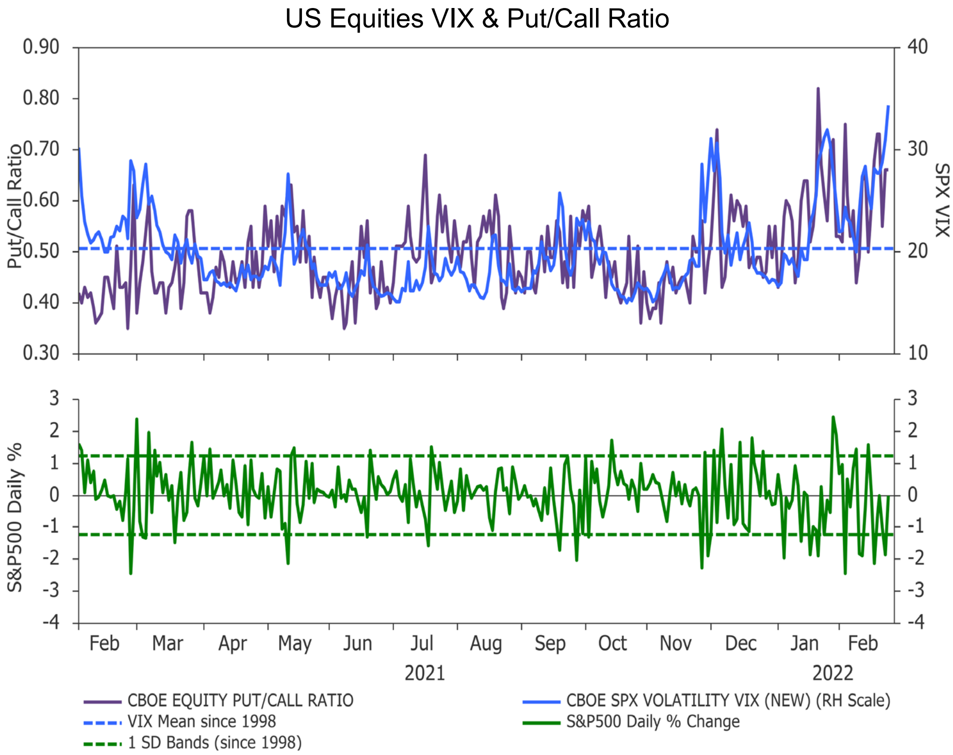
The volatility in US equities hit its highest rate since the COVID-19 driven recession, while the put/call ratio remained high signalling that investors were seeking downside protection (see Figure 2). Investors should be prepared for additional volatility, but history shows that geopolitical shocks are often transitory. For example, Reuters reported (19 Feb 2022) that of the 30 or so global geopolitical crises since WWII, the US S&P500 had rebounded higher after three months for 60% of the shocks (and was higher one year later for 85% of the shock events).

Figure 1: Movements in key risk assets



Source: Refinitiv Datastream, 25 February 2022

Figure 2: US equity volatility and put/call 'protection indicator'



Source: Refinitiv Datastream, 25 February 2022

NATO's Secretary-General Stoltenberg condemned Russia's attack and said NATO allies will meet to tackle the consequences of Moscow's aggression. However, it is not clear that NATO forces would engage Russian forces in Ukraine, and certainly President Biden does not want to involve US troops.

What remains most likely for now is that the Western countries will fight Russia with economic and financial sanctions, and give financial, diplomatic, and military (equipment) support to Ukraine to help them defend their sovereignty.

Figure 3: Russian troop build-up before the Ukraine Invasion

Source: The Economist, February 2022

The West will fight with sanctions and aid for now

To choke-off Russian capital flows, the US, UK, EU, Japan, and Canada had already announced measures to limit their trade of Russian sovereign debt. Infrastructure investment benefiting Russia had also been restricted, with sanctions against the Swiss company Nord Stream AG that built the Nord Stream 2 gas pipeline[1].

In response to Russia invading Ukraine, the G7 announced more severe sanctions that will adversely impact trade and capital flows to Russia over time. On 24th February, US President Biden outlined new trade restrictions (especially on Russian imports of high-tech equipment), the freezing of Russian assets held offshore, and embargos on foreign interactions with Russian banks.

The West also announced that it will impose restrictions on Russia's central bank which will limit its ability to utilise its $640bn (USD) international reserves to support the economy[2]. The most dramatic action was to remove select Russian banks from the SWIFT international payments system. SWIFT removal is the so-called "financial nuclear weapon" because of the significant damage it can inflict by making Russian trade and business activities much more difficult.

Global sanctions this time around are likely to have a much more painful and lasting impact on Russian economic activity, and its financial assets, than was the case in 2014 after Russia's annexation of Crimea. A key motivation of the sanctions is to try and maximise the pain on Russia over time but minimise any adverse spill-over effect to Western countries. On the latter, that is a key reason why, at this stage, embargos are not being placed on Russia's oil and gas exports.

[1] Nord Stream AG's parent company is the Russian state-owned gas giant Gazprom. The Nord Stream 2 $11bn (USD) pipeline was finished in September 2021 but is still not operational, pending certification by Germany and the EU. It is a 1,200km pipeline under the Baltic Sea which will take gas from the Russian coast near St Petersburg to Lubmin in Germany. It runs parallel to the existing gas pipeline, Nord Stream, which has been operational since 2011.

[2] Source: Reuters News, 25 February 2022. Sanctions were also placed against Russian President Putin and Foreign Minister Lavrov. Such actions against heads of state are rare: other examples include the leaders of North Korea, Syria, and Belarus.

Western countries, dominated by the US, the EU, and the UK, are also likely to give Ukraine significant financial support, military hardware, and equipment, to help give the best defence against Russia's invasion. Ukraine's President Zelenskyy has called on all Ukrainians to fight to preserve their independence and sovereignty, and has urged all Russians living in the region to pressure Russian President Putin to end the invasion.

The invasion could end quickly, but Western countries may economically isolate Russia for years

Russia's motivation seems to be that it wants to force a change of government in Ukraine, and a new regime could help Russia re-establish its sphere of influence over the former Soviet Republic. Ukraine was the second most powerful republic in the former Soviet Union, and Russia seems to have become increasingly concerned, since it annexed Crimea back in 2014, that Ukraine is building stronger relationships with the West.

Given Russia's significant cyber warfare expertise, and military power, it may be able to destroy Ukrainian military installations and resources quickly and then topple the Ukrainian government. Russia will certainly want to avoid any prospect of a prolonged conflict against a country that it hopes to shape politically, and that is home to many Russian citizens. If Ukraine loses its sovereignty, then Western countries could economically isolate Russia for years.

What may ultimately prove the greatest concern and uncertainty for investors is what will Russia do next if it successfully annexes Ukraine. President Biden has stated that if a NATO member is attacked, then US troops will be committed, which would likely create a much greater conflict across Europe (Ukraine is not a NATO member).

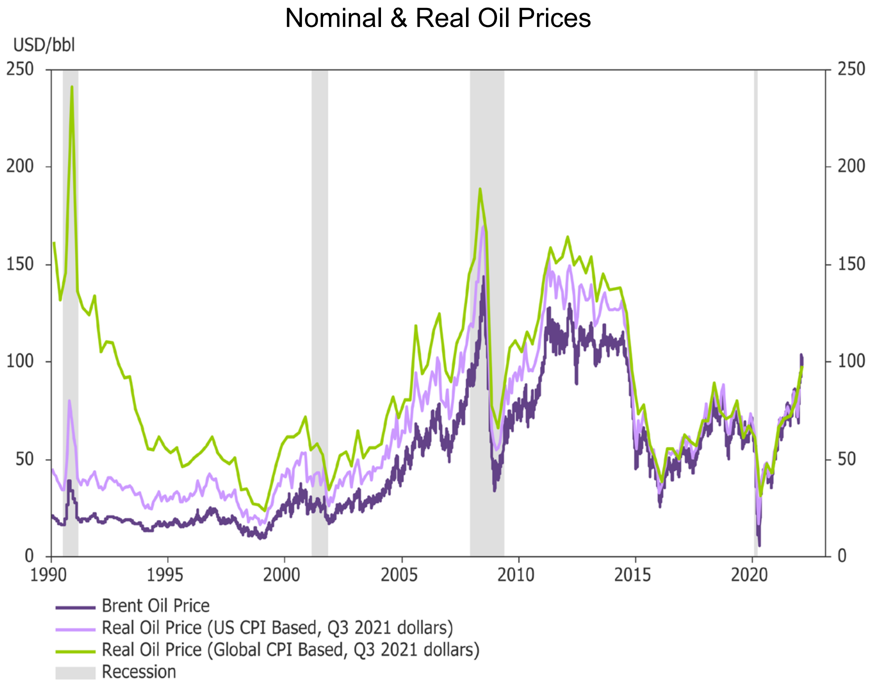
Investors face significant stagflation risks from higher oil prices

With Russia being such a significant player in global energy markets, real oil prices (i.e. with the effect of generalised inflation removed) have surged higher and remain a significant downside risk to global growth going forward.

High commodity prices, especially for energy, and surging raw material costs, will push inflation even higher and may cause significant cuts in industrial production and household spending. If global growth comes under significant stress then such stagflationary forces could cause markets and central banks to be less hawkish on tightening policy. If recession risks appear on the radar, then excessive wage inflation will ultimately collapse, and global policymakers may be forced to bring back more stimulus.

That said, there may still be some cushion to the global economy as the degree of stress from high real oil prices is not yet as large as periods in the past, when demand destruction proved much more significant, such as pre-GFC (2008) or even during the Gulf War in 1990 (see Figure 4).

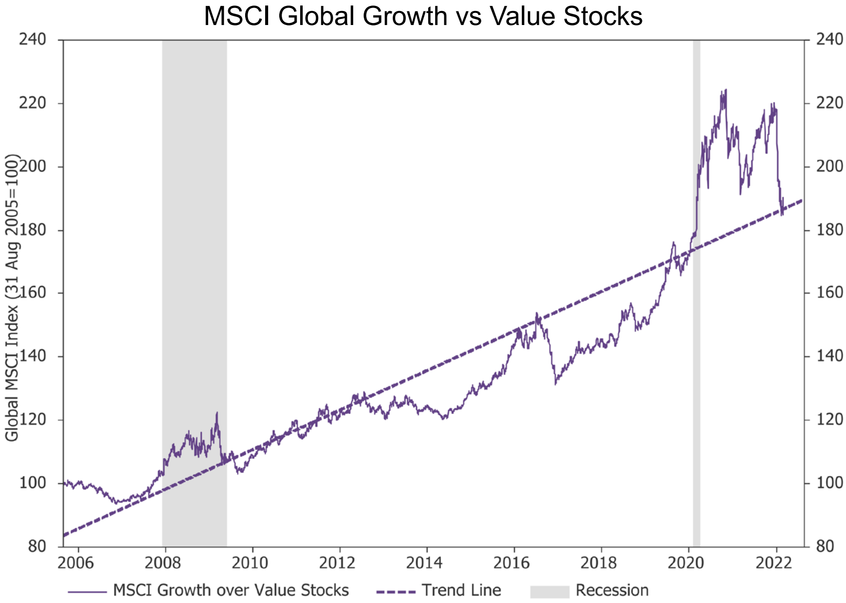
Figure 4: Oil price shocks



Source: Refinitiv Datastream, 25 February 2022

As sharp as corrections have been into this year, it is premature to be too bearish on global risk assets. Investors should still remain active as growth assets have favourable longer-term trends (see Figure 5), but be extra cautious and consider taking some money off the table for now, with the aim of being better positioned to take advantage of potential rebounds.

Figure 5: Global growth stocks relative to value stocks – strong long-term outperformance from growth over value since 2006



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