Investment Strategy

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Russia-Ukraine tensions: market implications

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- **A sharp escalation in Russia-Ukraine tensions took many investors by surprise.**
- **In this note, we detail our thoughts on market implications over short/medium/long-term.**
- **We remove our preference for Russia USD Sovereign debt which we held since March 2019.**

A sharp escalation in the Russia-Ukraine stand-off quickly spiralled into what is arguably the "biggest military conflict in Europe since the second world war" and caught many investors including us by surprise. What was initially seen as a "peacekeeping mission" by the Russian troops in Ukraine quickly turned into a full-scale invasion and this resulted in a range of punitive sanctions on Russia by the West. Financial markets were hit by volatility as they tried digesting the barrage of headlines. While we bear in mind that the situation continues to evolve, in this report we try to assess the implications of this development based on the information we had at the time of writing this report. We try assessing the impact on three different time horizons: short-term, medium-term, and long-term.

Short-term (next few weeks to a couple of months)

In the short-term, should the geopolitical risks materially intensify from here, risk assets could see further downside. Equally as the geopolitical tensions abate, financial markets could see a tactical bounce over the next weeks to months. It is indeed difficult to time the turn in the market sentiment. Yet most geopolitical risk-off events of the past (outside the world wars) provided a good buying opportunity with most risk assets recording a robust performance over the subsequent 12 months (exhibit 1). Of course, this time around, there are additional drivers including the concerns about a tighter monetary policy that put any durable bounce into question. Yet, looking at recent market performances, and putting them against the historical templates of escalating geopolitical tensions, once the geopolitical risks peak, one should expect a move higher in equities led by cyclical segments including emerging markets and Eurozone equities by geography, and information technology, consumer discretionary, industrials, and materials by sectors. Rise of geopolitical risks in commodity exporting countries has always embedded a premium into the commodity prices which remained high even during the normalization phase. Oil, industrial metals, and food commodities have all been in focus over the recent weeks. Here, we think oil prices have already embedded a significant risk premium and could be vulnerable to any increase in supplies by the OPEC members or the return of the US shale production. Equally should additional sanctions target Russian energy exports, oil prices could rise sharply too. Food prices could remain elevated through the spring months of the Northern hemisphere on unfavourable weather and potential disruptions to supplies from Russia and Ukraine. FX trends showed a mixed picture in the past episodes of rising geopolitical tensions. However, given the current situation, it may not be unreasonable to expect the EUR to recover against the US dollar in the near-term, in case risks begin to subside.

Medium-term (up to 12-18 months)

The recent rise of geopolitical risks could have a range of implications. In our view, the fundamental impact of any sharp rise in commodity prices due to disruptions and the implications of sanctions are likely to be felt on this time frame. Here, as we know Russia and Ukraine are both major commodity producers. Russia produces about 10% of the world's oil, and Russia and Ukraine together account for one-third of the world's wheat and one-fifth of the world's corn production, according to the US Department of Agriculture. Russia produces about 40% of the world's palladium, and about 6% of the world's aluminium. Any interruption to energy exports from Russia could also have secondary impact on production of goods in the importing countries. Also, these disruptions could have more acute impact on some regions compared to others. Here, Europe stands out being more vulnerable thanks to its geographical proximity to Russia and Ukraine, strong trade and financial linkages (exhibits 2 and 3), and higher dependence on Russian energy. Sanctions on Russia by the West continued to be tightening even at the time of writing this report. The sanctions imposed by European Union, the UK and US so far were aimed at Russia's oligarchs as well as banks, high-tech companies, and aircraft makers. West's sanctions on Russia's central bank and their decision to cut some Russian lenders from the Swift global payments system could be the most impactful of the current set of restrictions ("Western leaders to sanction Russia central bank and cut some lenders from Swift", Financial Times, February 27 2022). Whilst it is true that most acute impact should be felt in Russia, some of these sanctions could impact growth in developed economies too, in our view. Developed world central banks which were about to embark on a policy normalization path could face the 'renewed' conundrum (see 2022 Outlook: Catch'22) of further rise in prices of energy and other commodities, but also the prospects of weaker growth in their economies.

Long-term (next couple of years and beyond)

There could be wide-ranging implications difficult to quantify at this stage. A multi-polar world with the rise of the East – which was challenging the hegemonic stability of the world – was already under making even before this event. This power-shift will likely get accelerated through the current set of events. Deglobalization or slow-lane globalization or hypo globalization – whatever one might want to call it – could pick-up pace and in turn reshape trade and financial relations around the globe. Spends on defence goods, cybersecurity, energy security and food security should rise across major economies.

Risk-premia could rise for European markets due to their geographical proximity to the epicentre of the current conflict. Also, markets could extrapolate the events in Russia and Ukraine to other regions – for example Asia – and that could increase the risk-premia there. This reinforces our thesis of lower long-term returns from financial assets broadly. In this context, it is worth noting that while the equity risk premium has not fallen substantially over the past couple of decades, total cost of equity fell as risk-free rates continued to decline (exhibit 4). This has two implications – first that equity returns should be lower over the next decade (does not immediately imply losses but lower returns compared to recent times), and second that equities should outperform bonds.

Summary

In the near to medium term, a tactical bounce in risk assets is possible as geopolitical risks fade into the background. However, that should shift the focus back to renewed dilemma of central banks and feed into uncertainty for financial markets. This means headline volatility will remain high over the next couple of months possibly paving a way for a better second half of the year. But in absence of concrete evidence of a recession, we think it is prudent to stay invested with a diversified and disciplined approach. We reiterate our asset allocation strategy of staying **overweight cash, underweight bonds, and neutral on both equities and alternatives**.

Removing our selective preference for Russia USD Sovereign debt

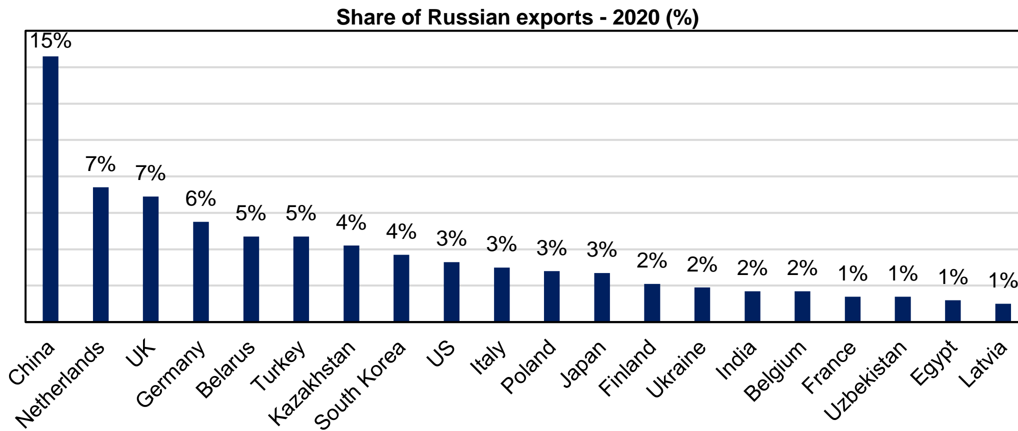
We remove our selective preference for Russia dollar sovereign bonds on the back of rising political risk premium and risk of rating downgrades. US along with the allies and partners have announced a range of new measures targeting Russia's bond markets. The first round of measures announced by the US and the EU targeted trading restrictions in the secondary market of new Russian sovereign bonds issued post March 1 2022. The second round of measures announced on February 24 2022 by US President Biden in partnership with US allies and partners targeted Russia's banking, technology and aerospace sectors. The new measures also include new restrictions which "stop the Russian government from raising money from US or European investors". These restrictions have also been imposed on the trading of new debt of Russia's largest state-owned enterprises and banks issued after March 26 2022. US investors have been banned from purchasing new dollar-denominated Russian debt since 2014 while US banks were restricted from participating in the primary market for new sovereign Eurobonds since 2019. However, before the introduction of the new measures, indirect participation was still possible with investors buying from local banks who participated in the primary market. Given the restrictions on new primary issuance participation, there is a rising probability of the possible exclusion of the Russia dollar bonds from the Global/EM bond indices. S&P ratings has downgraded Russia's foreign currency rating to BB+ while Moody's rating agency is reviewing a possible downgrade to junk status. A rating downgrade by Moody's rating agency could result in exclusion of Russia bonds from the Bloomberg Global Aggregate Bond index as the index rule requires two out of three rating agencies to hold an investment grade rating (BBB+ and above) to remain part of the Global Aggregate bond index. Russia accounts for a small weight of 0.19% in the Bloomberg Global Aggregate Bond index. Even in the EM USD bond indices, the weight of Russia is marginal. Russia USD bonds (sovereign + quasi-sovereign+ corporate) have a weight of 2% in the EM USD aggregate bond index. The share of Russia USD sovereign bonds in the EM USD sovereign bond index is lower at 1.9%, and has more than halved from 4.6% in 2020. However, despite these insignificant amounts and decline in country weights of Russia over the years, EM USD bonds have been the worst impacted in the fixed income space during the market sell-off that followed Russia's invasion of Ukraine. We believe the underperformance of EM USD bonds will have to do with the rising risk-off sentiment due to the Russia-Ukraine risks coupled with the prevalence of Fed tightening risks rather to do with the exposure to Russia bonds which is limited in the fixed income indices. EM USD HY particularly those with weak external balances will be most vulnerable to the market volatility. Within our fixed income allocation, **we maintain our neutral stance on EM USD sovereign bonds and keep our selective preference for high-quality GCC bonds and Brazil USD sovereign bonds**.

Exhibit 1: Performance of various assets around geopolitical crises

	During crises*					Subsequent 12 months**					Average***	
	Russian crisis	9-Nov	Iraq invasion	Crimea annexation	Ukraine invasion	Russian crisis	9-Nov	Iraq invasion	Crimea annexation	Ukraine invasion	During crises	Subsequent 12M
Equity risk premium & rates (bps)												
Global ERP	98	80	140	3	40	-105	-14	-101	18		80	-51
UST 2Y yield	-129	-75	-177	12	5	156	-97	15	15		-93	22
UST 10Y yield	-122	-24	-144	3	4	170	-91	21	-82		-72	5
Equity regions (%)												
ACWI	-20	-16	-24	0	-2	33	-10	48	7		-15	19
DM	-19	-16	-24	0	-2	32	-11	47	7		-15	19
EM	-32	-18	-23	-1	-6	60	15	78	3		-18	39
US	-15	-15	-23	2	-1	29	-14	39	13		-13	17
Canada	-28	-13	-11	0	-3	42	-7	53	-6		-13	20
Europe ex UK	-26	-22	-29	0	-5	23	-9	66	-4		-19	19
UK	-20	-16	-27	-3	-3	20	-8	50	-3		-17	15
Japan	-19	-9	-22	-4	-4	82	-12	48	17		-14	34
APac ex Japan	-16	-18	-20	-1	-5	63	21	63	7		-14	38
EM LatAm	-35	-19	-31	0	0	25	-14	91	-18		-21	21
EM EMEA	-37	-19	-7	-4	-10	62	12	72	-9		-17	34
Equity global sectors (%)												
Comm. Services	-13	-5	-16	1	-2	36	-35	47	2		-8	12
Cons. Discr.	-23	-22	-29	-1	-5	42	1	54	12		-19	27
Cons. Staples	-15	-8	-24	1	-1	1	3	36	10		-12	12
Energy	-7	-14	-19	1	-4	20	-4	36	-17		-10	9
Financials	-32	-20	-27	0	-5	33	-7	57	5		-20	22
Health Care	-10	-6	-18	0	0	9	-17	27	23		-9	11
Industrials	-22	-20	-27	0	-2	38	-5	52	5		-17	22
IT	-20	-21	-24	1	-2	103	-22	59	18		-16	40
Materials	-21	-19	-21	-3	-2	36	11	60	-6		-16	26
Utilities	-3	-8	-23	2	0	-3	-24	39	1		-8	3
Equity factors/styles/sizes (%)												
Large cap	-19	-16	-23	0	-3	35	-10	45	7		-15	19
Mid cap	-22	-18	-23	1	-2	34	-2	59	7		-16	25
Small cap	-23	-17	-23	2	-2	38	1	70	3		-15	28
Growth	-19	-15	-22	0	-2	37	-7	42	11		-14	21
Value	-21	-16	-26	0	-3	29	-14	54	3		-16	18
Dividend yield	-15	-16	-24	0	-2	15	-4	42	1		-14	13
Quality	NA	-13	-20	0	-1	NA	-5	33	11		-11	13
Momentum	-25	-14	-19	0	-3	44	5	42	11		-14	25
Nasdaq-100	-13	-23	-17	0	-1	88	-23	49	22		-13	34
Commodities (%)												
ICE Brent	12	-4	32	-2	4	65	12	-2	-48		10	7
Nymex WTI	12	-5	42	-1	-2	57	14	-1	-54		12	4
Gold	3	6	13	1	3	2	12	14	-11		6	4
Silver	-1	10	2	-4	3	7	2	48	-18		2	10
Platinum	-10	10	33	1	3	16	15	28	-22		9	9
Copper	-5	-3	6	-10	0	9	3	79	-6		-3	21
Alluminium	-2	-3	5	-1	8	14	-3	17	7		0	9
FX (%)												
EUR USD	8	0	20	1	-1	-10	7	12	-22		7	-3
GBP USD	3	0	9	-2	-1	-3	7	15	-9		3	3
USD JPY	-3	-2	-8	1	0	-23	6	-4	17		-3	-1
CHF USD	-10	-5	-16	-1	0	10	-6	-5	10		-8	3

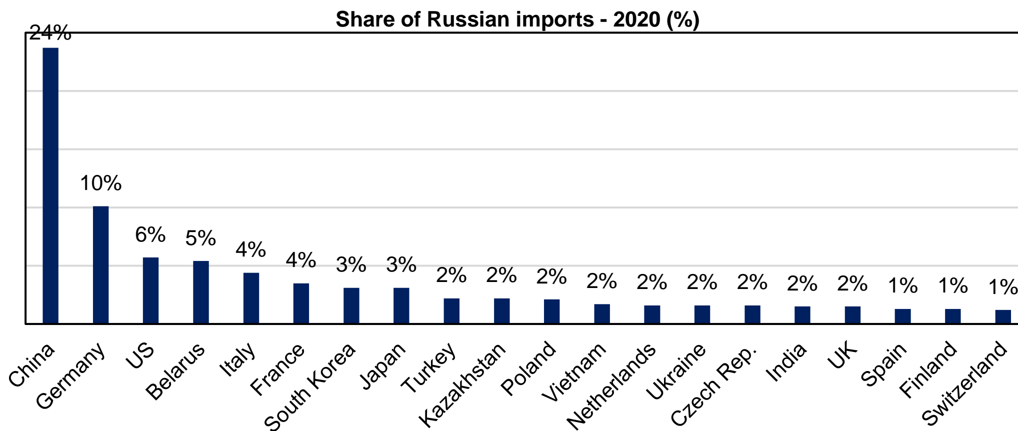
Source: MSCI, Refinitiv, and ADCB Asset Management | Notes: *Russian crisis (17/7/1998 - 2/10/1998), 9/11 (31/8/2001 - 21/9/2001), Iraq invasion (7/5/2002 - 7/3/2003), Crimea annexation (20/2/2014 - 26/3/2014), and Ukraine invasion (11/2/2022 - till date). **Performance 12m after the end of crises. ***Average of Russian, 9/11, Iraq, and Crimea crises.

Exhibit 2: Russian exports largely go to China and Europe



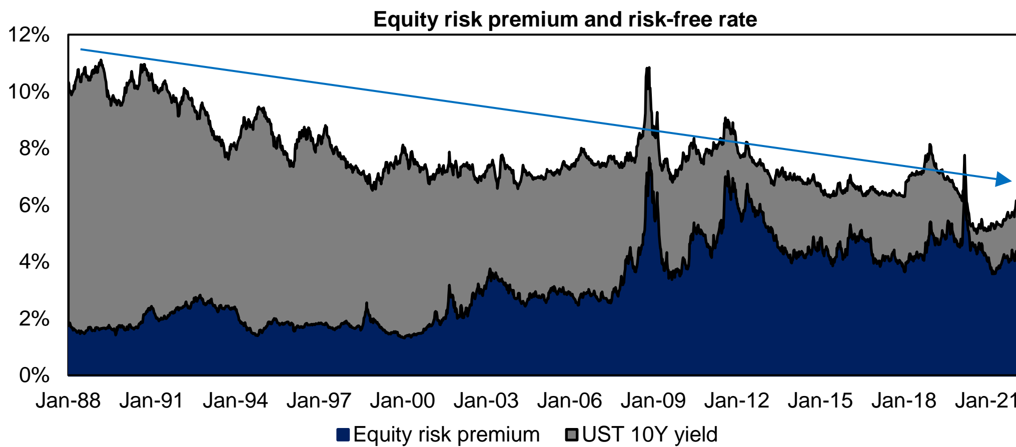
Source: International Trade Center, and ADCB Asset Management

Exhibit 3: Russian imports largely come from China and Europe



Source: International Trade Center, and ADCB Asset Management

Exhibit 4: While the equity risk premium has not fallen substantially over the past couple of decades, total cost of equity fell as risk-free rates continued to decline



Source: ASR, Refinitiv, and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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