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Special Coverage:

Geopolitical developments surrounding Russia-Ukraine

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Key takeaways

- After weeks of rising tensions, a military incursion in Ukraine was announced on the morning of Feb 24th. Attention is squarely focused on military developments and repercussions, including political decisions and sanctions which are likely to be announced in due course.
- From a market perspective, the risk-off tone has to led to support for safe haven assets. Commodity prices are higher across the board on fears of supply disruption and inflation pressures overshadowing growth concerns. Weak sentiment is also weighing on equity markets across Europe and the US – we downgrade our view on Global Equities to neutral and European Equities to underweight.
- Investors should stay invested, as geopolitical events have historically led to sharp (albeit short-lived) corrections, and over time the broader economic context will eventually dominate. Nevertheless, the elevated uncertainty requires a more prudent stance in portfolios, whereas the impact of high energy prices on inflation requires diversification. We also emphasise a balanced approach between cyclicals and defensives.

What happened?

- The situation escalated dramatically with Russia's "special military authorisation" to demilitarise Ukraine. The US, European Union, UK and other nations effectively characterised this move as a "full scale invasion". Martial law has been declared in Ukraine, and the UN security council has been convened, with developments unfolding.
- A first round of sanctions imposed on Russia has already been announced – targeting political figures, lawmakers and some financial institutions. Approval of a major gas pipeline (not yet operational) connecting Russia to Germany was also put on hold, delaying any future gas supplies rather than immediately cutting energy supplies. Market impact of the said measures was relatively contained, with further rounds of sanctions expected as developments unfold.

What has been the market reaction?

- The MOEX Russian equity index plunged by more than 30% after market open, the largest amount on record. Russia USD sovereign bonds fell as much as 35pts in the long end.
- Oil future surged more than 5%, with Brent rising above the USD100 threshold and trading at USD102.75.
- As Russia maintains a large share of commodities production, a range of commodities saw upward pressure over potential supply disruption. Aluminum, for instance, spiked to record highs, though the market will keenly watch developments surrounding natural gas, given that Europe imports 90% of its needs, with at least 40% of the share originating from Russia.
- Demand for safe haven assets has naturally increased, with Gold reaching a 13-month high of USD1,940 and the US 10-year Treasury yield falling 11bps to 1.87% before retracing to 1.92% later on the morning of Feb 24.

What to look out for next

- Military developments on the ground, political decisions behind the scenes, and sanctions will remain key catalysts in the near term. Institutional investors are likely to limit their exposure to the region on any sign of harder sanctions. Potential disruptions of natural gas or energy, with depleted inventories and high prices, and further strains on securing energy supplies, may weigh on inflation in the Europe and the ECB's guidance.
- The market has maintained its previous expectations for interest rate hike normalisation, even though policy makers will keep a close eye on financial conditions, asset price moves and any signs of confidence or growth. Forward markets are still pricing in six rate hikes in the US and 40bps of hikes in Europe this year, as higher energy prices are overshadowing growth concerns.

Investment summary

- Depending on their severity, geopolitical events have historically led to sharp – yet short lived – market sell-offs. In the vast majority of instances, remaining invested has been a strategy that has paid off, as the market assigns a greater weight on the overall economic context (global growth, inflation, monetary policy, corporate earnings, etc). This has been the case during the Crimea invasion, Gulf War, September 11 attacks, the Brexit referendum, etc. Timing markets is a very difficult exercise, and raising high cash allocations can be at the detriment of clients, as positions may be sold while the correction is already well-underway, whereas reinvestment may not be quick enough to capture the recovery.
- We **downgrade Global Equities to neutral**, bringing cyclicality in line with our allocation to defensives. We also **downgrade European Equities to underweight**, as the region will trade with a higher beta to Russian developments in the near-term, given geographical proximity and higher trade linkages compared to the US.
- We maintain an **overweight in Energy stocks** that have outperformed in the value rotation, remain cheap and are likely to benefit from elevated oil prices. In the US, the rig count has notably increased in recent weeks, driven by the rise in oil prices. And although major energy companies are enjoying stronger profitability, geopolitical developments will only accelerate the urgency of European and other nations to diversify their source of supplies and reduce the over-reliance on one trading partner. The rise in oil and natural gas prices highlights the relative cheapness of wind and solar, and the shift to renewables should in any case accelerate as climate goals strengthen and emissions reductions become enforced.
- The energy sector dynamics should also **lend support to US high yield bonds** over the medium term, given the sector's large weight within the index. In the short term, risk sentiment may weigh on spreads, however given the flatness of the US yield curve, the low default rates in credit, improved entry points – we believe **short-dated high yield opportunities will become increasingly attractive** once the geopolitical situation becomes more clear.
- We also continue to emphasise scaling in to long–term secular trends in technology (including cybersecurity), as companies and nations deploy more capital to improve the resilience of their networks and business operations.

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