How Russia's invasion of Ukraine has impacted markets

We're assessing how economic and financial sanctions, energy price rises and the market's reaction determine what the conflict might mean for investors.

On Thursday Ukraine woke up to explosions as peace in Europe was shattered. After Russia spent several weeks building up a sizable military force along its border with Ukraine, President Vladimir Putin ordered the army to invade Ukraine. NATO said "We now have war in Europe on a scale and of a type we thought belonged to history."

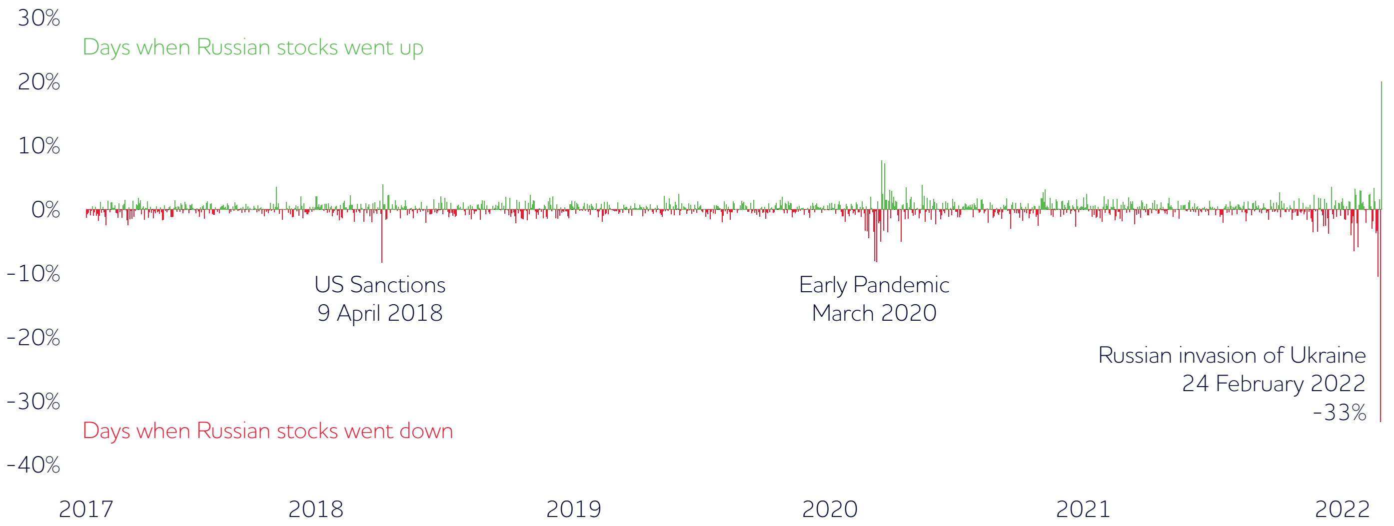
Although a Russian attack on Ukraine had been feared, investors appeared surprised by the decision to launch a broad-scale invasion beyond the Donbass region. News of attacks on the capital, Kyiv, and other major Ukrainian cities on Wednesday evening and Thursday morning triggered a wave of risk aversion across global financial markets, including – but going far beyond – an historic crash in Russia's stock markets (figure 1).* Amid the geopolitical tension and genuine humanitarian concern, it became obvious that regardless of the outcome, this conflict could complicate a challenging economic outlook even further.

Nations around the world have condemned Russia's actions, and the US, the UK, and other European powers have made good on their promise to implement new sanctions in response, sanctions that target key Russian individuals linked to the Putin regime and significant financial institutions. The US has cut off Russia's biggest lenders from its financial system, while the UK banned Russian airlines from its airspace, with Europe following suit over the weekend. Germany has halted approval of Gazprom's Nord Stream 2 pipeline, which would transport natural gas from Russia.

Over the weekend, Russia was removed from the Swift payment system, preventing its firms from settling transactions. Perhaps the most hard-hitting sanctions are those that have frozen the Russian central bank out of the global financial system, leaving it unable to access its dollar and euro reserves and struggling to maintain the value of the rouble, which dropped by more than 40% in the early hours of Monday 28 February.

Figure 1: Russia's stock market has suffered

Daily movement of the MOEX Russia Index.



Source: Bloomberg

* The Omnis strategy funds had no direct exposure to Russia by this point
https://omnisinvestments.com/news/2022/an-update-on-current-geopolitical-tensions

Omnis INVESTMENTS

In response, Putin has placed his nuclear forces on high alert and restricted access to Russia's airspace. Meanwhile, to counteract the economic consequences of the west's actions, the Russian central bank has raised interest rates from 9.5% to 20% and engaged in currency markets in an attempt to support the rouble. The bank is also injecting liquidity into the system to try and contain the fall-out from the sudden increase in demand for cash from businesses and individuals alike.

Market volatility has risen sharply and most major markets initially fell on the news of the invasion, before recovering somewhat later in the week (figure 2). It is reasonable to expect markets to remain volatile for the foreseeable future. It is likely that the conflict will continue impact investor sentiment over the short-to-medium term.

The biggest risk to the global economy is the likelihood that this conflict will push commodity prices higher which in turn could push inflation higher. Even before Russian tanks rolled into Ukraine, western governments were struggling with rising energy prices that threatened to derail economies emerging from two years of a pandemic.

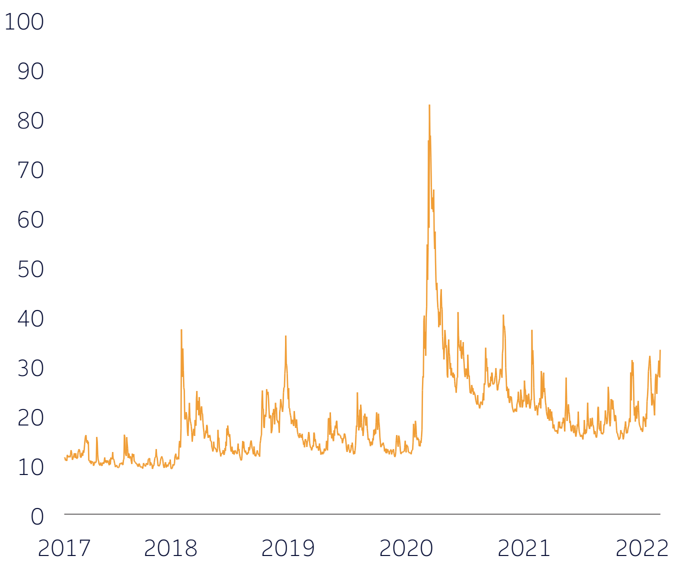
From crude oil to diesel to natural gas, the fossil fuels that power the global economy are trading at or towards record levels (figure 3). This rise threatens to redraw geopolitical relations between producers and consumers, drive up inflation and potentially even disrupt the fight against climate change. Russia and Ukraine are also large producers of wheat, grain and cereals, and the conflict could feed through into food price inflation.

European natural gas prices also spiked this week, reflecting fears that Russia could retaliate by withholding exports accounting for about a third of the continent's gas needs in retaliation for new sanctions and Germany's decision to indefinitely suspend certification of the Nord Stream 2 pipeline.

This makes life difficult for central banks. On one hand, they wouldn't want to raise interest rates into an environment where there is a war in Europe. But this is going to be inflationary, so they can't just sit tight. It's going to be a bit of balancing act from here. For example, there had been talked that the US central bank, the Federal Reserve (Fed), might raise rates by half a percentage point in March. As a result of last week's events, many now expect that the Fed will still raise rates, but maybe by a more modest quarter percentage point instead.

Figure 2: Market volatility has increased

The VIX Index, which measures of the amount of volatility traders expect for the US' S&P 500 index during the next 30 days. It closed on a level of 30 on Thursday 25 February, well above its average since 1990 of 19, and steeply higher than its start of year level of 17. It's not hard to imagine a scenario where it moves even higher in the coming days as events continue to unfold.



Source: Bloomberg

Figure 3: Energy prices have soared

The price of oil, which had already been climbing as economies reopened post-Covid, has breached the $100/barrel mark in the last week as a result of the escalation of the Ukraine/Russia conflict.

Source: Bloomberg, using Generic 1st Crude Oil, Brent.

The other important angle here is that higher energy (and food) prices are active headwinds to economic growth – so this is a stagflationary scenario. The prospect of increasing rates in a slowing growth environment is a dilemma for central banks.

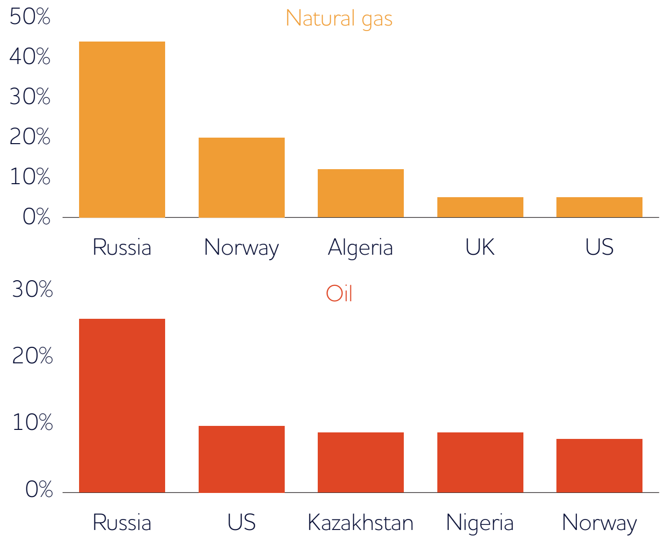
From an investment perspective, we think that Europe is likely to be impacted the most given its proximity to the conflict zone and its dependence on energy imported from Russia (figure 4).

Times like these remind us of the value of safe haven assets that are present in your portfolios – high-quality bonds such as US Treasuries and UK gilts or those denominated in the Japanese yen. They can protect against stock market volatility in periods of stress, and while in the long-term they may not deliver exceptional returns, they provide a valuable insurance policy, adding some stability to your portfolio in times of trouble, such as these.

History has shown that markets are capable of riding geopolitical tensions (figure 5). Trying to time the peaks and troughs remains a guess at best. The best investment strategy remains to stay invested for the long-term and in line with your attitude to risk.

Figure 4: Share of EU imports (top 5 trading partners in 2020)

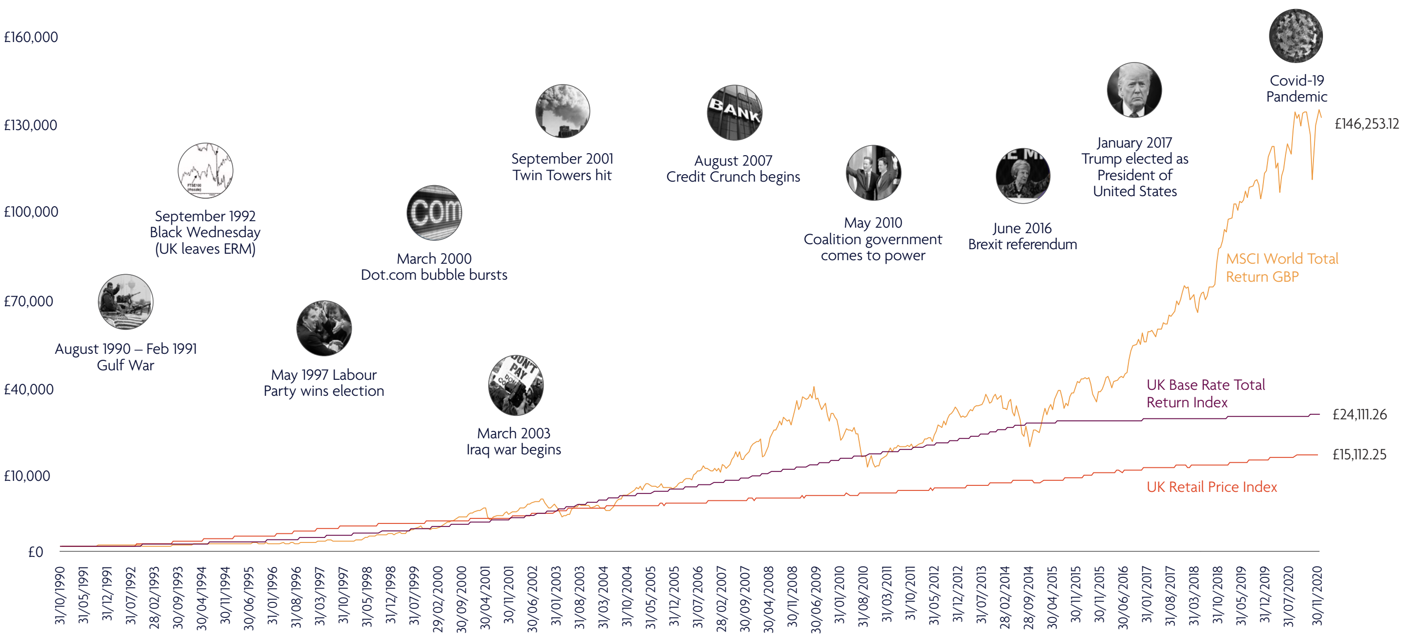
Europe relies on Russia's gas and oil. In 2020 Russia accounted for over 40% of all of the EU's gas imports and over a quarter of petroleum oil imports.



Source: Eurostat

Figure 5: Geopolitical events

History shows that key historical events can disrupt markets in the short term, but they almost always recover.



Source: Financial Express 30 November. This graph shows performance from 31 October 1990 to 30 November 2020.
Past performance is not a guide to future performance and should not be relied on. The value of investments and any income from them can fall as well as rise and you may not get back the original amount invested.

All our managers continue to manage our funds in line with their objectives and with a long-term horizon. Here are some of their initial reactions to the ongoing situation.

Fidelity International

Russia's invasion of Ukraine is not a complete surprise given the recent troop positioning, but is a significant and terrible escalation that creates a lot of uncertainty.

The exposure of European stock markets to revenues and profits generated in Russia and the Ukraine is very limited, but it clearly has significant knock on implications for commodity markets including oil, gas and wheat where Russia and Ukraine are key exporters. The sanctions imposed on Russia by the West focus on areas such as energy and defence, and naturally target Putin's closest allies. Beyond the US the matter is highly complex given Europe's dependence on Russia for its natural gas and oil needs.

As such, the key impact is less about economic contagion (Russia is only 1.3% of global GDP) or financial contagion (the US, UK and Germany have less than 0.2% of bank assets in Russia) but via commodities (Russia accounts for c.10% of global oil production and 41% of European gas imports, and is also a critical supplier of nitrogen fertilizers, palladium, nickel, potash and aluminium.[1] There is likely to therefore be further impact on headline inflation in Europe over the coming months. This may have implications for central bank policy, but this is usually driven by core rather than headline inflation and the commodity price rises would need to start impacting global growth before we see a change in direction.

Fidelity manages the Omnis European Equity Leaders Fund, the Omnis Global Emerging Markets Equity Leaders Fund and the Omnis Strategic Bond Fund.

Somerset Capital Management LLP

More than likely negotiations will resume after a de-escalation, albeit against the backdrop of sanctions. We believe sanctions will be directly targeted against the Russian state and associated individuals, not the Russian people per se. Russia has a large pool of reserves as a buffer against an economic shock. Russia also has oil wealth on which much of Europe is reliant. As unpalatable as the situation is today, there is likely to be a negotiation between Russia, Europe and the US once military action has concluded (which we hope will happen sooner rather than later). There will be a hit to the Russian economy from sanctions, but we believe non-state affiliated companies will be able to go about their business.

Somerset Capital Management manages the Omnis Global Emerging Markets Equity Opportunities Fund.

Schroders

We think events of Thursday are taking the global economy in a more stagflationary direction. We're adjusting upwards our forecast for inflation, while taking our forecast for growth downwards.

We expect Europe to be the region that takes the biggest hit to both growth and inflation. Globally the effects are likely to be less substantial as we were heading in a stagflationary direction anyway, given that the tightness of supply chains and labour markets is worse than expected.

We think US will have slightly higher inflation than we previously forecast, but is less affected by events in the Ukraine. So too China and emerging markets, though clearly if we have slightly slower economic growth than forecast, these markets will be impacted.

Turning to central banks, we think the Federal Reserve (Fed) will be more gradual now in its monetary tightening. we still expect it to raise rates in March, though perhaps only by 0.25%. We expect four rate rises from the Fed this year now.

The European Central Bank (ECB) is a different matter, because Europe is worse affected by the Ukraine conflict. This week's events have reinforced our conviction that the ECB won't raise rates this year.

Schroders manages the Omnis Japanese Equity Fund

T. Rowe Price℠

Further market impacts will depend on the ratcheting up of sanctions. Sanctions on the banking sector have the potential to disrupt some financial activity and international payments. The impact of any sanctions on technology imports are more complex to decipher, with China likely to be an alternative source for Russian businesses. Here, the response of the U.S. will be important to watch.

The predicament for major nations is how to sanction the Russian government without exacerbating the energy crisis— which would be supportive for Russia. Banning Russian oil and gas would have a huge impact on already high energy prices. This leaves other corporates exposed as potential targets. We continue to monitor developments here.

Higher oil prices will clearly continue to feed through to inflation outside of Russia. Inflation is already surging across the globe, weighing on markets, and putting pressure on central banks to raise interest rates. Higher energy prices will put central banks under even greater pressure. Much will depend on the extent and duration of the conflict and the wider implications and any secondary effects of sanctions. Sanctions will hurt the Russian economy, but the surge in energy prices could offset that pain.

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[1] Credit Suisse, as at 18 February 2022

War is always inflationary, but Fed policymakers will have to weigh the trade-off between financial conditions and higher commodity prices – both Ukraine and Russia are leading grain exporters, and Russia is a major supplier of aluminium, titanium, nickel and especially palladium. Germany's suspension of the construction of the Nord Stream 2 pipeline supplying natural gas from Russia to Western Europe, along with sanctions on Russian oil exports, could result in a classic supply-side energy shock to inflation.

At the same time, the team have observed that higher premiums on risk assets, the stronger US dollar and falling equity valuations as a result of the crisis are already helping achieve the Fed's goal in raising interest rates – tightening financial conditions to lower inflation. As a result, the Fed may not have to raise rates as much as recently expected. On balance, though, we believe that the Fed will not be deterred from starting its interest rate hiking programme in March in order to fulfil its mandate to keep inflation low and steady.

Our economists are closely watching the natural gas market to judge the impact of the Russia-Ukraine war on the eurozone economy. In the worst-case scenario, high gas prices stemming in part from a prolonged supply shortage could tip the economy back into recession.

T. Rowe Price manages the Omnis US Equity Leaders Fund and the Omnis US Smaller Companies Fund.

WESTERN ASSET

As we determine our current investment outlook, the Russian invasion of Ukraine supersedes the previous driving considerations of Covid, global growth and elevated inflation. The enormity of the shock poses the potential for dramatic negative repercussions. The long slog to a more pre-Covid world has been meaningfully derailed.

The investment landscape now faces enormous uncertainty. Much like the aftermath of Iraq's invasion of Kuwait, and of 9/11, the evolution of the global response will shape the outcome. A continuation of the fighting and an accelerated Western response might bring spectacularly higher oil prices, weakening growth trajectories, and very difficult risk market outcomes. The case for US Treasuries is less clear, given current elevated inflation readings, but the traditional desire for such a global safe haven is likely to be very powerful.

On the emerging markets (EM) front, volatility will be very elevated. The irony that EM debt was finally performing admirably relative to developed market risk assets will be overtaken by specific geopolitical concerns.

As we have in the past, we will react to changing circumstances and focus on the longer-term ingredients of fundamental value, which we believe should continue to be the winning strategy.

Western Asset manages the Omnis Global Bond Fund.

To discuss your portfolio in more detail, please contact your financial adviser. Omnis will continue to publish updates on its website.