MARKET COMMENTARY

Flash Alert – What impact from Russia's invasion of Ukraine?

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- **Russia's invasion of Ukraine has been a surprise, given the substantial economic costs for Russia. We look at potential scenarios and suspect that a rapid de-escalation is unlikely. President Putin may try to take advantage from a peculiar political environment on both sides of the Atlantic. Social stress emanating from the energy transition and inflation is giving more leverage to Russia, especially on energy-dependent countries like Germany and Italy. Both the US and France face elections this year.**
- **We discuss the potential range of sanctions. Their direct impact on the global economy is manageable; yet the main risk lies in a continued surge of energy prices, potentially precipitating an economic slowdown. All eyes on the consumer's purchasing power.**
- **The crisis has increased the stagflation risks. Already we had reduced our pro-risk bias in the face of high inflation and upcoming monetary policy tightening. While geopolitical stress often creates buying opportunities, we see no rush to buy the dips. Further reduce the cyclicality of portfolios for now, waiting for more stability in both the geopolitical and energy complexes. Temporarily increase cash, reduce cyclical stocks, and to a lower extent the Value bias – especially financials, while keeping Energy exposure. Stay overweight Credit but more in IG than HY. Sovereign balance sheets look more exposed than private ones.**

The Russian invasion of Ukraine is a historical attack against the European post-war order, with potentially far-reaching ramifications. The government in Kyiv declared martial law. Markets have reacted violently to the incursion, with equities selling off and energy prices soaring. Indeed, the surprise effect has been significant: President Putin escalated the crisis despite the severe economic and potentially military costs for Russia – likely much worse than during the Georgia crisis in 2008. While Putin has declared the demilitarisation of Ukraine a key goal, his true plans remain opaque. We discuss four main scenarios, from worst to best in terms of market impact:

- In a worst (tail risk) case, Russia completes a full-blown invasion that may reflect ambitions to redraw European borders. Of course, concomitant China/Taiwan tensions would create a perfect storm.
- The **more likely scenario** is that Putin aims to topple the Ukrainian government and install a pro-Russian government which would in effect subject Ukraine to Russian control. It may even formally annex the country, as done with Crimea. Given the size of the country and the Ukrainian army, this may be associated with prolonged fights and human victims.
- In a more benign case, Putin may aim at destabilising the Ukrainian government and secure the full control of the Donbas provinces.
- In the best-case scenario, Russia, having achieved a better negotiating position from the attacks, accepts to return to the diplomatic route and renegotiate the geographic settlement that ended the Cold War. His target would then be to stop the expansion of NATO that threatens Russia's security.

We have limited hope on the latter scenario for now. The chances of a timely de-escalation seem low, with Putin seeing Western governments generally weak and fractured (sharply divided US political class, President Biden likely to lose mid-term elections, fresh German government, upcoming French elections, chaotic energy transition causing price pressure and social discontent, social fatigue after two years of disputed sanitary policies). This may explain the timing of the attack and reduces the chance of a quick resolution.

What sanctions? Western allies will not actively stand by Ukraine but are set to embark on severe sanctions. These will include extended sanctions on key stakeholder in the Russian economic and political system or Specially Designated Nationals (SDN). It will likely include export controls, depriving Russia of high-tech imports, as well as sanctions on the Russian financial sector, including impairing current RUB operations, shutting Russian banks out of Western financial markets, and preventing Russian companies from raising money on western markets.

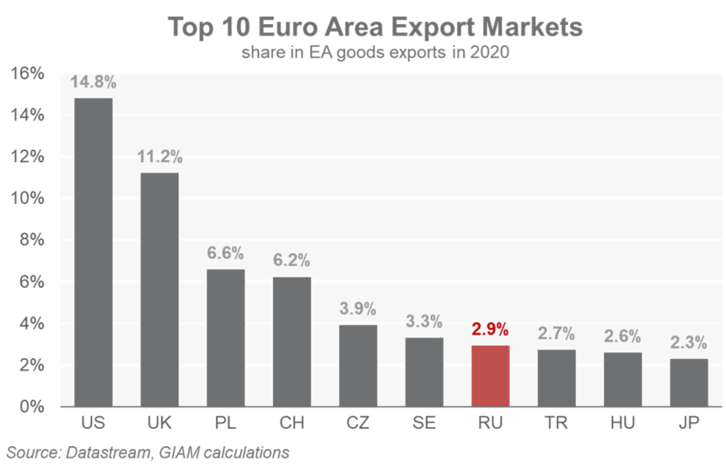
In a more drastic, though less likely 'nuclear' scenario, the US, EU, and its allies would also exclude Russia from the SWIFT payment notification system or sanction Russian commodity exports. Given Russia's heavy dependence on energy exports (about 15% of GDP), this would severely hurt the Russian economy. But it would also risk energy supply and payment disruptions for European companies, entailing a more significant collateral damage for Western economies. At this stage of the crisis, such drastic measures are still less likely.

What direct economic impact on Europe? While the crisis will surely cause a recession in Russia (as well as double-digit inflation), deeper ties with China, a lower dependency on USD funding and the development of its own payment system may reduce the blow. Meanwhile, the direct impact of sanctions on the US and European economy should be relatively mild. Russia accounts for only 3% of EU exports, while the exposure of European banks is small especially following the reduction of loans in the wake of the 2014 Crimea crisis. The direct impact on business and consumer confidence may be limited, with consumers still awash with excess savings and the easing of Covid restrictions triggering a rebound from the winter speed bump.

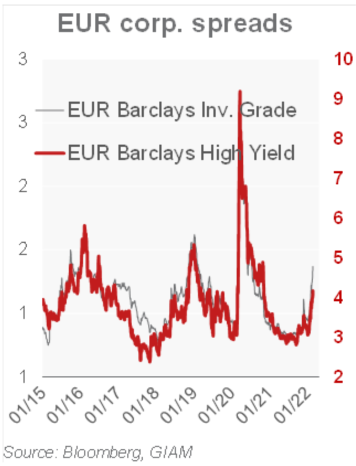
Yet the key vulnerability lies in the energy supply. Europe (Germany and Italy in particular) are heavily dependent on gas and oil imports from Russia. Nearly 40% of EU gas and 20% of EU oil originate from Russia. While the mild winter and negotiations with alternative providers may help to compensate for potential energy supply disruptions, the conflict and potential sanctions are likely to drive energy prices substantially higher for a longer period. Oil prices are up some 25% year-to-date, and natural gas prices have roughly doubled on the invasion; if persistent, such moves could well add one point to EA inflation this year and take more than half a point of GDP growth. Energy inflation is adding to already elevated price pressures and will intensify headaches at central banks, keen to prevent current inflation spikes from turning into a sustained wage/price spiral.

Inflation worries are also a social concern and a drawback on consumption and, to a lesser extent, capex plans. As slowing consumer spending adds to tighter financial conditions, central banks will face a delicate balancing act in maintaining their inflation credentials on the one hand and taming the risk of a policy mistake choking off growth on the other. Following steeply increased public debt burdens over the pandemic, fiscal policy support will be constrained, as the retreat of central banks from asset purchases enhances market scrutiny regarding debt sustainability.

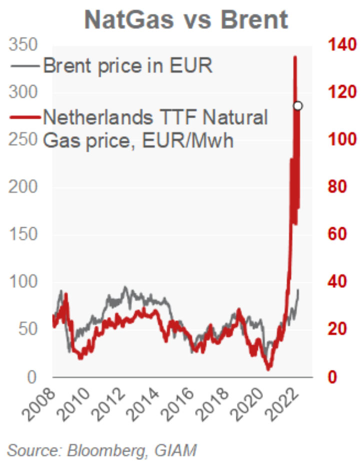
What offsetting policies in the toolbox? Despite the smaller fiscal room, expect more efforts from European governments to cushion the blow on the consumer's finances. Central banks may take a more cautious path, e.g. a 50bp hike from the Fed on 16 March looks even less likely now, while the ECB might not accelerate its tapering as fast as it looked before the crisis. Freeing up Iranian oil supplies to soften the blow from potentially lower Russia exports is also an option, though it is questionable how quickly international progress could be made there.



Source: Datastream, GIAM calculations



Source: Bloomberg, GIAM

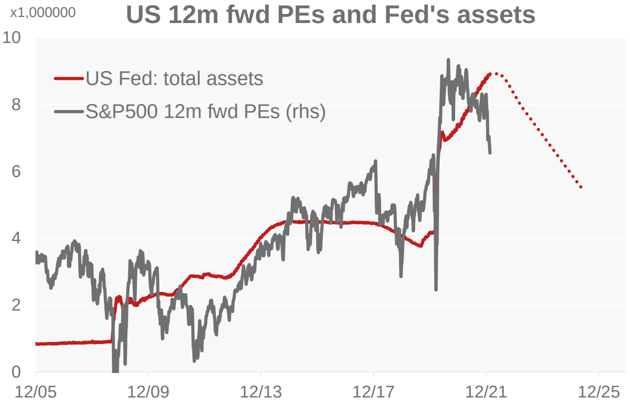


Source: Bloomberg, GIAM

What impact on portfolio allocations? Markets have already quickly discounted the sharp rise in political uncertainty and the risk of an energy crisis. The oil price (Brent) has surged above US$ 100/bl, and we see the risks tilted towards a more protracted rise. The flight to safety status of Bunds and Treasuries is partially offset by rising inflation worries; long-term real yields have pulled back a bit, but inflation breakevens have surged, along with energy prices. EUR 5-year inflation swaps, at 2.63%, are trading at a new cycle high, if still short of the 2008 record (3.0%). Credit spreads have widened, but not exploded (X-over above 400bp this morning, but closing around 365bp, up 15bp on the day; 5y Main closing just 3bp wider).

A continued escalation may favour some **further (moderate) bull flattening** of the “risk-free” yield curves in the near term, with the short-dated yields still underpinned by central banks’ need to tackle inflation. Southern European bond spreads have widened and may remain under some pressure on rising growth concerns (threatening debt sustainability). Out of the Covid Crises, **sovereign balance sheets are more exposed than private ones** (corporate and households). Equities look already cheap on some measures (including increased risk premia), but in the current highly volatile environment buying the dips looks premature. Another 5-7% decline of European and US equity indices would push risk premia to levels that historically have proven rather attractive (see chart). Increase cash positions for now with the aim of redeploying risk when we get more geo-political and energy price stability. **Intensifying stagflation worries suggest reducing the cyclicality of portfolios for now**. Our greatest concern indeed is that a full-blown energy crisis would precipitate an economic slowdown and threaten the earnings outlook. We recommend **shifting from cyclical exposure and increase defensive stocks** while also **reducing over-exposure to value stocks amid a pullback in real yields**. We stay overweight Credit, considering that the ECB will cautiously consider CSPP tapering in the view of keeping funding conditions healthy. In contrast to our previous recommendations, we recommend reducing exposure to financial credit relative to non-financials; we also underweight the periphery versus the core, favour IG over HY, and subordinated versus pure HY. In FX markets, the USD and JPY are set to enjoy strong demand amid the global uncertainties, while Eastern European currencies are exposed to some further pressure from political risks.

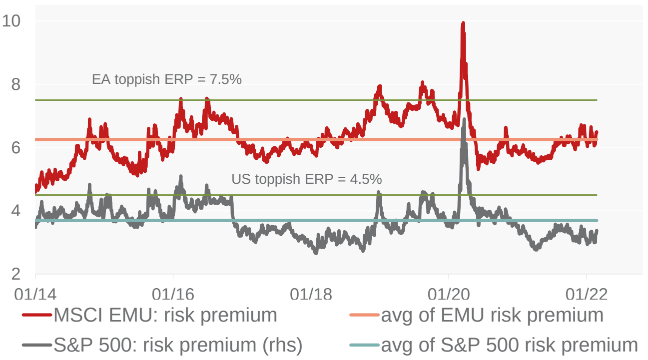
US 12m fwd PEs and Fed's assets



Source: Datastream, GIAM calculations

MSCI EMU and S&P: risk premium

earnings yield (12m fwd) minus 10-year rate



Source: Datastream, GIAM calculations