Market impact of Russian escalation in Ukraine

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The current situation

We believe the war between Russia and Ukraine will be an active conflict for some time, with Russia's goal being to first demilitarize Ukraine and then overthrow and install a new government.

This war is not going nearly as well as Putin expected. The Ukrainian military effort has been nothing short of heroic, and is fending off some advancements of the Russian army. But I think that Putin is not going to relent before more aggressively pursuing those two goals.

The economic sanctions placed on Russia by the rest of the world have been very severe. The Russian economy essentially has been plunged into recession, or even depression. But for now, we don't think Putin is threatened enough domestically that he is going to suspend military operations or pursue a sustained ceasefire until he's tried to take over.

Scenarios

The scenarios from here can be characterized as negative, very negative and extremely negative.

The negative, which may be as good an outcome as we can expect from here is that at some point Putin gives up. Assuming that the war stays within Ukraine's borders, that, of course, is negative from the perspective of Ukraine and the world. But that probably will lead to some stabilization in markets, provided there are no major additional sanctions placed on Russia.

The more negative scenario is more intensified war, with weapons and planes sent from the rest of the world to Ukraine and bolstering its defense, which angers Russia to the point that it cuts off natural gas. If the humanitarian situation becomes very bad, policymakers in the West may implement more soft sanctions, particularly on commodities.

The extremely negative scenario, the extreme tail risk, which we believe is very low probability but within the realm of possibility, is direct military NATO conflict. Neither the West nor Russia likely wants that. Russia could not hope to succeed in any direct military conflict with NATO given how stressed they are with Ukraine.

Economic effects/market positioning

The primary channel affected as of now is commodities. We all see oil prices above USD 100 and natural gas prices surging. Russia and Ukraine are among the largest food producers in the world, so a cutoff in supply would aggravate inflation pressures globally.

Europe is the most vulnerable. Europe depends on Russian natural gas. If Russia were to cut off Europe's natural gas supply, that would likely put Europe into a recession. We have seen the markets react accordingly with a rather large underperformance in European equities and the euro relative to the US dollar. An oil cutoff, whether that is Russia unilaterally doing so or more unified sanctions against Russians by the West could push oil prices much higher, as high as USD 180, at least temporarily.

We had a major inflation problem before the Russian invasion of Ukraine, globally. The US CPI print for February was nearly 8% for headline inflation. The war is aggravating problems we already had. And it puts the central bankers in a very tough position because higher energy prices are going to weigh on growth.

What we're seeing so far from the US Fed and the European Central Bank (ECB), is that even though this is a growth shock, they're still going to push ahead with tightening in response to inflation. Inflation expectations are rising and central bankers appear not to want to get into a situation where they have to tighten very aggressively and likely bring an end to the cycle.

We expect to see steady tightening from the Fed and the ECB. We expect the Fed to tighten 25 basis points per meeting, and if inflation fails to cool down, 50 basis points could be possible. Steady tightening in an environment where activity is slowing down is usually not a great combination for the market.

The global economy before the Russia/Ukraine war, was very strong and rebounding from an Omicron-induced soft patch. Private sector balance sheets continue to be in great shape. China is stimulating after a difficult year last year. So we believe global growth will be a little bit weaker as a result of the war, but as long as we don't get that extremely negative scenario, the economy should be able to withstand this shock and growth is highly likely to stay relatively robust on a global basis.

Stagflation is being thrown around as a scenario, which is high inflation and below trend growth. In Europe, it's a more difficult situation, but in the US in particular, we see this as an inflationary boom as opposed to stagflation.

The S&P 500 and MSCI World indexes are down roughly 10%. The track record of buying into political shocks that caused this kind of drawdown has been very strong. We have not had a 20% drawdown in the S&P outside of recession. There is a possibility of recession of course.

I think the underlying message is are we jumping to buy equities here? No, we're not because we do think these uncertainties are very real. We are concerned about those very negative and extremely negative scenarios which are within the probability distribution.

But if things do get worse, we will be looking to add. We are managing risk given the volatility and making sure that we do have some dry powder in case of there's some deterioration that we think creates an overshoot in financial markets. We still do have a value over growth tilt. In an environment with an inflationary boom, value should do better.

Energy and other commodities remain very good hedges , especially in case we do get that full cutoff of energy supply. There's plenty of volatility in the energy space. We have this risk, but we also have potential supply offsets such as the strategic petroleum reserves. But if oil prices do go down from here, it probably means the rest of our portfolios are doing better.

In this environment, we do still want to be underweight bonds, as inflationary pressures are still prominent and central banks are tightening. If we get a major geopolitical shock, bonds will likely rally even given these inflationary pressures, so that doesn't mean abandon US Treasuries, but it makes sense to be underweight.

In credit, we like US high yield. We believe the US economy is going to remain in good shape and credit spreads are widening, so within the credit space, that should be a reasonably good place to be. We are looking for opportunities in EM and Europe, but we want to wait a little bit before making moves on either of those.

In currencies, the US dollar is likely to continue to have upside, because the Fed is reacting to very high inflation and growth that remains strong.

We think gold is attractive for a few reasons. One reason is because we have geopolitical uncertainty. Second, even as inflation pressures are rising and central banks are moving, are they necessarily moving fast enough at beginning to get inflation under control? I think there are major questions about that. Third, given the severe sanctions from the US on Russia, if you consider the perspective of other global reserve managers, there is an incentive to somewhat move away from US dollars as a share of reserve, and so we might see structurally more inflows into gold.

Questions

What are your thoughts on how the current Ukraine/Russia crisis might impact sustainable green investments, from a corporate and legislative perspective?

I think this will accelerate it. We’re seeing energy prices increase, so logically we need to reduce our dependency on Russia’s natural gas and move in an environmentally friendly direction.

There's going to be a lot of debate, particularly in the US, about whether we should be encouraging, at least in the short term, US shale producers to increase supply, notwithstanding the longer term considerations for growth and concerns about the environment. That debate is happening right now and it's going to continue to happen. But overall, the direction of travel seems to be moving towards green energy, and this will only accelerate it.

Should Putin get toppled, would that be an equity rally indicator or cause more unease?

My suspicion is that if Putin were removed from power, that that would be a risk-on event, if it was clearly creating a lot of concern about Russia as a whole.

If we do get a clear movement towards the end game, is that the all clear for risk assets and is that alone enough to send us through all time highs?

I don't think so. I think we need to see inflation pressures moderate. One thing we saw in the US CPI for February is that inflation pressures are broadening out, not just energy, not just food. It's not just supply constraints. We are seeing some of the stickier components of inflation rise significantly, whether that's rents or other service costs, and wage growth of course is rising fast. We need to see that moderation in place before we get comfort that the Fed will not have to accelerate its hiking, which remains a key risk to the market.

If we do get inflation moderating over the second half of this year, then I think people will be a lot more comfortable with the outlook and I absolutely do see a scenario in which we can hit all time highs this year.

What are the biggest risks for countries who are large trade partners with Russia, such as China and India?

We are very focused on which countries are large importers, not just of Russian exports, but broad commodity importers, and China's a large energy importer. India is probably the biggest importer of energy and this is very damaging in terms of trade shock to them. There are gainers in this scenario, a lot of them in Latin America, commodity producers that have been performing remarkably well.

One thing that we should keep an eye on with China is the potential for secondary sanctions. As we all know, China has not joined officially the sanctions that the West has put on Russia, but there is potential for secondary sanctions placed on companies and financial institution that are serving as counterparties to Russian companies.

We are looking at China on a company by company basis. Those secondary sanctions and the risk of that is something that we're watching carefully.

What about a kind of Bretton Woods III moment where commodity rich countries challenge the role of the US dollar as the world's leading reserve currency, similar to 1971 when Nixon closed the gold window?

I don't see any threat to the US dollar as a reserve currency. I can see some diversification away from the US dollar and I mentioned gold as a potential option. But there is no substitute at all for the liquidity, the size of the market and the importance in the global payment system of the US and the US dollar.

There may be some moderation of that. That might be something that puts downward pressure on the dollar over time. But in no way [do I see a dramatic impact on the US Dollar], whether that's China becoming a reserve currency or gold getting more inflows, or commodity currencies, which are just not large enough to take those kinds of inflows. I do not see any threat at all to the US dollar as the main reserve currency of the world.

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