Insights
**Multi-Asset Solutions**

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# Russia-Ukraine War: Investment Implications for Asset Allocators

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Russia's invasion of Ukraine has brought devastation and a humanitarian crisis that is escalating rapidly. How long this war persists and the nature of its ending is very unclear. And that uncertainty has been reflected in heightened financial market volatility as investors try to navigate the short-term ramifications of war and sanctions while contemplating the longer-term implications for investment portfolio allocations.

## Pivot in Market Focus

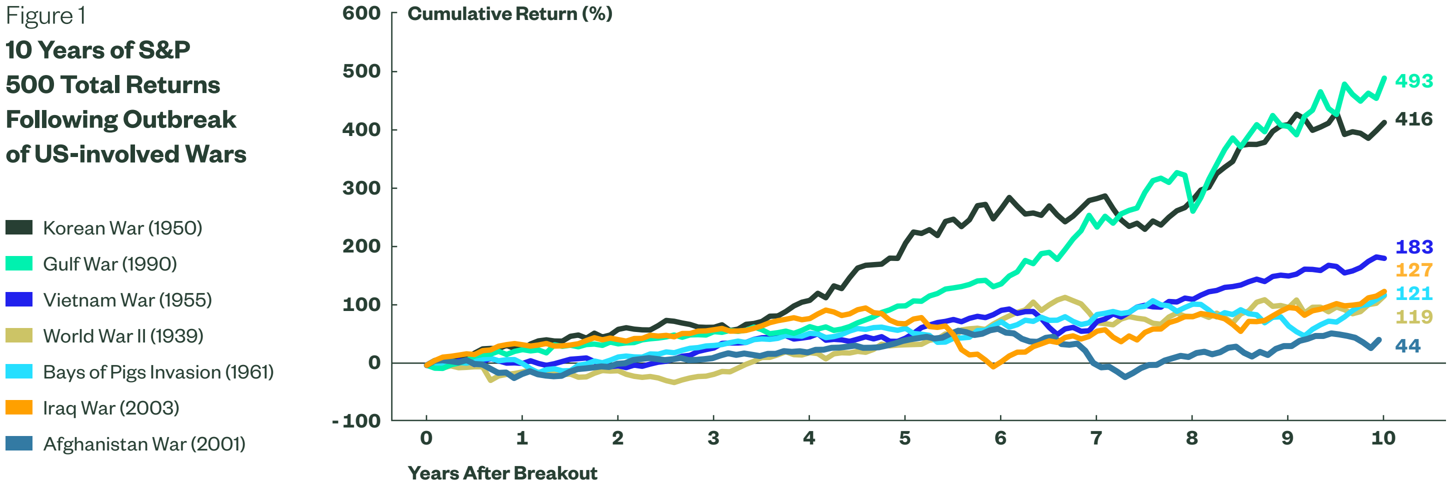
Financial market attention is firmly focused on the war's growing impact and establishing what that means across asset classes. No corner of the market is unaffected. We have seen a classic risk-off response from investors, with equities selling off and government bonds regaining some of the recent inflation-driven losses. Meanwhile, the commodities complex has experienced some remarkable price action, reflecting concern around short- and medium-term supply dynamics.

The fast-evolving market conditions partly stem from a reassessment of interest rate expectations. As recently as the middle of February, markets were pricing in 175 basis points of US Federal Reserve rate hikes in 2022 against a backdrop of sustained high inflation. The consensus view now projects a more modest Fed response. Indeed, the market revising down its expectations to about 100bps of tightening suggest a belief that the Fed may choose to tolerate uncomfortably high inflation rather than risk damaging growth. Given this backdrop, the spectre of stagflation (economic stagnation and elevated inflation) looms large in the market's mind.

## How Concerned Should Investors Be?

Uncertainty overshadows every war until a resolution is achieved. But it's worth noting how markets have reacted over the long term to previous US-involved conflicts. As Figure 1 illustrates, there was a wide range of returns for the US S&P 500 index in the 10-year period after war broke out — going back to World War II. A significant factor in the scale of each recovery was the economic and market backdrop at the time. For example, the 10 years after the start of the Afghan War encompassed the implosion of the dot-com bubble and the Global Financial Crisis, whereas the Vietnam War 45 years earlier came against a backdrop of the roaring Nifty Fifty — this resulted in very different return profiles. So rather than focusing purely on the nature of the war, investors should keep front of mind the health of the market and economy beforehand, and consider what scope governments and central banks have to provide supportive policy measures.

Figure 1
**10 Years of S&P 500 Total Returns Following Outbreak of US-involved Wars**




Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 February 2022. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

## The Asset Allocation Challenge

Ahead of the invasion, the world was emerging from the COVID-19 pandemic. The robust economic backdrop and decades-high inflation meant that the efficacy of bonds as portfolio ballast was starting to come under scrutiny. Historically, falling bond yields would cushion balanced portfolios when equity markets dropped, but as yield levels have slumped since the global financial crisis, their diversifying qualities have become more limited. As inflation remains high and erodes the value of fixed income assets, the potential for lower yields to offset equity declines going forward seems historically low.

We have been telling clients that a prudent approach to the changed environment includes looking for alternative diversifying assets:

- Commodities
- 'Safe Haven' Currencies (US dollar, Japan yen, Swiss franc)
- Long Duration US Treasuries

Crucially, it is important that investors don't overly rely on data and assumptions that shaped the last two decades. Financial markets are in a different place today and regular stress-testing of portfolios with 'White Swan' events is recommended.

## Inflation-Hedging Real Assets

Investors seeking to protect against a sustained move higher in inflation should look to real assets, which have historically performed well in such an environment, with higher beta and correlation to inflation than traditional assets (Figure 2).

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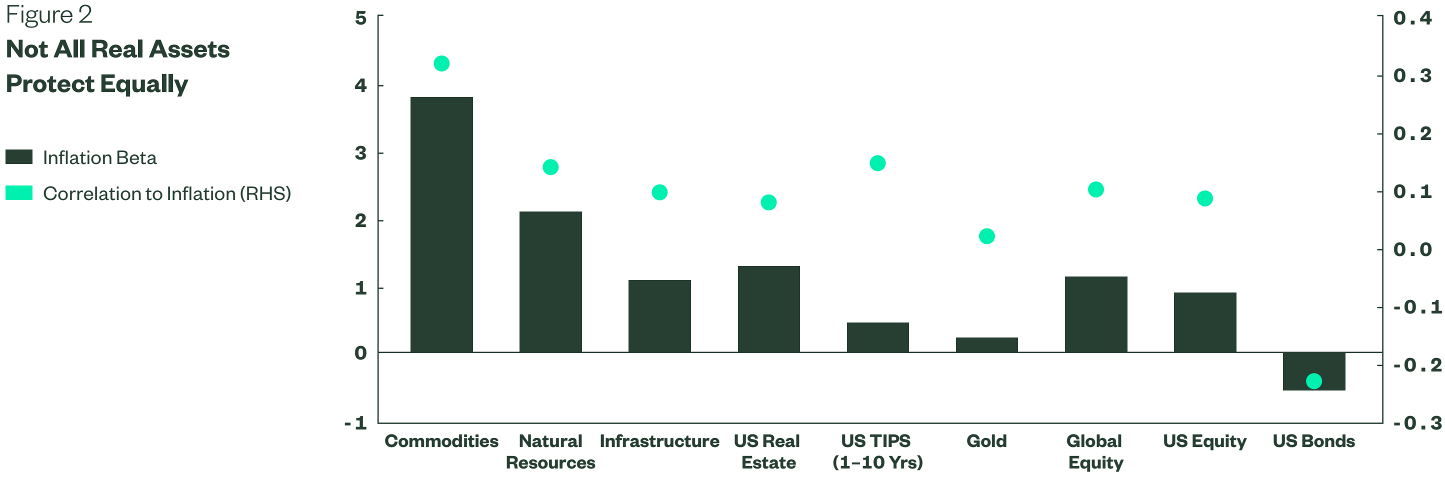
|---|---|
| **Commodities/Natural Resources** | The pick-up in inflation had already seen commodities and natural resources perform strongly and Russia's invasion has stoked prices even higher |
| **Real Estate** | The sector has been recovering and adjusting its business models to the new reality of the post-pandemic work environment and increased shift to e-commerce |
| **Inflation-linked Bonds** | These may have already experienced much of the increase in inflation expectations. Shifting exposure to shorter-duration securities would be a way to mitigate interest rate volatility and better align with future inflation moves without giving up too much yield at current levels |
| **Gold** | If inflation overshoots at sustained higher levels, gold may play a more significant role due to the negative effect inflation can have on broad equity and fixed income exposures |

Figure 2
**Not All Real Assets Protect Equally**




Source: State Street Global Advisors, FactSet as of 31 December 2021.

## A Role for Emerging Market Assets

Clearly there are investment implications with regard to Russian assets in the current environment, given widespread sanctions and subsequent index changes. And for the wider emerging markets complex there are other considerations, including rising US interest rates that are traditionally a sensitive issue for EM assets. On the equity front, more selectivity between regions and individual countries is warranted. For example, we believe Chinese equities continue to justify consideration, not least because they have historically been positively exposed to US rates, and are trading around average valuations.

In the EM debt space, a similar situation applies with the local currency bonds most impacted (beyond Russia) being those with a close proximity to the war zone — Hungarian and Romanian currencies have been particularly hard hit. But as with equities we think Chinese Government Bonds can offer diversification and total return. High commodity prices will benefit some countries more than others, while the undervaluation of EM currencies, on an aggregate basis, offers a potential tailwind.

## Uncertainty to Remain

War is not only about what happens on the battlefield. We have seen a remarkable degree of Western financial sanctions (an economic war) imposed on Russia and their full effects will take time to emerge. Whether the war is short-lived or not, it is difficult to envisage a quick return to the pre-war geopolitical landscape. It may be that a likely outcome is that Russia holds onto some Ukraine territory, but the trajectory of this war has been surprising in many respects.

For investors, a new normal of higher market volatility seems likely. Other implications could include sustained high inflation being allowed by central banks to run hot for longer, potentially leading to stagflation and raising the importance of inflation hedges such as real assets. The disruption experienced in some supply chains will likely remain for some time as the war impacts trade routes. While oil prices should subside as production gets ramped up in the US and elsewhere, food price inflation could linger longer given the importance of Russia and Ukraine food and fertiliser production.

**Additional Reading**

A Framework for Understanding the Investment Impact of the Russia/Ukraine Crisis (ssga.com)

The Most Urgent Investment Questions Emerging from the Russia/Ukraine Conflict (ssga.com)

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- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $4.14 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.