Insights
Geopolitics & Policy

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The Most Urgent Investment Questions Emerging from the Russia/Ukraine Conflict

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As the Russia/Ukraine conflict continues to unfold, the grave human toll is our foremost concern. As investors, we are watching events and markets closely as we work to guide our clients through the investment challenges presented by this crisis. In this commentary, we'll provide our current views on some of the most urgent questions we're receiving from clients today.

Current State of Market Liquidity, Risk, and Index Composition

What Is the Liquidity Status of Markets?

Graham Sorrell Head of Equity and Currency Trading EMEA
Sharon Ruffles Head of Fixed Income Dealing

As of this writing, the Moscow Stock Exchange has not yet opened for this week, and the Russian markets remain significantly pressured. The Russian bond market is nearly untradeable, and liquidity levels are very low. The CBR announced that foreign, non-resident locals are banned from transacting. Consequently, the Russia GDR Index fell more than 50% during the first two business days this week. Year-to-date, we have seen decreases in some DR prices of more than 90%. Effectively, the CBR has blocked foreigners from trading and settling trades locally in Russia, even if the Moscow Stock Exchange were to reopen. We are also closely watching Russian bond coupon payments. Our view is that income and redemption payments on Russian domestic securities, if paid, will be blocked from distribution.

Since late last week, global markets have witnessed some disruptions in trading and liquidity. Developed market European equities are down about 3% from a week and a half ago, while US equities are flat over that same time frame. Trading volumes have grown substantially, and spreads have widened. In fixed income, both outperformance in developed markets and significant moves in yields are notable, as is lower liquidity resulting from many investors being sidelined by the headline risk.

Regarding Russian assets and markets, there are typically two ways of trading Russian securities: locally on the Moscow Stock Exchange and via depositary receipts (DR) listed on the London Stock Exchange or the Nasdaq. Late last week, the Central Bank of Russia (CBR) put in place short-sale bans for local shares. As a result, the borrowing market in Russia completely dried up, thereby largely preventing counterparts from being able to trade. The DR market in London has mostly remained open and tradeable, albeit with large moves and volatile conditions. Trading of American Depositary Receipts (ADR) on the Nasdaq was suspended at the start of this week.

What Is the Impact of Sanctions from a Risk Perspective?

Sebastjan Smodis CFA, FRM, Global Head of Equity, ETF and Liquidity Risk Management

We have been closely monitoring the impact of the Russia/Ukraine conflict and sanctions on markets and our funds. We're relying on our sanctions implementation "playbooks," which begin with sanctions interpretation and risk analysis, followed by implementation across funds. The impact of Russia sanctions on companies and individuals on our book of business and funds has been limited so far, and in most cases, index vendors will remove securities issued by sanctioned entities from indexes, and there will be divestment from impacted funds. We don't have any counterparty or securities lending exposure to any of the sanctioned banks.

It is also important to note that these sanctions are very fast-moving and subject to change. The recently announced sanctions impacting SWIFT and Bank of Russia foreign reserves access could lead to second-order market impacts due to a global flight-to-quality.

What Is the Current Russia Exposure in Most Common Equity Indexes?

Graham Sorrell Head of Equity and Currency Trading EMEA
Sharon Ruffles Head of Fixed Income Dealing

As of 28 February, Russian equities represented 1.6% of the market cap weight of the MSCI Emerging Markets Index and 0.19% of the market cap weight of the MSCI ACWI Index. Both percentages represent substantial declines over the market cap weight percentages for these indexes at year-end 2021.

As of this writing, MSCI has not made any decisions on the treatment of Russian equities but is considering removing them from the MSCI Emerging Market Index and creating a standalone country index. MSCI did announce in recent days that it would not implement the previously announced changes for Russian securities as part of the February 2022 Quarterly Index Review (QIR) for the MSCI Russia Indexes or impacted composite indexes. We anticipate further guidance from MSCI, FTSE, and S&P in the coming days on how they plan to treat Russia.

Regardless of provider, the main goal of an index is to ensure investability, and that is being challenged in recent days. Russian markets are currently closed, and when they open, foreign, non-resident investors are banned from participating.

What Are the Implications of the Crisis for Fixed Income Indexes?

David Furey Head of Fixed Income Strategists, EMEA

As of 28 February, Russian bonds represented 0.14% of the Global Aggregate Index and 0.95% of the Emerging Markets Bond Index (EMBI). We are in constant dialogue with the key index providers on what the implications should be. There are three specific developments that will impact how Russia is treated by the index providers:

- Downgrade below investment grade: This is highly likely, as S&P already moved last week and Moody's and Fitch are likely to follow. This will impact Global Aggregate/Global Treasury benchmarks, with Russia being excluded at the next rebalancing. However, the timing of this exclusion needs to be considered given that local government bonds cannot currently be traded.

- Default: Russia has banned coupon payments to international owners of its local bonds. This is likely to result in a selective default, which would affect local emerging market debt (EMD) benchmarks such as JPM-GBI-EM Global Diversified or the Bloomberg Emerging Local Markets benchmark. Normally, bonds are excluded if they default; however, in this situation it depends on whether the default is temporary and whether a cross default is deemed to have taken place. Again, the inability to trade/sell existing positions also makes the timing and valuation of such actions difficult to implement.

- Index ineligibility: Capital controls that restrict investor movements into and out of markets usually deem them as no longer eligible for index inclusion. While capital controls are not specifically in place, restrictions on securities sales and settlement are in place, resulting in de-facto capital controls. It is likely, therefore, that Russian securities could be deemed ineligible at some point.

For hard currency bonds it is a slightly different matter, as trading is offshore with settlement via Euroclear, etc., so the closure of Russian exchanges to non-domestic participants has had less of an impact. With denomination in hard currency (primarily USD), there are no issues with Russian ruble exchangeability. These bonds also have greater legal protections than local currency issues as they are predominantly issued under international law — such as US or UK law. Hard currency bonds are still subject to broader sanctions on Russian debt, most notably those bonds issued by banks that have had restrictions placed on them. In light of these restrictions and because sanctions continue to evolve, hard currency bonds have been trading at a significant discount, but importantly, continue to have a market price. These bonds are likely to continue to trade, albeit at distressed levels.

Current State of the Conflict

What Is the Current Geopolitical Situation, and Where Do You See It Going? What Might Be the Impact on Markets?

Elliot Hentov Head of Policy Research

While the eventual outcome of the conflict remains very uncertain, Ukrainian forces' robust resistance makes the prospect of an early cease fire and an accompanying risk-on rally less likely in our view, leading to the potential for continued sanctions uncertainty and increasingly the likelihood of modest stagflation, particularly in Europe. The table summarizes three possible paths for the conflict, along with implications for sanctions, macroeonomic conditions, and markets.

Figure 1

Potential Scenarios and Market Reactions

Scenarios	Sanctions	Macro	Market
Early Cease-Fire — Less Likely Talks relate to treatment of areas under Russian control	• Peak sanctions behind us • Potential for sanctions relief late in 2022 or 2023 as part of wider European security agreement	• Limited spillover • Disinflationary effect from risk premia dissolving in commodity complex	• Risk-on rally (constrained by return to monetary policy focus) • EUR and EM assets benefit disproportionately
Partition — More Likely Separation into pro-Russian "East" Ukraine (annexed?) and pro-EUR "West" Ukraine	• Continued sanctions uncertainty • Russian counter-actions follow in non-financial domains	• Modest stagflationary impulse in Europe, but rest of world less affected • Commodity prices stay elevated but plateau, helping exporters	• Global markets recover, but weaker arguments for US/rest-of-world outperformance given hampered Europe
Prolonged Insurgency — Less Likely Invasion continues, including urban insurgency and high death toll	• Sanctions escalation continues and expands into many other areas, with individual cyberattacks on key institutions or markets	• Repeated commodity supply disruptions, including in agriculture • Stagflationary effect on rest of world (though not enough for recession)	• No relief rally, with risk premia settling in as semi-permanent • Sentiment channel heavily impaired • Safe-haven FX, gold, and non-cyclicals outperform • US/rest-of-world equity outperformance restored

Source: State Street Global Advisors Global Macro Policy Research.

Macroeconomic Impact

What Has Been the Economic Impact of the Crisis so Far, and What Are Your Expectations? How Will This Crisis Affect Central-bank Action on Rates?

Simona Mocuta Chief Economist

The main macro impact channel is through supply disruption, whether commodities or broader supply chains. Because of this, duration of the crisis is critical. In this sense, from a global growth standpoint, the conflict might prove similar to Omicron: in with a vengeance, but out of the picture just as quickly. There seems to be more downside risk with this crisis than with Omicron insofar as Omicron was merely a variation of a pre-existing situation, whereas the Russian invasion is altogether a new shock. Short-term severity could be far greater if there are interruptions to energy supply in Europe. Price shocks are easier to digest and provide less worry, in our view, than actual energy shortages on the ground, especially if these impact industrial output. We expect some hope from timing as the weather improves with spring, reducing household heating needs.

While the short-term impulse is stagflationary, we should be cautious about extrapolating too much. The impact on consumer prices is highly dependent on potential compensatory government actions on taxes, subsidies, and therefore, it is so too early to comment. The crisis likely re-engages fiscal policy into the response picture, even if only temporary; yet more so in Europe. While Central Bank views are not changed from last week, we see March hikes still likely by the Bank of Canada, the Bank of England, and the US Federal Reserve, but we expect the pace thereafter to be more questionable. Markets have pulled in full-year rate expectations but we are still more dovish than the market is pricing in currently. Most central banks will need to revise 2022 inflation forecasts higher in the near term, but are also likely to lower them at the forecast horizon, which would leave them in a bind.

With respect to the "positive on Europe" views that we have voiced since last year, we see this as a short-term headwind, but a positive reinforcement for the view on a medium-term basis. If Crimea wasn't enough of an eye opener for the failure of the European defense approach, we think Ukraine is too big not to trigger some lasting changes. Germany's shifting position is critically important and, in our view, a long-awaited change. The Europeans have essentially outsourced their defense for far too long and have lived we believe in an idealized world where defense investments were seen as optional, rather than mandatory investments. Internalizing this lesson and reassessing the union's policy mix on macro, defense, and energy, will strengthen Europe and make the European Union more resilient. We are encouraged by privatization efforts in Italy and hope the country portents a more market-friendly macro policy mix in years to come.

Crisis Impact by Asset Class

Commodities: Do You Expect Oil Prices to Ease? How Has the Crisis Affected the Commodity Complex in General and Energy Prices in Particular?

Michael Narkiewicz Portfolio Manager, Investment Solutions Group

Across commodities markets, we have seen heightened volatility and a swift move higher for certain commodities, including oil and natural gas prices. As of this writing, oil prices are at 7-year highs with West Texas Intermediate (WTI), a specific grade of crude oil and one of the main three benchmarks in oil pricing, along with Brent and Dubai Crude, approaching $106/barrel and Brent marching towards $107/barrel. European natural gas prices also remain volatile after initially spiking 50%, and risks across energy commodities remain skewed to the upside.

Outside of energy, we have also seen broad-based gains in key metals and agricultural commodities. Russia is a major producer of metals such as nickel, aluminum, and copper, all of which have very tight inventories, and any lost production would likely result in higher prices. Along with Russia, Ukraine is a large producer of agricultural commodities, including wheat, barley, corn, and sunflower oil. Importantly, these commodities would be vulnerable to supply disruptions as well. Additionally, Ukraine has key ports in the Black Sea which makes the country important in terms of the global transportation of commodities.

As prices evolve, fundamentals in our view support longer-term price appreciation. Inventories remain tight and are down by ~660 million barrels since July 2020. Geopolitical shocks are typically short-lived; however, we view the potential for a sustained shock with oil prices moving to $125/barrel or higher. Russia's energy exports are irreplaceable and global spare capacity is so low that there is no other country able to fill the gap (including Saudi Arabia). OPEC+ has underproduced output target by a growing margin and since the beginning of 2021 the underperformance has effectively removed 300 millions of barrels from the market. A significant question is whether the war will remain a military conflict, or will it turn into an economic war, where Russia retaliates against sanctions by cutting off oil and gas supplies.

We are closely watching Russian energy supply, spare capacity of energy, and globally-coordinated Strategic Petroleum Reserve (SPR) releases. We are monitoring any curtailment of Russian energy supply and exports since they are irreplaceable. Russia is the largest natural gas exporter in the world with volumes around 22-23 billion cubic feet per day, a majority of which supply Germany and the rest of Europe. Further, spare capacity of energy is expected to continue to fall throughout the year. The lack of spare capacity is so important since it leaves little to no cushion for supply disruptions. And lastly, globally-coordinated Strategic Petroleum Reserve (SPR) releases we do not expect will be able to fill the gap or solve the global supply problem.

In terms of portfolio positioning, we are overweight broad commodities. Commodities have also been an excellent inflation hedge and a long-standing overweight position for us. In addition, we are overweight gold as part of our tail risk basket as our Market Regime Indicator (MRI) reached High Risk and Crisis regimes. We view holding gold as beneficial, too, as an inflation hedge.

Currencies: How Have Currency Markets Reacted, and Where Do We Think They're Going?

Aaron Hurd Senior Portfolio Manager, Currency

Currency markets have had a rational response to the Russia/Ukraine crisis, with returns fairly well aligned to the geographic proximity to the war, sensitivity to commodity exposure, and general sensitivity to global risk sentiment.

The Russian ruble is in serious jeopardy of becoming untradable, after the recent sanctions on Russian banks, the Russian central bank, and Russian restrictions on payments to foreigners in response to those sanctions. Outside of the ruble, the currencies of Central and Eastern Europe have been hardest hit due to the risk that the conflict spills over into their countries, as well as growth risks from higher energy prices.

The currencies of the broader EU and UK have reacted more to the stagflationary risks of spikes in energy prices and the general impairment in investor and consumer sentiment. The US Dollar which typically performs well during global crisis periods, is doing well but is not the star performer of this crisis. Currencies of countries geographically removed from Europe, with limited economic ties to Russia, a positive commodity exposure, and attractive long-run valuations have outperformed. These include the Australian, New Zealand, and Canadian dollars, as well as the Chilean peso. The Norwegian krone has also outperformed, as its positive oil exposure has more than offset the drag from its proximity to the conflict. Going forward, the high degree of uncertainty regarding the duration and severity of the conflict and associated sanctions should keep European currencies on the defensive and help support the US Dollar over the near term.

We do see some pockets of opportunity. The additional risk premium in the Polish zloty and Hungarian forint appears overdone. Both are historically cheap to our estimates of fair value, have rising interest rates, and strong enough growth prospects to withstand the strain from the conflict. More importantly, we see the potential spillover impacts to these NATO countries as more limited than recent price action would suggest. We expect continued near-term downside pressures for the zloty and forint, but the medium- to longer-term outlook is increasingly attractive. Beyond that, we see additional upside potential in undervalued, commodity-linked currencies, with rising interest rates that have outperformed since the start of this crisis. Importantly, we see that upside potential both with a quick resolution to the war and a longer, drawn-out conflict.

Fixed Income: How Has the Crisis Impacted Fixed Income Markets? How Do You Expect That Impact to Evolve?

Matt Nest Global Head of Active Fixed Income

Our baseline coming into the last couple of weeks was for continued bear flattening of the yield curve, as inflation concerns were front and center and central banks were on the move pressuring short-term interest rates higher. At the same time, growth was slowing, albeit from high levels, leading to relative anchoring of longer-dated yields. We had been reducing credit throughout the fourth quarter and first part of this year as rich valuations, spreads leaking wider, and deteriorating technicals combined to create a more bearish outlook (we were not overly concerned, as the fundamental credit outlook remained healthy with continued strong earnings and a benign default picture). At the same time, we were watching value build in the front end of the yield curve, providing a potential opportunity for long-duration positions.

Recently the situation in Russia/Ukraine has led to a more classic risk-off environment in fixed income markets, with credit spreads moving wider and interest rates moving lower. While this is likely to continue until the picture becomes more clear, our view, consistent with the firm's macro view, is that this event likely exacerbates the baseline dynamics and provides a further stagflationary backdrop while not yet bleeding into broad-based credit concerns. While we have not changed the direction of travel with respect to positioning, the events of the past couple of weeks have the potential to create opportunities in both yield curves and broad credit if markets continue to move along the path they have been on most recently, so we are watching closely.

Equities: How Has the Crisis Impacted Equity Markets? What's Next for Equities?

Gaurav Mallik Chief Investment Strategist

As the crisis unfolds, equity risk premia has risen across all markets. This is understandable given the level of uncertainty regarding the path of the conflict and its consequences.

Our base case heading into 2022 was positive on equities due to strong fundamentals (including earnings, dividends, and buybacks). Earnings in Q4 2021 were strong, and earnings estimates heading into 2022 were on an upward trajectory. Estimates have leveled off in the wake of the crisis, but earnings growth has remained comparatively strong so far in 2022. This suggests to us that commodities pressure is exerting the primary influence on equities prices right now (as opposed to an actual drop in demand).

Given our expectations for above-par economic growth in most economies, even in light of the crisis, we think equities will remain attractive. At the start of the year, as we looked forward to 2022, we advised investors to consider equity positions outside the US, particularly in Europe and China. Since then, of course, we've seen a significant correction in European stocks. We have so far maintained an overweight position in European equities, based on positive earnings and favorable valuations; however, we're keeping a close eye on further developments in the region that might derail our expectations.

In emerging markets (EM), we see some pockets of potential value emerging, but the time is not yet ripe to make an entry. In our experience, EM equities tend to provide superior returns compared to developed market (DM) equities when investors feel confident that EM growth will outpace DM growth. Given the degree of uncertainty in economic growth trajectories, we suggest caution in EM. We have taken incremental positioning in EM commodity producers as a hedge against the rising threat of inflation. We're also keeping a close eye on monetary and fiscal policy easing in China, as this trend could provide a significant EM growth lever.

We recognize an elevated level of volatility in equity markets, influenced in particular by sharply rising commodities prices. We'll be paying close attention to the results of the Q1 2022 earnings season to guide our path forward.

Portfolio Implications

Have You Changed Your Portfolio Positioning in Light of the Crisis? What Are You Watching to Guide Your Portfolio Allocation?

Rob Spencer Senior Portfolio Strategist, Investment Solutions Group

Growth expectations and a degree of caution regarding rising inflation guided our views on portfolio positioning heading into the crisis, and continue to influence our thinking. The current conflict is tragic and has certainly been unsettling for market participants. As of this writing, we believe there is a relatively low risk of the conflict spreading further. We believe that global growth, while moderating, will continue to be strong in 2022, with equities, in some regions, and commodities positioned to outperform.

Heading into the crisis, we held a modest underweight to equities in aggregate and to bonds in our tactical portfolios, offset by overweights to cash and commodities. In the aftermath of the escalation to invasion, as our proprietary market regime indicator (MRI) spiked to a Crisis regime, we increased our position in global equities and gold. In general, we believe that it's important to incorporate investor risk sentiment into our portfolio positioning, and this movement in the MRI suggests to us that investors may have become overly pessimistic, which in turn can serve as a contrarian signal that is supportive of equities. Overall, we're comfortable with our current positioning, but we are monitoring the situation closely and will act quickly in our tactical portfolios, if needed.

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* Pensions & Investments Research Center, as of December 31, 2020.

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Investing in commodities entail significant risk and is not appropriate for all investors.

Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates.

Illiquid risk/Asset investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities.

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