

Markets Update: Russia-Ukraine Crisis



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Elaine O'Shea: Our thoughts are first and foremost with the people of Ukraine and those with family there. We also want to take this opportunity to update on this rapidly developing situation. Maarten, can you outline the background of this conflict and what we've seen happening so far?

Maarten Jan Bakkum: Well, it's quite clear that the conflict has escalated a lot, starting with troops being built along the Ukraine borders, then the Russian authorities recognizing the separatist held parts of eastern Ukraine and finally the military attacks to weaken the army.

I think, so far, the conflict is like the Georgia-Russia War of 2008. That was a 12-day war where the Russian troops gained two territories and the idea then was to undermine the Georgian state and overthrow the government.

They succeeded then and have maintained the status quo since. In Georgia, there were two territories, South Ossetia and Abkhazia, which were actually kept for longer. Now, we must look at the intentions of the Kremlin and what are they doing in Ukraine? I think it's the same. They want to overthrow the government of Zelenskyy and at the same time, occupy a few regions. I think that's where we now are. And the question is really, how far will they go and how will the conflict develop?

Elaine O'Shea: And how do you think it will develop from here?

Maarten Jan Bakkum: Well, that's a big question. It's clear that the West has reacted quite strongly, and this makes things even more difficult. There's a risk that there will be a bloody war that could last much longer than Georgia.

The sanctions have now isolated Russia with the exclusion of banks from the SWIFT system, the freezing of reserves for the Central Bank in Europe and US and the multinationals leaving Russia. That makes it very difficult for the Russian economy.

Previously, we thought the build up of reserves and a lot of input substitution in recent years could limit damage, but I think at this point, it looks so much worse for them. So, we should expect the pressure on the Russian economy to grow. There will be more inflation...there might be social unrest. There are many uncertainties.

At the same time, there is rapid militarization of the Eastern flank of NATO with weapons supplies from many countries to Ukraine while a refugee crisis is also developing. Europe has been united and able to deal with it, but over 500,000 people have already fled, and that number could easily grow.

There's also the question of what other countries will do, China in particular. So far, they have not explicitly condemned the Russian attack but at the same time, have quietly joined the sanctions with state banks refusing financing for imports of Russian commodities. That's quite interesting. They also did that in 2014 when the sanctions came and suggest at this point that China is being pragmatic but that can change as well, so one to watch.

There's also the question of what's going to happen with the Kremlin itself. Is Putin overplaying his hand? Is there going to be social unrest, economic damage? Will his tactics backfire? So, at this point, a lot of uncertainties. For us, the main thing is that energy prices and commodity prices will stay high. That has implications for our economies and our central bank policies.

Elaine O’Shea: Thanks, Maarten. Lenny, we’ve seen the market reaction and maybe you can update on what we’ve seen so far and what might happen going forward.

Lenny McLoughlin: Even before the Russia-Ukraine issue, equity markets were down c.8% in local currency terms so far this year. Much of that weakness was driven by concerns around central banks tightening policy given the higher inflation that’s persisted and compounded by the ECB indicating a tightening of policy faster than markets had anticipated.

Since last Thursday, global equities are actually up about 2%, driven by the US, and bond markets are also a little bit better. What we have seen is a flight to safe-haven assets with yields falling on concern around what the impact on growth and inflation is going to be.

The moves since Thursday really reflect a couple of things. One is the fact that Russia and Ukraine account for less than 2% of global GDP. We have a couple of banks across Europe which have exposure to Russia but overall the exposure within the financial system globally and in Europe is relatively modest.

The big concern is the inflation risk from higher commodity prices as Russia accounts for about 12% of global oil production, about 17% of gas production and about 5% or 6% of many metals. Also, Russia and Ukraine combined account for about 25% of wheat exports globally. So, very important players.

The sensitivity of global growth to a 10% rise in oil prices is estimated at a -0.2%-0.25% and on inflation globally, by about 0.15%. That pressure on growth also points to a potential squeeze in real incomes. In Europe, inflation is already running at 5.1%, wages are only running at 1.5%.

Europe is also very sensitive to energy imports with about 40% of its gas coming from Russia. Just to give you some sensitivity, a 10% increase in gas prices is estimated to add +0.3% to European inflation. Gas prices have risen about 35% over the last week and substantially up compared to where there were this time last year.

The reason we haven’t seen markets react so much to the crisis is because the authorities have been able to ring fence the impact on commodity prices, particularly oil. It’s only up, I would say \$8 or \$9 since last week because we’ve managed to keep those supply lines open between Russia and the rest of the world. Supplies are flowing in terms of oil and gas.

The other big issue is in relation to sanctions on the SWIFT system, blocking most of the banking system in Russia. Again, we’ve been able to carve out energy within that, so payments can be made for any supplies of oil that are coming through. The oil price has increased but not to the extent that many feared up at maybe at \$120-\$125 remaining around \$100 for now.

We also have other potential sources of oil, like the Iran-US deal being concluded, which would add about a million barrels per day. Furthermore, we could see increased production from both shale producers in the States, non-OPEC producers, OPEC and get reserve releases from strategic reserves globally. That has capped the pressure on oil prices.

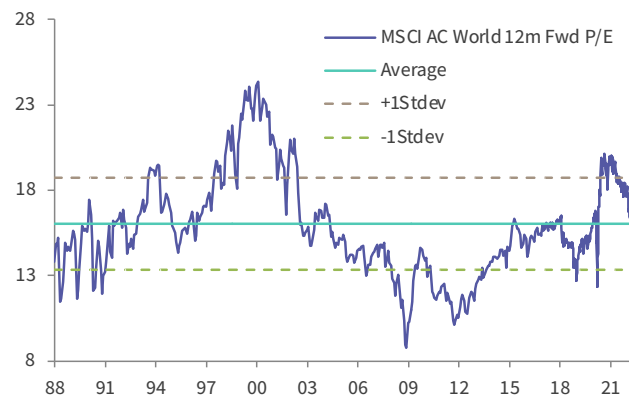
Central banks and governments have a dilemma being faced with potentially slower growth and higher inflation particularly as lots of supports were used up during Covid. On balance, I think you’re likely to see some loosening of policy, particularly in Europe, and a slowdown in the projected timing of any rate rises out to probably January 2023. If asset purchases were to reduce, recent comments would suggest the possibility of increasing the again, exists.

Elaine O’Shea: Where does that leave markets then Lenny?

Lenny McLoughlin: I think the huge volatility we’ve seen in recent days is likely to continue. Medium to long term however, equities still look attractive. Valuations have come down substantially given the fall in markets along with strong levels of earnings growth over the last a couple years.

P/E multiples are 16.3x for global equities vs long term averages of 16x. If equities don’t rise for the next 12 months, even allowing for lower growth, could fall to 15.5x. So, the premium of higher absolute valuations is gone. Equities are now finding support on an absolute valuation basis and continue to look attractive on a relative valuation basis also with bond yields currently suggesting about 15% upside to get back to fair value versus bonds. On a medium-term view, assuming that the impact from this crisis on growth is relatively limited, you can see equities generating positive returns in a 6-12 month view, but short term, I think a lot of that uncertainty just means that volatility remains in markets.

Global 12 month Forward P/e



Source: Bloomberg, 25 February 2022

Elaine O’Shea: Thanks Lenny. So what should we expect going forward – has history taught us anything about events like these?

Lenny McLoughlin: We’ve looked at crises going back since the end of the Second World War and typically what you see is that equity markets fall somewhere in the region of 7% to 9% initially. Where a crisis proves not to have a huge impact on global growth, it fades into the background and markets quickly recover.

S&P 500 During Geo-Political events

S&P 500		Max Drawdown +/-				
		-3m	1w	1m	3m	6m
May-48	Arab Israeli War	-3.8%	7.2%	10.9%	2.0%	-0.8%
Jun-50	Korean War	-14.0%	-7.6%	-10.0%	1.5%	4.9%
Nov-54	Algerian War	-3.3%	3.9%	6.9%	15.5%	19.4%
Nov-55	Vietnam War	-10.6%	4.4%	7.3%	4.1%	13.9%
Jun-67	6 Day War	-6.5%	4.1%	3.3%	6.5%	7.7%
Mar-69	War od Attrition	-9.2%	-0.7%	1.5%	3.5%	-6.0%
Oct-73	Yom Kippur War	-17.3%	1.4%	-4.5%	-10.0%	-15.3%
Mar-76	Dirty War	-4.7%	1.1%	-0.3%	1.4%	2.9%
Sep-80	Iran/Iraq War	-5.3%	-5.3%	1.2%	4.1%	2.8%
Apr-82	Falklands War	-12.7%	1.0%	1.1%	-6.5%	6.0%
Aug-90	Gulf War	-19.9%	-3.3%	-8.2%	-11.3%	-2.4%
Apr-92	Bosnian War	-6.2%	0.1%	2.8%	2.0%	0.4%
Mar-98	Kosovo War	-1.6%	3.4%	8.5%	7.6%	-5.9%
Oct-01	Afghan War	-20.9%	1.9%	4.1%	8.7%	4.8%
Mar-03	Iraq War	-14.1%	-0.8%	2.0%	13.7%	18.3%
Feb-11	Libya Civil War	-6.4%	-0.9%	-3.5%	0.7%	-9.3%
Mar-11	Syria Civil War	-6.4%	0.9%	2.9%	-1.3%	-5.7%
Feb-14	Crimea	-5.8%	1.3%	1.6%	3.5%	8.3%
Sep-14	Yemen Civil War	-7.4%	0.5%	-6.1%	0.3%	3.5%
Feb-22	Russia/Ukraine	-11.9%				
	Median	-7.0%	1.0%	1.6%	2.0%	2.9%
	Average	-9.4%	0.7%	1.1%	2.4%	2.5%

Source: Bloomberg, JP Morgan 28 February



We have seen some modest downward reductions to global growth forecast for this year to about 3.8% from 4.2%. That is still very strong versus trend growth of 2.7% and well above what we saw after the financial crisis. And if growth stabilizes around those levels, again, medium to long term, it suggests that there is upside in equity markets.

Finally, in bonds, yields continue to fall across Europe in particular. German 10year yields were over 0.3% two weeks ago but now at 0.05%. I think that kind of move to safe-haven assets could continue in the short term. Medium to long term, you could see a return of that 10 year yield in Germany towards 0.3%.

The key things to watch for are where commodity prices go. So long as they're contained, the impact on global growth will be relatively modest. If that proves to be the case, then the medium term outlook for equity markets is positive.

In terms of the outlook for bonds, we think any up upside in yields is capped around 0.3% for German 10 year yields on a 12-month view.

Elaine O'Shea: Super. Thanks very much Lenny. I'd like to thank you and Maarten, both for an interesting discussion with great insights on the complex and quickly evolving situation.

Although every geopolitical event is different, and unique in certain respects, they all typically have one thing in common, a combination of falling markets, higher levels of volatility and investor uncertainty.

Our job as fund managers is not to predict what will happen or when, but to construct funds in such a way as to reduce the impact of these events by incorporating risk management strategies like low volatility and allocating to alternatives, but also to keep the funds positioned to deliver good returns over the medium to longer term.

While we don't know exactly how this event will play out, we are confident and have high conviction on the strategic asset allocation within our flagship multi-asset funds to deliver for investors over the medium to longer term.

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