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Ukraine conflict – Key questions answered

Global financial markets

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- The war in Ukraine has added to uncertainty and market volatility. Global stocks and bond yields have fallen, while safe havens and energy prices have rallied.
- As the humanitarian costs continue to mount, so have restrictive global policies aimed at Russia, including the recent US ban on oil imports. Against this backdrop, we expect continued volatility.
- In this note, we answer some of the biggest questions for investors—including whether the events will trigger a global recession, what is the outlook for commodities, if it is the time to sell now, and what safe-haven or hedging options exist. We also consider whether now is the time to buy on dips.

Source: ddp

The Russian invasion of Ukraine has triggered a broad risk-off move. In this note we address some of the biggest questions for investors.

Will the events trigger a global recession?

The first-order effects of the crisis are not likely to be large. Russia and Ukraine account for only 2% of global GDP. However, where risks have clearly increased is with respect to second-order impacts.

The most prominent second-order effect is how higher commodity prices impact growth. Brent crude oil, which closed at USD 96.8 a barrel the day before Russia's 24 February invasion, hit an intraday high of USD 139.8/bbl on 7 March. At the time of writing, it stands around USD 125/bbl, up around 60% so far in 2022. Sanctions have started to impact Russia's energy sector directly, with the US banning imports from Russia and the UK aiming to phase out imports by the end of 2022. Even ahead of this move, supplies have been indirectly affected as buyers have sought alternatives to Russian oil.

We now expect Brent to trade around USD 125/bbl by June, before gradually declining over the remainder of the year, although there are significant upside risks for oil. We estimate that if Brent prices remain above USD 125/bbl for around six months, it could shave up to half a percentage point off global GDP growth this year. However, we think this is not enough to reverse the broader recovery from the pandemic. Economic headwinds would increase further if there is an interruption to Russian gas supplies, either due to curbs from Europe, which have so far been resisted by Germany, or due to retaliation by Russia. Developments on this front will be a key focus for markets, especially as European public opinion hardens against the Russian government's actions.

Another key second-order effect is what higher commodity prices mean for monetary policy. We continue

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to expect the Federal Reserve to hike rates in March and think central banks will look beyond the current events. However, if we were to see a wage-price spiral starting to emerge, potentially due to higher commodity prices making inflation more persistent, the Fed could potentially need to enact aggressive hikes in the future. So far, the market appears to be pricing in the former scenario as more likely, moving from expecting 6.5 Fed rate hikes by the end of the year to around six hikes. Five-year, five-year forward inflation swaps (a measure of long-term inflation expectations) have moved from around 2.36% in mid-February to 2.57% at the time of writing.

Overall, the probability of recession has risen because of recent events, but this is still not our base case.

Where will commodity prices go from here?
Broadly diversified commodity indexes have risen between 19% and 26% on a total return basis so far this year. In the week of 28 February to 6 March alone, they surged by low-teens percentages to register one of their strongest weeks ever. Energy and grain prices have led the rally, climbing 35–45% on a sector and subsector level.

But despite the steep rally, we continue to see more upside in selected commodities and have raised our forecasts across the sector. The global commodity market was already facing a supply challenge before the onset of the Russia-Ukraine conflict. Now, disruption to supplies arising from the war will exert even more pressure on supply.

Energy has been the focus for most investors. We have been seeing a greater willingness of Western nations to endure economic pain by directly targeting Russia’s energy sector. On 8 March, the US banned the import of Russian oil, and the UK said it would stop imports by the end of 2022, the first time that Russia's commodity exports have been directly targeted by sanctions. The EU announced the goal of reducing its imports of gas by two-thirds this year. While only about 8% of Russia’s oil exports go to the US, versus around 60% to Europe (2% to the UK), the move was a sign that the US is willing to accept more economic pain to punish Russia. The move contributed to a further rise in Brent crude, which closed above USD 130/bbl. Even before the move, however, Russian energy exports had already been disrupted due to self-sanctioning by buyers of Russian crude on concerns over future sanctions or reputational risks.

Meanwhile, OPEC+ is already struggling to meet its higher production targets. US frackers may take six months to shore up shale production, which has slowed due to capital discipline by producers. Any Iranian oil supply would take time to reach the market, as Iran will need to prove it has curbed nuclear activities. Tapping strategic oil reserves will eventually exhaust spare capacity.

We consider our near-term forecast of USD 125/bbl for Brent crude oil as a soft cap for prices, although prices could rise beyond that if disruptions worsen or become protracted. A prolonged war could send Brent above USD 150/bbl, in our view. We also see potential upside for industrial metals and agricultural commodities.

Should I sell now?
The war in Ukraine has caused the equity rally to stall. We believe it can resume if our base case for a cease-fire and a cooling of rhetoric between NATO and Russia by the summer plays out. This would allow a gradual reduction of energy prices, limiting the drag on economic growth and earnings.

In addition, market drawdowns typically don’t last long: Since 1945, markets have spent only about 14% of the time actively "falling" and 86% recovering previous losses or breaking through new all-time highs. And drawdowns based on geopolitical events have been particularly brief: If we look at S&P 500 performance following key military conflicts since 1945, markets were usually down within the first week, but on 14 of the 18 occasions, they were up within three months, with median performance of around 2%.

But while we favor maintaining long-term exposure to equities, near-term uncertainties have increased. Investors are struggling to assess a range of factors on the basis of imperfect information, including Russian President Vladimir Putin’s intentions, the extent of future sanctions, and possible outcomes to the war. The economic impacts are also less clear, with the trajectory for commodity prices, global growth, inflation, and central bank policy all now harder to predict with confidence.

As a result, the risk-reward profile for equities has deteriorated in the near term. We now favor a neutral stance on stocks over a tactical horizon, so investors should bring equity allocations back to strategic targets. This does not mean exiting markets, however. We see a variety of ways in which investors can both hedge risks and keep sight of long-term goals.

For example, we see energy equities as a hedge against the risks arising from the war. Investors can also seek to position for the energy transition, as a period of higher commodity prices focuses the attention of governments on energy security and independence. This chimes with a desire to reduce carbon emissions, all of which speak in favor of investment in greentech, clean air and carbon reduction, and carbon trading strategies. We also see China’s market as being less impacted by the conflict, and we expect it to outperform other Asian markets over a tactical horizon.

Where are the safe havens?
Many classic "safe-haven" assets have performed well, including US Treasuries, the Japanese yen, the Swiss franc, and gold. But while these assets may continue to outperform in the near term, we see better ways of building defensive exposure into portfolios at present.

We like the US dollar, which typically outperforms during geopolitical crises, and has done so again. The DXY index is up close to 3% since the Russian invasion. We think the dollar should also be well supported by central bank policy divergence, with the Fed on track to raise rates faster than the European Central Bank.

Another way to build some defense into portfolios is to add to more defensive sectors and strategies. Global healthcare is our preferred defensive sector (though we expect US healthcare to trade in line with the rest of the US market). The ex-US sector has a higher exposure to pharma (at 61%), a defensive subsector, and in our view benefits from a stronger dollar given relatively high sales exposure to the US.

We also see dividend strategies, dynamic allocation strategies, and the use of structured solutions as attractive means of improving the risk-return profiles of overall portfolios. During periods of elevated volatility, investors can earn high yields with volatility-selling strategies, provided they are willing to tolerate the risk.

Other perceived safe havens, such as gold, the Swiss franc, and US Treasuries are unlikely to perform well, in our view. While the latest crisis has underlined gold's insurance qualities, we continue to expect a drag from higher real rates and a stronger US dollar later in the year. The Swiss franc is also a suboptimal hedge, in our view, due to its exposure to the European economy, which would be impacted if energy supplies were interrupted. Longer-duration US Treasuries still offer unattractive yields, and with central bank rate rises imminent, we don't expect a sustained rally in the 10-year US Treasury.

How can I hedge a portfolio?
There is no one-size-fits-all hedge for investors, and while volatility remains elevated, buying outright protection for equity positions can be expensive. But by keeping portfolio principles in mind investors can help shield overall portfolios from volatility.

Diversification is a good overall hedge for portfolios. By diversifying across regions, sectors, and asset classes, investors can reduce their exposure to idiosyncratic risks related to the war in Ukraine, or to other emergent political risks around the world. This is particularly important when we consider how recent events could magnify geopolitical risks elsewhere in the world. Consider, for example, the potential effects of high commodity prices on general civil unrest.

Commodities can be an effective specific hedge today, given the potential for a disruption of supplies from Russia and Ukraine. Russia accounts for around 40% of the European Union's gas imports and 30% of its oil imports, and is the world's largest wheat supplier. Ukraine is a material exporter of corn, wheat, and oilseeds. Amid the risk of supply disruptions, we think broad commodities can be an effective geopolitical hedge for portfolios, as well as offering an attractive source of returns in an environment of accelerating growth, inflation risks, and higher rates. We think that longer-dated commodity contracts are a good way to gain exposure to commodity markets, with lower volatility than in the shorter-term contracts.

We also like *energy equities*. After a strong start to the year, we note that the performance of energy equities has recently begun to lag that of the oil price. Part of this is due to the market not expecting current high oil prices to persist, and part may be due to idiosyncratic risks posed by the conflict to some oil and gas producers. However, overall we would still expect energy equities to rise in the event of an escalation in the conflict, and in the event of continued strong demand for oil as countries lift COVID-19 restrictions.

Investors can also consider adding *alternatives* within portfolios, including allocations to *hedge funds, private markets, global direct real estate,* and *structured investments*. Hedge funds have outperformed stocks in most years that equity markets have fallen over the past two decades. Private markets also have a low correlation to public markets, offering diversification benefits. Furthermore, in an environment in which inflation is perceived as a threat to markets, the correlation between equities and bonds may rise, increasing the value of alternative assets from a diversification perspective.

Is this a time to buy the dip?
Volatility is likely to remain high in the near term, and so we cannot rule out the possibility of further near-term downside for global markets. We also recently downgraded our view for Eurozone equities to neutral given the region's exposure to disruptions in Russian energy supplies. As a result, we are now neutral on equities overall on a tactical basis. So we do not recommend adding exposure above long-term strategic targets at present.

However, in our base case we do not currently expect this downswing to last, and note that over the longer term, at least since World War II, geopolitical events have tended not to have a major bearing on market returns.

For investors looking to build up exposure at his time, we would recommend focusing on the following areas. China stocks look attractive versus peers in Asia and from a diversification standpoint. China's equity market underperformed global markets last year, with MSCI China falling 22.8% versus a gain of 16.8% in the MSCI All Country World Index. But we expect the macro slowdown to bottom out by April, helped by a significant easing of monetary policy by the People's Bank of China. This should contribute to a stabilization in the earnings outlook for Chinese companies by the early summer, and the consensus forecast is for 14.7% earnings per share growth in 2022. While volatility remains a risk for China's tech companies, we believe the worst is likely over from a regulatory perspective, and that China's market is also relatively well insulated against current global interest rate and geopolitical risks.

Among longer-term investments, cybersecurity looks well placed, with cyberattacks associated with the conflict underlining the need for more spending on defensive measures by companies and governments around the world. According to the 2021 Norton Cyber Safety Insights Report, nearly 330 million people in 10 countries have experienced cybercrime in the past 12 months, spending 2.7 billion hours dealing with the aftermath.

Greentech stocks have underperformed in recent weeks, partly due to concerns about the impact of higher interest rates on valuations, but we see them as attractive both tactically and structurally. In the near term, high commodity valuations and a heightened focus on energy security are likely to boost focus on the sector. Structurally, the sector should benefit from growing pressure for economies to transition to net-zero carbon emissions. We see opportunity across greentech, clean air and carbon reduction solutions, as well as in carbon trading strategies and ESG leaders.

The "ABCs of tech"—artificial intelligence, big data, and cybersecurity—are all supported by secular trends, and tech companies have recently been falling due to higher rates. While it is not possible to pinpoint the perfect time to buy, these industries look attractive over the long term, in our view, and as such are candidates for investors to buy during periods of volatility. We expect our "ABCs of tech" theme to generate 10% annual revenue growth and 16% annual earnings per share growth over 2020–25 on average.

Notwithstanding the ongoing volatility due to the Ukraine war and rising inflation and rates, we believe the fundamentals of 5G companies in the basket remain attractive. 5G is expected to be commercialized over the next three years, and will impact a wide range of industries. We expect the 5G market to grow by more than 9x from 2022 to 2025, with total 5G equipment revenues reaching USD 150bn by 2025. We believe the theme remains well positioned to benefit over the longer term from a proliferation of 5G-related use cases such as metaverse, autonomous driving and AI.

Should I buy now or wait?

Selecting the perfect time to enter the market—or exit it—is notoriously difficult, and building exposure during a geopolitical crisis can seem daunting, especially given the potential for further losses. Given uncertainties at present, we advise investors against adding to exposure in equities beyond long-term target allocations.

But at the same time, it is often during periods of volatility when investors can make the best longer-term investments, and there are certain strategies that can reduce the risks from buying dips.

Phasing into markets can help lower the potential timing risks, especially when putting large sums to work. Investors can consider also adding exposure first to less volatile assets, such as defensive sectors like the pharmaceutical industry, and later phasing into more volatile assets. We believe the best strategy is to establish a set schedule, and to accelerate each phase-in tranche if there is a market dip of at least 5%.

A put-writing strategy enables investors to earn a premium by giving others the right to sell them a security at an agreed-upon price, typically a discount to the current market price. If the market does not fall, the option expires worthless, and the put writer keeps the premium. If the market falls, the put-writer—who had been intending to increase exposure to equities anyway—ends up taking delivery of the stock. While this strategy is not without its drawbacks, it can mitigate the drag on returns as an investor gradually enters the market.

As an alternative to option strategies or other derivatives, some investors may be willing to commit their cash fully upfront in exchange for a structured investment that provides some combination of these strategies' characteristics. For example, some structured investments limit upside participation in an underlying index, in exchange for downside protection, a fixed coupon payment until maturity or other features to adjust the distribution of returns.

Appendix

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
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Appendix

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