Market Update

Geopolitical developments surrounding Russia-Ukraine

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- After weeks of rising tensions, a military incursion in Ukraine was announced, with reports of airstrikes and shelling across parts of the country. Developments are still unfolding, and the attention is squarely focused on military developments and repercussions, including political decisions and sanctions, which are likely to be announced soon.
- The risk-off tone has led to a support for safe-haven assets, with Gold reaching a 13-month high, CHF and JPY both bid and US Treasury yields shifting lower (price going up). Commodities are higher across the board, with Brent trading at $104.9 and European natural gas prices surging 40% on fears of supply disruption and the repercussions on inflation pressure overshadowing growth concerns for now, as futures market continues to price in 6 rate hikes in the US and almost 40bps of hikes in Europe this year.
- Weak sentiment is weighing on equity markets, with European indices down 3.5% and underperforming US stocks which are poised for a 2%-2.5% decline ahead of market open. Russian equity markets are down over 30%, whereas illiquidity in the bond market has pushed USD sovereigns down by as much as 35points, with the yield curve inverted.
- Investors should stay invested and not panic as geopolitical events have historically led to sharp – yet short lived corrections as the broader economic context will eventually dominate. Nevertheless, the escalation of events and the elevated uncertainty of how the situation will unfold requires a more prudent stance in portfolios, whereas the impact of high energy prices on inflation requires diversification.
- We downgrade our view on global equities to neutral, reducing our US equity overweight and bringing European equities to a mild underweight. We cut Russian bonds to underweight, and use proceeds to add to cash (tactically), US investment grade bonds and hedge funds. Portfolio diversification remains paramount, and we emphasise a balanced approach between cyclicals and defensives. We upgrade CHF to neutral and remain negative on the EUR, whereas our existing allocation to gold provides a good hedge. Energy stocks will remain in favour, and our long-term themes on Total Security (including cybersecurity) and Energy Transition (benefitting from diversification of suppliers) remain appealing.

Geopolitical events in Russia and Ukraine

1. What happened?

After weeks of rising tensions between Russia and Ukraine that saw a substantial build-up of troops and military equipment around the borders, the situation escalated dramatically this week when Russia authorized a "special military authorization" in order to demilitarize Ukraine. The move was immediately condemned by US, European, UK and other nations, who effectively characterize the move as a "full scale invasion" of Ukraine, as bombing has been reported across a number of cities including air strikes in Kyiv. Martial law has been declared in Ukraine, and the UN security council has been convened, with developments continuing to unfold. The situation had already deteriorated earlier this week, when Russia recognized the independence of two self-proclaimed republics (Donetsk and Luhansk) that have been controlled by separatist militias in the aftermath of the 2014 Crimea invasion. This was followed by the entry of Russian troops within the breakaway region, a move that sparked fears that any further incidents could be used as a pretext for a broader incursion into Ukrainian territory.

2. Sanctions announced so far

The series of developments have been immediately condemned by the US, UK and European Union. A first round of sanctions has already been announced. These measures targeted a number of political figures and lawmakers, as well as some financial institutions (one of these is a state-owned development bank and another one has been known to provide financing to the Russian military). The most notable measure included the unprecedented restriction against foreigners investing in Russian sovereign bond issues. Although trading restrictions on primary markets had already been enforced in the past, the new measure is equally restricting secondary market trading for local currency and hard currency bonds issued after 1st March. The certification of a major gas pipeline connecting Russia to Germany was also put on hold. The market impact of these measures earlier this week (before the broader incursion) was relatively contained, with Western nations seeking not to "play all their cards in one go," retaining the flexibility to announce incremental measures on any further developments, a step which they are now expected to take with further measures being currently discussed.

3. How has the market handled the sanctions?

The first round of sanctions targeted sovereign bond restrictions. Foreigners are estimated to hold approximately $40bln worth of RUB denominated sovereign bonds, and an additional $20.5bln worth of USD denominated bonds according to December 2021 data, with current positioning likely to have declined further. It is worth noting that these holdings are not in scope of the latest round of sanctions, but the fear of incremental and broader restrictions will weigh on sovereign yields in our view. The banks that were targeted were not major issuers in the market, whereas the gas pipeline was not yet operational, so it will rather delay any future, potential gas supplies rather than immediately cut energy supplies. Further rounds of sanctions are expected to be announced based on the latest developments, and their degree of severity will be closely assessed in local asset pricing.

4. What has been the market reaction?

The MOEX Russian equity index plunged by more than 30% after market open, the largest amount on record. The RUB weakened to record lows of 89.99 against the USD. Russia USD sovereign bonds fell as much as 35pts in the long end and 5yr USD CDS was reported at 800 compared to 425bps close of yesterday. Russian local bonds opened around 350bps wider in yield terms at the start of London trading hours. Oil futures surged more than 5% this morning, with Brent rising above the $100 threshold at trading around $102.75. A range of other commodities saw upward pressure, as the market weighs any sign of potential supply disruption given Russia maintains large share of production. Aluminium for instance spiked to record highs, yet the market will keenly watch developments surrounding natural gas, given that Europe imports 90% of its needs, with at least 40% of the share coming from Russia.

Demand for safe havens has naturally increased, with Gold reaching a 13month high of 1,940 and US 10yr Treasury yield falling 11bps to 1.87% before retracing to 1.92% later in the morning. The USD is trading firm against key currency pairs, with the EUR falling below the 1.125 threshold as 1month implied volatility reached its highest levels since 2020. Asia markets opened in the red, with European futures down more than -3% and US futures down 2% on average, with growth oriented tech indices set to underperform at market open. In fact, the Nasdaq may enter a bear market, as futures suggest the market will start trading this afternoon at levels, which would be more than 20% below recent highs.

5. What to look out for next

Military developments on the ground, political decisions behind the scenes, and sanctions will remain key catalysts in the near term. Institutional investors are likely to limit their exposure to the region on any sign of harder sanctions, irrespective of whether limitations will ultimately be placed on the trading of select financial instruments by US or other persons. The market will carefully assess whether there will be any disruptions in the flow of natural gas or energy – with depleted inventories and high prices, any further strains on securing energy supplies may weigh on European inflation and in term on the ECB's forward guidance. The market has maintained its previous expectations for interest rate hike normalization, even though policy makers will keep a close eye on financial conditions, asset price moves and any signs of confidence or growth. Forward markets are still pricing in 6 hikes in the US and 40bps of hikes in Europe this year, as higher energy prices are overshadowing growth concerns.

6. Our positioning before the latest turn of events

Our tactical asset allocation already had zero exposure to EM EMEA stocks, implying no exposure to Russian equities. In fixed income, we had already downgraded Russian corporates to neutral earlier this year. Although we have been overweight global equities, our reduction in cyclicality coupled with an increase in the allocation of defensives, value and energy stocks and our allocation to gold have helped shield us against some of the recent moves, whereas gold continues to provide an effective hedge.

How do we position our portfolios?

From a general market perspective, depending on their severity, geopolitical events have historically led to sharp – yet short lived – sell-offs. The size of the fall varies each time, but in the vast majority of instances, remaining invested has been a strategy that has paid off, as the market assigns a greater weight on the overall economic context (global growth, inflation, monetary policy, corporate earnings, etc). This has also been the case during the Crimea invasion, but also with other major events such as the Gulf War, September 11 attacks, the war in Syria but equally so with political surprises such as the Brexit referendum, elections or other developments. Timing markets is a very difficult exercise, and raising high cash allocations can be at the detriment of clients, as positions may be sold while the correction is already well-underway, whereas reinvestment may not be quick enough to capture the recovery.

1. Downgrade global equities

That said, a more prudent allocation is clearly warranted in the short term, and we make a number of changes in our tactical asset allocation including bringing our allocation to Global equities close to neutral. We implement this by trimming our US equity overweight, bringing cyclicality in line with our allocation to defensives. On the other hand, we take Europe to a mild underweight, as the region will trade with a higher beta to Russian developments in the near-term, given geographical proximity and higher trade linkages compared to the US.

2. Increase liquid assets

We increase our allocation to cash tactically and upgrade CHF to neutral as the currency should outperform the EUR and equally benefit from near term demand for havens. In fixed income, we turn underweight Russian sovereign and corporate debt, given the uncertainty of sanctions and the possibility of more severe actions compared to the first round imposed this week. Any spread widening can be viewed as an opportunity to increase exposure to US investment grade, which should benefit from the flight to quality whilst a significant number of Fed rate hikes are already priced in.

3. Positive on energy sector and high yields

We maintain an overweight exposure to energy stocks which have outperformed in the value rotation, remain cheap and which are likely to benefit from elevated oil prices. In the US the rig count has notably increased in recent weeks, driven by the rise in oil prices. The fracking business will add to high pay job creation and support the case for "energy independence", providing a net positive tailwind for the US economy and US markets, which have limited trade and sales exposure to Russia.

The energy sector dynamics should also lend support to US high yield over the medium term, given the sector's large weight within the index. In the short term, risk sentiment may weigh on spreads, however given the flatness of the US yield curve, the low default rates in credit, improved entry points – we believe short dated high yield opportunities will become increasingly attractive once the geopolitical situation becomes more clear.

We continue however to emphasise our energy transition theme as well – although energy majors are enjoying stronger profitability, geopolitical developments will only accelerate the urgency of European and other nations to diversify their source of supplies and reduce the overreliance on one trading partner. The rise in oil and natural gas prices highlights the relative cheapness of wind and solar, and the shift to renewables should in any case accelerate as climate goals strengthen and emissions reductions become enforced.

4. Invest in Total Security and Energy Transition themes

We continue to emphasise scaling in to long –term secular trends such as Total Security (which includes cybersecurity), which are likely to remain in favour, as companies and nations deploy more capital to improve the resilience of their networks and business operations. Our energy transition theme should continue to perform well – energy majors are certainly benefitting from high oil prices, but the overreliance of securing energy supplies from a few trading partners will only raise the urgency to diversify supplies (reduce overreliance on one trading partner) and achieve a stronger share of renewables to trim carbon emissions.

5. Add hedge funds for diversification

Although our cash allocation is increased, the size of this remains measured. Cash rates are not yet attractive enough, especially in light of inflation, whereas as mentioned earlier, markets will quickly factor-in the latest events, and although the duration and repercussions of the incursion remain unknown, the broader economic context will eventually become again the most dominant factor for markets. We therefore also add to our exposure in hedge funds, that generally exhibit smaller drawdowns in markets and which can quickly exploit market dislocations and position themselves accordingly.

Our allocation to alternatives remain supported by private debt and private equity, which aside from elevated expected returns will remain attractive for investors as they can "see through" the near-term uncertainty and capitalize on cheaper entry points for long-term convictions.

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Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

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Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

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High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:
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• Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

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• Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
• Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

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