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Russia-Ukraine: more than just posturing?

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Financial markets have had a nervy start to the year, with most asset classes being impacted by the reality of higher near-term inflation and a potentially altered path for interest rates. We noted at the end of last year that markets could be more volatile in 2022 as they adjusted to a changed monetary scene. However, we felt that quite a benign backdrop of reasonably robust economic growth (albeit slowing from 2021's fast pace of pandemic recovery), relatively modest taps on the monetary brakes and receding inflationary pressures as the year unfolded would remain supportive for risk assets, particularly stockmarkets.

This fundamental, medium-term view has not altered. It means that we remain comfortable with our elevated commitment to stockmarkets for each risk strategy but, where relevant, a relatively cautious stance towards bond market positioning whilst monetary policy adjusts to a new level.

The escalation of Russia-Ukraine tensions has, however, added extra complexity to the inflation and interest rate debate in recent weeks. Oil, gas and agricultural commodity prices have risen since the start of the year and an actual invasion of Ukraine by Russia is likely to push prices higher still. Capital Economics, an independent research consultancy, estimate that two percentage points could be added to annualised Organisation for Economic Co-operation and Development ('OECD') inflation under a worst-case scenario. Financial markets' concern is that this could lead to some acceleration of the rate tightening timetable already pencilled in by key central banks and might see interest rates settling at a higher level than currently factored in by forecasters. Bond markets would suffer under this scenario, followed by greater risk aversion in global stockmarkets. This is the risk markets are likely to focus on in the near term, not the global economic growth consequences that are likely to be relatively minor and play out over a much longer time period.

But such a commodity-induced inflation spike is expected to be relatively short-lived, as it has been in various previous energy-linked conflicts; central banks will be mindful of this and therefore the chances that monetary policy will drift significantly off the expected path are still quite small. Markets do, however, dislike uncertainty so there remains some risk that a further re-pricing of stock and bond markets could occur near term if matters escalate to the point of conflict.

It is still very unclear whether Russia will actually invade Ukraine or what its intensions are. Is this a genuine attempt to bring Ukraine under Russia's wing or is it an extreme and convoluted way of disrupting international relations and testing Nato's capabilities and reactions? Or indeed is it an elaborate plan to pump up the profits of Gazprom (the Russian majority state-owned energy company) via higher energy prices, thereby strengthening Russia's balance sheet? Time will tell, but it does appear that Russia has much more to lose, longer term, than the powers that it is up against by escalating the situation beyond where it is currently.

Some commentators are right to argue that Russia's economy is now in a much stronger position to flex its muscles and withstand international sanctions, having bolstered its financial reserves over the past decade. Whilst this is true, Russia will equally be thinking carefully, we have to assume, about whether it is willing to risk losing its reputation as an energy exporter to Europe. If Russia were to deploy the energy weapon and cut off European gas supplies, for example, then the long-term damage done to Gazprom would be colossal – it would face significant financial penalties for the failure to supply contracted energy and indeed find it very difficult to collect payments due to it if access to international payment systems were halted, as has been mooted under proposed sanctions.

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Russia is a vital supplier of gas to key European economies such as Germany and closing the supply taps would certainly be damaging to those economies directly reliant on impacted routes for their gas supplies. But without wishing to dismiss the seriousness of the situation, it is worth noting that even at the peak of the Cold War the Soviet Union did not cut off gas exports and it was only Ukraine (not other countries) that saw a very brief disruption to gas supplies during Russia's last significant dispute with the country in 2009.

On another positive note, the longer this political and military posturing continues, the better it should be for Europe – we will soon be emerging from winter and the onset of spring typically brings significantly reduced demand for gas, thereby weakening Russia's position of leverage over European energy supply. Meanwhile, Europe does have other measures that can help mitigate any drop in energy supply: its energy markets are now better connected than they were in 2009, whilst it can also turn to spare capacity in liquified natural gas markets, including arranging for shipments destined for other parts of the world to be diverted, if necessary. Keeping the diplomatic channels open therefore buys Europe some time to formulate some contingency plans. All of these combined measures could help alleviate disruption and keep things ticking over for a few months at a time when European energy demand is steadily decreasing. Turning the gas taps off to Europe would certainly be disruptive and costly, but the cost is more likely to be seen in higher energy prices and higher interest rates than in the lights literally going out on the European economy.

All of the above is adding complexity to short-term market sentiment, but there is still a chance for diplomacy to win out and for Russia's military presence near the Ukraine border to be scaled back and for tensions to ease. With so many mixed messages being fed to markets at present, our current advice is to sit tight – a fairly serious outcome and the fallout in energy markets, plus knock-on impacts on higher short-term inflation, has already been absorbed by markets and reflected in depressed equity prices and elevated government bond yields (and hence lower bond prices). However, any actual commencement of military action or sense of significant energy supply disruption would almost certainly create some additional short-term market anxiety. But as noted, if one observes previous conflict-influenced market sell-offs and energy market dislocations, such disruptions have typically not lasted long – markets have historically overreacted to events and seen greater volatility ahead of any conflict and rallied fairly shortly afterwards. A sudden de-escalation of tensions or even some sense that diplomatic efforts are making some decent headway would almost certainly see a rally in financial markets. Whilst that possibility remains, we feel it is best to take a longer-term perspective and ride out what we believe will be a shorter-term influence on financial assets.

Unsettled periods such as the one we are currently seeing will often tar many businesses with the same brush, irrespective of their specific exposure to any particular threat or risk. This type of volatile market environment typically plays nicely into the hands of active managers who can take advantage of mis-priced opportunities in financially solid, well-managed companies in long-term growth sectors that have been inadvertently caught up in the melee. Participating in that activity and the rebound that generally follows testing periods such as this can only happen if one keeps the longer-term perspective in mind by staying invested – barring a completely altered landscape, that is what we intend to do.

Risk warnings

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