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Investors confront volatility as Russia invades Ukraine

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Markets reacted strongly this week to news that Russia invaded neighbouring Ukraine. The world has been watching tensions in the region escalate since the beginning of year. Russia objects to the idea of Ukraine joining NATO, a move that it believes encroaches on its sphere of influence and places the US at its doorstep. The invasion is likely to have a significant human toll, and our thoughts are certainly with the people in Ukraine.

Prior to the Russian action, investors were largely focused on high inflation and imminent rising interest rates. Now the focus has shifted to the attack's expected impacts on energy, global growth, inflation, and central bank actions.

Energy: clarity needed on further sanctions

Simmering tensions between Russia and Ukraine have pushed oil prices higher since the beginning of the year. Given a fragile high demand/tight supply dynamic, volatility in energy prices may continue, especially if sanctions on Russia ratchet up and provoke a further Russian response. Both the US and Europe are trying to penalise Russia – but without straining the energy markets and creating further inflationary pressure. Russia supplies an enormous amount of natural gas to Europe, and this cannot be swiftly replaced.

Greater vulnerability for growth and inflation in Europe

The US and Europe were already under pressure from high inflation due to a combination of supply issues and strong demand. But inflation and growth in Europe are more vulnerable to an energy price shock as, relative to the US, economies across the region are manufacturing and trade-heavy. In the US, the economy is more diversified and services-heavy, making it less sensitive to energy price shocks; while trade as a share of GDP is 23% (in comparison, it's 81% in Germany)[1].

[1] The World Bank, data.worldbank.org, as at 25 Feb 2022 (last full year reported is 2020).

The Fed is unlikely to change course on tightening monetary policy

For central banks, the geopolitical tensions introduce complexity on the timing and magnitude of rate hikes. The European Central Bank's (ECB) strategy may be impacted more directly should the crisis escalate (and we may see it delay plans to withdraw monetary accommodation later this year). In the US, the Fed is unlikely to change course on tightening monetary policy and we continue to expect the first 25 basis point hike in the Fed Funds Rate in March.

The Fed will be looking for a slowdown in inflation and wage growth in the second half of 2022 as a guide on whether to accelerate or decelerate monetary tightening. Oil prices are unlikely to play a major role in this decision, unless any change were to impact the outlook for economic growth meaningfully.

Market response

We are seeing a risk-off sentiment across emerging markets, as the possibility of imposed sanctions increases, although Russia and Ukraine together comprise around 3.5% of the Emerging Market Debt hard currency index. From a credit perspective, investment grade and high yield markets appear to be selling first and asking questions later. Most Russian companies are at the lower end of Investment Grade ratings and could be downgraded to High Yield as a result of sanction risks.

Our portfolios

Across global equities portfolios, we have no direct exposure to Russia or Ukraine, while our Global Emerging Market equities portfolios have around 4.5% investment in Russian companies[2] with minimal exposure to Ruble-denominated names.

On the fixed income side, strategies such as Threadneedle (Lux) Global Investment Grade Credit Opportunities, Threadneedle (Lux) Global Corporate Bond, and Threadneedle (Lux) European Corporate Bond have no exposure to Russia or Ukraine. We have been selective in what we are doing in portfolios, focusing on fundamental credit research and bonds that are selling off at least as much as the market but with less negative connections to what could be a longer conflict.

Now is not the time to panic

Market corrections driven by wars and oil market disruptions have historically been sharp but short-lived. As ever, volatility creates an urge among investors to do something, but our guide continues to be to stay invested and focused on long-term goals. Active asset management can help investors ride out short-term shocks in markets while capitalising on longer-term trends.

While recent events have been a difficult period for markets, it's important to remember that volatility can offer opportunities to identify valuation discrepancies, unearth hidden gems or add to existing holdings at opportune moments.

[2] Source: Columbia Threadneedle Investments, Bloomberg, as at 24 February 2022.

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