February 28th 2022

Escalation breeds Defensiveness

- **With NATO's response to the Ukraine crisis becoming firmer and aggressive, we could be in for a long-drawn-out conflict**
- **Last week's market relief rally is proving to be temporary**
- **If the crisis lingers, oil flirting with $150 isn't ruled out, further complicating the already-high inflation situation**
- **At this juncture, investors could defend their portfolios with gold and indexed-linked bonds**
- **While European equity markets appear vulnerable, US equities aren't entirely insulated from the crisis**
- **Asian equity markets could be defensive but markedly inflation would create challenges**

Our worst fears were realised with Russia invading Ukraine. As the events in Ukraine unfold and a shocked world community watches in distress, the response from NATO countries is gradually building into something far more concrete—and aggressive—than what was initially expected. At this juncture, **we believe that investors are complacent** about the markets' future risks. We suspect that last week's rally in risk assets will not hold**. Investors should look to defend their portfolios not look for opportunities for bottom fishing.**

As the war rages, investors should not make the mistake of interpreting the recent asset market performance as accurately reflecting the risks from the crisis. Everything appears fluid at the moment as governments and central bankers globally react with alacrity to developments in Ukraine. For example, there was a 'relief' rally in equity markets when investors saw the initial sanctions on Russia as 'watered down' and largely ineffective. When the invasion began, there was widespread belief that a closing-off of access to the SWIFT system for Russian banks was politically impossible. As of this moment, some Russian banks appear set to lose access to SWIFT, NATO countries have ratcheted up sanctions, and the Russian central bank will fear a run on the rouble with few levers to pull to stop the rout.

Such has been the global outrage at events in Ukraine that support for aggressive and far-reaching action against Russia has quickly gathered steam and pressured governments to markedly ratchet up their efforts in defence of Ukraine and against Russia.

Looking back at the start of the conflict, commentators were almost united in their **unspoken assumption that Ukraine would roll over quickly**, leaving a Russia-imposed puppet government in charge. Everyone would calm down eventually, and financial markets would revert to familiar themes. **Most commentators now see a starkly different reality.**

Current indications are that this could be a long-drawn-out conflict. Political pressure will build for NATO countries to institute further punitive policies that impact Russia. We note that several countries are now openly talking about supplying offensive and defensive weapons to Ukraine. Sadly, the Ukraine crisis is at risk of becoming the proxy between Russia and NATO.

While equity markets rallied Friday, we believe the risk of higher inflation and lower growth has increased materially.

Risk of higher inflation emanates from oil prices likely persisting at levels far higher than previously envisaged. Various forecasters suggest that oil could spike to maybe as high as $150. **JPMorgan estimates that a $150 oil price would decrease global growth by an annualised 3% and boost inflation by 4%.**

The risk of oil vaulting to $150 would be even more likely if Russia were to cut its supplies to Europe. Oil markets are already in a state of short supply, low inventories, and robust demand. OPEC's latest forecasts released last week envisage an oil market with less supply and lower stocks than previously forecast. OPEC meets on March 2nd and is expected to endorse its previous target of increasing oil supplies by 400,000 b/d in the coming months. However, recent OPEC output has been running at around 1m b/d below even its current target.

Given the tragic circumstances in Ukraine, commenting on 'opportunities' to profit from such events leaves us cold. However, there are some strategies that investors should employ to protect their wealth. **We believe that the inflation risk is currently underpriced in the bond market**. In the US, the breakeven level of inflation in the five-year TIP is 3.1% but it is a level of implied inflation that was priced back in November. We expect implieds to rise to price materially higher inflation, benefiting the returns on inflation-linked bonds.

We believe that gold remains a good investment in current conditions. Some commentators suggest that gold has not performed, but that is simply incorrect. Gold has risen from $1800 to $1900 in February alone.

Equity markets remain vulnerable. At the epicentre of the crisis, European markets are probably the most vulnerable, even though they are not that expensive. Investors will be concerned that the region will suffer heavily from higher energy prices and as the fallout from Ukraine unnerves consumers and industrialists affecting post-COVID economic growth.

The further investors are from Ukraine the greater the probability that they will not worry so much—perhaps wrongly so. We recognise that could be the case in Asia, but it could be a narrow base of countries only. ASEAN markets essentially held their own last week. However, Singapore equities were weak in line with the global norms. The government delaying some elements of its recently announced re-opening of the economy was seen as a negative.

North Asian equity markets are having a more torrid time. The Hang Seng index fell 6.4% last week with a further government crackdown on tech stocks. Chinese stocks, which had started to show some resilience on hopes of greater support from the Chinese central bank (PBOC), have largely lost their momentum.

The US equity market falls into two camps; the positive is that the US is a long way from Ukraine, so US investors could simply discount the crisis as a European problem. However, it is more complicated than that. The Ukraine crisis is rapidly becoming a proxy conflict between Russia and NATO. The possibility of much higher energy prices would hurt the US economy. But, more importantly, **the US equity market remains an expensive market that needs low interest rates and consistent good growth to maintain its poise**. We would hazard a guess that if the current crisis deteriorates further, with significant risk aversion

among investors, the US equity market could be looking at up to a 30% correction, bringing it back to the pre-COVID trend levels.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)