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I've got Ukraine on my Mind

- **The geopolitical risks – and not a new macroeconomic regime – are the markets' latest worry**
- **The stakes are high as an attack on Ukraine by Russian forces appears imminent**
- **Europe will never look the same raising considerably uncertainty in the region**
- **With inflation continuing to be a vexing problem, markets are now confronted with the prospects of even higher commodity prices**
- **We continue to prefer Asian asset markets for their ability to weather a crisis with characteristic resilience**
- **High yield markets start to price angst**

Just when the markets were getting concerned about a new macroeconomic regime taking shape, the rapidly evolving situation on the geopolitical front overwhelmed them further. The Russian-Ukraine sabre-rattling, even as the prospects of inflation remaining sticky loomed large, appeared set to unnerve markets. As we write, it now appears that President Putin has made up his mind to invade Ukraine. While a war, if it breaks out, will have deeper geopolitical consequences, frequent diplomatic parleys—and threats of sanctions from the US and European governments—have done little to deter Putin so far.

Memory goes back to 1961, when the Berlin Wall went up. It is exasperating to think that we may have come full circle with what looks like an imminent invasion of Ukraine by Russian forces. Such a move by President Putin, if it materialises, risks seeing the barriers go up between Russia and the countries bordering Russia as more countries worry about maintaining their sovereignty. The United States and Europe have a tough task at hand—of reconsidering their entire defence strategy. The conventional forces in the West appear to have been completely dismantled—at least for the time being—as President Putin does a land grab of a European country almost without consequences. The US, France and the UK are hardly going to revert to a nuclear threat to Russia over one nation. Quite frankly, nor would they at this stage have the suitable military scale on the ground in Europe to support a NATO country.

The Ukraine crisis can only exacerbate some of the evident macroeconomic trends seen over the past 12 months. As the conflict unfolds, the world faces further disruption to supply lines and renewed strategizing around securing energy and food supplies. We wrote last week about why Russia is important for Europe's energy needs and global wheat supplies. We see only upward pressure on energy and food prices as countries scramble to rebuild the current inventories and strategic holdings. Near term, growth is compromised as the uncertainty generated by the latest events dampens both consumer and industrial confidence.

Russia's importance in commodity markets, goes beyond just food and energy. As shown in the table below, the country is a crucial supplier of several critical industrial commodities. Sanctions/disruption to supplies can only worsen global inflation further. We expect commodity prices to rise further as the impact of the current geopolitical events sink in.

Table 1: Russia's key commodities (share of global production)

Aluminium	6.0%	Platinum	10.0%
Copper	3.5%	Gold	10.0%
Cobalt	4.0%	Steel	4.0%
Nickel	7.0%	Fertilisers	13.0%
Palladium	40%	Wheat	17.0%

Source: Reuters

For the moment, it appears that the US is not going to take away access to the SWIFT payments system from Russia. However, countries such as Austria, Italy, France and Germany will be concerned about their banks' exposure to lending in Russia. S&P reports that "among the European banks with a Russian presence, Raiffeisen Bank International AG would be most exposed to risk stemming from sanctions tightening, followed by Hungary-based OTP Bank Nyrt., Italy's UniCredit SpA and France's Société Générale SA, according to JPMorgan analysts. The Russian units of RBI, UniCredit and Société Générale are also among Russia's systemically important banks".

While Russia may avoid losing access to SWIFT, it is likely to lose access to dollars. A point worth noting here: Russia has \$635bn in gold and foreign exchange reserves. Russian State Bank data shows that Russia's largest reserve currency holding is the Euro, which accounts for a third of all reserves. Gold is the second largest, and US Dollar the third. Chinese Yuan comprises about 12%. Its FX reserves equate to about 40% of its GDP and twice the value of its imports.

Equity investors are fretting about whether key index support levels will hold in the face of a deterioration in the geopolitical situation. And, if the support breaks, how much of a correction we could see before the Fed steps in.

Last week's sell-off in equities brings us to a year-to-date loss of 7.6% for global equity markets in US dollar terms. The global equity index sits on a critical support line, which, if broken, could easily see the markets plunge a further 12%. This would take us back to the levels of last March. US equity markets lack some of the positive factors they enjoyed before, such as:

1. Investor sentiment is down to levels that normally precede a significant market correction.
2. The ratio of negative corporate guidance to positive guidance has not been this bad since the global financial crisis.
3. Measures of equity market liquidity are rock bottom and provide little help if meaningful selling hits the market.

Another factor working against the market is that there is a lot less confidence that the Fed put is alive and kicking. The Federal Reserve probably is neither inclined (with inflation still a pesky problem) nor indeed it is the power to resurrect an equity market that quite frankly has barely unwound some of its froth.

We continue to urge investors to look to Asia for opportunities, particularly if markets were to witness a severe sell-off. As we have said before, Asia could see a meaningful resurgence as economies re-open. Thailand, Singapore, Malaysia, Indonesia, and Japan have all started to roll back some of their COVID restrictions on mobility. For a change, these shifts appear to be more permanent and signal the start of a move to significantly open up in the coming months.

While a deterioration in Ukraine would be a tragedy with far-reaching political and economic consequences, Asian countries in the “post-COVID world” appear more resilient to weather any crisis.

Credit spreads are on the move - Higher

In the post-Covid era, the mantra has been to add risk on the dips. Recent developments question the wisdom of sticking with the strategy.

Chart 1: BBB and Single-B Spreads are widening

(%)



Source: Bloomberg

At current levels, BBB spreads have widened from the low just above 1% to 1.45%. Single-B credits from 3% in January to 4% by the close last week. The increases seen constitute the biggest consistent spread rise since April 2020 – data on the chart does not include that jump as it distorts the picture. It will be no surprise to find that both Investment Grade (IG) corporate bonds and High Yield (HY) bonds have posted negative returns YTD. According to Bloomberg data, in the case of US IG, the loss stands at 5.71%, and for HY, the loss is 4.27%.

So what comes next? History tells us that widening HY spreads can be a harbinger of trouble. In 2008, there seemed to be a period of disconnect between credit and equity when the credit market was in clear distress before equities caught up. Today, the credit widening is not that wide yet, but the echo is familiar.

There are some very clear headwinds for credit: First, higher inflation brings higher rates, undermining returns in all fixed income, not just credit. Second, higher outright yields bring challenges to weaker companies that have lived off historically low interest rates for a long time. Roughly calculated, the average single B-rated entity faces a funding cost of 1.5% more today than in November 2021.

The rosy outlook is changing: Currently, rating agencies and analysts alike foresee very low defaults for 2022: in the region of 2% for speculative-grade paper. Usually, the impact of higher yields and tighter cash flow can take upwards of twelve months to start showing up in the default numbers. With rates set to move higher and faster than predicted when the last default forecasts were run, it could well be the case that the market is ahead of the analysts here and looking for weaker credit fundamentals.

Positioning is thus challenging, but from experience, the key is to avoid the weaker sectors. Prefer higher grade to lower grade (irrespective of the siren song of higher yield!), and be overweight DM versus EM: Emerging market corporates have added debt at a much faster clip than DM during the pandemic.

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