Insight INVESTMENT

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INSTANT INSIGHTS
GEOPOLITICAL CRISIS

THE GEOPOLITICAL CRISIS IN UKRAINE HAS ESCALATED INTO THE MOST WORRYING OUTCOME FOR THE PEOPLE OF UKRAINE, AND FOR PEACE AND STABILITY.

WE EXPECT THIS TO PARTICULARLY IMPACT COMMODITY MARKETS AND, ON BALANCE, PROVIDE INFLATIONARY IMPULSES IN THE NEAR TERM. WE THEREFORE SEE NO CHANGE IN THE FEDERAL RESERVE'S PLANS TO ENACT A HIKING CYCLE. WE FURTHER BELIEVE INVESTORS SHOULD TREAD CAREFULLY AND MAY WISH TO CONSIDER VALUE OPPORTUNITIES SELECTIVELY.

A WATERSHED GEOPOLITICAL MOMENT MEANS UNCERTAINTY

Russia has launched a "full scale" invasion of Ukraine, with missile strikes on military and transportation systems across most major Ukrainian cities as well as ground incursions.

This moment likely marks a watershed moment in the post-Cold War era which has been defined by greater political stability and closer worldwide economic integration. As such, this event potentially illustrates our view that Globalization is increasingly making way for Regionalization and the return of "spheres of influence".

GEOPOLITICAL RISKS HAVE RISEN OVER THE MEDIUM TERM

Markets have taken the invasion as a shock. Intelligence from the US had stated a full-scale invasion was highly likely, but it conflicted with European intelligence and the views of many geopolitical forecasters.

In the end, the US intelligence proved correct. However, the key question for investors in the near term is whether the conflict will expand beyond Ukraine, which would be a major risk-off event.

However, we currently see these events as serious medium-term, rather than near-term, risks. Nonetheless, during chaos and conflict, tragic accidents cannot be ruled out.

IN THE NEAR TERM, WE EXPECT THE CONFLICT TO BE CONCENTRATED IN UKRAINE

Ukraine is the second-largest European country (after Russia itself), similar in size to Afghanistan and with a population similar to Spain. As such, the possibility of protracted conflict is not negligible.

We expect commodity markets to be at the center of disruption. The key Russian export from a geopolitical perspective is natural gas. But elsewhere, Russia accounts for ~15% of oil production, Russia and Ukraine collectively supply ~30% of global wheat and Russia is also a significant exporter of chemicals such as potash, phosphate and nitrogen as well as industrial and precious metals.

Russia has also stockpiled $600 billion in foreign exchange reserves which potentially offers Putin some limited room to maneuver in response to global sanctions or intermittently stop commodity exports.

The effects will differ across the globe. The US, being a net natural gas exporter, will be more insulated from rising global natural gas prices, while its personal savings rate is also a potential buffer for consumers. Russia supplies Europe 35% of its imported natural gas, and so European governments may consider near-term subsidies to ease pricing pressures.

On balance, we see the risks as clearly inflationary. We expect the Federal Reserve to press ahead with its hiking cycle and plans to reduce its balance sheet. To reactivate the 'Fed put', we believe we would need to see a great deal more market volatility over the coming weeks.

TIME FOR INVESTORS TO BE CAREFUL AND FOCUS ON VALUE

Investors need to be clear-eyed about the risks. In recent weeks we had felt that the market had evolved to be overly sanguine over President Putin's intentions in Ukraine. As such, we kept active credit risk low and reduced our short interest rate position in recent weeks.

In the near-term, we believe fixed income investors need to take a careful, value-based approach to investing and seek robustly underwritten credits tied to strong fundamentals based on the domestic growth outlook in the US.

FIND OUT MORE

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