Investment Implications of Russia's Invasion of Ukraine

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pfm asset management

The world has watched Russia's unprovoked invasion of Ukraine in shock and anguish, its devastating toll on the civilian population, and the resulting humanitarian and refugee crisis it has created over the past three weeks. Our hearts go out to the families affected by the evolving tragedy.

Response and Sanctions

Countries around the world, including the U.S., UK, those in the EU, Canada, Japan, Australia and others, have acted in near unison to impose severe sanctions against Russia. Those sanctions include:

- Blocking Russia's central bank and sovereign wealth fund from using its emergency reserves by selling dollars or euros;
- Freezing assets and restricting access to U.S. dollar funding markets for Russia's largest banks;
- Removing key Russian banks from SWIFT, the international system that facilitates financial transactions and interbank payments, effectively blocking their ability to trade internationally;
- Freezing the assets of, and instituting travel bans on, several key Russian politicians, officials and oligarchs;
- Bans of Russian aircraft in EU, UK and U.S. airspace, and exports of certain technology to Russia; and
- Suspension of the Bank of Russia from the Bank for International Settlements (BIS), considered the central bank of central banks, limiting its ability to circumvent sanctions.

Most recently, the U.S. announced a ban on importing Russian oil, liquefied natural gas and coal. The UK also announced it will phase out imports of Russian oil and oil products by the end of 2022, while the EU presented a plan to cut Russian gas imports by two-thirds this year.

Multinational companies have followed suit. Below is a partial and growing list of companies suspending or limiting operations, investments or sales in Russia.

Companies Suspending or Limiting Operations, Investments or Sales in Russia

- **Autos:** GM, Ford, Volkswagen, Toyota, Volvo, Nissan, Mercedes, Honda, BMW
- **Consumer Goods/Retail:** Unilever, Ikea, TJX, H&M, Canada Goose, Adidas, Levi's, 3M
- **Energy:** Shell, BP, Exxon Mobil
- **Finance:** American Express, Mastercard, Visa
- **Accounting and Consulting:** Deloitte, EY, KPMG, PwC, Bain, McKinsey, Boston Consulting Group
- **Media:** Netflix, Disney, Sony, Warner Bros.
- **Food:** McDonald's, Starbucks, Pepsi, Coca Cola, Yum Brands
- **Technology:** Amazon, Google, Microsoft, Apple, IBM, Samsung, Spotify, Oracle, Dell
- **Shipping/Logistics:** UPS, FedEx, DHL
- **Airlines:** Airbus, Boeing, American Airlines, Delta, United
- **Manufacturing:** Caterpillar, John Deere

Investment Implications

The invasion and subsequent sanctions have led to increased volatility in global bond, equity, currency and commodity markets. The Russian stock market has plummeted, and the largest Russian stock exchange remains closed. The Russian ruble has fallen in value by more than a third. Energy prices have surged, reaching a 14-year high. The turmoil has also triggered corrections of 10% or more in the S&P 500 and most other major global equity market indices.

While the humanitarian toll remains on the top of our minds, we must also consider the investment implications for our clients. We are focusing our investment analysis and attention on three key areas:

1. **Geopolitical Risk:** What does Russia's military incursion mean for the post-WWII rules-based world order? What will become of the "peace dividend" that has marked relative stability in Europe and elsewhere? What are the implications for NATO, especially the countries of Eastern Europe that share borders with Russia, Belarus or Ukraine? How will this affect globalization and supply chains in the future? At the moment, these are fundamentally unanswerable questions as the world begins a significant "rewiring" of the political economy.

2. **Inflation and Economic Growth:** The most immediate impact has been a surge in prices, particularly oil, gasoline, agricultural products and industrial metals. Even before the conflict erupted, gasoline prices were high because of supply and demand dynamics resulting from the pandemic. Russia is one of the largest exporters of energy products, including oil and gas, especially to Europe. Given that both Europe and the U.S. are reducing their energy imports from Russia, prices have risen in those regions. In the U.S., the result has been the highest gasoline prices on record, with a gallon of regular gas costing an average of $4.30 (as of March 9, 2022).

   Food prices are also surging. Russia and Ukraine make up approximately 14% of the entire world's wheat supply, so we have seen the war cause wheat prices to climb to record levels. Furthermore, Ukraine is considered the breadbasket of Europe and is a leading exporter of many agricultural products. Spring planting season is coming up, and it appears that farmers in Ukraine may be unable or unwilling to plant this season's crops, further reducing supply. Additionally, metal prices have been soaring, especially nickel and palladium, which are also large Russian exports.

   This all means higher inflation – higher costs – than what we were already experiencing. Prior to the invasion, Consumer Price Index (CPI) inflation was nearing 8% on a year-over-year basis in the U.S., driven by supply chain issues and labor shortages, with energy prices and new/used car prices as main contributors. With commodity and energy prices skyrocketing, this inflationary trend is likely to get even worse. For households, it means less disposable income for other consumer goods.

For the U.S. and the global economy as a whole, it will be a significant drag on gross domestic product (GDP). Fortunately, the global economic reopening set the stage for strong anticipated growth in 2022, but the consequences of the war in Ukraine will negatively impact those expectations. The U.S., with its abundance of natural resources, will be less affected than Europe, but commodity inflation easily crosses borders and continents.

3. **Interest Rates and the Federal Reserve (Fed):** Volatility is up, liquidity is weaker, and uncertainty is high, but the impact on financial markets has been orderly and relatively contained so far. For instance, the U.S. stock market was already trending lower prior to the invasion, and the total downturn year-to-date effectively just reversed the strong gains of the second half of 2021.

   Fed Chair Jerome Powell has emphasized the need to move forward with raising short-term interest rates to combat persistent inflation, with the first expected rate hike occurring at the upcoming March Federal Open Market Committee (FOMC) meeting, despite the change in geopolitics. While Treasury yields would normally fall during significant geopolitical events, yields today remain more closely tied to expected Fed policy rather than other factors. For example, the yield on the 2-year Treasury note recently reached 1.70% (as of March 10, 2022), a new high for this cycle. We are, however, seeing a modest and logical "risk-off" sentiment, causing credit spreads to widen. At present, the Fed remains committed to following through on their plan to normalize monetary policy through rate hikes and balance sheet reduction. High inflation makes that a near necessity, but heightened uncertainty, a broader military conflict, or materially slower economic growth could push the Fed to alter its course later in the year.

We continue to seek to protect our clients' assets by sticking to the fundamentals: adapting to emerging interest rate trends, evaluating the impact current events may have on the creditworthiness of issuers for investment in client portfolios, and maintaining broad portfolio diversification across sectors, industries and issuers.

Since most large banks and corporations operate globally, many may have some direct or indirect exposure to current events through sales, operations or loans in the affected region. We are evaluating that exposure in particular and watching emerging conditions in the financial markets carefully.

But rest assured, across all of PFM Asset Management's fixed income investment strategies, we hold no issuers domiciled in Russia, Belarus or Ukraine, and all securities we purchase on behalf of clients are denominated in U.S. dollars.

As always, we are here to help you navigate this time of uncertainty and welcome the opportunity to discuss this in more detail with you.

To learn more or discuss in greater detail, please contact your PFMAM relationship manager