Implications of the Russian invasion of Ukraine

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In a dramatic escalation, Russia has today begun a full scale invasion of Ukraine, launching a barrage of missile, artillery and air attacks early on Thursday 24th February and triggering the worst security crisis in Europe in decades. At time of writing there were reports from Ukraine's Interior Ministry that the capital Kyiv was being targeted.

For investors the following are things to consider:

1 Sanctions

After the first round of sanctions following the recognition of Luhansk and Donetsk, it seems likely that a more severe range of sanctions will be imposed in the coming days by western powers. The fact that the Russian economy has been strengthening (largely due to energy prices) and has built its foreign reserves with little use of the dollar, suggests it remains capable of withstanding external actions. However severe sanctions will have an impact on its economy and ability to trade. The challenge for Europe will be to design sanctions that don't hurt the EU more than Russia. It is also important to bear in mind that the Russian economy while 11th largest in the world, remains small relative to the EU or US (it is roughly the size of Belgium & the Netherlands combined[1]), so its impact internationally will be limited, save for its role in commodity markets.

2 Commodity markets

Russia is a significant player in commodity markets (See Figure 1). Predictably energy prices are responding to the escalation in the crisis and as of this morning oil had spiked to $105[2] per barrel, (the first time it's greater than $100 since 2014). European natural gas spiked again by 20.1%[2] and coal and electricity prices have also increased. (Source: Bloomberg, 24.02.22). As Russia is the largest supplier of gas and oil to Europe, about a third of which travel across pipelines in the Ukraine, it threatens to spark an energy crisis in Europe. The new Nordstrom2 (energy infrastructure project) pipeline between Russia and Germany has been suspended by Germany as part of the first round of sanctions.

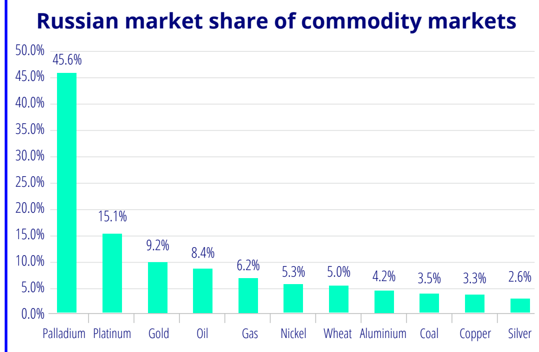
3 Inflation

Given the massive influence that energy prices have been exerting on inflation, it seems likely that this could extend the period of higher inflation. All other things being equal this in turn will add to the challenge that the European Central Bank (ECB) in particular faces and may be a further factor in the timing of their interest rate increases.

4 Financial assets

We have seen volatility in equity and bond markets spike up as a result of the uncertainty these events have created. (Source: Bloomberg, 24.02.22).

Figure 1: Russian share of commodity markets



Source: J.P. Morgan Feb '22

1 Source: Investopedia 24/2/22
2 All prices indicated are sourced from Bloomberg as of 10.15 am 24/2/22

Warning: Past performance is not a reliable guide to future performance.

Implications of the Russian invasion of Ukraine (Cont'd.)

Equities

Global equities have had a difficult start to 2022 and this has added to the losses bringing year to date performance to c.10% (a 'correction' in the market's eyes).

European equities dropped on the news by c.3.9%[2]. Russian equities slumped the most on record before trading was suspended (down 48% YTD). S&P and NASDAQ futures were down 2% and 2.5% respectively[2]. (Source: Bloomberg, 24.02.22).

Bonds

So far in 2022, bond yields have been moving upwards in response to changed central bank policy settings. The US 10 year had reached a high of 2.04% and the German equivalent had reached 0.3%. As of this morning there has been demand for safe havens and this has brought the US 10 year to 1.87% and the German 10 year to near 0.13%[2]. (Source: Bloomberg, 24.02.22).

Commodities

The big movements in energy prices were the most immediate impact but we have also seen safe havens such as gold increase to $1966, a level not seen since mid-2020. (Source: Bloomberg, 24.02.22).

Advice

Given this turn of events, the most likely scenario now looks likely to be Russian occupation of the Donbass region following a very costly conflict given the scale of Ukrainian military capability to oppose. That will leave Ukraine in a greatly weakened state and unable to seek to join NATO, which would seem to accomplish what Putin has set out to do. It seems unlikely that NATO will take a direct involvement and that leaves the energy prices as the main economic fallout that western economies will see.

Geopolitical events of this kind have a short term and very unsettling impact on markets. However the lessons of the past are that markets will adjust in a relatively short timeframe once the conflict is contained.

The following table shows the length of time that events of this nature have impacted on markets using the S&P 500 as a gauge.

Geopolitical events and stock market reactions

		S&P 500 Index		Calendar Days To	
Market Shock Events	Event Date	One-Day	Total Drawdown	Bottom	Recovery
Iranian General Killed In Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.2%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		-1.2%	-5.0%	22	47

Source: LPL Research, S&P, CFRA 01.6.20

The escalation of the crisis in Ukraine into conflict will hamper markets in the near term and we are experiencing its effect across the asset classes. However once it is contained and doesn't result in western military engagement its market impact should prove short lived. It may add to the inflationary pressures that the ECB is facing as energy prices could be impacted for longer than had been hoped.

For more information:

Fund Centre

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Warning: If you invest in these funds you may lose some or all of your investment.

Warning: These funds may be affected by changes in currency exchange rates.

Warning: Forecasts are not a reliable indicator of future performance.

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Bank of Ireland