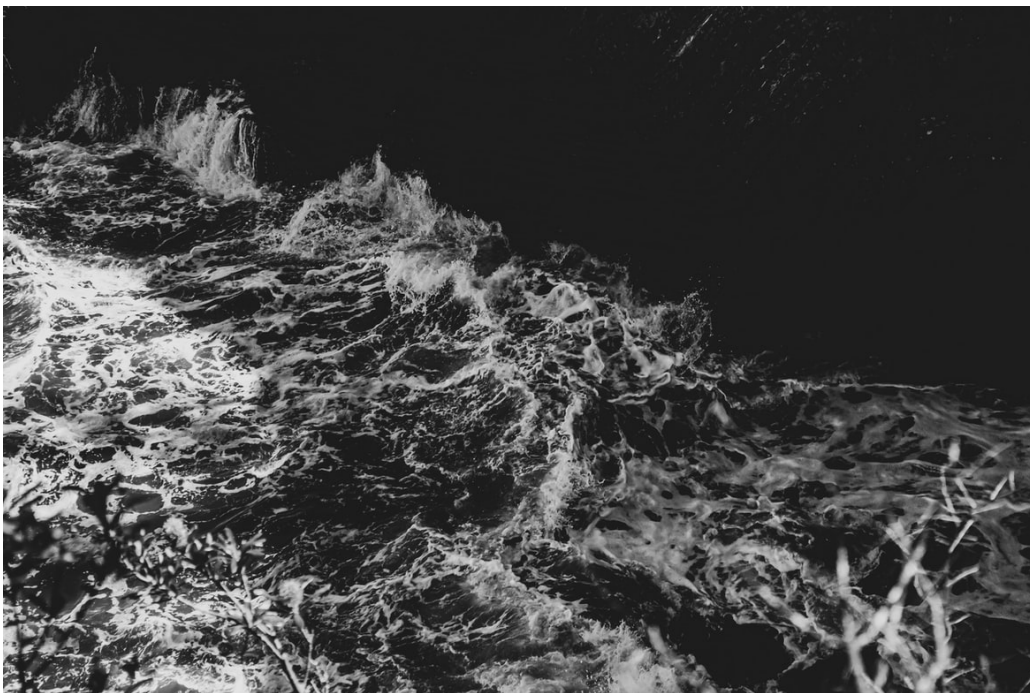


March 4, 2022

BILBoard March 2022 – Crisis in Ukraine



The conflict in Ukraine has introduced new uncertainty for markets, which already had a volatile start to the year with investors concerned about inflation at 40-year highs and the end of ultra-easy monetary policy. Following the unexpected full invasion on 24 February, markets exhibited a textbook risk-off reaction with safe havens strengthening and equities retreating. However, markets are not good at pricing geopolitical risk, and the knee-jerk reactions became less pronounced in the days to follow. US equity markets recovered the same day and are more or less in the same place as they were beforehand, while European equities are still slightly down.

Most important for equity markets is how the crisis affects underlying fundamental market drivers like growth and inflation. Taken in isolation, the war in Ukraine is unlikely to derail the global economy; it is the resulting sanctions and commodity price spikes that will have the most significant impact on global growth.

The US, Europe and allies have imposed cascading sanctions on Russia, its companies and individuals. These have limited Russia's ability to carry out foreign currency transactions and

frozen the assets of multiple Russian banks. Western nations have also cut off Russia's banks from the SWIFT global payments system (considered as a nuclear, last-resort option).

Between them, Russia and Ukraine are important exporters of various hard and soft commodities including oil (Russia is the world's second largest producer), gas, wheat, corn and metals. In response to the crisis, global commodity prices (as measured by the S&P GSCI Index) are on track for the biggest weekly rally in more than 50 years, with Brent crude hitting \$112 per barrel and Europe's natural gas prices hitting new highs. Europe gets 40% of its gas needs from Russia, and the risk is that these supplies are cut off as an act of retaliation. Even if this does not play out, war risks disrupting the supply of various commodities, a lot of which are shipped out of ports on the Black Sea where shipping traffic has thinned.

Rising commodity prices threaten to exacerbate the cost of living crisis that was already taking hold in major regions. Not only do these higher costs threaten to push up inflation, they threaten to change the nature of inflation: shifting it from demand-side to supply-side inflation – the kind of inflation that central banks have limited power to influence.

As such, central banks face an ever more complicated task in trying to tame inflation without shutting off growth. From our perspective, the crisis will most probably lead to central banks being less hawkish this year than had been anticipated, especially in Europe. The ECB has remained accommodative, only taking a slight step towards future tightening and it is likely that this will be further postponed – interest rate lift-off will probably be postponed until 2023, when markets had foreseen this for late 2022. Across the Atlantic, the crisis is unlikely to derail the Fed from its rate-hiking cycle which will kick off in March, though it seems to have swung the pendulum in favour of a 25 bp hike, rather than a 50 bp hike. The market expectation is now for five Fed hikes in 2022, down from six previously.

ECONOMIC IMPLICATIONS

Prior to the crisis, the global economy was doing well and even improving, with the Citi Economic Surprise Index turning positive once again. Industrial and service activity remained strong (only constrained by supply shortages) and corporates and consumers alike showed healthy balance sheets. In the US, consumption was overshooting expectations (even if inflation has been eating away at sentiment survey results), while in the EU it had already started to dip.

Our base case is that economic growth will continue this year, albeit at a slower pace globally because of higher commodity and energy costs, which are akin to a global tax. Regionally speaking, we expect US growth to remain strong, while European growth remains positive and "ok" versus prior strong expectations. This is because Europe is likely to feel a greater impact economically due to its deeper trade ties with Russia, its dependence on Russian energy and its sheer proximity. On top of that, European governments (like Germany) have announced greater defence spending, and money spent on this is money pulled away from other growth-boosting

projects.

INVESTMENT IMPLICATIONS

We can only hope that diplomacy prevails and a peaceful resolution can be found. When things begin to stabilise, given the currently strong underlying fundamentals, markets could move very quickly. As such, we have not reduced our equity overweight, with this asset class supported by strong earnings and sound fundamentals. Moreover, we think it is important to avoid getting caught in the market whipsaws: a lot of bad news is already priced in, leaving valuations at attractive levels.

However, the situation is developing day by day, and the situation on the ground is dominating short-term market moves. As such, we have made important adjustments to our tactical allocation in order to add some ballast to our portfolios to allow them to better withstand the current pressure.

Where we have exposure to risk assets (namely equities and high yield bonds), we shifted the regional allocation away from Europe over to the US. The US boasts a large proportion of quality, large cap names on the equity side, and the US high yield sector is a key beneficiary of higher oil prices, given the proportion of energy names in this segment.

With regard to equity sectors, overall we still give preference to materials (a key beneficiary of rising commodity prices), energy, IT and healthcare. In Europe, we reduced our exposure to financials in favour of utilities (a defensive sector), given that European banks are more impacted by the announced Russian sanctions, while the ECB's policy pathway is more susceptible than the Fed's to be influenced by geopolitical tensions. We remain overweight US financials.

In the fixed income space, while we still see value in investment grade bonds, we decided it prudent to slightly reduce credit risk by switching some of our investment grade bond exposure into government bonds, which also slightly increased duration.

We also added gold to all eligible risk profiles as it continues to benefit from its safe-haven status and central bank demand. We have not adjusted our currency exposure, being comfortable with our constructive stance on safe haven currencies like the US dollar and the Swiss franc.

Beyond these tactical adjustments, we remain focused on long-term market drivers. The best advice we can give is to stick to your long-term investment objectives, respecting your individual risk tolerances and time horizon. The key for investors is not to panic: while geopolitics dominate the short-term direction of markets, inflation and central bank action are likely to dictate the long-term trajectory.

It won't be an easy ride from here on out; the outsize gains seen in recent years should not be taken for granted, and active, professional portfolio management is becoming ever more crucial.

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