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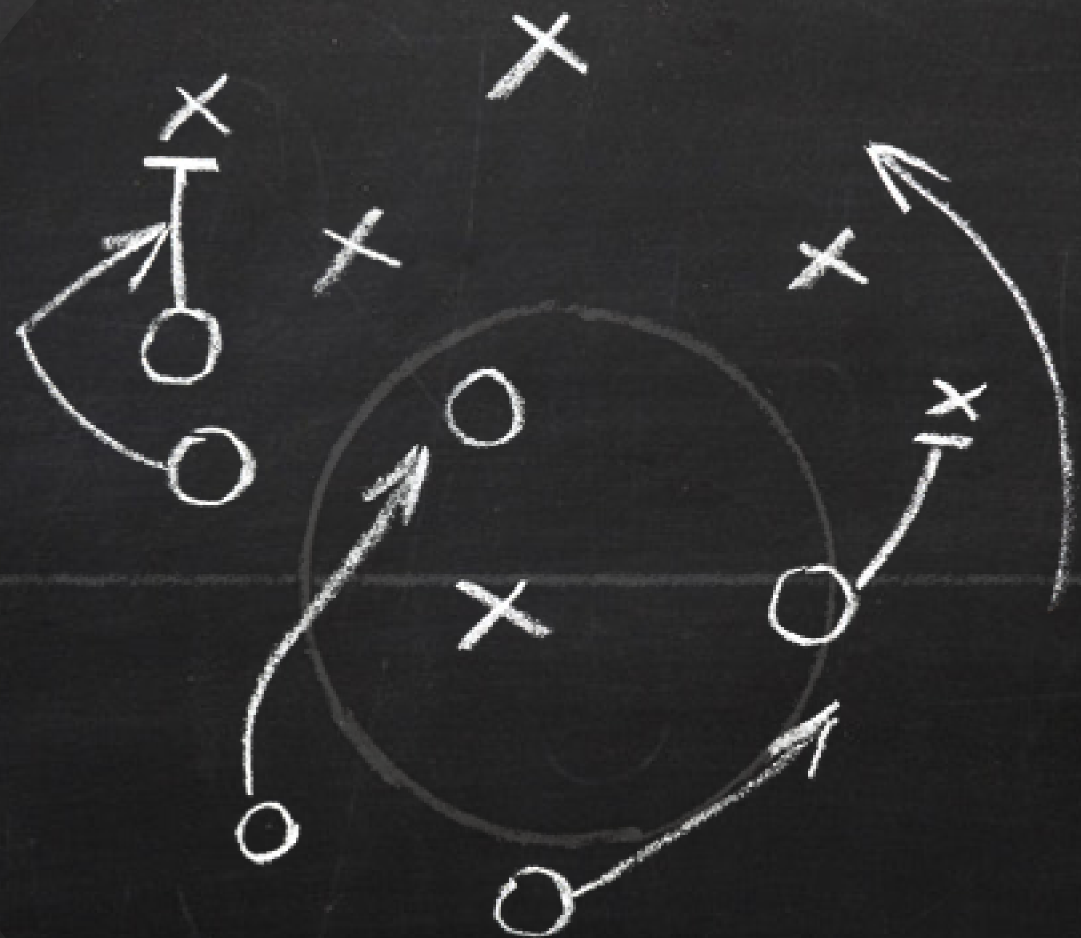

NOTE FROM THE CIO

The Market Impact of Russian Aggression in Ukraine.

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"In the great game of geopolitical chess, Russia has effectively removed the pawn of Ukraine off the global map."

Ahmed Riesgo
Chief Investment Officer
Insigneo Financial Group

Introductory Comments

As many of you know, on February 1st we put out a note on this region where we warned that "at least a minor Russian invasion or incursion of Ukraine has now become a probable event in our view." Furthermore, we wrote that we "do not think a minor invasion or incursion in Ukraine will have a lasting effect on global financial markets, though they will take a short-term hit. For investors, the way to play this is to leave cash undeployed and wait for either **a. sell-off post invasion, or b. a conclusive diplomatic resolution.** If you are very risk averse, then the time to sell is now." The reason I rehash those comments from early February is because we are now assessing whether we are now entering a worst-case scenario here with respect to Ukraine as a broader scale Russian incursion appears to be unfolding. We also said on that day that "we do not expect a full invasion (still low probability event, in our view)." Well, although we were correct in asserting that Russia would indeed attack Ukraine, our odds of a full-scale invasion were clearly too low as it now seems to be unfolding before our eyes with an imminent siege of Kyiv in the works and an aim to remove the current government and instill a Russia-friendly regime similar to Belarus and what existed in Ukraine before 2014. In other words, **in the great game of geopolitical chess, Russia has effectively removed the pawn of Ukraine off the global map**.

While Russia's intervention will clearly invite further US and EU sanctions, we do not expect this conflict to broaden beyond the borders of Ukraine itself and involve either NATO nations or western military personnel, even though that tail risk has also clearly increased. In a televised speech at the onset of hostilities, Vladimir Putin said the plan is not to "occupy" Ukraine but to "demilitarize" and "denazify" the country which he described as a threat to Russia. Russia's initial military maneuvers involved air, artillery and missile strikes launched from Crimea, Belarus, and the Ukrainian separatist republics. They targeted Ukrainian military infrastructure and border positions. But what is becoming apparent is that **the real target is Kyiv and the government**. This means that Russian military maneuvers could last for several days and require a land-based assault on the capital, which could significantly increase the number of casualties depending on the level of Ukrainian resistance. Obviously, the West will impose heavier sanctions on Russia, but these have been highly anticipated by Russia and the country has done much in recent years to shield itself from sanctions by building up cash reserves, de-dollarizing their economy by building an alternative to the SWIFT payments system and settling many transactions in Renminbi, and of course aligning closer to Beijing as they will help blunt the full effect of any sanctions.

Again, **we do not expect Western military intervention**. If it were to occur, then we would reiterate our position staked out on February 1st where we said that "a long, drawn-out conflict and/or full-scale invasion would trigger a recession in Europe (and possibly the US) due to rising energy prices and the impact on financial markets" and de-risk portfolios aggressively. But direct Western military involvement is improbable. While the alliance may accelerate their transfer of weapons, they also would want to avoid a direct military confrontation that could escalate to other parts of Europe. According to European Commission President Ursula von der Leyen, Brussels will present "a package of massive and targeted sanctions… that will target the strategic sectors of the Russian economy by blocking the access to technologies and markets that are key for Russia." This is likely to include semiconductors and other key technologies intended to weaken Russia's economy and its capacity to modernize. Again, these are known to Putin and a price he is prepared to visit on the Russian economy and its people. With respect to the SWIFT payment system, the Baltic states and the US are likely to press for it, but Europe might balk at the idea. We are also likely to see increased flows of refugees into the European Union and Russian cyberattacks.

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Why do we view conflict beyond Ukraine's borders as improbable?

Because it does not serve Russia's strategic interests currently. As previously stated, we now assess Russia's imperative to be the installation of a pro-Russian government in Ukraine and, thus, create an additional buffer state between itself and NATO. Moreover, beyond Ukraine, most neighboring states are European NATO members, and are subject to the pact's collective defense agreement. **But European leaders will have to be Machiavellian about this – they will have to talk a big game but carry a small stick**. In the end, they are resigned to the fact that they are importing Russian natural gas. In fact, 40% of European natural gas come from Russia. It is our view that they too will impose further sanctions but will fall short of causing Russia to suspend exports of natural gas to Europe because that would induce a recession in Europe. Sanctions will focus on the technology and financial sector, as Russia will continue to sell energy to Europe just as they did when they invaded Czechoslovakia in 1948. So, let us be clear, in the short-term, **the key question that must be addressed is will Europe take any actions that will prompt Russia to end natural gas exports to the Continent?** If the answer to that question is "yes," then an exogenous price shock may roil Europe into a recession as countries will be forced to cut power consumption and governments may even have to ration electricity. But if the answer is "no," which is our expectation, then the current market dislocation and adverse price shocks are probably then a passing shock unlikely to fully derail the global recovery and end the business cycle expansion. **In the long-term, however, Western decoupling from Russia (and China) is a trend that will strengthen as both Europeans, Americans, and others around the world minimize their exposure to the goods produced by Russia**. From an investment perspective, this means an even greater push to renewable energy.

Potential Macroeconomic Impact

Russia's actions suggest increased risks of a period of prolonged instability and volatility with potential spillovers into Europe and other places. We are trimming our global growth forecasts of real GDP from 4.25% to 4.05%, and our EU forecasts from 4.25% to 4% as we are now expecting higher oil, European natural gas, and food prices over the next several weeks and months due to the conflict. Higher energy prices will continue to feed into overall inflation. Our US real GDP estimate for 2022 was already below Street consensus at 3.25% and we find no reason to alter that view now. Remember, spending on energy and energy services in the US is much smaller than it used to be. Of course, Russia (and Ukraine) will endure the worst of the recent action. Russian GDP will fall anywhere from -0.7% to -1.2% over the coming years and may enter a recession.

Potential Market Impact

Russia has also felt the greatest impact from a market perspective. Today, the Russian ruble fell to an all-time low of 89.60 against the USD in overnight trading, and it forced the Bank of Russia to aggressively intervene to support the currency. The Moscow Stock Exchange suspended trading for two hours before reopening after stocks fell 50%. Discretion is the better part of valor, and one does not want to be invested in Russian or Ukrainian assets at this time. It is too early for bottom-fishing as we still have not seen all the sanctions and fallout. **It is important to remember that the current global correction in equity prices predates the Ukrainian-linked hostilities**. It was centered around rapidly shifting central bank tightening fears in the developed world given still elevated inflation figures and the broadening of those price pressures. If the predominant impact of Russia's action is the tightening of financial conditions, then the Fed may be forced to soften its hawkish stance and take dramatic moves off the table. But given that financial conditions have eased today in the US with the dramatic turnaround in the Nasdaq and S&P 500 (and the US 10-year bond trading at 1.95%), our inclination is to think that the Fed's hawkish tilt will be long-lasting, and we are still expecting anywhere from four to six hikes this year. Certainly, a tightening of financial conditions, but still not "tight" or restrictive given where we believe the neutral rate of interest to be. We believe that the Fed wants to engineer a mild growth recession (e.g., '93- '95). In other words, a slowdown in growth but not an outright contraction. That is why we have been consistently below consensus on US growth forecasts and remain so. In Europe, the situation is a bit more unclear because the economic impact would be greater in Europe, especially if Russia threatens to cut energy exports.

Asset Allocation Changes

This communique is report of an ad hoc Insigneo Investment Committee convened this morning. Though we are thoroughly analyzing several contingency plans, **we opted not to enact any asset allocation changes now, awaiting more data and information before acting**. In part, we decided to do so because we had fortified our portfolio from such shocks given our overweight allocations to industrial commodities, precious metals, and Chinese sovereign RMB bonds as hedges. Moreover, we had tilted away from growth into value, from large caps to small caps, and away from the US. **One area where we might reduce risk is our ex-US exposure in Europe given the region's greater vulnerability to military miscalculations and exposure to price shocks**. A few days ago, we altered some major price targets here at Insigneo, reacting to new incoming data on wage pressures and inflationary figures, arguing that we were slightly revising up our expectations of Fed tightening. **For the US, we revised our targets on the UST 10-year and the S&P 500 from 2.00 – 2.25% to 2.15% to 2.40%, a 15 bps increase, and from 5000 – 5100 to 4800 to 4900, respectively**. There is no reason to alter those given the present situation and our projections. As John Maynard Keynes may have once said, "When the facts change, I change my mind. What do you do?"

It should also be noted that the last time anything Russia-related had a lasting, major market impact was the sovereign bond default that led to the LTCM crisis in 1998. As an economy, Russia is about the size of Italy, even though it packs a greater political punch due to its military and soft power projection capabilities. That said, we do not want to project the notion that Russia does not matter – it does and the outcome here is very binary and tail risks have certainly increased. **Consequently, maintaining elevated cash levels (i.e., above a neutral allocation) are prudent, especially for highly risk adverse clients**.

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