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FIRST ANALYSIS
Institute Alert

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Portfolio guidance as Russia invades Ukraine

Key takeaways

- Russia's invasion into Ukrainian territory marks the end of the guessing game on *whether* an invasion would occur, but opens a new period of uncertainty.
- In the near term, we expect a negative path for global equity markets and for risk appetite more generally across capital markets.

What it may mean for investors

- We would not be buying this selloff, given the latest developments. The uncertainty of the current markets and the difficulty of relying on Russia's stated intentions makes it too difficult to predict exactly how the incursion will develop. We favor patience.

Russian armored units crossed the Ukrainian border this morning, and air attacks began on dozens of cities, including Kyiv. After weeks of saying that Russia had no intention of invading Ukraine, Russian President Putin today announced that the invasion is to topple Ukraine's government. The assault on Ukraine today marks the end of the guessing game on *whether* an invasion would occur, but opens a new period of uncertainty and potentially rapidly moving events that we believe will accompany a negative path for global equity markets and for risk appetite more generally across capital markets.

A large part of the uncertainty about the immediate future is that official statements from the Kremlin have not matched subsequent Russian actions. We expect the Kremlin to continue to use messaging to test the reactions of NATO and Ukrainian officials, but without necessarily intending a commitment to those statements. This intentional unpredictability should add downward pressure to risk markets.

We also expect Thursday to begin new rounds of sanctions, including from the U.S. We expect much harsher penalties on Russia than what the U.S. and other NATO members issued two days ago. The list of potential measures for application now include curtailing Russia's ability to participate in global trade and financial markets. The U.S. is likely to provide its complete list quickly, but the European NATO members may need more time to approve their measures collectively. The prospect of Russian retaliation — possibly including reduced commodity exports and stepped-up cyber attacks — adds to the uncertainty in the immediate present.

Economic and market impact

Russia's economy is only 3.1% of the global total, and Ukraine's is only 0.14%, and we doubt that the invasion will trigger the next global recession. As we described in our previous report, the second-order effects to economies through inflation and the uncertainty about the invasion do pose new uncertainties and risks, particularly for the European economies. Europe's reliance on Russian energy imports means that sanctions and possible disruptions to Russian pipelines that run through Ukraine should raise energy and food prices further, since Ukraine is a major exporter of grains via its Black Sea ports. We see inflation risk as the main spillover risk for the global economy, including the U.S.

Markets broadly were not expecting a full-scale invasion, so reaction has reduced risk appetite quickly. Bond yields are down across the maturity spectrum. Perceived safe-haven currencies — such as the U.S. dollar, the Swiss franc and the Japanese yen — are gaining, at the expense of currencies such as the euro and the British pound. Global equity prices are broadly lower, and the S&P 500 Index has retested its January intraday low of 4,222. Additional downside is possible, with firmer resistance at 3,850, roughly a 20% drop from the all-time high in January.

Russia's incursion has virtually eliminated the risk of a half-point rate hike by the Federal Reserve at its March 16 meeting. In general, we expect central banks (especially the European Central Bank) to be less aggressive worldwide on concerns of the energy price shock, combined with spill-through effects of heightened sanctions and the potential for Russian retaliation.

Our guidance remains in place

We believe that our current guidance, in place since last November, is well-positioned to be underweight Developed Market (ex-US) Equities and overweight commodities. It is reasonable to have some extra cash here. We would not be buying this selloff, given the latest developments. We expect to have time to add to risk positions, but the uncertainty of the current markets and the difficulty of relying on Russia's stated intentions makes it too difficult to predict exactly how the incursion will develop. We favor patience here.

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