

## Markets Update: Russia-Ukraine Crisis



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**Sandra Rockett:** Hello everybody and thank you for joining me today to hear from our CIO, Anthony MacGuinness, as he shares our investment perspective on the Ukraine humanitarian crisis. Firstly, though, I would like to speak to the current situation in Ukraine which is truly awful and we're all deeply saddened and shocked by what we're seeing, and our hearts go out to everybody who's impacted.

On the investment side, if I could turn to you Anthony, clearly the impact of this crisis is global. I was reflecting in terms of our own investment outlook at the beginning of the year, and you talked about the uncertainty you saw for global markets over the coming year. Have recent events exacerbated that view?

**Anthony MacGuinness:** Thank you, Sandra. I think, firstly, to echo your opening statements in terms of the humanitarian cost here, but from a market's perspective, yes, absolutely this has increased levels of uncertainty. We had anticipated that the higher inflation backdrop, the change in Central Bank policy and potential challenges to growth coming into this year, in terms of supply chain disruptions etc., were going to lead to uncertainty and volatility across assets. Recent events have only exacerbated those views.

What we have seen are two key developments in the market.

The first I would categorize as a flight to quality and a move away from risk assets on concerns about elevated volatility from certain parts of the market, like Russian and the Ukraine where asset values have fallen dramatically.

Global equities are now down 8% in Euro terms this year and about 3% since the invasion started. Interest rates had also risen in anticipation of Central Bank tightening which have now fallen back significantly. That's that flight to quality piece.

The second is a flight to scarcity. The response to Putin's aggression has been material with significant sanctions placed on Russian

exports, trade, access to the SWIFT payment system, and freezing of central bank reserves but also corporates voluntarily pulling back activity within the region.

We now anticipate a 30% fall in terms of Russian GDP in Q2 and 10% for the year. So a very significant impact. The impact on commodity markets for the West, though, has also been significant. Energy prices are up with natural gas, where Russia is 40% of the market's supply into Europe, up 150% since the invasion. Crude oil is up 30%, touching close to \$139 a barrel yesterday, on speculation of increased sanctions on oil exports and wheat prices, where Russia and Ukraine account for 17% of global exports of wheat, up 36% since the invasion. So these are material moves. These are crisis level moves.

Both the flight to scarcity and flight to quality have led to a material jump in volatility with intraday prices swings of 3% to 4% - yesterday that was over 6.5% in European markets. So, I think for the near term, it means elevated volatility across assets which we're considering in terms of framing our longer-term view.

**Sandra Rockett:** You mentioned sanctions there, clearly a very significant part of the Western response to Russia and I think the FT is talking about sanctions "blowing a hole" in the Russian economy. As you look forward now, what is your longer-term growth perspective?

**Anthony MacGuinness:** Sanctions from the west could escalate however we should note there are two sides to this sword in terms of the impact for Russia and the West. The US are more insulated than Europe in terms of how biting these sanctions are, in terms of growth and inflation. The US are much more energy resilient and independent and their economy is less exposed to the current commodity price moves. It is telling to see German Chancellor Scholz pushed back against the US proposal of increased sanctions on Russian oil stating that such a move would be detrimental to European growth.

At present, we're certainly anticipating lower European growth, probably to the tune of 1% to 2% and higher inflation levels for longer. We had anticipated that inflation would peak around Q2 in Europe, and then fall in the second half of the year. That's unlikely to happen at this point.

**Sandra Rockett: And what would your expectation be now?**

**Anthony MacGuinness:** We're probably now looking at about 50-75 basis point higher pricing of five-year inflation expectations with eurozone inflation closer to 5% this year on the back of commodity price moves and supply chain concerns. We are seeing the impact of that in equity pricing at the moment, with certain European markets off 20% year to date.

We talked about the policy response. I think there's two dimensions to that. One is monetary policy, and the other is fiscal, and it depends by region.

In the US, the Fed will continue on its trajectory to increase interest rates this year to combat inflation, because they are adamant that they do not want that getting embedded into long-term contract negotiations.

In Europe, the ECB were moving more towards a tightening position with the realization that inflation may not be transitory. They are now probably looking at the growth impact of this crises and will maybe delay increases, perhaps even into 2023.

If we think of China, its administration has targeted a 5.5% growth level, which means that they will use both monetary and fiscal levers to support that growth delivery.

Finally, the Euro block has just announced is it likely to fund increased defense spending and an accelerated move to energy independence. That means the issuance of euro denominated block debt which I think will see a possible demand increase, which is already being priced in favourably in the market.

**Sandra Rockett: If we can maybe just bring that conversation on and bring it into the client portfolios that we manage. I know we've been having conversations about what actions we can and should take and while our overall exposure to Russia has been very limited, clearly there is still going to be an impact in terms of returns.**

**Can you talk to us about the impact on client portfolios we manage for retail or defined contribution clients, and maybe those more institutional mandates that we have for defined benefit clients?**

**Anthony MacGuinness:** Sure. Russian direct holdings account for about 0.12% of our total firm assets, mostly held through index funds, where we have mandated holdings but with very limited exposure in any individual country.

That said, we've been working actively with the leading global index providers to clarify the position that Russia will play in indices going forward. We have seen direct action from MSCI, FTSE, S&P and overnight, JP Morgan, to remove Russia because since the sanctions have been in place, there is a lack of trading activity in both local debt and equity with the no trading or settlement of ruble denominated securities. Euroclear and other settlement entities have stopped all settlement activity.

We cannot trade currently but we're committed to working with our clients to manage those positions out of portfolios, in an orderly fashion when market conditions allow.

**Sandra Rockett: Ok, and then what about the discretionary portfolios?**

**Anthony MacGuinness:** We have very limited exposure to Russia there. Also, with MAPS, for instance, some of the key diversification and risk management strategies have helped insulate clients from some of this heightened level of volatility over this period.

Our alternative allocations, for example, are positive year to date. They've been able to exploit opportunities in this higher volatility window leading to positive returns.

Our low volatility defensive equity allocations have also insulated investors from much of the market volatility that we've experienced. This strategy has returned -1-2% vs. -9% for the broader market and that's helped investors through this period of heightened volatility.

**Sandra Rockett: And for the DB clients?**

**Anthony MacGuinness:** We've been helping many of those DB clients in a number of ways. One, building up inflation protection within their portfolios over the last number of years. That's serving them well in this higher inflation environment, in terms of insulating their schemes. Secondly, putting in constructive derisking and monitor plans to help them tactically take opportunities where they occur and arise, to de-risk their portfolios.

So earlier this year, for example, when German bonds moved from a negative to a positive yield, some clients were able to take money out of growth assets and buy defensive assets at that point.

**Sandra Rockett: I know one of the takeaways I will reflect on from this conversation is the uncertainty, the volatility that's prevailing. In terms of the future outlook, taking that medium to longer term view, how do you see this playing out for investors?**

**Anthony MacGuinness:** I think volatility is going to remain at very high levels for the near term. I think we need to have a healthy degree of humility, in terms of trying to forecast either the geopolitical events that will happen or the market response or policy responses. I think we'll have greater certainty on the medium-term impact to inflation, remaining higher for longer, and also growth, which is going to take a negative shock here. This does increase stagflationary risks, particularly in Europe and we are mindful of that.

Longer term, periods like these can present opportunities to achieve higher returns. Markets tends to overreact short term but certainly opportunity does present itself and staying invested in a well-constructed, diversified portfolio, aligned with your longer-term needs is absolutely the right course of action today, I think. We shouldn't be overreacting to heightened volatility and selling down positions at this point.

I think a second point is the benefits of diversification. I already spoke about alternatives but we've also been adding allocations to infrastructure, to real assets, which offer both inflation linked exposures but insulate against short-term volatility. I think the role of diversification is key.



**Sandra Rockett:** Anthony, is there a bigger picture ESG consideration or opportunity here?

**Anthony MacGuinness:** Absolutely, we have been on an ESG journey with our clients for some time now considering how best to incorporate it into their investment plans as it supports diversification over the long term. Short term, the pain is in the move in energy prices, and that being contrary to the longer term decarbonization of the economy.

This crisis raises two important ESG considerations for investors – an urgency to fund energy security for the West that probably accelerates investments into alternative energy sources. That is good for green investment, an area we are looking to create opportunities and solutions for our clients to take exposure.

Also, the importance of how you go about this. Not just excluding companies, but more about integration and being part of the solution by having capital at play. That's something that is very much in the philosophy of what we do within our ESG portfolios.

**Sandra Rockett:** Anthony, I think you have contextualized the investment scenarios and the investment perspective incredibly well. And I suppose for clients, I hope it contextualizes a lot of the daily news reports, in terms of their own investment portfolios. I just want to say thank you very much for sharing those perspectives.

To our clients, this is an incredibly challenging and uncertain time for us all to work through. Our commitment is to work closely with you to navigate this environment and work to protect your portfolios over the longer term.

I just want to say thank you again to Anthony, for sharing your perspective and the actions undertaken by the whole team to protect client portfolios. To our clients, thank you as ever for your continued support.

**Anthony MacGuinness:** Thank you.

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