Perspectives

By Mabrouk Chetouane & Nicolas Malagardis - Global Market Strategy, NIM Solutions March 2022

There are decades where nothing happens; and there are weeks where decades happen

- While higher inflation in Europe will undermine its growth in 2022, the US should withstand it better
- To avoid an economic hard-landing in 2023, fewer hikes will be implemented by the Fed, and none by the ECB
- We reduce our allocation on risk assets but still remain constructive given fundamental support

What happened?

Since the dissolution of the Soviet Union, more than three decades ago, the NATO had tried to encourage dialogue with Russia. But, since 2014—when the previous severe political crisis between Ukraine and Russia took place, most of the cooperation efforts were suspended. They were not reconvened until many years later and not without Ukraine on the top of the agenda. Meanwhile, Ukraine was repeatedly reaffirming its desire to become a member of both NATO and the EU, an ambition that is even enshrined in the country's constitution. The Kremlin, however, has continuously demanded for assurances that Ukraine will never join NATO's military alliance as it "would pose severe national security concerns for Russia".

On February 24th, Russian President Vladimir Putin gave a jarring speech and announced a "special operation" to protect Donetsk and Luhansk, which Russia had just recently recognized as independent republics, and warned the West against any retaliation measures. Since then, the situation has significantly escalated as Russian troops have invaded Ukraine from multiple axes, triggering a profound humanitarian crisis with over 1.7 million people fleeing Ukraine to neighbouring countries during the first two weeks.

Going forward, we believe that the West will limit itself to provide weapons and economic support, discarding any military intervention given the asymmetric negatively risk-reward of such an action. Thus, should Ukraine want to de-escalate the conflict, though it is becoming increasingly difficult to imagine it, it would have to come into terms with some of Russia's demands:

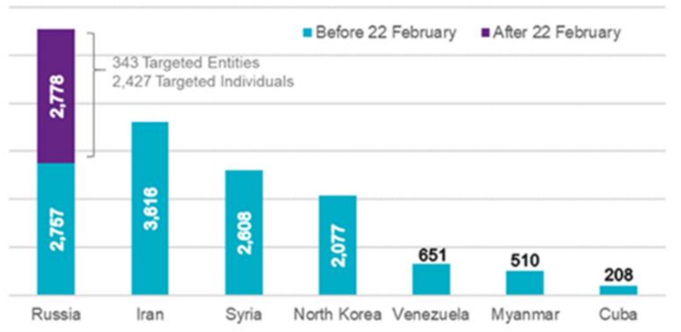
1. Cease any military activity
2. Enshrined neutrality on its constitution
3. Acknowledge Crimea as Russian territory
4. Recognise Donetsk and Luhansk as independent states.

The world's reaction

Unlike in previous instances, Western countries have moved both decisively and cohesively to implement sanctions aimed at economically isolate Russia and pressure Vladimir Putin to end its military operations.

Doing business as usual with Russian companies has been largely disrupted as several major Russian banks have been removed from the SWIFT international payment messaging system, making it hard for lenders and companies to make and receive payments.

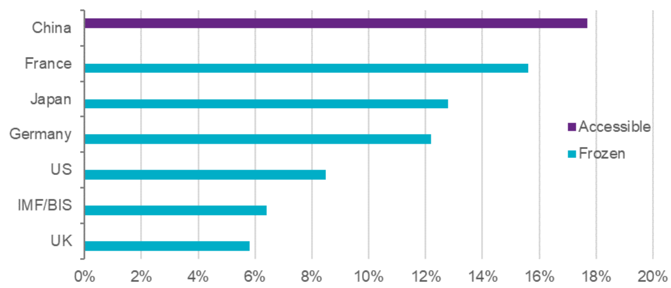
Russia is the World's Most Sanctioned Country



Source: Castellum.AI

Moreover, the Central Bank of Russia's (CBoR) ability to defend the rubble by using its USD 630 billion of foreign reserves has been significantly curtailed, particularly after the unexpected and unprecedented step towards freezing the CBoRs reserves held abroad. Noteworthy, Switzerland has set aside its usual policy of neutrality and frozen the assets held by targeted Russian individuals as well.

Location of CBR's Foreign Exchange Reserves



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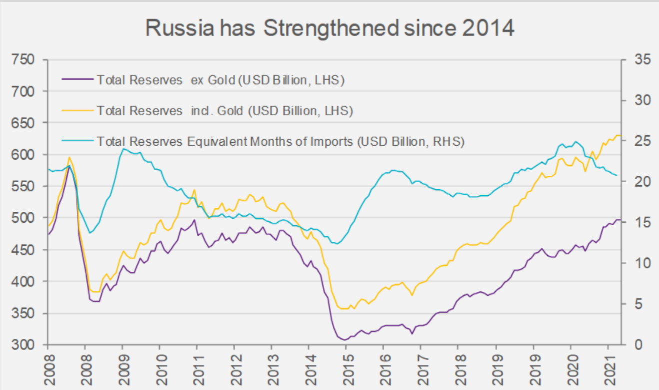
This has led rating agencies to downgrade Russian debt, raising concerns for bond investors on whether Russia is headed to a technical default on its debt since it might not be able to meet its coupon nor principal obligations due to international sanctions.

The Russian reaction

In an emergency move, the CBoR more than doubled its key policy rate from 9.5% to 20%, its highest in almost twenty years, and provided vast amounts of liquidity to its banking sector. Besides, in order to stop capital outflows and avoid further downside pressure on the currency, the Kremlin has implemented capital controls. Exporting companies have been ordered to sell 80% of their foreign revenues to support the rubble and foreign investors have been temporarily curbed from selling Russian assets. In addition, the Russian government has stated its intention to tap its USD 175 billion National Wealth Fund, which does not hold US dollars, to reduce the amount of borrowing this year as well as to buy shares in Russian companies.

The Russian economy has become more resilient

Sanctions following the Crimea 2014 crisis have made the Russian economy less reliant on external financing. The rubble is no longer pegged to the US dollar, substantially reducing the pressure from the CBR to redirect foreign reserves to defend its currency. In addition, Russia's current account surplus as percentage of GDP has increased, largely driven by energy exports, by almost five fold to 9% since 2014, while the percentage of trade settled in US dollars and the percentage of CBR's reserves in US dollars have both steadily declined, falling about 25% and 50%, respectively since then. And, interestingly, Russia's foreign reserves (excl. gold) and gold reserves have surged over 46% and 188%, respectively since 2014.



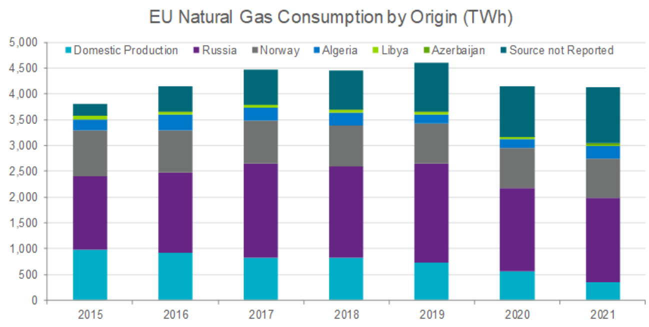
Source: Bloomberg

Therefore, even though the challenge that the sanctions rolled out so far may pose to the Russia economy is certainly greater than in previous occasions, such as the 2008 Georgia conflict or the 2014 annexation of Crimea, Russia's multiyear steps to diversify itself away from the US dollar is likely to help it withstand the worst economic fallout. Furthermore, estimates suggest that surging crude prices had already pushed Russian's January 2022 current account to USD 19 billion, more than doubling on a year-over-year basis and, thus, reducing Russia's need to access foreign capital markets.

How systemic is the Russian economy?

From a global trade perspective, although Russia is not large enough to derail global growth, it can certainly induce a material slowdown in Europe and trigger severe food security issues in vulnerable economies.

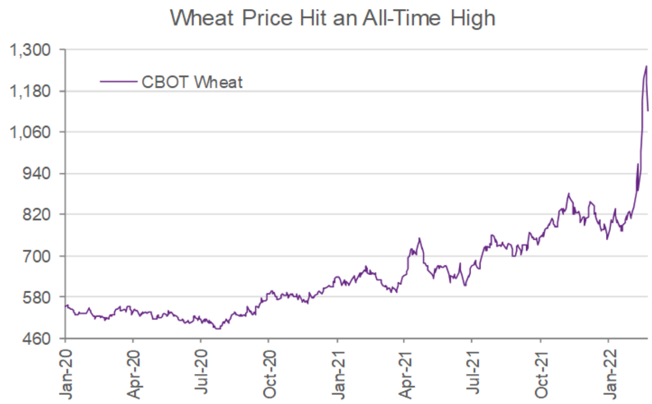
Russia is the world's third largest oil producer behind the US and Saudi Arabia, supplying 11 million barrels of oil per day and exporting roughly 50% of them, from which a half goes to the EU —Russia's share of EU's total oil imports is 26%. Russia is also the world's second largest producer of natural gas, only behind the US, and accounts for 44% of EU's gas imports and almost 40% of its total gas consumption. In addition, despite the recent rise of renewable energy consumption in Europe, oil and gas consumption still accounts for over 60% of the total. All this leaves the EU as, arguably, the worst economically positioned region to tackle the current conflict.



Source: Bruegel

Furthermore, no attempt to reduce Russian energy dependency is, at least in the short-term, feasible given that the other main producers have little or no spare capacity left to ramp up production. In addition, US Liquefied Natural Gas (LNG) is more expensive and Europe's LNG infrastructure cannot absorb any extra supply. Hence, Europe's high dependency on Russian natural gas is, admittedly, the reason why the West cannot so far impose sanctions on Russian gas exports.

Far less headline-grabber has been the impact that the current conflict is having on food's availability and, thus, prices. In fact, food prices were already rising before the conflict started due to severe supply disruptions caused by the pandemic as well as to higher energy costs. On this front, Russia and Ukraine together account for around 15% of global wheat production and almost 30% of exports. Moreover, while most the grain export terminals are located in the Western side of Ukraine, security and logistical issues are still interrupting export flows. And it is not just wheat, the Black Sea region of Russia and Ukraine also produces about 60% of all sunflower oil and exports over 75% of it through the Black Sea to the Middle East and Africa

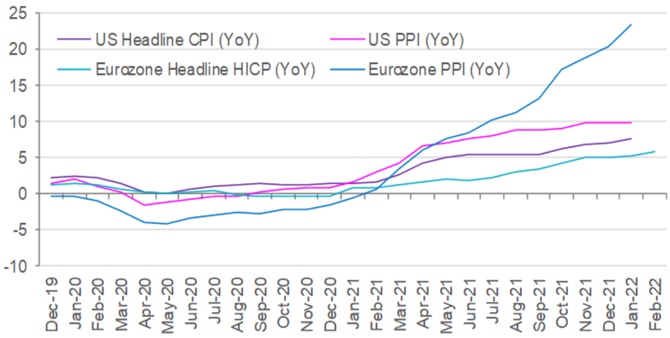


Source: Bloomberg

Higher inflation on the horizon

All in all, the probability of seeing higher consumer inflation prints through 2022 has been significantly revised up, particularly in the Eurozone, where energy currently accounts for over 50% of price increases. Still, base effects from an already elevated level last year will play an offsetting role and somewhat smooth the looming price increases. However, this new exogenous shock will make supply chain disruptions last longer than expected, risking not only to sustain commodity prices at multiyear highs, but also to further spread price pressures throughout the economy.

Moreover, while we have seen relatively lower consumer inflation prints in Eurozone compared to the US, the latter has at least seen some convergence between its producer and consumer price indices. For instance, US producer prices (PPI) stood at 9.8% year-over-year in January while headline consumer prices at 7.9% year-over-year. This has not been the case for Eurozone's inflation, where the last series of prints show a much wider spread. For instance, Germany's producer prices advanced at 25% year-over-year in January while the harmonised index of consumer prices (HICP) increased 5.5% year-over-year February. The same is true for most Eurozone countries, suggesting that, even before the Ukrainian conflict started, higher inflation prints in the Eurozone were already looming.



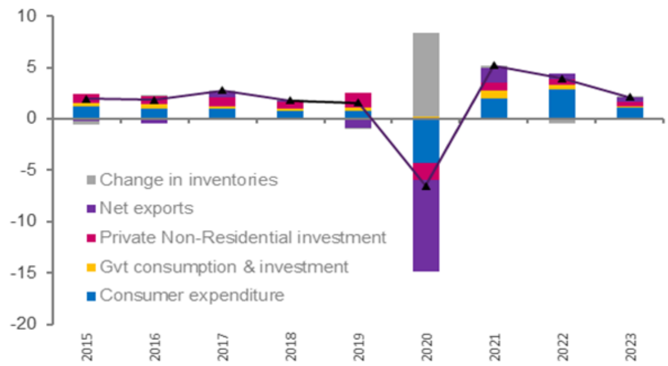
Source: Bloomberg

On the other hand, however, the demand slowdown expected in the Eurozone as a result of the current uncertainty shock, is likely to help in keeping the region's core HICP, i.e., inflation excluding volatile items such as unprocessed food and energy, relatively contained. The US core CPI, by contrast, is expected to stay supported in the short-term, especially as price pressure in the US housing sector continue to rise as homebuilders, impacted by workforce and supply shortages, are not being able to meet the elevated levels of demand. Besides, medical services keep surging and leading indicators, such as the Manheim used-car index, still point towards higher prices for used-cars and trucks.

Are we headed for an economic hard-landing?

Any economic forecasts against this backdrop should be taken with caution as the situation remains very fluid and, thus, the spectrum of possible scenarios is ample.

Over the short-term, we expect a deceleration in global growth, especially in Europe—where stagflationary pressures have increased, as a consequence of the negative supply shock on commodities, the loss of households' purchasing power and the possible postponement of private spending. However, although recession risks are now tilted to the upside, we believe that fears are misguided, at least in the short-term, and expect global growth to stay above its long-term potential for most of 2022. Indeed, our newly produced forecasts see the Eurozone real GDP growth standing at 3.0% through 2022, revised downwards by 0.4pp compared to January 2022.



Source: NIM Solutions

European countries are likely to utilize any room of manoeuvre left on their government budgets to soften the impact on consumption, especially on energy spending for low income households. Policymakers are likely to initiate discussions on their available options to deal with their dual energy and defence crises, which will likely drive expectations for an increase in jointly issued European debt.

This backdrop could affect major central banks' monetary policy normalization agendas, making them pull the brakes as the deterioration of financial conditions is being faster than expected. However, the European Central Bank (ECB) has already shifted gears and adopted a less accommodative tone. In this sense, although President Lagarde announced an acceleration of the tapering, we do not expect the ECB to increase its key policy rate in 2022 and, whether it does so in 2023, will ultimately depend on the extent of the demand destruction caused by the conflict.

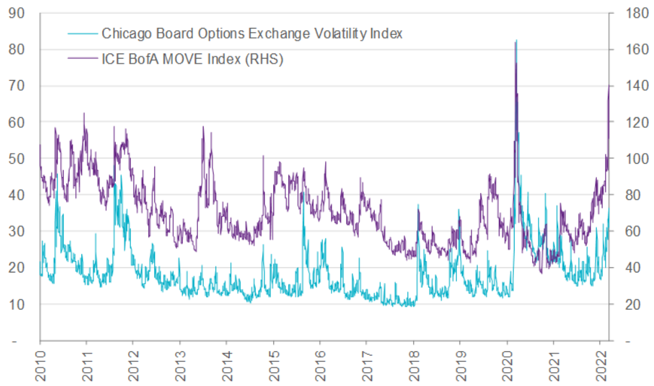
Along similar lines, the Federal Reserve (Fed) is unlikely to implement as many interest's rate increases as are currently priced in by Fed Funds futures. It is true, however, that the US might remain relatively immune in the short-term, but we still believe that the Fed will proceed cautiously aware of the possible ripple effects if Europe's economy were to slow in excess. Overall, we see the Fed delivering between 3 to 4 rate increases in a gradual manner in order to carefully monitor—the already tightening—financial conditions.

Asset Class Details

Equities

Sentiment has suffered significantly during the last couple of weeks as investors have incorporated the geopolitical risk premium, particularly for European stocks, and added Ukraine's invasion to their Wall of Worry. Positioning has considerably declined as risk aversion increased and investors sought for safety. Despite the rising rates environment, Value stocks have suffered while the Minimum Volatility and Quality styles have benefitted. Indeed, the VIX index, which derives equities' implied volatility from the options market, jumped over the 38% following Russia's invasion and has remained elevated thereafter. Going forward volatility will be highly dependent on the geopolitical front and, thus, is likely to stay high.

The rise in uncertainty has pushed volatility up



Source: Bloomberg

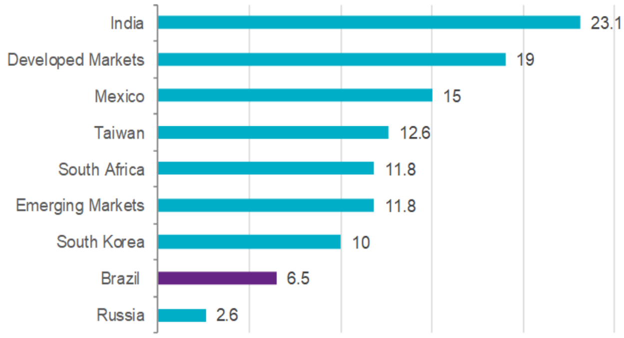
Given that European economic growth is set to slowdown, we expect the region's EPS 12-month forward rate, which ended 2021 ~40% up on a year-over-year basis and 2022's expectation was at 8% before the conflict, to come into pressure as rising commodity prices weigh on both corporate operating margins and consumer's propensity to spend. In addition, although Russia's relatively small economy is unlikely to put financial stability at risk if it were to default, we decided to reduce our exposure to European banks given their high sensitivity to the economic cycle.

Moreover, we believe that the US equity market is better suited to withstand the current shock given its relative insulation and stronger economic growth. However, growth risks are tilting to the downside since a broader based inflation is likely to continue dampening consumer sentiment at times when real wage growth remains negative.

In the short-term, central banks' meetings are likely to provide support and improve visibility on their policy normalization agendas. In addition, news on Ukraine moving towards negotiating with Russia remains a possibility. Therefore, although we have reduced our exposure, we remain constructive on risk assets given that economic growth, though currently threatened, is still strong.

Furthermore, we find Brazil as an interesting market that stands to benefit given its commodity-rich profile, attractive valuations and relative isolation from the Ukraine-Russian conflict. The latter is due to that renewable energy already accounts for over 80% of Brazil's electricity mix, and to Brazil's marginal trade exposure to Russia. In addition, the Brazilian has typically enjoyed positive returns whenever China has stimulated its economy; as it is currently the case.

Price/Earnings Ratio - Last 12-Months Before the Conflict



Source: Bloomberg

Fixed Income

Despite the magnitude of the flight for safety observed in equity markets, bonds have not reacted that much. Core sovereign yields have stayed relatively contained as inflation pressures likely kept investors cautious. In fact, most sovereign yields have already bounced back to pre-conflict levels. This, however, has not come without the largest spike in bond volatility since the onset of the pandemic, suggesting an increasing level of uncertainty regarding the expected path that central banks may take with their normalization agendas and forward guidance.

Given that inflation risks are tilted to the upside, long-term yields so do, hence, we prefer to maintain our short duration exposure on core sovereign bonds. However, at the current yield levels, their upside is starting to look somewhat limited, especially given that if inflation were to rise in excess, they would end up slowing demand and, thus, growth.

Similarly, we keep our underweight in credit debt both in the US and in Europe as spreads are likely to continue widening amid poor liquidity conditions, especially in the US, where several attempts of new issuances in the high yield primary market are falling short of interested investors.

Currencies

Defensive, safe-haven currencies, such as the US dollar, the Swiss franc and the Japanese yen, have and probably will continue benefitting during this volatile environment. On this front, we like the US dollar "smile theory" and, hence, see it holding up at current levels.

Leaving the Russian rubble aside, the Euro has suffered following the region's growth outlook deterioration, and, will probably continue to so given the Eurozone's high exposure to the Ukraine-Russia war.

Moreover, the Chinese yuan apparent strength amid the current geopolitical turmoil seems interesting from a diversification standpoint. The yuan strengthened throughout the last couple of years despite the country's slowdown, and China's inflation remains particularly low (headline CPI at 0.9% year-over-year in February) when compared with other countries. Likewise, the Brazilian real looks attractive due to the aforementioned factors and the country's high interest key rate, which has been raised from to 10.75% from 2% just one year ago.

Asset Allocation Views

	Asset Class	Tactical View	Comments
Developed Equity	EMU	-1 0	We have reduced our European equity exposure to Moderate Underweight (-1) given that the invasion of Ukraine has clouded Europe's economic outlook. Both the rising energy prices and negative confidence shock will likely impact business and household's income.
Developed Equity	Europe ex-EMU	0	We maintained our Neutral (0) stance on UK and Northern European equity markets as they should continue to benefit from the energy crisis and investors' necessity to diversify their exposure to Europe. Conversely, we are likely to remain neutral as long as the lack of visibility continues.
Developed Equity	North America	-1	We have reduced our US equity exposure to Moderate Underweight (-1) since, although the US economy is likely to remain relatively insulated to the conflict, the deteriorating global backdrop coupled with the impending liquidity tightening induced by the QT, will weigh on sentiment.
Developed Equity	Japan	0	We maintain our Neutral (0) stance on Japan's equity market given that it presents an attractive diversification option due to the country's limited trade exposure to Russia.
Emerging Equity	Emerging Asia	-1	We keep our moderate Underweight exposure to Emerging Asia given that China's deteriorating health situation together with its zero-Covid policy is tilting the region's growth risk to the downside. In addition, the Chinese regulatory crack-down continues, particularly for technology companies, suggesting that investors' will remain cautious until more clarity is provided.
Emerging Equity	Latam	-2 0	We have markedly upgraded our stance on Latam equity markets from Strong Underweight to Neutral (0) given the region's strong prospects to benefit from rising commodity prices. We find Brazil particularly interesting given its high commodity exposure, very limited energy dependence. As such, we remove our call on China to finance our tactical call on Brazil.
Sov. Bonds	Euro	-2	We maintain our Strong Underweight stance (-2) on European sovereign bonds given the decelerating economic growth environment and the ongoing concerns about inflation, which is expected to average 5% during 2022. In addition, the recently announced tapering acceleration is likely to add further upside pressure on European sovereign yields.
Sov. Bonds	US	-1	We keep our Underweight stance (-1) on US sovereign bonds given that the economic momentum remains robust and, thus, the Fed is expected to raise its key rate and withdraw liquidity. This backdrop is likely to keep supporting yields and offsetting their traditional risk-haven role.
Spreads	Euro Credit	-2	We maintained our Strong Underweight (-2) stance on European credit markets as the poor visibility conditions is weighing on liquidity and is leading to spreads to widen.
Spreads	US Credit	-2	We maintained our Strong Underweight (-2) stance on US credit markets given the worsening economic environment as well as the looming tightening on financial conditions.
Spreads	EM Credit	-2	We maintained our Strong Underweight (-2) stance on EM hard-currency credit markets as the US dollar is expected to remain strong supported by the deteriorating global economic outlook.
Cash	Euro	2	We keep our Strong Overweight (+2) stance on cash given that the uncertainty around the global economic environment has increased, and await for signs of improvement and further tactical opportunities to deploy it.

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