

Economic and asset class implications of the Russia-Ukraine crisis

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As I write this, the crisis among Russia, Ukraine and the West has escalated. Russian President Vladimir Putin has recognized the breakaway “People’s Republics” in eastern Ukraine and ordered Russian troops to begin a “peacemaking operation” there. This represents a breakdown in negotiations and diplomacy, but it is still short of open warfare.

Above all else, my thoughts are with everyone in the region, and I pray that world leaders can de-escalate the situation and avoid the loss of life and human devastation that war would bring. For the purposes of this piece, I will examine the potential ramifications from an economic and market perspective.

What are the implications for the global economy?

Investors are understandably nervous that further hostilities could undermine stability in Europe, and that retaliatory sanctions by the West and counter-sanctions by Russia could drive up energy, metals, and grain prices, which would slow global economic recovery and boost inflation pressures.

It seems likely that there will be at least some further escalation from here, though we are still quite far from a full-blown invasion or extreme sanctions that might seriously damage the global economy. The outbreak of hostilities is a serious source of geopolitical tension and financial volatility, but we believe the actual economic and market disruption is likely to fall mainly in Ukraine and Russia, with some risk to the rest of Europe but limited fallout for the world as a whole — unless there is open war.

What are the implications for the asset classes?

Let’s discuss what this likely means for various asset classes:

- **Stocks:** The bad news is that this geopolitical crisis will only amplify the volatility and potential sell-offs created by the start of monetary policy tightening. The good news is that it is likely to be short-lived, at least for major markets – though pressure and volatility in regional markets is likely to continue. My colleague Paul Jackson looked at six historical conflicts (WW1, WW2, the Cuban Missile Crisis, the Yom Kippur War, the Kuwait War and the Iraq War), and found that the S&P 500 Index (and prior to its existence, the US equity market equivalent as constructed by Robert Shiller) has on average lost 9% following the start of those conflicts.¹ However, it bottomed within 12 months and recovered the losses within 18 months.¹
- **Oil:** Oil is likely to be impacted by a Russian invasion of Ukraine, especially if there are extreme sanctions, as I mentioned in last week’s blog. Paul Jackson reviewed the history of oil prices and found that, as expressed in today’s prices, an oil price of \$100 is rare (West Texas Intermediate has been above \$100 in only 8% of months since January 1870).² In fact, demand and supply dynamics have typically brought the price of oil back into the \$20-\$60 range (in today’s prices).² A variety of factors — the strong economic

recovery, reduced supply, and geopolitics — have pushed prices upward but seem unlikely to endure. If we look at spot and futures prices, short-dated prices are currently much higher than longer-dated prices (a phenomenon called backwardation). This is because there is a perceived risk of shortages in the short term due to strong demand and anticipated disruptions in supply from Russia. Such a degree of backwardation rarely persists and is usually resolved by a decline in shorter-dated prices.

We have to remember that the global economy is far less dependent on oil than it was in the 1970s. Now there could very well be a visceral reaction to a ramping up of the conflict from here that drives up oil prices in the short run, but we are inclined to believe that much may already be priced in given the run up in oil prices that we have seen thus far. It is also worth noting that the United States is currently in negotiations with Iran and may reduce sanctions there, leading to a significant increase in available oil supply which should help limit the rise in oil prices. That said, bringing Iran's oil exports back into the global market would not be a perfect substitute for any interruption in Russia's oil exports. Russia is the third-largest oil producer in the world, producing about 11 million barrels per day, exporting about 4.3 million barrels per day, and supplies about a quarter of Western Europe's oil imports.³ Based on a variety of official and private sources, Iran's total oil output is less than a third of Russia's and its exportable surplus is less than half as much, some of which is already being exported despite the sanctions.³

- **Gas:** Russia is a crucial exporter, accounting for about 40% of Western Europe's imports.⁴ The International Energy Agency (IEA) reckons that Russia had already reduced supplies to the West by about 30%, contributing to spikes and higher energy prices throughout Europe.⁴ Gas on the spot market had already surged roughly in line with oil at the time of writing. Gas supplies via liquified natural gas and other sources in the Middle East and worldwide are being diverted to Western Europe, but further reductions in Russia's gas exports would probably drive up prices and could pose a headwind to consumption during the winter by driving up global gas and other energy prices. Gas is especially worth keeping an eye on since it tends to be a more localized market distributed through pipelines rather than shipped from exporting to importing countries — which could provide Russia more direct leverage against retaliatory sanctions than oil, which is a somewhat more global market.
- **Other commodities:** As I mentioned last week, Russia is the largest exporter of palladium and is also a significant exporter of other metals. Ukraine and Russia also are major producers of wheat and, for Ukraine, corn. So I expect prices of those commodities to rise.
- **Gold:** Gold has historically exhibited a relatively close correlation with geopolitical risks. One study found that gold shows a strong positive relationship with geopolitical risks, unlike other precious metals.⁵ A one standard deviation change in the Geopolitical Risk Index resulted in a 0.80% gold price return.⁵ I would expect gold to rise if the situation in Ukraine escalates further.
- **Cryptocurrency:** Given that Bitcoin is often described as “digital gold,” investors seem eager to assume Bitcoin has many of the same characteristics as this precious metal. However, the gold and geopolitical risk study I referenced above revealed that the price of Bitcoin is not correlated to geopolitical risks.⁵ Having said that, we have to recognize this study was released four years ago, and

Bitcoin's behavior has changed in recent years as it has gone "mainstream." However, I do not expect Bitcoin to be a hedge against geopolitical risks going forward. While the price of gold has risen as geopolitical risks have increased, the price of Bitcoin has fallen in the past week.⁶

- **Safe-haven fiat currencies and conventional "safe assets":** During periods of significant geopolitical turbulence that truly threaten the global economy, a few conventional financial assets tend to do well, outperforming risk assets like stocks that are more directly geared to growth. These include the US dollar, Japanese yen, Swiss franc as well as US Treasuries, Japanese Government Bonds, and German Bunds.

At the time of this writing, we don't see all that much upward pressure on these "safe assets," with the major currencies and bond markets being driven mainly by views about inflation and central bank policies. Nor do we see downward pressure on the euro, for example. This is in line with our view that, barring a full-scale invasion, the crisis is likely to remain localized both economically and financially.

Sanctions have already begun and will probably be ratcheted up — but we believe they are likely to remain largely targeted against specific individuals, firms, and sectors in Russia, rather than broader measures that prevent European energy imports and limit Russia's ability to export. That said, if hostilities do target Kiev or extend to a full-blown invasion of Ukraine, sanctions are likely to be ramped up, posing a greater challenge in global markets. It is worth noting that Germany has already put a stop to approval of Nord Stream 2, a second gas pipeline which could allow Russian gas exports to Western Europe to bypass Ukraine. If there is a full invasion, the project could conceivably be cancelled and other tougher sanctions imposed. But sanctions on Russia are only one way prices could be driven higher. Russia could also reduce exports as a non-military tool to inflict economic pain. In addition, if the military conflict escalates, there could be damage to infrastructure that reduces the production and export of commodities.

Given the increase in tensions and the real risk of further hostilities, stocks are likely to get volatile and a bit messy in the short run, and oil and gas prices could easily move higher in the short run. There have historically been few asset classes that have been effective hedges against geopolitical risk, although gold has been one of them along with the dollar, yen and Swiss franc. In this environment, investors should remind themselves of their time horizon before reacting emotionally to events that are likely to have a short-term impact on asset classes.

And while various economists' and strategists' forecasts for Federal Reserve rate hikes this year continue to increase, last week saw signs that the Fed may have a more measured approach to hikes in 2022:

The Federal Reserve Board of New York's Survey of Consumer Expectations released last week showed that longer-term inflation expectations peaked in the fall and have since fallen materially.

Federal Open Market Committee minutes showed that Federal Reserve Board of St. Louis President James Bullard appears to be an outlier in terms of his views on tightening; they were in general more dovish than expected. While there was a desire for a "significant reduction in the size of the balance sheet," it was clear the Fed will remain very data dependent when it comes to tightening.

Looking ahead

In addition to monitoring the situation with Russia and Ukraine, I will be most interested in:

- The Conference Board's US Consumer Confidence Survey
- Japan and eurozone flash estimates of Purchasing Managers Indexes
- US gross domestic product
- The University of Michigan's Consumer Sentiment Index. I would like to see confirmation of the inflation expectations we saw recently in the New York Fed's Survey.
- Scheduled remarks from European Central Bank President Christine Lagarde

With contributions from Arnab Das and Paul Jackson

Notes

¹Invesco analysis of data from Bloomberg, L.P.(S&P 500 Index), and Robert Shiller of Yale University

²Global Financial Data, Refinitiv Datastream and Invesco. Oil price is monthly data from January 1870 to Feb. 17, 2022. WTI is West Texas Intermediate. Real WTI is calculated by dividing the price of WTI by an index of US consumer prices. Past performance is no guarantee of future results.

³Russia data for 2021 from S&P Global. Iran comparisons are based on US Energy Information Agency January 2022 and OPEC 2021 estimates of Iranian production and exports.

⁴International Energy Agency

⁵"Gold and Geopolitical Risk," Dirk Bauer and Lee Smales, January 2018

⁶Bloomberg, L.P.

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Past performance is not a guarantee of future results.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Bitcoins are considered a highly speculative investment due to their lack of guaranteed value and limited track record. Because of their digital nature, they pose risk from hackers, malware, fraud, and operational glitches. Bitcoins are not legal tender and are operated by a decentralized authority, unlike government-issued currencies. Bitcoin exchanges and Bitcoin accounts are not backed or insured by any type of federal or government program or bank.

Businesses in the energy sector may be adversely affected by foreign, federal or state regulations governing energy production, distribution and sale as well as supply-and-demand for energy resources. Short-term volatility in energy prices may cause share price fluctuations.

The Geopolitical Risk Index measures adverse geopolitical events based on a tally of articles covering geopolitical tensions from 10 different newspapers.

The Conference Board's US Consumer Confidence Survey® is published monthly, based on a survey of US consumers' buying attitudes and buying intentions.

The New York Fed's Survey of Consumer Expectations is a nationally representative, Internet-based survey of a rotating panel of approximately 1,300 household heads.

The University of Michigan's Consumer Sentiment Index is published monthly, based on a telephone survey designed to assess US consumer expectations for the economy and their personal spending.

Purchasing Managers Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

West Texas Intermediate (WTI) is light, sweet crude oil commonly referred to as "oil" in the Western world.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

The International Energy Agency includes 30 member countries and focuses on areas including data and statistics, training, innovation, and international cooperation.

The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Correlation is the degree to which two investments have historically moved in relation to each other.

The opinions referenced above are those of the author as of Feb. 22, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.