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RUSSIA UKRAINE WAR – IMPLICATIONS ON ECONOMY, MARKETS & INVESTING

MARCH 2022

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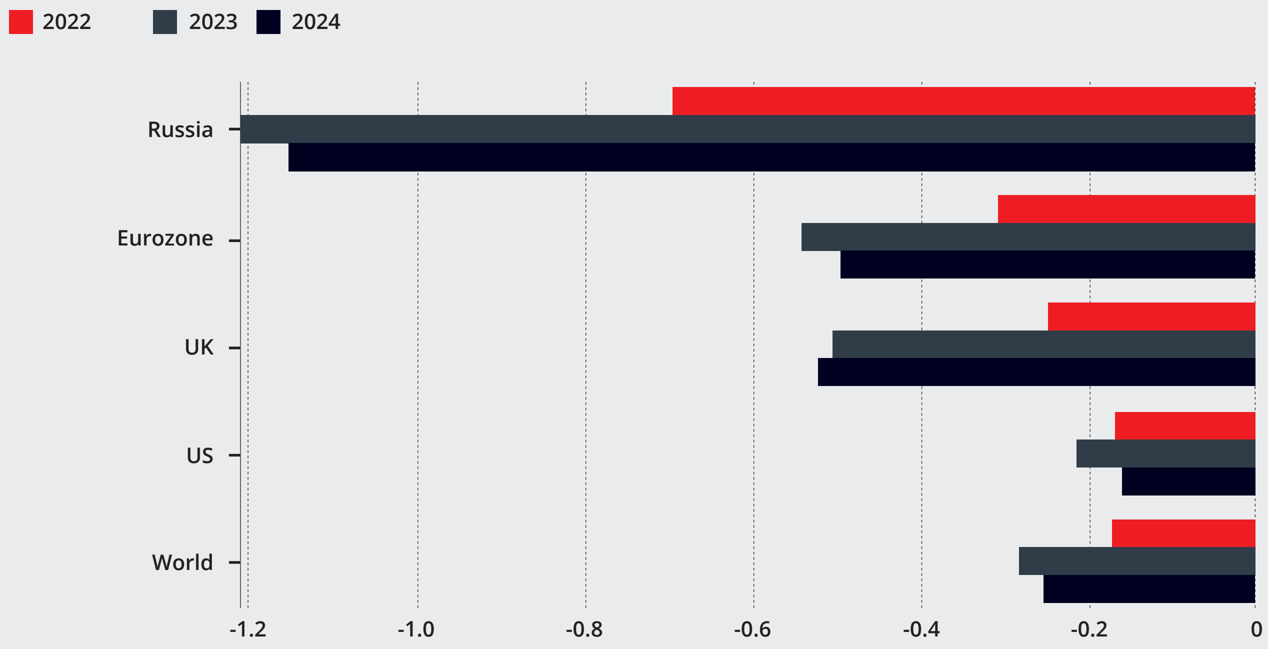
IMPACT ON THE GLOBAL ECONOMY

The war in Ukraine is rapidly changing the global geopolitical and economic landscape. Even though Russia and Ukraine together account for less than 2% of the world's GDP, both countries are major commodities and energy exporters, and the war is threatening to aggravate the already worrisome inflation picture. Oxford Economics expects the **global economy to grow by 3.8% in 2022, down from the 4% forecast before the invasion.** The knock-on effects could also impact consumer and business confidence at a time when the world was witnessing a fragile recovery from the pandemic.

Europe will face a bigger impact due to its geographic proximity and reliance on Russian oil and gas. UBS Bank estimates that for every 10% increase in prices of fuels, gas and electricity, consumer-spending growth in the eurozone slows by 0.4 of a percentage point, and economic growth by 0.2 of a percentage point.

Estimated impact of Ukraine crisis on global economic growth

% change in gross domestic product from no conflict baseline



Source: Oxford Economics

Oil and gas

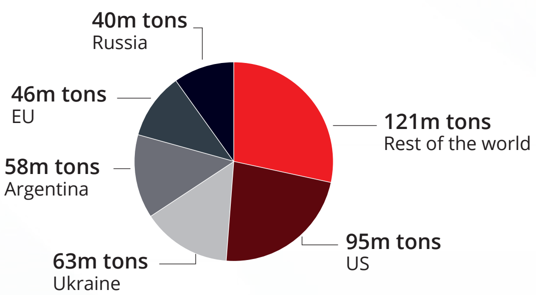
Russia pumps about 10% of the world's oil. Energy makes up 60% of Russian exports and 30% of its GDP. The war and sanctions have already pushed crude oil prices to over $110/bl, and according to Goldman Sachs, **oil prices are expected to average $135/bl in 2022.** Similarly, Economist Intelligence Unit expects gas prices to rise by at least 50% this year, on top of a fivefold rise last year.

Under the worst-case scenario of a protracted war, energy prices could hit unprecedented levels. According to Barclays, if most of Russia's seaborne crude supplies are disrupted, oil prices could push above $200/bl.

Food and other commodities

Ukraine and Russia account for 30% of the world's exports of wheat, 19% of corn and 80% of sunflower oil, which is used in food processing. **The threat to farms in Ukraine, sanctions on Russia and restrictions on exports through Black Sea ports could reduce food supplies amid pre-existing shortages and the highest prices since 2011.** Russia is also a major producer of the key ingredients for fertilizers such as urea and potash. Disruptions in those supplies could further drive food prices.

Ukraine and Russia Account for Quarter of Global Grain Exports

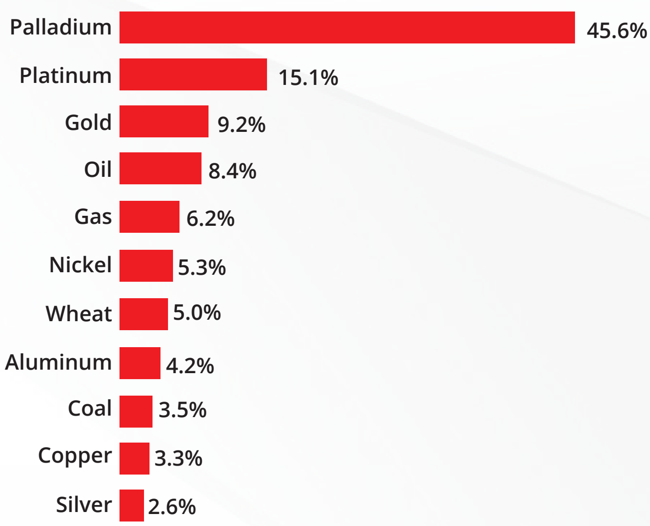


Source: Bloomberg

In addition, Russia is a major producer and exporter of minerals and metals which are crucial to several industries:

- Russia's MC Norilsk Nickel PJSC is the world's largest producer of palladium, responsible for between 25% and 30% of total output. The automobile industry, which is struggling with a shortage of semiconductors, could face additional problems due to palladium shortages.
- Russia and Ukraine together produce 70% of the world's neon, critical in the making of semiconductors. Neon is crucial to making computer chips. When Russia invaded Crimea in 2014, neon prices shot up 600%.
- Russia and Ukraine together supply 13% of the world's titanium, which is used to make passenger jets. Russia also is a major producer of nickel, used to produce electric car batteries and steel. Global nickel prices have doubled to $100,000 per ton amid the ongoing war.

Russia's Exports as a Share of Global Production



Source: Bloomberg

Surging inflation

Restrictions on global energy and agricultural supplies could inflict a "stagflationary" shock on the rest of the world. EIU expects global inflation to jump above 6% this year. According to Capital Economics, **if gas prices remain high throughout the year, it would add about 2 percentage points to advanced economy inflation.**

The situation has been complicated by demand-driven price rise before the war and the start of a global credit tightening cycle with the US Fed expected to start hiking interest rates in March. In February, U.S. consumer prices rose 7.9% from a year earlier, the biggest such jump since 1982. In Europe, inflation is expected to reach 5.8% in February.

Supply chains disruptions

The global supply chain has been severely disrupted amid a halt in production and trade across the black sea. In addition, the possible destruction of some transport infrastructure in Ukraine is compounding existing supply-chain issues.

Land-based trade routes between Asia and Europe will be disrupted as transit through Russia becomes more difficult from a compliance or safety perspective.

Air ties between Asia and Europe will be severely hampered due to the closure of airspace. About 35% of global freight was being transported by air prior to the pandemic.

Sea freight routes through the Black Sea have been cancelled following Ukraine's decision to shut down commercial shipping and Turkey's move to restrict transit through the Bosphorus.

As a result, trade costs are expected to rise drastically. According to FourKites, a supply chain consultancy, ocean rates could double or triple to $30,000 a container from $10,000 a container, and airfreight costs are expected to jump even higher.

Larger defense budgets

Defense budgets are likely to rise in Europe, the US, and some other countries to reflect the increasingly dangerous global situation. **This could impact spending on stimulating the economies post-pandemic especially healthcare and clean energy.** Germany announced 100 billion euros for military investments from its 2022 budget, raising the spending to over 2% of GDP. This is significant compared to Germany's entire defense budget of 47 billion euros in 2021.

Reduced globalization

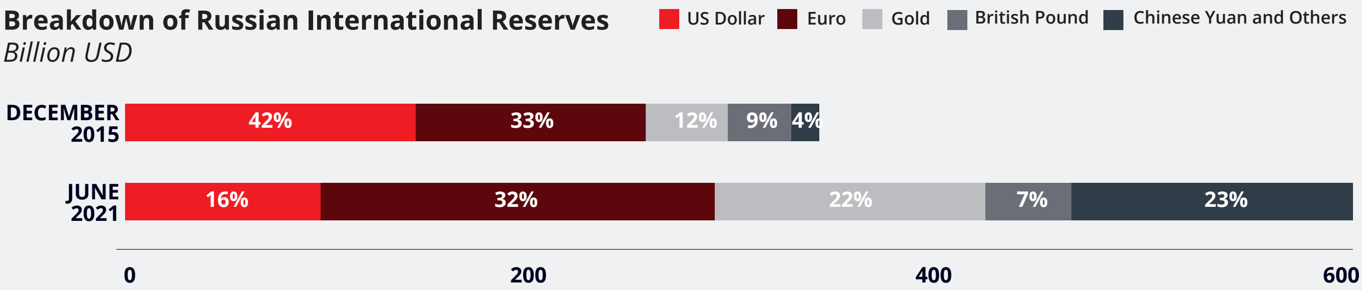
A reversal in globalization has been evident in recent years, notably the US-China trade war. The ongoing conflict had accelerated this reversal. Even with an immediate end to the war, Russia will be excluded from much trade with the West for years. More so, **higher risk of conflict also add to pressure for onshoring. Businesses will require to deploy measures to manage margins and agility.**

Impact on Russia

Despite a significant shock to the economy, Russia is not expected to wind down its operation in Ukraine.

- Europe is yet to sanction oil and gas imports from Russia which constitutes the bulk of Russian economy.
- China is expected to be a major Russian ally over the coming months in terms of buying Russian commodities and supporting its financial system to evade sanctions.

More so, Russia has been taking measures to de-couple from the US-led financial system:



Source: MSIM, Haver, Bank of Russia, ING, Reuters. Data as of June 2021

After the 2014 sanctions, Russia divested from dollar assets, selling $83 billion in US Treasuries, and replacing them with gold and greenbacks, which allows them to transact in dollars without using SWIFT.

Russian Central Bank has created its own SWIFT like payments system. The System for Transfer of Financial Messages (SPFS). Last year it was reported that Russia's domestic interbank traffic could easily be transferred to this platform.

Over the years, Russia has diverted eastward. For example, recently Rosneft signed an $80 billion 10-year oil deal with China's CNPC.

GLOBAL MARKETS PERFORMANCE

The market didn't witness a major sell-off when the war started. **The perception set in that the NATO and the western alliance is strong enough to prevent any spillover across Europe. However, as the conflict spreads across Ukraine, markets are becoming more jittery.**

Global Asset Class Performance since the Invasion

MSCI All Country World Index	S&P 500	Euro Stoxx 600	FTSE 100	MSCI Emerging Markets Index
-4.56%	-2.05%	-7.31%	-5.52%	-10.48%

Bond Yield (10 year US Treasury)	US Dollar Index	Bitcoin	Gold	Oil
0.001 percentage points	2.60%	-1.48%	5.44%	16.88%

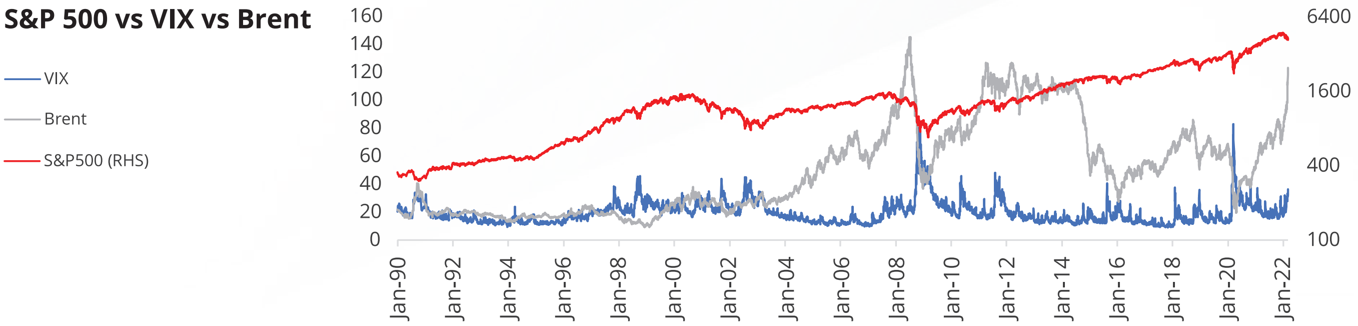
GCC Markets

FADGI (Abu Dhabi)	DFMI (Dubai)	TASI (Saudi Arabia)	QSE (Qatar)	GCC S&P Index
4.92%	1.66%	1.66%	7.02%	3.08%

***Data as on 11th March**

The extent of uncertainty is demonstrated by VIX volatility index. Historically it has averaged at a level of about 19. Currently, it is above 30. Under the worst-case scenario of conflict escalation and a significant rise in inflation, the global market could witness up to 20% correction.

S&P 500 vs VIX vs Brent



However, **over the long term, the conflict is not expected to cause any major market downturn.**

- Since 1945 markets usually fell during the first week of key military conflicts. But in 14 of 18 cases, they rose within three months. *(UBS)*
- Over 13 major geopolitical conflicts/attacks since MSCI Emerging Market (EM) inception in 1988, the 12-month forward return for MSCI EM in USD terms is generally positive (+18.5% on average, +3.5% on median basis) with a 70% probability of being positive over the full 12-month period after the onset of the event. *(Morgan Stanley)*

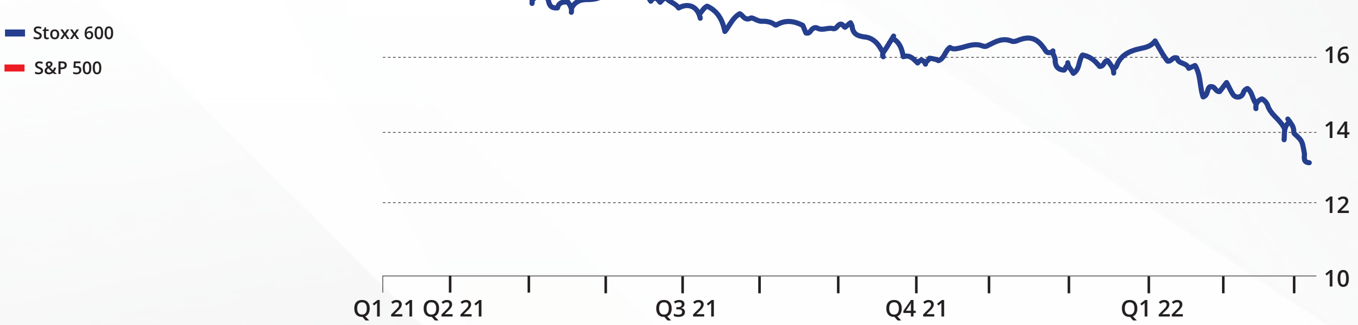
In most cases, these events tend to have a significant and lasting impact on global financial markets if they have a sustained macroeconomic impact on major economies.

Europe is cheap but risky

European markets were offering high value and poised for growth in 2022. However, since Moscow ordered troops into Ukraine, the Stoxx 600 Europe index has declined by over 7%. According to asset management firm Janus Henderson, **euro-area stocks are now trading at a 25% discount to consensus analyst targets. The market could witness a major boost once the first sign of any de-escalation appears.**

Valuation gap between Europe and US stocks widens

Forward price to earnings ratio

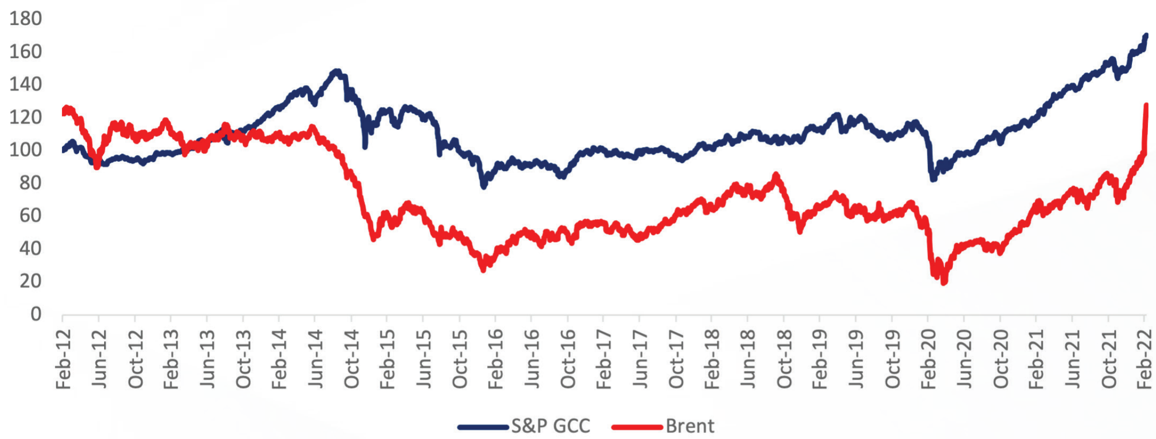


Source: FT

Commodity exporting markets to outperform

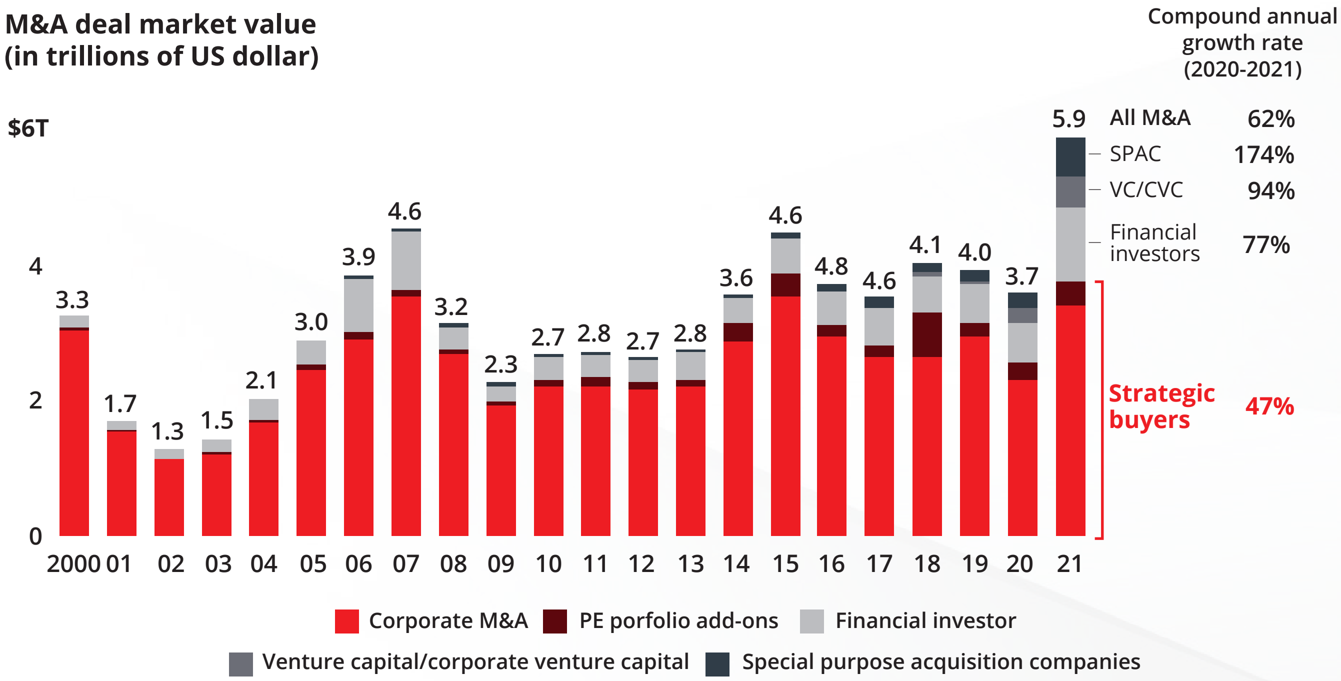
Markets across commodity-exporting countries are expected to outperform amid energy prices. This is evident from the recent market performance with the GCC S&P Index rising over 3% since the conflict began. In addition, **regional policymakers will have significant room to stimulate growth and mitigate the impact of rising prices through spending.**

S&P GCC Index and Oil Price



TRANSACTIONS AND M&A DYNAMICS

After a slowdown in 2020, deal value rebounded to an all-time high in 2021, with soaring valuations and low interest rates. The total M&A transaction value reached a record $5.9 trillion, with strategic deals hitting $3.8 trillion, according to Bain & Company.



2022 Performance: The double Whammy of Conflict and Rising Rates

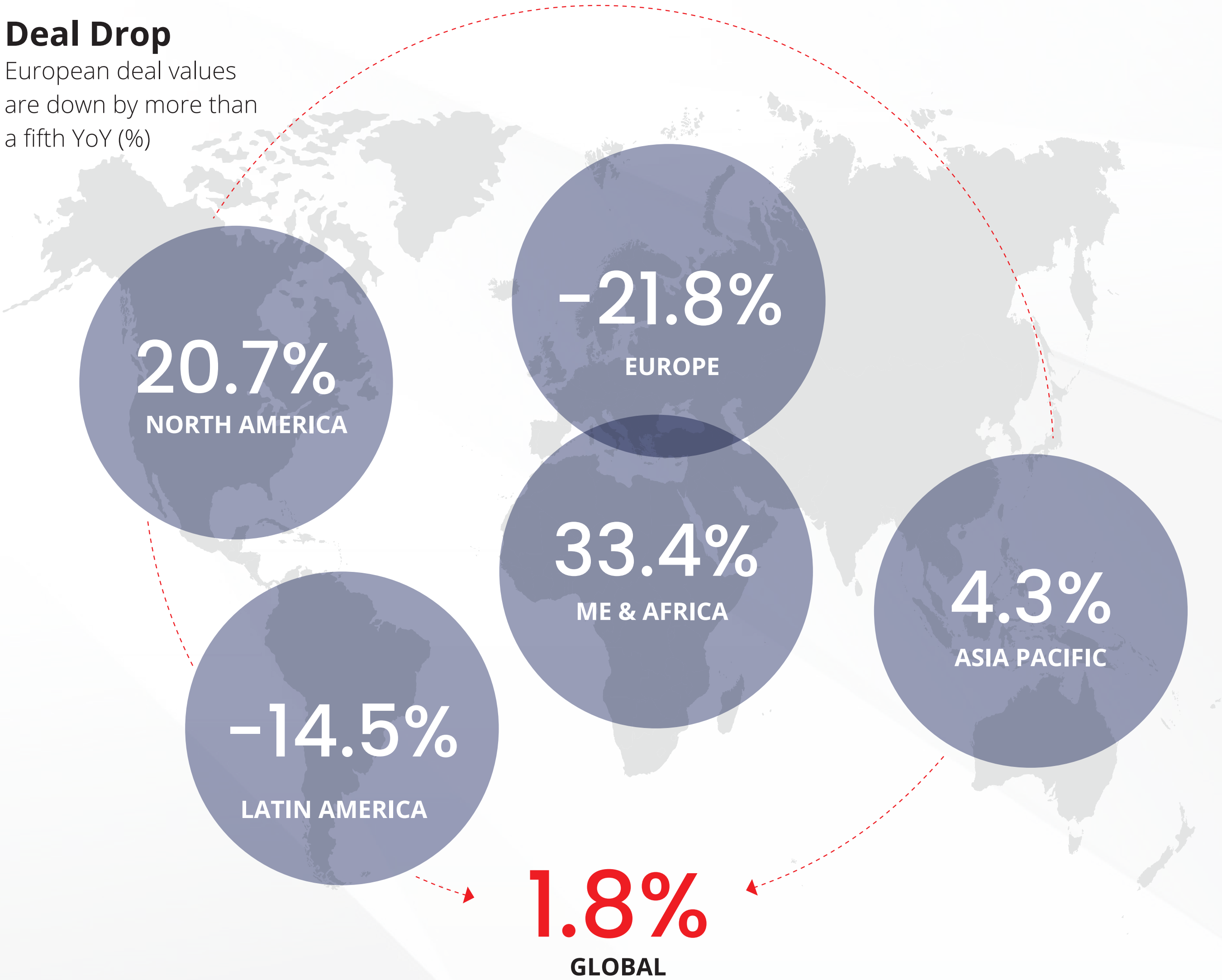
Since the fall of the Soviet Union, investors enjoyed decades of global economic stability in which military conflicts and foreign diplomacy played a diminished role in investing decisions. Russia's invasion of Ukraine has changed this dynamic. Many experts have described the revival of tensions between Western nations and Russia as a second Cold War.

Even before the war, global markets were witnessing a downturn amid the threat of rising interest rates and high inflation. Companies raised less than $2.5 billion through US initial public offerings during the first two months of 2022, compared to more than $24 billion during the same period last year, according to Dealogic. The war has further impacted the deal flow:

- **Global mergers and acquisitions (M&A) slumped 35% in February** as Russia's invasion of Ukraine rattled global financial markets.
- **Deals valuing $296.7 billion were announced by firms during February, down 35%** on the value recorded during February 2021, and 33% down on January 2022, according to Refinitiv.
- **Cross border acquisitions of European firms also plunged 26%** compared to February last year, the lowest monthly total in ten months, while Asia Pacific deal value fell 54%, the lowest monthly total for the market in five years.

Deal Drop

European deal values are down by more than a fifth YoY (%)



Ist Jan - 2nd March 2022

Source: Bloomberg

KEY CONSIDERATIONS ON INVESTING DURING CONFLICT

THE RETURN OF GEOPOLITICAL RISK

Geopolitical risks that were largely ignored since the Cold War have returned, reversing years of peace dividend. Investors need to internalize the risk of sanctions, cyber-attacks and conflicts in their screening models. Furthermore, high-growth economies across emerging markets will be under an additional layer of scrutiny and may require higher risk premiums to attract funds.

EXCHANGE RATE RISK

The ongoing conflict has led to a strong dollar appreciation as investors flee towards safety. This poses more of a headwind for emerging market investments and markets directly impacted by the conflict. Notably, the euro has depreciated by 5% against the US dollar since mid-February.

UNCERTAINTY AND COMPLEXITY OF MONETARY TIGHTENING

Near-term inflation expectations have risen recently, as energy prices could remain higher given Russia's role as a major producer. The US Fed is largely expected to start raising interest rates towards the end of March. However, the conflict is complicating the policy shift and a major trade-off between growth and inflation could emerge.

PRESSURE ON CORPORATE PROFIT MARGINS

Many companies have asserted that they are sheltered from inflationary drags by strong pricing power. But in a sustained inflationary scenario, it will be difficult to sustain this advantage unless businesses create strong productivity enhancers.

CAUTIOUS APPROACH EVEN WITH LOW VALUATION

Even though recent declines have made valuations look more attractive, markets have not priced in any major escalation in Ukraine. As the war drags on and sanctions start to bite Russia, this perception could change leading to another phase of a downturn. Having a cautious approach with an adequate cash position will be advantageous going forward.

RECALIBRATE EXPECTATIONS AND FOCUS ON THE FUNDAMENTALS

Amid high inflation and low consumer confidence, corporate returns could soften compared to earlier expectations. While recent softening, especially across the US and EU markets has created better entry points, it is crucial to stick to business with strong cash flow and margins.

LOOKING BEYOND VOLATILITY

Volatility is expected to be a norm especially if events in Ukraine continue to escalate and the West's security response ramps up. It is crucial to focus on long term themes, changes in the competitive landscape and business durability over the long term.

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