

# Market and Portfolio Update: The War in Ukraine

25 February 2022

## What has happened so far?

In the night of yesterday large-scale military operations of the Russian army in Ukraine have begun. The military operations are not limited to the Eastern provinces, Donetsk and Luhansk. Russia has attacked military targets throughout the country, such as airports, ammunition depots, and Ukrainian air defence positions, already causing extensive damage. There are also reports of combat operations near Kiev.

President Volodymyr Zelensky has declared a state of war and ended diplomatic relations with Russia. Western politicians have sharply criticized Russia's actions and announced far-reaching sanctions.

As a result, stock markets plummeted, the German DAX index, for example, lost 4% during the day, the oil price rose to well over USD 100 and the gold price climbed to over USD 1,970.

## What happens next?

It is becoming apparent that Vladimir Putin will not only annex the eastern provinces, but at least wants to establish a pro-Russian government in Ukraine.

We assume, and this was also communicated today by several decision-makers, that neither Europe nor the U.S. nor NATO will intervene militarily.

## Sanctions Policy

A number of sanctions were already decided: EU funds of a large number of Russian individuals and institutions were frozen, trade with Russia was significantly restricted, trade in Russian government bonds was banned, and Russian banks were denied access to the EU capital market. Further sanctions will follow.

Although these sanctions will be painful for Russia, Russia has been preparing for such measures for a long time. Russia already faced various sanctions when it annexed Crimea in 2014. Russia currently has quite high defence reserves and has developed self-sufficient systems in various areas.

## The gas market

So far, Europe has shied away from introducing sanctions in relation to the gas market. However, yesterday Germany stopped the Nordstream 2 project. The dependence on Russian gas is very high in Europe and cannot be easily reduced. Europe gets 40% of its gas from Russia. However,

import quotas vary widely within the EU, from almost 100% in Bulgaria, 55% in Germany to 0% in Spain and Portugal. Currently, gas storage facilities are sufficient to meet demand through the winter months. However, Europe will probably increase the share of alternative gas suppliers in the medium term, especially liquefied natural gas from the USA and Qatar.

It is highly likely that energy prices and their volatility will remain significantly elevated for some time to come.

### **The market for crude oil**

We expect Saudi Arabia, the UAE and Kuwait to significantly increase their daily oil production volumes in order to curb the sharp rise in oil prices. U.S. President Biden has already held talks with Saudi Arabia's King Salman in this regard. In addition, there are signs that an agreement could soon be reached in the Iran nuclear dispute, which could lead to the lifting of sanctions and an increase in Iranian oil production. In addition, U.S. shale oil producers could increase their production capacities. In total, these additional oil production volumes would compensate for any Russian shortfalls. Nevertheless, crude oil prices will likely remain above USD 90 per barrel for the time being.

### **The European banking system**

A further risk could be that European banks in particular hold Russian debt instruments which may no longer be serviced. The ECB has recently conducted stress tests on this. It seems that the risks for the European banking system are manageable. The banks with the largest Russian risks are Société Générale, UniCredit and Raiffeisen Bank International.

### **Our baseline scenario**

The political climate will remain poisoned for the foreseeable future. We will probably continue to

see high and possibly further rising oil and gas prices. This will lead to continued high inflation and reduce purchasing power and economic growth. In our base scenario, however, this will not lead to a recession. Exports from Europe to Russia amount to only 1% of GDP. Furthermore, analysis of past geo-political crises shows that market corrections have been relatively short-term in nature.

In this scenario, we assume that the largest losses in the financial markets will be reversed.

### **Risk scenario**

Nevertheless, there is undoubtedly an increased risk that the distortions on the gas market could develop into a major energy crisis in Europe with gas prices doubling. In this case, a recession (or at least a significant slump in growth) could well be expected. As a result, the decline in equity market values could accelerate further.

### **Our portfolios**

Our portfolios have exposure to Russia through various passive investment products in the emerging markets, but this exposure is only around 0.4%.

Our Income and Balanced portfolios have been very robust since the beginning of the year and have lost significantly less than comparable portfolios measured by the Morningstar Index. Our Income portfolios have lost about 3.9% since the beginning of the year, our Balanced portfolios about 5%. This was achieved in particular by the following portfolio components:

- Insurance-linked bonds are not affected by the geopolitical crisis.
- Commodities have had a very strong performance of 16.7% since the beginning of the year.
- The dividend aristocrats, in which we invested at the end of last year, have performed significantly better than the rest of the equity market.

- The trend following program has achieved a performance of 7.5%.

### **Outlook**

In the base scenario described above, our portfolios will be able to benefit from rising equity markets. However, should the risk scenario materialize, with a further sell-off in the equity markets, our portfolios would suffer further losses.

However, in this case our volatility strategies would develop their hedging properties and compensate for part of the portfolio losses.

Since the beginning of the year, our volatility strategies have lost value. This is mainly due to the fact that long-term option prices have not yet risen, and have even tended to fall. Should the risk scenario materialize, long-term option prices will certainly rise significantly and lead to high profits and thus the desired hedging effect.

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