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TRANSCRIPT

The Russia-Ukraine War and the Markets: One Year Later

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Adam Bass

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is February 23rd, 2023. Tomorrow, February 24th marks one year since Russian troops crossed the border and invaded Ukraine. Of course, the impact of the war in terms of lives taken and lives in upheaval is the paramount effect.

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Adam Bass

This program, however, is focused on providing an understanding of what events around the world mean for markets and investors. That is where we'll spend our time today looking at where economies and investment markets around the world, where they stand one year later. To do so, we sat down for a roundtable discussion. We then asked experts with four different perspectives to bring you as complete a picture as possible.

00:01:02:14 - 00:01:34:14

Adam Bass

Ashish Lodh from the Equity Solutions Research Team, friend of the Pod, Andy Sparks Head of Portfolio Management Research. Tom Leahy, who heads European Commercial Property Research and Elchin Mammadov, who is the co-head of ESG and climate research in EMEA, and also leads the global utilities sector team. You'll hear from Ashish, Andy, Tom and Elchin in that order. Thanks, first of all to everyone for joining.

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Adam Bass

I'd like to start out, if we could, by by taking on the direct effects of the war. Now, understood from our previous conversations that those direct effects have lessened and investors have started to incorporate the reality of the war into their expectations, into their analysis. But as we speak today and we're about a week out from the anniversary of the end invasion right now, what impact do we see?

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Adam Bass

Ashish, let's start with you.

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Ashish Lodh

Thank you, Adam, for having me. And you are absolutely right. The start of last year was indeed quite shaky for equity markets across the globe. A number of factors, such as fears of stagflation with rising inflation and even a possible recession, were already driving a negative investor sentiment even before the conflict began. And from the economic point of view, what Russia-Ukraine conflict did was it was and some of those problems, especially the ones related to energy price led inflation in Europe, at least in the short term.

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Ashish Lodh

However, a lot has changed over the year, especially in the second half of the year. The oil prices started to come down. Europe managed to secure alternative LNG supplies from the US. And also US inflation started showing some signs of easing. As a result, what we saw was that most equity markets started to recover around the end of the third quarter of last year.

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Ashish Lodh

So yes, one could argue that the direct effects of the war have lessened. And if I focus a bit more on Europe, what was indeed surprising here was that European equities were the fastest to recover, which is contrary to most to what most market analysts expected, given Europe's proximity to the conflict zone and also its high reliance on Russian gas.

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Ashish Lodh

To give you some color, the MSCI Europe Index in local currency finished about 2% positive over the year, while the US and emerging market indexes were down more than 7% over the year. And it seems

European equities benefited from slower than expected rate hikes and also lifting of COVID restrictions in China and China being a big market for Europe luxury goods.

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Ashish Lodh

And lastly, I think it's also important to note that the performance dispersion across European country equity markets remained quite high. For example, countries like Hungary, Poland and Germany. Their equity markets were the worst hit, which could be owing to their geographical proximity and also due to energy dependency on ratio.

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Adam Bass

And Andy, a couple of fixed income related topics touched on there. What did you see from your angle?

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Andy Sparks

Well, the immediate response in the fixed income market after the after the invasion of Ukraine was definitely a very swift and very large. And partly I think the audience needs to understand that there was surging inflation even ahead of the invasion and the invasion with the spike in energy prices and a bad inflation situation that much worse. In addition to major impacts on countries neighboring Russia and countries very dependent on energy imports from Russia.

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Andy Sparks

Government yield curve shifted up a lot and corporate spreads widened and this negative return in bonds was occurring at the same time as the trade off in equities and other sectors. And it really created a terrible situation for folio managers. And this belief that bonds offer diversification at a times of crisis was missing. And we've experienced some of the worst returns in in the past 60 years for portfolios with mixed assets.

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Andy Sparks

Since roughly Q3, the tone has improved and the fixed income market there has been a rally. But nevertheless, do you just look at the level of yields now versus just before the onset of hostilities, yields are still much higher and I think those higher yields are definitely tempting some investors to add allocation to fixed income.

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Adam Bass

Tom, both Ashish and Andy have spoken about geographic differences for fixed income in equities. Was the same true on the real estate front?

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Tom Leahy

I think you have to think about the effects in the war and in two ways. It's the direct impact of the indirect impacts in terms of real estate in Russia and Ukraine itself. I think the Ukraine is a very, very limited institution, investment market and in Russia there has been an institutional investment market with some U.S. and European firms active there.

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Tom Leahy

But they've really portfolios that are relatively small and actually versus pricing out, trying to exit those properties. But it's really the indirect impact in much of aspect stems from what Andy and he's already talked about, and that's caused a pretty sharp correction in real estate. But that is still underway really in terms of the geographical split and obviously the proximity of Central and Eastern European markets to the war zone would suggest they might be worse affected.

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Tom Leahy

But the data doesn't necessarily show that actually in terms of the European market, that has seen the sharpest correction set in terms of transaction volumes, that's properties being bought and sold in 2022, that was Germany. And clearly Germany's reliance on energy supplies from overseas and from Russia was something of an Achilles heel. And that led to a multiple in sentiment in the German real estate market, so linked to some of the economic sense in Germany, but also the higher cost of debt because of higher interest rates and debt costs have really rocketed for almost all commercial real estate asset classes.

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Tom Leahy

We saw two huge months of uncertainty at the pricing. And when you've got that uncertainty of a pricing buyer and seller expectations move apart as property is a private asset. And so these kind of effects take a while to feed through into the market. And so we're seeing that sending similar volumes.

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Adam Bass

What about Russia itself? The world has come together to impose, continue to impose even through today, heavy sanctions. What's been the effect on the markets across the board there?

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Elchin Mammadov

Let me start with the with the impact on the energy markets with my energy analyst hat on. As you know, the prices for energy have initially surged and then they have since come down and this has generated a lot of winners and losers depending on which part of the energy value chain you are in and also what geography you're present.

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Elchin Mammadov

If you are an oil and gas company. Most of them weren't affected negatively. And actually net net the impact has been positive. There were only a handful of oil and gas companies with significant presence in Russia. So the net benefit for them was that the energy prices meant that they could sell their hydrocarbons for for higher price. So even if they had to take some impairments on their Ru ssian investments, the net impact was positive.

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Elchin Mammadov

If you were a US oil and gas company that you were only a net beneficiary because again, the energy prices still remain well above their pre-crisis levels, even despite the recent drop, the impact was more felt within European utility space, which rely on Russian not only gas but also coal. For them. Again, they weathered the storm relatively well because only a few of them had an exposure to Russia and those who did suffered badly.

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Elchin Mammadov

And the biggest sufferers were, in essence, clean energy, nuclear power plants. So unfortunately, in the short term, they suffered the most because of this imposed windfall taxes. But the sector, even for utilities, was a net beneficiary because it's considered to be a safe haven. So a lot of money went in there, even in Europe.

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Ashish Lodh

Probably, I can add. Russian equity market index point of view. So Russia as a country is a very small part of our global equity index. It is a slightly bigger part of our emerging market index, a decent until the middle of last year when it was removed. As a result of the Ukraine Russia crisis, the impact of Russian market on the global equities, the direct impact was not too big.

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Ashish Lodh

It was slightly more meaningful in the emerging market index, but it was again soon removed. So that impact was also not long lasting.

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Elchin Mammadov

The thing that impressed me the most, Ashish, is actually European industrials. The de-industrialization of Europe, because of the surging input costs hasn't really happened yet. And it looks like the sector has weathered the storm. Yes, we are seeing some of the factories operating at well below capacity. Others have been mothballed, but it's growing on a localized scale.

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Andy Sparks

Adam In Russian bonds, initially there was some trading immediately after the invasion, but Western governments quickly began imposing sanctions and effectively the hard currency. Russian bonds are in a state of default. You can't really trade them. Russia had a lot of reserves with central banks globally, particularly the US dollars. Those were frozen as well. And so for a while, as energy prices were very high, Russia's oil sales continued to generate very high revenues.

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Andy Sparks

But as the price of oil's come down, as caps have been imposed on them, the fiscal situation in Russia is probably going to be deteriorating.

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Adam Bass

So with that foundation in place, let's look at what investors are focused on, which if I'm hearing you all correctly and reading the papers correctly, seems to be inflation, rising rates. And though it's tempered a bit in some places, talk of recession. Andy, as our resident student of the Fed, you've been on here many times to to talk about the Fed as well as other central banks around the world.

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Adam Bass

Help us put some of this into context, if you could.

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Andy Sparks

The role played by central banks cannot be understated and we've seen continually over the course of the past year markets, not just the bond market, but also the equity market and other sectors, including real estate, they have been moving very directly with some views around central bank actions. And so I think to get a good understanding of what could happen going forward, I think it's really important to focus on inflation, economic growth, which are two key goals of central banks and in the case of United States, maximum employment and low and stable prices.

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Andy Sparks

So the question is how effective will monetary policy be in in driving inflation lower without causing a sharp recession? I think it is worthwhile to look at this in a little bit of historical context to number one, the Fed sees inflation as its responsibility, and high inflation means the Fed has fallen short. In 2021 and early 2022, the Fed continually understated inflation and as a result, the Fed.

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Andy Sparks

And it's not just the Fed, it's other central banks as well. But given that inflation was a lot higher th an central banks had been projecting, those central banks began to lose credibility in the eyes of quite a few market participants. So the Fed and other central banks changed its tone. In the case of the Fed, they have raised the Fed funds rate by four and a half percent since last March.

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Andy Sparks

And so I would argue that the Fed has followed up its tough talk with aggressive action. So one year since the invasion of Ukraine, inflation now appears to have peaked and is declining, but the Fed is not ready to declare victory. And in fact, recent messaging continues to emphasize that its job is not done and the road ahead may be bumpy.

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Adam Bass

Tom, Andy mentioned the direct effect on on real estate. You touched on that a bit earlier. But can you pick up the thread there?

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Tom Leahy

The low rate, low return environment really was the architect of the post GFC estate boom. So trillions of dollars are spent on global real estate. Where is since since the recovery from the GFC started in 2012 2010 and a lot of that capital is being pushed into property because of the real returns that the asset class could provide at a time when bond yields, especially while ultra low.

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Tom Leahy

And so the ball really seems to signal the end of that cycle. If properties as a cyclical asset class, as many as us principal asset classes are, but you can trace property cycles going back centuries and this particular cycle now looks to have peaked probably in the middle of 2022 to certain in terms of the caps, the values of the global real estate.

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Tom Leahy

And then that leads to again, uncertainty around pricing so that lower liquidity. And that's one of the things that makes property interesting and different from other asset classes is that it takes a long time for these real world impacts to feed through because you need to have buy and sell. It's come together to create transaction. Property deals take months to complete.

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Tom Leahy

They're not adapted instantaneously. So for the liquidity to come back to the market, I think we need to see some clarity on where rates are going to be, especially the cost of debt of which rocketed above property yields in the middle of last year. And but I do think if there's a longer term question, which is if the low rates environment was the architects of the global real estate boom, by that period is now over.

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Tom Leahy

And if rates settle down at a structurally higher level than they have been, I think the question for real estate investors is where does property fit in in that landscape And I think we have a clearer idea of where property will fit it until we see or get an idea of where long term rates will settle.

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Elchin Mammadov

There's a lot of similarities with clean tech assets. They benefited incredibly from lower for longer rate environment and a lot of pension funds and infrastructure funds were putting the capital in this high capital intensive projects, offshore wind, large onshore solar battery projects. And now that the rates are going up, the valuations are not as high as they were.

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Elchin Mammadov

At the same time, they're core investors that were investing outside of financial bubble are utilities, and a lot of those are now having to deleverage because their interest expense going up and one of the assets they know they can sell relatively easily is not a coal fired plant. Is there is a wind farm project or a solar project or a battery one

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Elchin Mammadov

And just as an aside, we've seen a lot in the press. Every year the cost of wind is coming down, the cost of solar is coming down. Now we're seeing actually that's reversing and the wind and solar costs are going up because of inflation, which impacts the steel cost and everything else that goes into them. But also the fact that the funding rate is going up.

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Ashish Lodh

I think it's very important to realize that inflation and interest rates, they don't have a homogeneous effect on the markets. And as inflation inevitable rapidly like they did over the past year, they do tend to drive performance of certain industries and certain style factors. For example, in Europe, as expected, oil and gas and energy stocks rallied and that was a direct consequence of the oil price increase.

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Ashish Lodh

And also the inflationary environment and inflation and global supply chain issues caused by the war also played a role in the rally of commodity focused industries such as metals and mining. In addition to that, European banks also started trending upwards due to the rising rates, while on the other hand, the technology sector started to underperform. And it brings us to a very interesting comparison since compared to the US, Europe equity market is heavy in financials and energy sector companies and lighting technology, the overall impact of the rate hike was less detrimental to Europe.

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Ashish Lodh

Equities compared to other developed global developed economies.

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Tom Leahy

Just coming back, I think of property as an asset class in general, but I think one of the interesting things about that is it's not emerging as asset class. For example, the sharpest correction in British pricing in the second half of last year was in industrial property, which had been the most sou ght after asset class, probably globally, especially on the back of a lot of that shift to online retailing.

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Tom Leahy

These saw during the pandemic, which is pushing warehouse occupiers like Amazon to take up huge volumes of space driving rental growth. And so investors followed into that and pushed yields down to very low levels. But with the higher rates that yields have had to move out and that's have not outsized impact on property values for that sector in particular.

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Tom Leahy

But there are structural reasons to keep on buying industrial property. If you believe that people are going to keep shopping online and actually rental growth for industrial properties, according to the MSCI data, get through. Our valuation indexes, remain positive throughout all these capital markets disruption. So that in very general terms, there are lots of stories and certainly there's headline news.

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Tom Leahy

The other part of the market that was also very much in fact in the pandemic was apartments or multifamily properties. Since then, across the pond in the US, again, there's been something of a correction after a post-pandemic boom in property prices. But if you believe there's a structural need for housing that housing's become less affordable, especially if we move into a higher rate environment, getting mortgages will become more expensive and so rental properties will be required.

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Tom Leahy

So there's plenty of our global investment manager clients who are trying to acquire residential assets.

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Adam Bass

Elchin, you've given us great insight into the energy sector and the relation with sanctions on Russia, etc. but what about the global push toward reducing reliance on fossil fuels? What's been the impact there?

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Elchin Mammadov

I think it's kind of going to lead to a one step back to step forward kind of thing. In the short term, we are seeing increased emissions as not just in Europe but also in Asia-Pac, that countries are switching to burning more coal, more fuel oil to offset some of the shortage in gas, which was quite expensive until recently.

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Elchin Mammadov

However, in the longer term, we do expect the governments and the companies trying to reduce the price volatility and also improve the energy security. And the easiest way to do that is to accelerate investment in renewables. There are climate subsidies. We've seen the Inflation Reduction Act in the US. We've seen repower EU in more recently EU Green Deal Industrial plan.

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Elchin Mammadov

We are seeing countries in China tackling overdue subsidy payments of their own to clean their companies, whereas in Japan and Korea reversing their nuclear phaseout plans and other countries seeking to follow suit. So there is a really huge momentum in favor of clean tech despite the headwinds that I expressed earlier due to the high inflation rate.

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Adam Bass

And of course, the question always on investors mind is what happens next. Andy, I'll look to you again. First year, you and your team, you've done some scenario analysis on this very question. Can you walk us through what you found?

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Andy Sparks

Yeah, sure. And the background is that we are living in uncertain times. And as we discussed a little earlier in this discussion, the inflation is top of the mind for investors. We're still coming out of the pandemic. There were major changes in the labor force resulting from the pandemic. The labor force participation rates, for instance, in the U.S. went down very noticeably.

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Andy Sparks

Then we had the Ukraine war and we now had just received the inflation for the United States for January unexpectedly. A bit on the high side, if you just annualize the past two months, inflation rates for core inflation in the US, it's it's and realizing at about a 4.8% rate versu s central bank goals of 2% versus the Fed's goal of 2%.

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Andy Sparks

And in current market pricing, the market is expecting a much lower inflation rate than what we're seeing. So in our analysis, we look at four different scenarios. We called one baseline, another hard landing, another mild stagflation, another strong rebound. In our baseline scenario, we expected elevated interest rates and volatile markets, mainly due to the ambiguity around growth and monetary policy.

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Andy Sparks

In this scenario, a portfolio of global equities in US bonds could gain approximately 3% in less favorable scenarios, such as a hard landing or stagflation. Our analysis showed the same portfolio could experience a loss of, in the case of the heartland, ending 8.5%, and in the case of stagflation, 7%. In this sort of environment, we see lots of investors who aren't exactly sure of what might happen, and they actually like looking at different possibilities.

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Andy Sparks

And so MSCI is not assigning probabilities to these different scenarios, but we are using our tools to look at how markets might respond if a specific scenario were realized.

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Adam Bass

And Ashish, I know you would mention some thoughts around this earlier.

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Ashish Lodh

So I cannot really speak about the possible scenarios. But what I can do is basically that considering the current environment and assuming that the current conditions prevail, we have to do some analysis from equity factors point of view and our findings indicate that in such economic conditions, historically speaking, investors might still prefer to have these two factors like value, quality and minimum volatility.

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Ashish Lodh

When we are speaking to clients, especially long horizon asset lines, they are being currently macro environment as a regime change compared to what we have seen over the past few years. Fair value factor softness, support for us at the expense of higher risk stocks and a lot more clients today are considering allocating to factors the recent events, basically the market dates that happened in the past two years.

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Ashish Lodh

They have also shed light on the importance of managing portfolio risk and drawdowns, and they have highlighted the role that low risk strategies such as minimum pool can play in equity allocations. And recent events have once again highlighted the importance of global densification, especially when we look at the regional performance of equity indexes. It becomes clear very quickly that it's not easy to pick the predicted market movements in short term, and in such a case, diversification can help us reduce the specific risk coming from a single bit.

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Adam Bass

Well, thank you all for a great discussion. I know investors will find these insights very valuable as they start to look forward more for the year. So thank you again for joining us. That's all for this week. A big thank you from Joe, Phil and me to Ashish, Andy, Tom and Elchin and to all of you for listening on our next episode.

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Adam Bass

It's MSCI, his annual look at the progress that women have made obtaining seats on corporate boards, as well as other positions of power at companies around the world. We'll examine where we are and why investors are paying such close attention. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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