FE Investments

Russia and Ukraine, what is happening and how is my portfolio positioned?

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The confrontation in eastern Ukraine is contributing to elevated levels of volatility in financial markets. The dispute between Ukraine and Russia is longstanding but the recent deterioration in relations between the two sides and Russia's increasingly belligerent attitude have added to market concerns about elevated oil and gas prices and the potential impact on global inflation.

Western markets have fallen with the inherent unpredictability of geopolitical risk, while government bonds have started to reverse their recent declines, as investors look for safety.

With the current evens unravelling quickly, we consider the background to the conflict, the economic consequences and how the portfolios are positioned.

The background to the conflict

Putin has always been fairly public on his thoughts regarding the breakup of Soviet Union; labelling it the "the greatest geopolitical catastrophe of the century" in 2014. When Ukraine's pro-Russian president was overthrown during the Revolution of Dignity of 2014 Russia invaded and annexed the Crimean Peninsula, arguing it had a historic claim to it.

Shortly after, Russian-backed separatist groups in Ukraine's eastern Donbas region, a primarily Russian speaking area, demanded independence. This resulted in a war between the separatists and Ukraine which has been ongoing since and Ukraine and the West have accused Russia of sending troops and weapons to support the rebels.

Although Ukraine is not officially part of NATO, there is NATO-Ukraine charter in place, giving Ukraine the right to consultations at NATO (and also the promise that in time it might be considered for membership). As a result, NATO supported Ukraine in this conflict, with the US and its NATO allies providing weapons to Ukraine, as well as holding joint military drills.

Ukraine aspires to join NATO. This is where many of Putin's issues lie. If it was to join, Russia's sphere of influence would be significantly reduced. Putin also sees it as a threat to national security, due to NATO member states' agreement to mutual defence in response to an attack by any external party. This presents multiple issues for Russia if Ukraine joins NATO

Another issue lies with the potential proximity of the Mark 41 missile launcher. The Mark 41 can fire precision-guided missiles. A NATO membership would allow the US deploy these strike systems in Ukraine cutting their missile flight time to Moscow down to seven minutes in the process. This is a huge challenge to security in the eyes of the Kremlin. The MK41 can also be used in a defensive capacity, to shoot down incoming missiles mid-flight.

The massing of Russian troops on its border with Ukraine has been accompanied by discussions between Europe, the US and Russia with Putin demanding that Ukraine is never allowed to join NATO. These discussions have failed, Russia recognised the rebel forces occupying Ukraine, and forces have now moved into the country. For the time being diplomacy is not on the table.

What are the consequences financially and economically?

It is hard to say precisely. The situation is fluid and the world is a complex place. We have expectations on the effect of the escalation, but the untilmate destinaiton is not certain, and will evolve over time. A lot depends on state actors and their decisions.

Russian economics

The economic consequences of a Russian invasion are liklely to be significant in the long run for capital markets and the economy. Russian investments including bonds and equities have fallen, along with the rouble. The Moex briefly fell 45% before recoving to a decline of 28% at the time of writing. Economic sanctions will bite, but their penetration will depend on the level of commitment from Western politicians.

Russia has been threatened with severe international sanctions. Since the threat the West has gradually escalated the sanctions which will become harsher since the invasion. This could have implications on the Russian economy but since 2014 they have positioned their country to withstand or deflect sanctions. The country's low levels of debt, both external and public debt to GDP ratio, and high FX reserves means it does not depend on the global financial system to a great extent. Trade has aligned more closely to India and China who can supply more core materials, from basic commodities, pharmaceuticals and technology. Russia has even developed their own payments system should the sanctions deny card payments or transfers through existing global infrastructure.

In addition, squeezing the Russian financial system would affect current standing international financial contracts. Russian entities owe international banks around $121bn in assets. On the other side of the ledger, international banks have some $128bn in loan and deposit funding owned by Russian entities. Cutting off Russia from international banking would have detrimental effects across the globe.

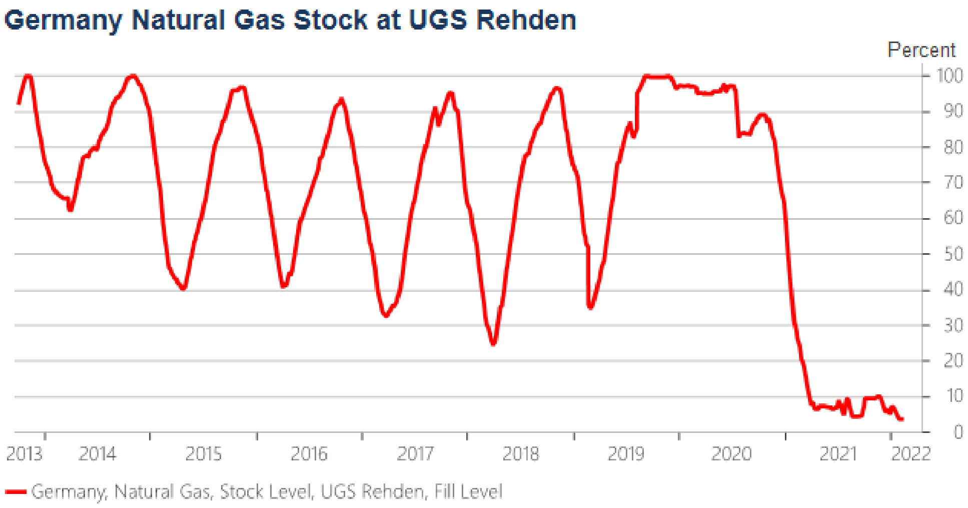
More severe sanctions from the EU requires a unanimous vote and some member states may not wish to impose such strong sanctions against Russia. Most notably Germany who merely suspended the Nord Stream 2 pipeline, rather than cancelled its review and ratification.

Energy

Russia supplies a significant amount of oil and gas to Europe, and America. They could use this as leverage, and to sell the commodities at a high prices to a desperately dependent West, to fund their objectives.

Russia's ability to tighten the taps on its oil and gas could result in price spikes and prolonged pressure on inflation. This would act as a "tax" on businesses and consumers but can have further reaching consequences too. The price of gas weighs heavily on consumer sentiment. If the escalating conflict leads to further oil price rises and reduced confidence, this would stifle economic activity, resulting in low growth with looser monetary policy, against elevated global inflation.

Some political analysts thought there is a veiled intention from the geopolitical pressure in Ukraine: Germany. Nord Stream 2 has yet to be ratified by the German parliament. High gas prices are strangling the country; and the current geopolitical pressure could serve to eliminate two problems at the same time. Putin knows that ratification of the pipeline was imminent and isn't off the table. So the current problem would force Germany to avoid permanently high prices in the long run and resolve the Ukraine / Nato security concerns. The pipeline is highly unlikely to be voted through in the spring, but there is a very slight glimmer in the long run. Domestic energy policy takes a long time to adapt and years of narrow thinking has left many countries exposed to geopolitical risk. More specifically Germany.



Source: Andreas Steno and Macrobond

The threat of imposing sanctions against Russia isn't the bargaining chip it would be against other less self-sufficient, better positioned countries.

<u>Does Putin want war with the West or is he seeking cover from the dissatisfaction of the Russian public?</u>

We don't know. We do know what Putin has said, and considering how NATO has encroached on Russian boarders, his grievances seem to have some credibility. Nord Stream 2 is also a reasonable consideration. There may be other reasons behind his manoeuvring.

High levels of corruption have led to historically low electoral ratings. This has been exacerbated by poor handling of the pandemic, contributing to stagnating incomes, so it's easy to see why Putin would want to distract the public from the realities the country is facing. Ironically this probably why Ukraine and other Eastern European states have nestled up to NATO.

Despite the aggression in eastern Ukraine, it's hard to tell whether a war with the West will materialise. His actions have already caused damage to the Russian economy and are likely to linger. Russia could become a pariah state as a result of its actions. Whilst we can speculate that war with NATO is a possibility, we think it is by far the least palatable option for all nation states and therefore the least likely.

<u>How have you managed the risks in my portfolio?</u>

Making a conviction market call and change in asset allocation is not part of our philosophy. Trying to call the events that have happened, and those which could occur, is likely to be inaccurate. We prefer to manage risk and focus on the aspects of investments that hold up over time.

UK gilt and US treasury prices have firmed up, but not too sharply, as investors have moved their portfolios toward safety. We have explained that government bonds are a "tool" in our portfolios. They anchor risk at an appropriate level for an investor and diversify the portfolios in times of stress. Gilts normally hold up their value when stock markets fall. During 2021 we pointed out that market events can unravel unexpectedly and gilts are a key element of an investor's portfolio. Russia and Ukraine is another case in point. Gilts should hold up the portfolios value if geopolitics push markets to extreme stress.

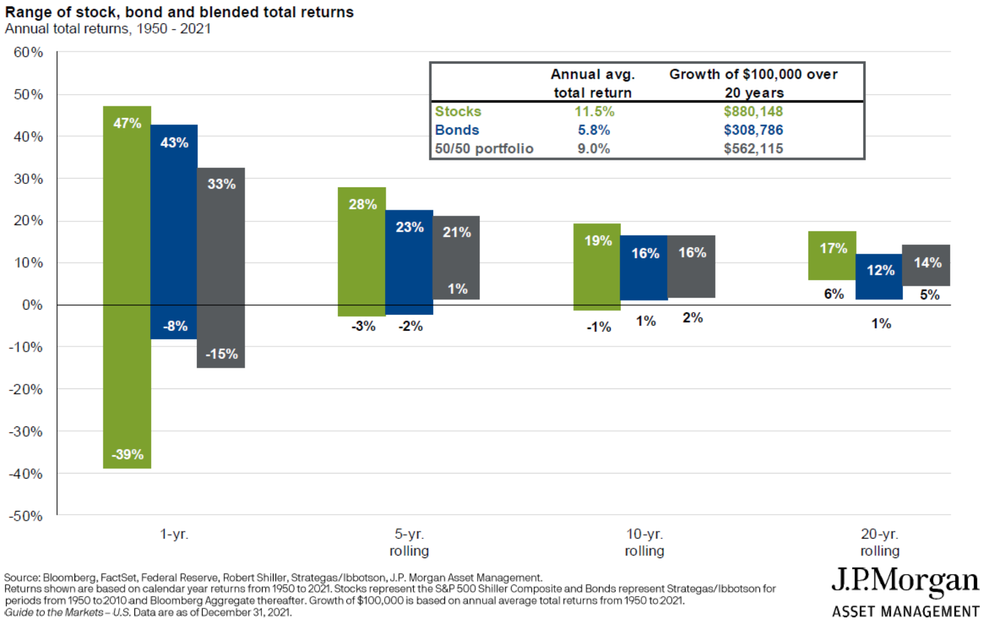
Over the last 14 years, since the global financial crisis, investors have become accustomed to relatively stable markets with low volatility. The current point in the cycle has seen volatility pick up, and combined with recent geopolitical events, investors are reminded that markets are not always stable. In equities, at the time of writing, markets have fallen and will likely pass through a volatile period while investors wrangle with uncertainty. We have taken steps over the last year to change the portfolio and mitigate inflationary effects on the portfolio. Geopolitical concerns caused oil and gas prices to moved higher and this will flow through to inflation which could persist longer than expected.

This month we rebalanced the portfolios to bring the risk levels of the portfolio in line with their constraints so they are not overly exposed. We also adjusted the asset allocation. The rebalance also provided an opportunity to adjust how we split our exposure between value and growth investments.

Value investments include energy, financial services and commodity companies and tend to perform well when inflation is elevated or interest rates rise. These investments contrast with growth investments that benefit from low rates and try to grow their profits quickly; as the economic cycle changes these investments tend to slow. We feel that the portfolios are better balanced to address the risk and volatility after the changes.

Time and patience along with diversification

The best way to handle these risks is to diversify and also be patient. Often the best times in markets follow the worst, and selling out too soon, can mean missing out. Diversification and patience are important parts of our investment philosophy that have served investors interests well.



Source: JP Morgan guide to the markets, Q1 2022

Over time we can see that returns become less uncertain and have a narrower band of rolling returns. So if returns become more certain over time (narrower range of potential outcomes), risk diminishes over time. For example 47% to -39% is less certain than 17% to 6% for equities. Risk, after all, is the uncertainty of return.

The 50/50 portfolio has the narrowest return over 5, 10 and 20 years. This is the diversification benefit of combining two asset classes together. Our philosophy is diversification focussed and we use our expertise and in-house technology to optimise diversification. In the long run, with the appropriate amount of risk, we think the returns will follow.

FE Investments Portfolios, Russian and Ukraine holdings

Due to the funds selected we do have some small exposure to Russia and Ukraine, below is the breakdown by portfolio. There is no exposure in our Responible Income portfolio or our Responsibly-Managed range.

Range	Portfolio	Country Exposure	
		Russia %	Ukraine %
Income	Defensive	--	0.07
Income	High	--	--
Income	Income & Growth	0.50	--
Income	Income Stability	0.30	0.09
Hybrid	1 Short	0.15	--
Hybrid	1 Medium	0.01	--
Hybrid	1 Long	0.28	--
Hybrid	2 Short	0.01	--
Hybrid	2 Medium	0.09	--
Hybrid	2 Long	0.16	--
Hybrid	3 Short	--	--
Hybrid	3 Medium	0.10	--
Hybrid	3 Long	0.05	--
Hybrid	4 Short	0.60	--
Hybrid	4 Medium	0.25	--
Hybrid	4 Long	0.54	--
Hybrid	5 Short	--	--
Hybrid	5 Medium	0.31	--
Hybrid	5 Long	0.49	--
Mosaic	1 Short	0.00	--
Mosaic	1 Medium	0.01	--
Mosaic	1 Long	0.01	--
Mosaic	2 Short	0.01	--
Mosaic	2 Medium	0.01	--
Mosaic	2 Long	0.02	--
Mosaic	3 Short	0.01	--
Mosaic	3 Medium	0.02	--
Mosaic	3 Long	0.02	--
Mosaic	4 Short	0.02	--
Mosaic	4 Medium	0.15	--
Mosaic	4 Long	0.33	0.01
Mosaic	5 Short	0.03	--
Mosaic	5 Medium	0.48	--
Mosaic	5 Long	0.55	--