

Ukraine invasion fears drive market volatility

UBS House View - Daily Europe

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What's happening?

Risk assets have faced sensitivity on Ukraine-Russia headlines over the past 24 hours as fears of military escalation again resurfaced. The S&P 500 fell 2.1% and the tech-heavy Nasdaq lost 2.9% on Thursday. Safe-haven assets rallied, with yields on the 10-year US Treasury down 8 basis points to 1.96% and gold briefly rising above USD 1,900/oz before moderating. Brent crude oil declined to near USD 92.5/bbl on Friday amid reported progress in US-Iranian negotiations and talk of Saudi supply measures in the event of any conflict.

Headlines remain fast changing. Earlier on Thursday, US Secretary of State Antony Blinken told the UN Security Council that Russia is "preparing to launch an attack against Ukraine in the coming days," and it could involve "a real attack using chemical weapons." The past 24 hours has also seen back and forth claims of shelling within disputed areas of Ukraine, while Russian officials described tensions as rising.

But sentiment improved early Friday after news Secretary Blinken had agreed to meet Russian foreign minister Lavrov next week. Russia media on Friday again said several convoys of heavy equipment and troops had returned to bases after completing drills, though troop movement claims remain an area of dispute. Asia equities on Friday moderated from their session lows, with the MSCI AxJ down 0.4% and STOXX 50 and Nasdaq futures pricing in a 0.4% and 0.8% rise at their respective opens.

How do we interpret this?

In our central scenario, we still think diplomatic efforts will eventually lead to a dialing-down of tensions. This may take several months, during which the possibility of flare-ups like the one we are experiencing right now remains elevated. But we believe that both sides will ultimately calculate that military conflict comes at a too high an economic and political cost to be worthwhile.

In the event of conflict, tighter sanctions by the West would seriously damage Russia's long-term growth outlook, and domestic sentiment could sour quickly, as the protests in Belarus in 2020, Russia in early 2021, and Kazakhstan this year illustrate.

Market update

ASX 200 -1.0%, Australia leading regional declines.

MSCI AxJ -0.3%, pressure moderating on Russia headlines.

S&P 500 futures +0.7%, US futures pointing to gains.

Brent -0.5%, crude oil slipping to USD 92.5/bbl.

What to watch: 18 February 2022

- UK January retail sales, US January existing home sales, Conference Board leading index
- Eurozone advance February consumer confidence
- Fed's Evans, Waller, and ECB's Panetta speak

Meanwhile, the European Union would also suffer sizable consequences, given that Russian energy accounts for nearly 40% of its gas imports and 30% of its oil imports.

We also think it is unlikely that energy flows would be significantly disrupted even in the event of a military invasion: A prolonged interruption of energy exports to Europe would significantly hurt the Russian economy.

For more of our analysis on the Russia-Ukraine situation, see our latest *Global Risk Radar* report titled “What do geopolitical tensions in Eastern Europe mean for global markets?” dated 25 January.

What should investors do?

Despite the recent volatility, it’s important to remember that we are still in an environment of robust economic and earnings growth, and in our base case we expect upside for equity markets over the balance of the year.

While some of our tactical recommendations, like our preference for Eurozone stocks, may suffer in the event of a military escalation, sectors like energy and financials, value stocks, and commodities are both positioned to benefit from robust economic growth and are relatively well insulated from the primary market risks.

We believe investors can both position for our base case of strong global growth, while also preparing for potential risk scenarios with the following measures:

1. *Diversify and keep a long-term view.* Drawdowns driven by geopolitical stress events are typically short-lived for well-diversified portfolios. As such, investors with diversified portfolios and a long-term investment plan should be well prepared for an eventual relaxation of geopolitical tensions as in our base case, as well as be better able to withstand setbacks from our risk-case scenarios.
2. *Consider geopolitical hedges, including commodities.* Allocations to commodities and energy stocks are an attractive option, in our view, to help investors hedge portfolio risks. Energy prices would likely rise in the event of an escalation in the situation, and regardless of the situation in Ukraine, we expect oil prices to rise further this year thanks to rising demand and somewhat constrained supply.
3. *Prepare for rising rates.* We think investors can mitigate the potential risks posed to portfolios by tighter US monetary policy by tilting toward parts of the market that can outperform in the face of higher interest rates. For example, the financial sector typically benefits as rates rise, thanks to higher net interest income. We would also expect value sectors to outperform growth sectors, such as technology, which face the greatest headwinds from rising rates. In fixed income, we see US senior loans as offering some protection from rising rates due to their floating-rate structure.

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

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Appendix

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