Global Strategy

Russia-Ukraine Risks: What's Priced & How to Hedge

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What risk is already priced in global assets: None

Russian and Ukrainian assets have been impacted, of course, but the channels through which one would expect these tensions to impact global assets have seen little movement. Over the last 30 days: (i) natural gas prices have not been incrementally more volatile, (ii) palladium prices have only begun to recover from close to two-year lows, in line with a pick-up in auto production, (iii) European consumer durables have outperformed their US peers, (iv) ECB's policy rate expectations over one year are 11bp higher, (v) EUR has only moved in line with rates differentials while EM FX is stronger and vol lower (vi) European HY credit has beaten US HY. Any hit to global risk assets has been driven by fears of liquidity withdrawal from central banks; little or no Russia-Ukraine risk appears to be priced in. This should also imply that any improvement in the situation should bring upside only to Russian and Ukrainian, not global, assets.

How did the markets react through Crimea tensions & Russia sanctions in '14?

The main lesson from those episodes was that little happened to international assets. A few non-Russian assets that were meaningfully impacted include those in Eastern Europe, such as PLN and the MSCI CEE index, palladium rallied but little happened to natural gas or oil (which fell hard later in the year). It seems, in not pricing-in any Russia discount to assets, the market is using that 2014 template. But there is a clear risk that the current situation could be more serious. Troops are amassed on both sides of the Russia-Ukraine border; NATO is pushing back harder than in 2014; the US and EU are threatening much more punitive sanctions that could cut trade and financing flows to/from Russia; energy and metals markets are already very tight. Given that the market can arguably be surprised only in one direction, it's wise to look for hedges.

Hedges: FX provides more convex hedges than equities

Equities have already seen a liquidity-tightening-induced move in volatility and skew, so one needs to be very selective in picking protection here. Commodity volatility has risen, though by less than that in equities. But we think it's FX, with volatility still on the floor, that provides the most convex hedges (Figure 8). Below are our preferred hedging expressions. (These are cheap hedges to protect our recommended investments, not our directional market views. As a base case, we remain overweight European equities, overweight Value, long EUR, and paid back-end European rates. JPYZAR long is the only call where UBS Research baseline view is in line with our hedging strategy.)

(1) DAX put spreads

(2) SXEE (European Oil & Gas) call, SX7E (European Banks) put spreads

(3) JPY call, ZAR put

(4) USD call, PLN put

(5) Buy Schatz (2y Germany) vs EUR swaps

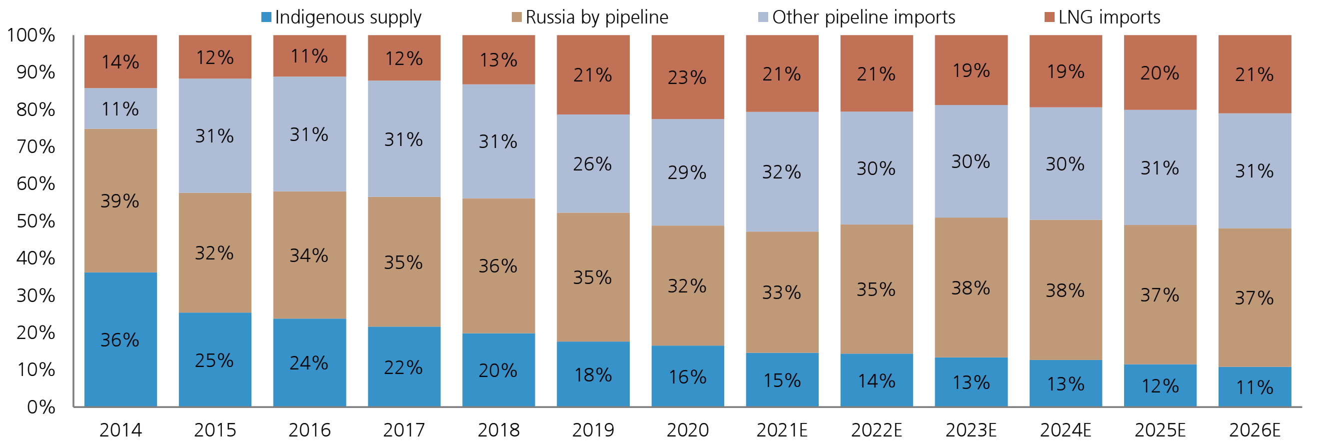
I: What risk of Russia-Ukraine tensions escalating is the market pricing?

Russian equities and FX valuations near 10-year lows. In global markets, little risk being priced in energy markets, near-zero elsewhere

Russian assets have been hit hard. They began to underperform since 10 November '21 and have underperformed strongly since 5 January '22. Since 10 November '21, the trade-weighted RUB is down 9% (now only 4.8% above its 10-year low in January 2016 when Brent oil troughed at $28/bbl); MOEX valuations have fallen to 4.7x on a 12-month forward P/E (10y low of 4.6x in March '14 during tensions in Crimea), and Russian five-year CDS has widened to 226bp (10y widest of 628bp in January '15; much less than history given the de-risking of the Russian economy through lesser foreign ownership, fiscal surpluses, FX reserve build-up).

But, to what extent have Russia-Ukraine tensions been discounted into global assets through this time? To none at all, as best as we can tell.

Figure 1: European gas consumption by source

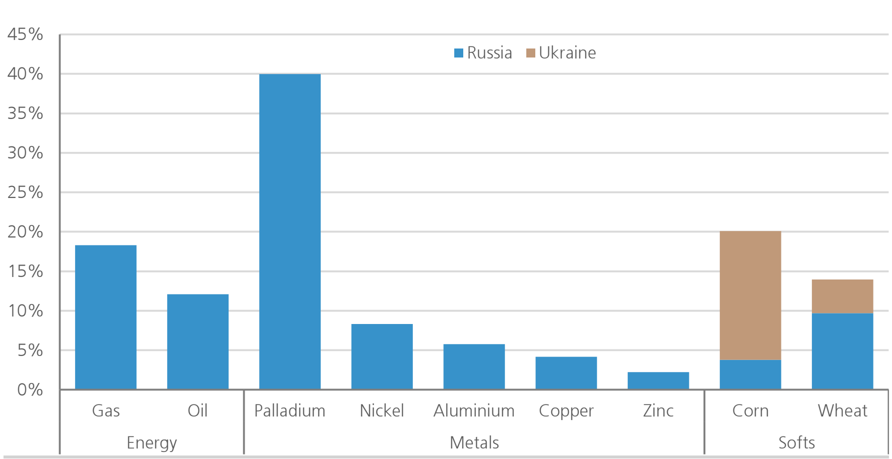


Source: BP statistical review of world energy, Eurostat, IEA, JODI, UBS

Little priced in energy makets: Volatility due to pre-existing market tightness, not Russia tensions

A) Little 'incremental' volatility in natural gas and oil: Gas future prices have risen through January (1st month up 24%, 12th month up 21%) but they have not been incrementally more volatile (nearly flat since early November). Low gas storage utilisation (Figure 5) is symptomatic of high demand (from China) – low supply (from Russia) mismatch, which, given Europe's reliance on Russian gas (Figure 1), has caused price volatility independent on Russia-Ukraine tensions. More than three-quarters of the move higher in gas prices through January has come on days when Russia's own markets have been stronger/stable, i.e. the rise in gas prices was likely not caused by the risks of a military conflict or heavy sanctions. About 4-5pp of 20-25% rise in natural gas prices in January can be attributed to Russia tensions. Crude oil prices have been similarly buoyant amidst low global inventories (Figure 6). Very harshly assessed, about a $6/bbl increase in Brent crude has been seen on days that coincided with higher Russia-Ukraine tensions. That's 8pp of the 12% year-to-date increase in the oil price.

Figure 2: Russia & Ukraine's share of global commodities supply



Source: IMF WEO, IEA, USDA, Haver, Bloomberg, UBS estimates

B) Russia supplies 40% of the world's palladium. It has seen only a modest economically-driven rebound. Even more than natural gas, oil, nickel and wheat, Russia is dominant as a supplier of palladium (Figure 2). Palladium prices have risen in January, but, again, given that the move has come mainly on the days where Russian assets were not stressed, it's likely there are other factors behind the rise. In late-Q4 '21, palladium prices were close to March '20 lows. They have risen since as semiconductor chip bottlenecks eased, creating more demand for the metal as auto production revives.

Nothing priced in palladium: Coming off a low

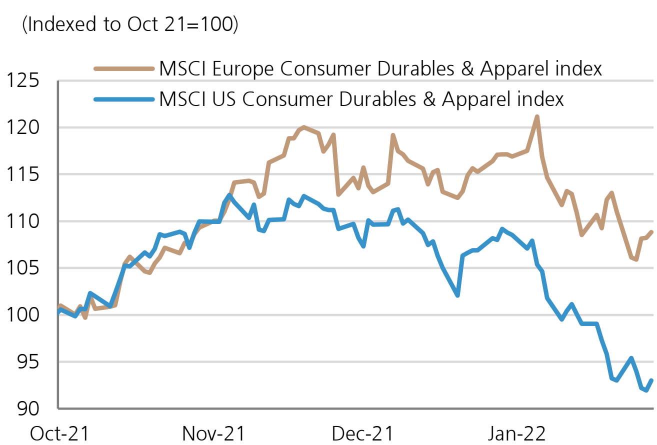
C) No evidence of higher inflation-slower growth worries European consumer stocks: Given Europe's dependence on Russian gas (Figure 1), a European consumer is much more vulnerable to Russia-Ukraine conflict than a US consumer. Presently there is little evidence of the market fearing a hit to European consumer demand from high energy/electricity costs and weaker incomes. European consumer durables have outperformed US consumer durables by 13.4% since mid-November and by 8.8% since the beginning of January (Figure 3). More broadly, European equities have outperformed US equities by around 2.8% over each of the two time frames. Markets are lower because of fears of tighter liquidity, not Russia-related risks, we think.

Nothing priced in the equity markets: European consumer equities outperforming

D) EUR moving in line with rates. EM currencies are stronger, vol is lower: The EUR is weaker, but very much in line with US interest rate differentials against Europe moving wider. As spot has moved lower, EUR vol is higher by 0.7 points since mid-November and by 0.5 points since early January, but is still in the bottom third of its 10y distribution. Meanwhile, EM currencies ex RUB are stronger both against the USD and against EUR, and their volatility has come significantly lower (Figure 4).

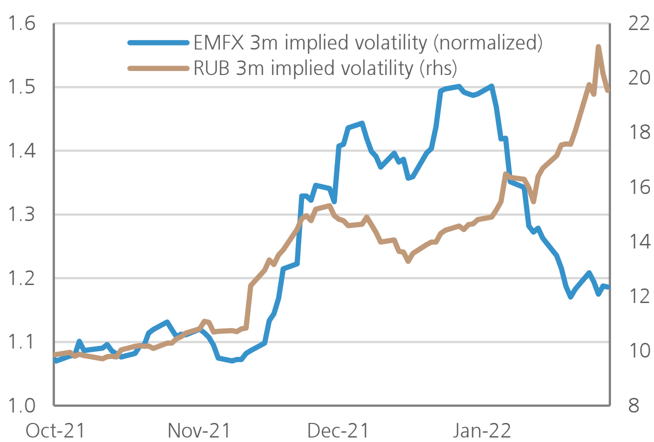
Nothing priced in FX markets: EM FX is stronger and vol lower

Figure 3: European consumer durables equities are outperforming, not underperforming



Source: MSCI, Bloomberg, UBS

Figure 4: 3m implied FX volatility: RUB and EM FX



Source: Bloomberg, UBS

E) ECB is still priced to be more hawkish: Market pricing of one-year-ahead ECB rate hikes has moved higher by 18bp since mid-November and by 11bp since the beginning of January. Higher cost-push inflation and weaker growth will see the ECB become more dovish, not more hawkish. The evolution of EONIA pricing is not consistent with a market worried about a growth-inflation hit from the Russia-Ukraine conflict.

Nothing priced in money markets: ECB still being more hawkishly

F) European credit spreads compressing relative to the US: Both US and European high-yield spreads are modestly wider as higher government-bond yields hurt sentiment, but Europe HY spreads are tighter to US HY by 23bp since early January '22 and by 26bp since mid-November last year. No underperformance here either.

Nothing priced in credit markets: European HY outperforming US HY

That fact that global assets do not appear to be pricing-in the risks of an escalation in Russia-Ukraine tensions implies that any improvement in the situation should bring upside only to Russian and Ukrainian, not global, assets.

II: How did the markets react through Crimea tensions & Russia sanctions in '14?

To understand what to expect in markets through the latest tensions between Russia and Ukraine, as well as potential sanctions on Russia, we looked at market moves during the two phases of similar stress in 2014 (Figure 7):

- Phase 1: Military tensions in Crimea (21 February – 14 March 2014);
- Phase 2: Economic sanctions on Russia (16 July – 12 September 2014).

We looked at market performance through two phases of Russia-Ukraine tensions in 2014. Details in Figure 7

The **main lesson** from those episodes was that little happened to international assets.

- Few equity markets reacted other than Russia's own index in Phase 1. Even Russia's market did not react in Phase 2.

Not much happened to international assets in 2014, and that's the template the market seems to be using today

- Other than the RUB, the PLN was the only currency that was hit in both phases. Through the second phase, the dollar was strengthening broadly, putting commodities under pressure.

- Equity volatility rose in Phase 1 but was better-behaved in Phase 2. The opposite was true for FX volatility amid a stronger greenback in Phase 2.

- Oil was broadly flat through Phase 1 and fell hard through phase 2 (shale supply increasing). Natural gas fell through both phases.

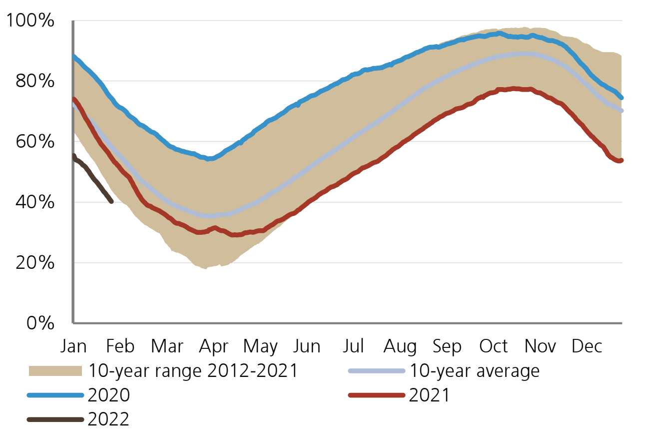
- Palladium rallied through Phase 1, but gave back those gains through Phase 2. Copper fell modestly through both phases.

In not pricing-in any Russia-related discount, the markets seem to be using the 2014 template. But there is a clear risk that the current situation is more serious. Troops are amassed on both sides of the Russia-Ukraine border; NATO is pushing back harder than in 2014; the US and EU are threatening much more punitive sanctions that could cut trade and financing flows to/from Russia; energy and metals markets are already very tight (Figure 5 and Figure 6).

2014 may not be the right template. There is a significant risk that the current situation has larger negative payoffs

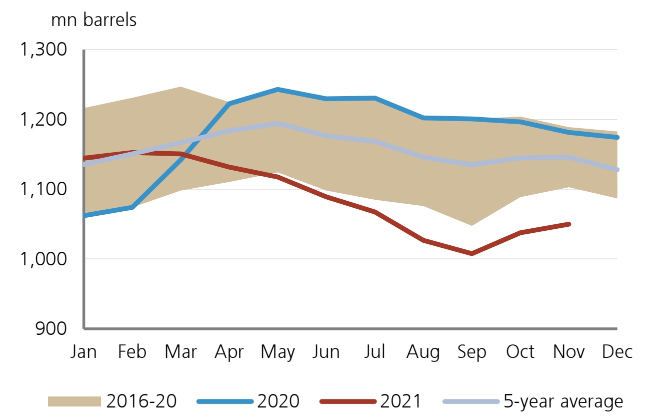
It is plausible that the Russia-NATO posturing does not escalate. It is also very plausible that, similar to Crimea 2014, any escalation would be short-lived and does not impact global growth or global inflation meaningfully. The market may then look past the situation. But that is precisely what it is already doing. Given that close to zero risk is currently priced in global assets, we believe the surprise can only come in one direction. It would be wise to look for hedges.

Figure 5: European gas storage utilisation: A tight market



Source: AGSI+, UBS

Figure 6: Total OECD industry stocks: Another tight market



Source: IEA, UBS

Figure 7: Market performance through Crimea military tensions (21 Feb – 14 Mar '14) and imposition of sanctions on Russia (16 Jul – 12 Sep '14)

	% / pp changes		Size of move in # of std deviations		Vol through this phase as % of vol in previous 60 days	
	Crimea military tensions	Sanctions imposed on Russia	Crimea military tensions	Sanctions imposed on Russia	Crimea military tensions	Sanctions imposed on Russia
Equities						
SPX	0.3%	0.2%	0.1	0.1	83%	134%
NDX	-0.9%	3.5%	-0.3	0.8	82%	105%
RTY	1.4%	0.8%	0.4	0.1	96%	87%
SXXP	-4.1%	0.4%	-1.4	0.1	130%	130%
EU Banks	-3.4%	5.4%	-0.6	0.6	124%	103%
EU O&G	-0.8%	-3.2%	-0.2	-0.5	114%	127%
MXEF	-2.2%	-0.5%	-0.8	-0.2	107%	117%
MOEX	-16.8%	-1.1%	-5.6	-0.1	419%	109%
CEE	-7.9%	2.8%	-2.2	0.6	201%	148%
GCC	1.4%	9.9%	1.1	2.5	158%	56%
China	-5.3%	5.1%	-1.3	1.0	100%	111%
India	3.4%	6.3%	1.2	1.1	89%	71%
FX (vs USD)						
EUR	1.2%	-4.3%	0.9	-2.9	106%	141%
JPY	1.1%	-5.6%	0.5	-3.7	82%	131%
CHF	1.7%	-3.9%	1.0	-2.3	87%	129%
CNH	-1.0%	1.1%	-2.8	1.3	226%	65%
BRL	0.0%	-5.2%	0.0	-1.3	93%	107%
ZAR	2.4%	-3.2%	0.7	-0.8	110%	83%
PLN	-0.5%	-6.1%	-0.3	-2.9	181%	117%
INR	1.5%	-0.9%	0.9	-0.4	87%	102%
RUB	-3.1%	-9.7%	-1.7	-2.8	158%	116%
Government bonds (yields)						
US 2y	0.0pp	0.1pp	0.4	0.8	88%	141%
US 10y	-0.1pp	0.1pp	-0.5	0.4	110%	112%
DE 2y	0.0pp	-0.1pp	0.5	-1.2	117%	137%
DE 10y	-0.1pp	-0.1pp	-1.0	-0.6	133%	111%
Credit (spreads)						
US HY	0.0pp	0.3pp	0.2	1.6	97%	185%
EU HY	-0.1pp	0.1pp	-0.9	0.3	147%	131%
EMBI	-0.1pp	0.2pp	-0.4	1.0	151%	136%
RU CDS	1.0pp	0.5pp	4.9	0.9	172%	116%
Commodities						
Brent 1m	-1.2%	-8.3%	-0.3	-1.7	112%	139%
12m	-0.7%	-4.8%	-0.3	-1.4	116%	129%
Copper 1m	-8.4%	-3.2%	-2.8	-0.6	162%	108%
12m	-7.5%	-3.4%	-3.1	-0.7	207%	121%
Gold	4.4%	-5.4%	1.1	-1.1	82%	84%
Palladium	4.3%	-4.1%	1.3	-0.6	102%	106%
Natural gas 1m	-27.9%	-6.4%	-1.8	-0.6	103%	111%
12m	-8.0%	-3.8%	-1.4	-0.8	109%	128%
Implied vol in equities						
S&P vol	3.1pp	2.3pp	0.7	0.7	89%	212%
NASDAQ vol	3.1pp	1.3pp	0.8	0.4	97%	166%
DAX vol	5.9pp	1.7pp	1.9	0.6	210%	145%
Euro Stoxx vol	5.8pp	1.1pp	1.5	0.4	187%	152%
3m ATM implied vol in FX						
EUR	0.3pp	2.2pp	0.5	2.2	95%	129%
JPY	-0.2pp	3.0pp	-0.2	2.8	69%	158%
CHF	0.0pp	2.3pp	0.0	2.3	102%	142%
CNH	0.7pp	-0.1pp	2.0	-0.2	271%	56%
BRL	-0.1pp	2.3pp	-0.1	1.3	78%	97%
ZAR	-0.4pp	0.5pp	-0.3	0.3	52%	68%
PLN	1.3pp	2.1pp	1.1	2.2	109%	132%
INR	0.0pp	0.1pp	0.0	0.0	85%	111%
RUB	1.6pp	2.4pp	1.2	1.7	204%	129%

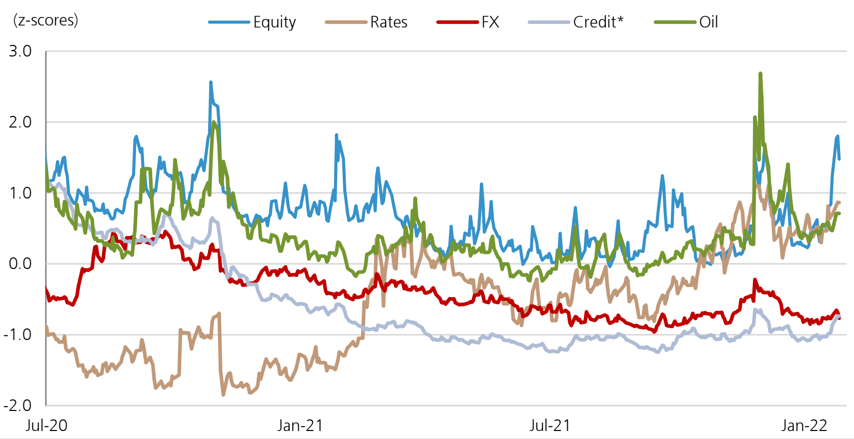
Source: Bloomberg, UBS

III: How to hedge?

Equity volatility is already elevated. FX provides more convex hedges

Equity volatility in major markets is close to the highest levels in a year and is consistent with 1-1.5% moves on a daily basis. Skew has been elevated in equities even when volatility was low, and remains elevated today. One needs to be very selective in hedging through equities. Commodity volatility is elevated too, but less so than in equities. By contrast, both the level of volatility and skew remain closer to their lows in FX, including for risk havens like the JPY (Figure 8).

Figure 8: Implied volatility across assets (normalised): Low volatility makes for more convex hedges in FX



Source: Bloomberg, UBS. *Spreads instead of implied volatility

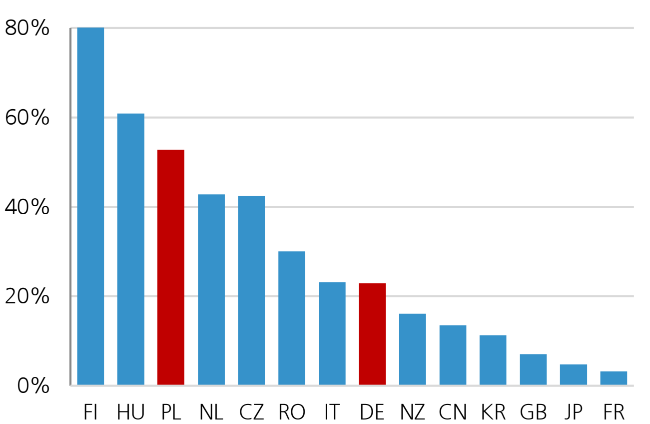
We'd reiterate that what we lay out below are our views on attractive hedges, not directional market views of UBS Research. As a base case, we remain overweight European and German equities, overweight Financials, long the EUR, and paid long-end forward rates in Europe. The only instances where our hedging recommendations coincide with our baseline views are a negative stance on the ZAR and a positive stance on the JPY.

DAX put spreads

High energy dependence on Russia, already high inflation and low volatility relative to developed-market peers make put spreads on the DAX an attractive hedge

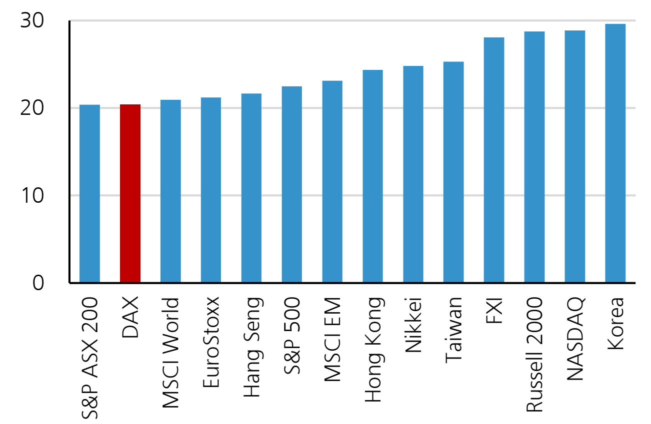
Germany's dependence on Russian energy imports (Figure 9) is in the middle of the range compared with others in developed Europe (higher for gas than for oil). High energy costs have already pushed German producer prices to just under 25% y/y (ex energy ~10% y/y, German HICP ~6% y/y). A bigger energy shock can compromise both margins and consumer confidence while weaker global growth would hit cyclically exposed DAX's revenues harder elsewhere in Europe. DAX 3m implied vol (21.5%, 84th percentile since 2017) is elevated versus history but low relative to recent realised volatility and screens the best across DM benchmarks in absolute terms and in our cross-asset relative value framework (Figure 10). Absolute skew (96th percentile) is very high as European equity markets have generally performed better in 2022 (DAX -3.6% vs SPX -7%); skew tends to decline once a sell-off has occurred. From a hedging perspective that means DAX is less costly while high skew means put spreads will price well.

Figure 9: Oil imports from Russia as % of total



Source: ITC, UBS

Figure 10: 3m ATM implied volatility (%)



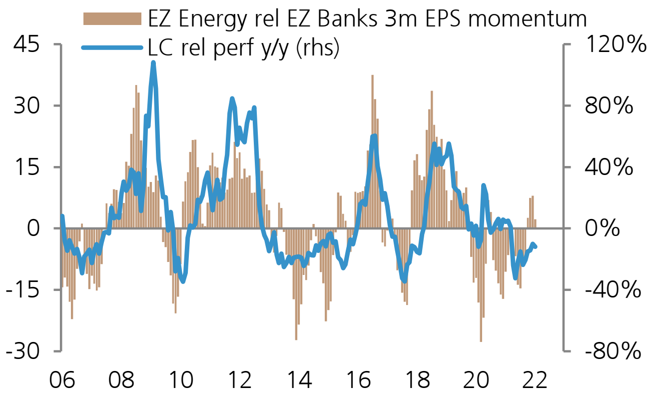
Source: Bloomberg, UBS

SXEE call, SX7E put spreads

A worsening growth-inflation mix likely to reverse the recent enthusiasm on European Financials

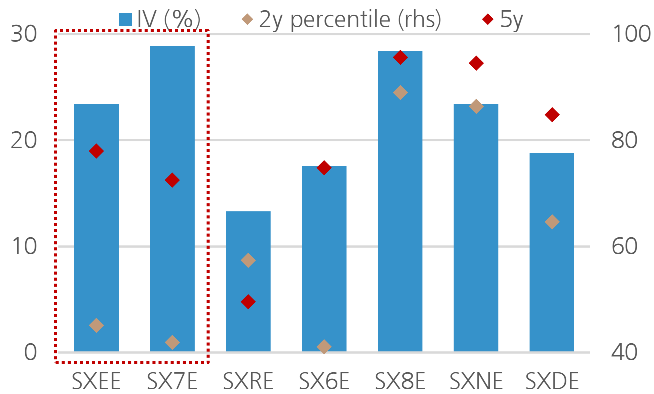
Energy already boasts attractive valuations, positive earnings momentum, and strong cash return (continued share buybacks, dividend yield of 5.0%). While valuations may further derate on an oil supply shock, higher earnings should see this sector hold up better than others. Banks have are already up 26% relative to the overall market, and the relative earnings momentum is fading (Figure 11). A worsening of the growth-inflation (which should mean a flatter yield curve) will hurt both banks' NIMs and ROAs. SXEE and SX7E currently have among the lowest at-the-money 3m and 6m implied volatilities among European sectors (Figure 12). From a two-year historical perspective, SXEE 3m implied volatility of 23% is at the 45th percentile, and for SX7E's 29% is at the 42nd percentile. The SX7E 95/105 skew is high on both the two-year (80th percentile) and five-year (84th percentile) horizons. The option pricing suggests that outright SXEE calls and SX7E put spreads are best suited for the hedge. SXEE 14-Apr 335 calls cost 5.5 EUR (1.7%) with a strike price 6.4% above the current price. SX7E 14-Apr 89/101 put spreads cost 2.4 EUR (2.2%) for protection in -6% to -17% range and best case payout at expiration of 1:5.

Figure 11: European Energy & Banks: Performance & earnings momentum



Source: MSCI, IBES, Datastream, UBS

Figure 12: 3m ATM implied volatility across European equity sectors



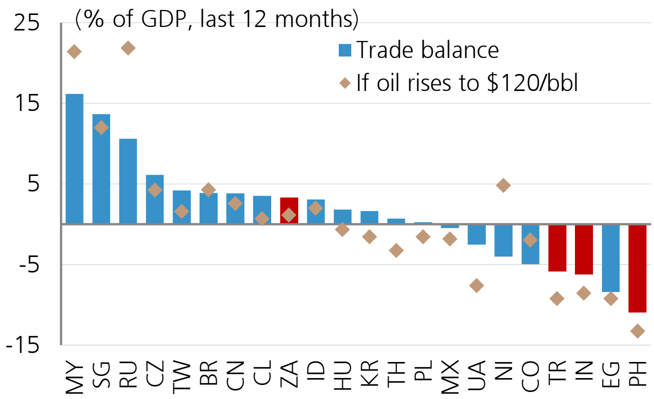
Source: Bloomberg, UBS

JPY call, ZAR put

ZAR hurts as the global growth-inflation mix deteriorates amidst an energy supply shock. The JPY benefits from US hikes being de-priced. Vol and skew are attractive in both

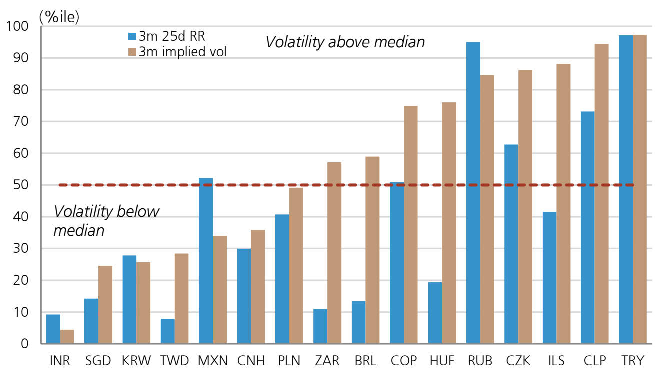
ZAR particularly weakens against JPY during periods of VIX spikes (last 5y correlation ~-0.7). According to our estimates, a spike in oil prices to USD120/bbl slashes 2.1ppt from SA's trade balance/GDP (falling to around 1%/GDP, (Figure 13). 3m risk reversals for USDZAR at 2.3 are below five-year averages (Figure 14). Instead of using ZAR one can also use long positions in JPY against INR, TRY or PHP as hedges against an energy shock. These are all economies where trade balance and inflation react very poorly to higher fuel prices (Figure 13). However, India does have reserves to defend the INR, the carry is very high in Turkey, and PHP can be illiquid. A negative view on the ZAR is therefore our preferred choice for expressing a global growth-inflation shock. JPY moves closely with front-end US rates. With nearly eight Fed hikes now priced in over two years, there is a lot of room for reversal amidst a global shock. A low level of volatility and compressed skews provide an attractive platform to position in this safe haven, which should benefit from a short squeeze, having been under depreciation pressure recently, unlike the CHF.

Figure 13: Trade balance sensitivity to a higher oil



Source: Haver, UBS

Figure 14: FX Volatility and skew (as 10y %iles)



Source: Bloomberg, UBS

USD call, PLN put

This hedge would benefit from both EUR weakness against USD and PLN weakness against higher energy prices would lead to further weakness in Poland's trade balance which has already deteriorated sharply since late 2020 and which fell into a deficit since mid-21 driven mainly by rising commodity/energy imports bill (more severe compared to the Czech Republic and Hungary). Poland's dependence on Russian energy (52% of total energy imports) is larger than that of its peers (Figure 9), and nearly 3% of its exports are directed to Russia (Figure 15). High inflationary pressures (8.6 y/y in December 2021, highest since 2001) are driven by high commodity/energy prices (fuel: 33% y/y, electricity, gas, other fuels: 14.3% y/y in December). We estimate real rates are currently at -635bp (lowest in CE3), and the central bank has so far been less hawkish compared to its peers in the region.

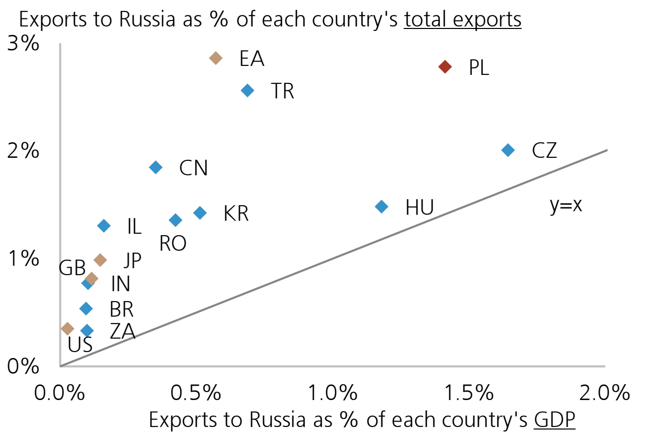
Even if we completely ignore an escalation of geopolitical risk with Russia amidst increasing NATO presence in Poland, the economic rationale is enough to make for a weaker zloty

Buy Schatz (2y Germany) vs EUR swaps

A classic risk-off dynamic in EUR fixed income is to seek the safety of the German front end (Schatz). The Schatz has continued to yield below the ECB's deposit rate as it is considered a store of value for all non-banking entities in the euro area who don't have access to ECB's deposit facility window. In times of market distress, flows move from risk assets to the Schatz, richening cash bonds versus EUR swaps. The latter could face cheapening pressure of their own if the risk-off leads to systemic fears and banking sector stress. As Figure 16 shows, Schatz ASW spreads have shown swift widening in risk events, especially those that have euro-area-wide implications, e.g., fears of Frexit around French presidential election in 2017, Italy general election in 2018 and the start of the pandemic in March 2020. While Schatz ASW is no longer at historically cheap levels (as it was in mid-21), it is still an effective hedge for global systemic risks.

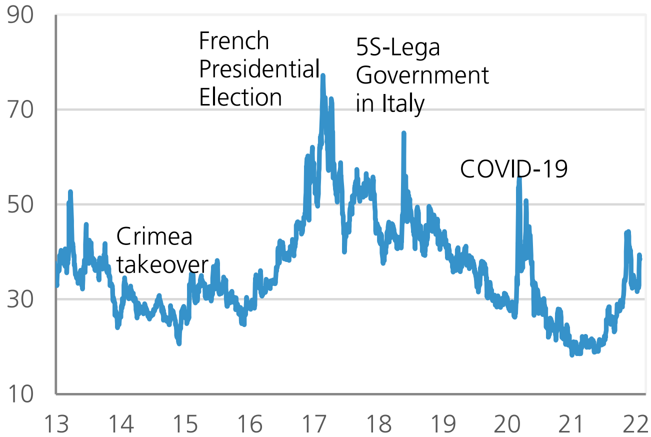
Schatz ASW spreads have shown swift widening in risk events

Figure 15: Exports to Russia in last 12 months



Source: Haver, UBS

Figure 16: Schatz asset swap widener (bp)



Source: Bloomberg, UBS

Valuation Method and Risk Statement

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