Russia-Ukraine conflict
Nikko AM's views

1 March 2022

IMPORTANT NOTICE: The contents within this compilation were written on or before 1 March 2022 and are based on facts known at the time of writing.

Introduction

In order to gain a range of perspectives on the Russia-Ukraine conflict, Nikko Asset Management has gathered the views of the following experts and investment teams, representing many of our major asset classes and geographical regions.

- John Vail, Chief Global Strategist
- Rob Samson, Joint Head of Global Multi-Asset (multi-asset)
- Asian fixed income team (Asian fixed income)
- Eric Khaw, Senior Portfolio Manager (Asian equities)
- Eng Teck Tan, Senior Portfolio Manager (China equities)
- Junichi Takayama, Investment Director and Naoki Kamiyama, Chief Strategist (Japan equities)
- Lucas Irisik, Portfolio Manager/Senior Analyst (global fixed income)

We hope that this range of views will provide a useful reference to readers as they navigate the global financial markets.

John Vail, Chief Global Strategist

As a famous US baseball player once said: "It's tough to make predictions, especially about the future." This could never be more true than today, but a good estimate is that Russian President Vladimir Putin may halt after achieving his primary goal of creating a buffer region of the coastline from the Dnieper River up through Russia's borders. He certainly wishes to avoid as much bloody urban conflict as possible, so much like 2014, when he took Crimea and some border regions and then faced tough resistance locally and globally, he may likely start to de-escalate once achieving his primary goal, which could take several weeks, and hope that much returns to normal. However, his and his country's punishment will likely be long-lasting. In the meantime, he may even feel the need to inflict pain on the West by further cutting energy supplies to Europe to gain leverage, but a severe cut is only a tail-risk.

Although sanctions have been fierce, the allowances for Russian energy and most other critical exports show that economic concerns remain extremely important. The sanctions on SWIFT for some banks and on Russia's central bank are especially fierce, with global ramifications, but they are not fully comprehensive nor permanent; rather they could hasten the speed at which Russia must seek a truce. The developed world knows how much damage a Russian cut-off of commodities could provoke, so there is reason for eventual compromise on many sanctions.

So, as an investor, along with the prospect for a military truce, one can build confidence that governments will support business profits and economic activity. However, knowing that exactly timing the market bottom is impossible, the best posture is to ride through this storm by maintaining long-term exposure to high quality equities.

Rob Samson, Joint Head of Global Multi-Asset (multi-asset)

On 24 February the low probability worst case scenario (assigned just a 35% probability by Eurasia Group as of 23 February) was realised—Russia launching a full-scale invasion of Ukraine, aiming to topple the country's leadership. Predictably, markets reacted violently given the new high levels of uncertainty pertaining to severe escalations of sanctions against Russia and then the Kremlin's response, adding to further inflationary pressures and slowing activity.

Here are some gathered thoughts on what to look for next.

- **Russia reaction to sanctions and potential implications:** The US Treasury imposed sanctions on Russian leadership, including Putin, and these steps have been deemed an act of war by Russia. Select Russian banks are also to be removed from SWIFT, which risks destabilising payment systems and global supply chains. In addition, Russia's central bank will be prevented from deploying its massive reserves, a critical unanticipated move that risks destabilising the country even further. Russia has already cut energy exports to Europe and could cut them further leading to higher prices for sure and likely rationing (not a great plan), which would have a serious negative impact on European growth. European gas reserves are low (it is early spring which helps somewhat), and oil deficits cannot be filled by Saudi Arabia, the US or even a deal with Iran as it would take at least a year to ramp up production. Russia would take a hit to energy export revenues, but based on higher energy prices for what it does export and fiscal buffers at home, the country has better capacity to wage a longer battle on the energy front than Europe probably can withstand.
- **Regional Impact:** Europe is clearly at the epicentre where Germany, the Netherlands and Italy are most exposed to lower gas imports while households and industry are the biggest consumers. Europe is also most vulnerable to inflation, but inflation will be lifted globally to varying degrees. Asia may be less exposed to energy directly, but it may be more exposed to rising grain and potash prices lifting food prices that weigh more heavily in their CPI indexes.
- **Further escalations and ripple effect:** The war may be relatively short, and it is unlikely (according to Eurasia Group) that Putin's ambitions extend beyond Ukraine. Still, we are at the beginning of a tit for tat response, each having specific and probably less tangible ripple effects beyond what is already quite significant. Given the uncertainties surrounding now even higher inflationary pressures, central bank tightening and now slowing growth in Europe and beyond, the adjustment is likely to be painful. US stocks, generally, are far from cheap. Slowing growth and earnings would certainly be a headwind, in our view.

Asian fixed income team (Asian fixed income)

Russian forces launched an attack on Ukraine on 24 February, following months of military build-up along the shared border. This prompted risk assets to sell-off and Brent crude oil to jump more than 5%, breaching USD 100 per barrel for the first time since 2014.

While we believe the direct trade and economic impact to Asia will likely be limited for now, a long, drawn-out war could translate to a protracted period of elevated commodity prices. Consequently, inflationary pressures are likely to rise and household purchasing power is likely to decrease, whereas external accounts of various Asian countries may deteriorate or improve depending on whether they are a net energy exporter or importer.

Inflation rates across Asia have been grinding higher but remain reasonably well behaved within the 2–4% range. India is an exception, with inflation hovering at around 6%. A sustained price rally in commodity prices means inflation rates in the region are likely to remain elevated in the near term. At the same time, Asian central banks are expected to continue moving toward normalising their monetary policies this year. Central banks in South Korea and Singapore have begun tightening their policies and may do so even more this year. Meanwhile, we expect central banks in India, Indonesia, Malaysia and the Philippines to eventually adjust their policy rates in 2022, as they balance support for their countries' economic recovery against the risks of rising inflation.

Within Asia local bond markets, we hold a cautious view on India, on the back of elevated inflation and the country's higher borrowing plans this year. Meanwhile, initial hostilities have had a muted effect on Chinese onshore bonds and investors quickly turned their attention to domestic factors. A swift settlement to the conflict should have a limited impact on China's already muted CPI inflation and we remain overweight on China bonds, as the People's Bank of China is likely to continue easing monetary policy, which should continue to be supportive for bonds.

Given our view that US Treasury (UST) yields will continue to rise heading into US Federal Reserve's (Fed) initial lift-off and normalisation phase, we are generally neutral to slightly underweight on duration in reference to countries whose bonds are relatively more sensitive to UST movements. Meanwhile, foreign positioning in Asia bonds markets is relatively light, making risk of capital outflow relatively low. We also expect global rates to stabilise after the initial phase of the Fed's rate hike cycle.

With the exception of Malaysia and Indonesia, most countries in the region are predominantly net oil importers, thus elevated oil prices would deteriorate their external balances. In particular, major oil-importing countries like India, South Korea and the Philippines will be highly vulnerable to rising oil import costs. In contrast, Malaysia and Indonesia will benefit from high oil prices. Overall, with more than 80% of its crude oil consumption being imported, India is likely to be the most sensitive within the region to soaring oil prices. That said, the significant amount of FX reserves accumulated by the Indian central bank over the years should reduce currency volatility resulting from the anticipated widening in the country's current account. Separately, the impact on the Chinese renminbi is likely to be muted. Despite China being a net oil importer, its net oil/gas imports are moderate in comparison to other Asian economies. Although Russia accounts for about 14% of oil and gas imports, China tends not to follow the US and EU in sanctions that would impact supply. Russia is also not a significant export market for China. Within Asia currencies, we prefer the renminbi, the Thai baht and the Singapore dollar over the Indian rupee and the Philippine peso.

For Asia credits, risk sentiment—already fragile owing to expectations of a more aggressive Fed policy normalisation—will be negatively impacted. Outflows from Emerging Markets (EM) hard currency bond funds and general de-risking by investors are potential risks that can lead to near-term spread widening.

The extent of Russian military action, and the sanctions by the US and its allies, remain uncertain, hence, it is difficult to calibrate how much spreads will widen. We already saw generic spread widening of around 10–15 basis points (bps) across benchmark Asia Investment Grade (IG) credits from yesterday, with some decompression of credit curves, as expected. In early 2014, Asia IG spreads widened around 25 bps in the lead-up to the Russian annexation of Crimea, although the present situation is arguably graver, adding to other headwinds to global credit spreads. Nevertheless, we note that Asia IG credit spreads subsequently tightened around 50 bps in the five months following the annexation of Crimea (from 4 February to mid–July 2014). Although the total return impact on Asia IG credits will likely be cushioned by the drop in UST yields, we expect the spread impact to be greater in the near-term. For Asia high yield (HY), ongoing developments with regards to the China HY property issuers and government regulations would have larger impact.

Eric Khaw, Senior Portfolio Manager (Asian equities)

The escalation of the Russia-Ukraine conflict is a fast developing and unpredictable geopolitical crisis and our hearts go out to the people most affected by the conflict. Whilst direct impact is limited in Asia with most of the region's direct exposure to Russia or Ukraine seen to be less than 10%, indirect impact could be potentially felt through commodities such as wheat, barley, palladium, oil, gas, coal, platinum, nickel and aluminium.

Despite the gloomy reality of a war in Eastern Europe, it is important to note that Asian economies are overall more than strong enough to withstand the commodities price hike even at current elevated levels. In fact, parts of Asia, as major suppliers of upstream commodities and agriculture, could emerge as major beneficiaries of this upstream commodities disruption. An example would be ASEAN countries like Indonesia which could gain from an improvement in its terms of trade through its exports of coal and nickel. In the medium term, Europe would also be expected to beef up its energy security and reduce its dependence on Russian energy supply. We can expect large scale European investments in alternative energy sources and in particular an acceleration in renewables investments, especially if energy prices remain persistently high. Renewable energy supply chains across North Asian economies such as China, Taiwan and South Korea would be major beneficiaries. Suffice to say, while we see opportunities for Asia, we are also cognizant of the areas in the region which are vulnerable to upstream disruptions. In particular, energy importers like India could be subjected to some downward pressure especially as valuations remain stretched in pockets of the market.

Our bottom up approach has primarily been focused on companies undergoing significant positive fundamental changes that can deliver strong sustainable returns in the future. That meant most of our focus has been concentrated on structural areas with policy support such as domestic Asian consumption, innovative healthcare, environment and areas of industrial technology. These are areas which we believe will be fairly shielded from fallout of the ongoing geopolitical conflict. We have taken a more cautious view of energy importers like India over the last few months while taking a more positive outlook on Indonesia and structural base metals such as nickel and copper which are geared towards the electrification of the world. We will continue to monitor the developments in Eastern Europe and remain nimble while anticipating, understanding and reacting to our fast changing world.

Eng Teck Tan, Senior Portfolio Manager (China equities)

Despite the uncertainty that has been stirred by the Russia-Ukraine conflict, China has been on a different monetary path with the developed world. China has been easing since December 2021 and has switched to a pro-growth mode. While the uncertainty stemming from the Russia-Ukraine conflict could accelerate the rise in commodity prices and thereby push cost inflation higher for most producers, China's exports and manufacturing sectors are unlikely to be impacted very much as they have been facing higher prices for the last few quarters and have moved towards higher valued-added and more efficient production.

Even though China is seen as the major economy with close diplomatic ties to Russia, in reality the economic impact Russia has on China is fairly limited. China's trade with Russia is less than 5% of its overall trade, and China could benefit slightly as Russia will now become a guaranteed a source of commodities, especially natural gas. At the same time, China might benefit from the push towards renewable energy by other countries, especially those in Europe, as it is the largest producer of solar equipment. In itself, China will also push for renewables (it already has a strong mandate to do so) and will likely achieve its renewable target sooner.

From a political perspective, there has been discussions on whether the Russia-Ukraine conflict could add to China's tensions with Taiwan. Our view remains that the historical background and the timeline regarding the two situations are different. We believe that there could be significantly more at stake for China in a potential conflict with Taiwan, which will likely attract even more attention from the international community, especially in Asia, and therefore such a development appears less likely. However, China is definitely watching the world's reaction to the Russia-Ukraine conflict. At the same time, given its close economic ties (probably the closest among the major economies) to Russia and status as the second largest economy in the world, the rest of the world is keeping a close eye on China's response to the Russia-Ukraine conflict to decide whether it has a future as a responsible major global power.

Japan equities

Junichi Takayama, Investment Director

Reaction by the Japanese government: Japanese Prime Minister Fumio Kishida wasted no time in condemning the Russian invasion of Ukraine at a G7 meeting and said that the act was a serious violation of international law and Charter of the United Nations. Japan's sanctions on Russia initially included export controls on semiconductors and a freeze on assets held be Russian banks. Japan has gone on to block certain Russian banks' access to SWIFT and joined the international sanction being imposed on Russia's central bank.

Financial impact: While Japan is not insulated from the risk-off sentiment in the overall market stemming from the Russia-Ukraine conflict, it is important to note that the impact on the Japanese market was limited during the Crimea crisis in 2014. That said, the events unfolding in the current economic backdrop poses certain risks to the environment Japanese companies currently operate in. Rising energy prices (oil and gas) as a result of expected supply shortages could weigh on Japanese companies' earnings as price hikes will eventually get passed onto downstream prices. Central banks around the world could react by accelerating the tightening of their monetary policy to curb inflation, which would put downward pressure on economic activities around the world. The Bank of Japan (BOJ) has so far kept its accommodative stance although monetary policies are being tightened around the world, but we will need to keep a close eye on a potential change in BOJ policy. Euro weakness would also dampen the earnings of Japanese exporters with relatively large revenues generated in Europe. This includes electronics, machinery and auto sectors. We will also need to watch out for potential escalation of the situation and additional retaliatory measures/sanctions that could potentially impact Japanese companies directly or indirectly.

Naoki Kamiyama, Chief Strategist

Potential impact of the spike in oil prices on the Japanese economy and markets: The rise in oil prices in the wake of the Russia-Ukraine conflict is unlikely, in our view, to have the same kind of detrimental effect of the oil shocks of the 1970s. The Nikkei, for example, continued to rise between 2012 and 2014 although oil prices remained above USD 100 per barrel during that period. Over the longer term, the economic impact of higher oil prices may be limited, as consumption has already lost some momentum due to lasting COVID-19 restrictions; meanwhile, US-destined exports are expected to continue to shore up the domestic economy.

Government and central bank policy outlook: The rise in oil prices gives the government the opportunity to reinforce its aim of pivoting towards renewable energy, a key policy pillar. It could be a chance for the government to buoy the economy by 1) increasing investments into renewable energy and 2) bringing forward renewable energy goals. The government may also have to provide subsidies to companies with business links to Russia. The BOJ may have to focus on dealing with market volatility resulting from speculative moves as the conflict unfolds. From a monetary policy perspective, it remains to be seen how the inflation story pans out in Japan at a time when domestic demand has been relatively subdued and wages remain suppressed.

How Japanese assets may fare if the conflict is prolonged: There may be some speculation that Japanese assets (stocks, bonds and currency) could become a safe haven if the conflict is prolonged, but we do not think that is likely as the conflict is not expected to deal a severe blow to the major economies at this juncture. The yen could appreciate if the US economy begins underperforming, but such a possibility is limited, in our view, with the US corporate earnings (and Japan's as well) expected to remain relatively steady even if the conflict drags on. We do, however, have to be mindful of the possibility of Japanese exports to the US decreasing if US consumers decide to take a more defensive stance due to higher energy prices.

Lucas Irisik, Portfolio Manager/Senior Analyst (global fixed income)

The unspeakable act of aggression on Ukraine by the Russian military has been met with far-reaching sanctions. Some of these sanctions are aimed at preventing the country's financial sector from raising new sources of funding externally, others aim at reducing the country's ability to import a wide range of technologies. Sanctions by their very nature are designed to inflict such significant economic cost that the military intervention abroad becomes politically untenable, leaving Putin's domestic popularity in tatters, and, in time, leading to his demise. The targeted exclusion of several Russian banks from the SWIFT payment system, and the freezing of Russia's central bank assets, might do just that. The issue is: how long will it take before the de-escalation occurs? Unfortunately for Ukraine, the country isn't a member state of NATO, which effectively leaves it exposed to any act of aggression, which Putin has exploited. The appetite for any military involvement in an open war with Russia has been unequivocally ruled out by the US and Europe alike. The vicious act of aggression by Russia and the heroic act of resistance by the Ukrainian army and civilians alike, has seen an enormous uproar internationally, resulting in a concerted effort by the West at militarising David in effort to withstand the pressure of Goliath, and in the coming days or weeks we will see if these actions prove sufficient.

At this moment in time it is too early to foresee any immediate resolution to this conflict, however, the swift takeover of Ukraine by Russia is starting to look increasingly unlikely. The conflict is entering the stages of urban warfare, where Russia's military supremacy is significantly reduced. Nevertheless, Ukraine's position remains incredibly precarious and the economic and humanitarian cost will become increasingly unbearable, the longer the conflict goes on. As for Europe, the most likely scenario is retaliatory sanctions from Russia, that could lead to restrictions in the flow of oil and gas, which further complicates the already difficult situation domestically, heightening inflation pressures even more. At this stage, it remains unlikely that Putin's territorial ambitions would directly threaten NATO itself, yet the unpredictable nature of any military confrontation makes it impossible to rule it out entirely. However, as long as the conflict centres within the eastern part of Ukraine, this scenario remains a tail risk.

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