CIO Perspectives

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Asset Allocation

Financial market impact of Russia-Ukraine conflict

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Key points

- Rising oil prices to foot the bill for war, as some gain and some lose
- Flight to safety to benefit gold, treasuries, and high grade credit. Demand for hedges are driving gold prices
- Past geopolitical conflict events suggest equity corrections are followed by sharp rebounds as fundamentals are not affected
- Resilient sectors with strong pricing power include semiconductors and health care
- Monitor European Banks for Russian exposure, unless sanctions are broadened

GLOBAL CROSS ASSETS

Returns of cross assets around the world

Index	Close	Overnight	YTD
DJIA	33,223.83	0.3%	-8.6%
S&P 500	4,288.70	1.5%	-10.0%
NASDAQ	13,473.58	3.3%	-13.9%
Stoxx Europe 600	438.96	-3.3%	-10.0%
DAX	14,052.10	-4.0%	-11.5%
CAC 40	6,521.05	-3.8%	-8.8%
FTSE 100	7,207.38	-3.9%	-2.4%
MSCI AxJ	738.74	-3.5%	-6.4%
Nikkei 225	25,970.82	-1.8%	-9.8%
SHCOMP	3,429.96	-1.7%	-5.8%
Hang Seng	22,901.56	-3.2%	-2.1%
MSCI EM	1,154.86	-4.3%	-6.3%
UST 10-yr yield*	1.96	-2.8	45.3
JGB 10-yr yield*	0.20	0.2	13.0
Bund 10-yr yield*	0.17	-5.7	35.1
US HY spread*	3.72	13.0	89.0
EM spread*	396.35	29.2	66.1
WTI (USD)	92.81	0.8%	23.4%
LMEX	4,864.40	1.1%	8.0%
Gold (USD)	1,903.89	-0.3%	4.1%

Source: Bloomberg
* Changes in basis points

Following the escalation of Russia-Ukraine tensions into a conflict, we are being watchful of a potential stagflation scenario, should the situation intensify. Elevated oil prices for a prolonged period could undermine confidence and hurt the nascent recovery as the world is just preparing for a post-pandemic resumption of activities.

While staying cautious over the development of conflict in Ukraine, we have identified potential winners and losers from the crisis:

<u>Positive reaction in markets</u>

- Oil: As Russia is the second largest exporter of oil, and Europe relies on Russia for 40% of gas supply, we see a disruption in oil and gas supply. Expect oil prices to stay elevated for longer in an already tight market.
- Oil majors and energy exposure: Strong earnings outlook arises from higher oil prices Meanwhile, sector valuation remains attractive with strong free cashflow. Resumption of dividends and share buybacks will continue to support the allure of the sector. In particular:
  - i. US Energy stocks have lower exposure to Russia and shale oil could make a comeback.
  - ii. Remain positive on European oil majors as sector laggards to oil prices. Exposure to Russian sanction risks to be mitigated by their geographical diversity in terms of business operations.
  - iii. Asian energy sector exposure in China and Thailand to benefit from higher oil prices.
- Gold: Expect demand for inflation hedges, geopolitical risks, and volatility to rise, leading to higher gold prices. As a hard asset, gold has preserved and risen in value during environments of hyperinflation, stagflation, and negative interest rates. Its attribute of being uncorrelated to risk assets make it an effective hedge during periods of high volatility.
- Gold mining sector: Gold miners are attractive as their correlation to gold price is a lot higher than to equities, shielding the sector from equity volatility while benefitting from higher gold prices. With earnings highly leverage to gold prices, current all-in sustaining costs (AISC) of USD1,200 still suggest a wide profit margin. Sector valuation is attractive.
- Commodity exporters: Countries such as Malaysia and Indonesia can be resilient, with their rich palm oil, natural gas, coal, metals, and minerals exposure benefitting from higher commodity prices.
- Treasuries and high grade credit: Risks in the growth outlook could temper enthusiasm among Developed Markets (DM) central bankers for hiking rates, invoking flight-to-safety flows.
- EM GCC/LatAm credit: High carry, commodity-exporting regions such as the Gulf Cooperation Council (GCC) and LatAm are likely to see tailwinds from higher oil prices.
- US equities: Past geopolitical events suggest corrections are followed by sharp rebounds as fundamentals are not affected.
- Semiconductor upstream supply chain: Winners include companies with pricing power and capacity advantage like IC design firms, wafer contract manufacturers, and equipment makers. Expect a surge in end demand for chipsets as global supply chains expedite production, stock up inventory, and drive up average selling prices. These

firms are less susceptible to geopolitical conditions in Eastern Europe. After the recent rounds of selloff, the sector's valuations appear attractive.

- Health care: We see a surge in end demand for medical supplies and health care solutions. Main beneficiaries include pharmaceutical firms and medical device makers as countries build up medical supplies and health care capacity.

Negative reaction in markets

- Banks with Russian exposure: Russia's large banks are deeply integrated into the global financial system. Banks with exposure to such large banks, especially the European ones, should be monitored if sanctions are broadened or SWIFT being cut off from Russia.
- Germany: Being Russia's trading partner in the European Union (EU), Germany will be the most impacted amongst EU countries. Higher energy prices could slow recovery, and negative impact from halting of Nord Stream 2 is yet to be determined as sanctions are also imposed on companies involved in the project.
- Asian net oil importers: South Korea and Japan are highly industrialised net oil importers. Every USD10 increase in oil price is estimated to worsen trade balance by 0.2% - 0.4% of GDP, and raise inflation by 35-45 bps.
- Russian credit/other assets: Threat of sanctions would provoke asset disposal due to deteriorating domestic outlook and limitations on counterparty trading of securities.
- EM Central and Eastern Europe (CEE) credit: The area's geographical proximity to conflict hotspots poses a risk to the credit market.

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