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Ukraine and the Markets, So Far

Featuring:

Peter Zangari, *Global Head of Research and Product Development, MSCI*

Thomas Verbraken, *Executive Director, MSCI Research*

Adam Bass (00:04):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is March 10th, 2022. To say they have changed since our last episode two weeks ago is an understatement. We're in a totally different world. There's war in Ukraine. Russia's unprovoked invasion has led it to be politically isolated. There have been unprecedented sanctions put in place, bans on Russian oil in the US and UK. But all of these efforts to quarantine Russia from the west have not stopped the uncertainty from spilling over into the markets as well. More devastating of course, than the economic toll is the humanitarian one.

Peter Zangari (00:58):

There's a human toll that is just horrific in terms of what you observe and see on a daily basis,

Adam Bass (01:08):

That's Peter Zangari, MSCI's head of research and product development. Peter's our first guest today. The second is Thomas Verbraken. Thomas is a member of MSCI's solutions research team who has recently used stress testing tool from MSCI to run some scenario analysis in terms of possible events in Ukraine. Thomas also happens to be in Budapest, so he has a very close up view of the war.

Thomas Verbraken (01:38):

What's really terrible to see is the humanitarian crisis unfolding. And I think that's the worst to see from, from that close. Hungary borders Ukraine and people are concerned about the situation. Refugees are arriving here and there's some initiatives as well to help them out.

Adam Bass (02:02):

Next to the real human horrors of war, it can seem almost trite to talk about markets and the economy. But the truth is the fallout from this catastrophe, the fallout hits us all economically. And that too has real human implications. So today we're going to talk about that. We'll address what's on investors'

minds, what concerns they have about uncertainty in the markets, and the results of the two stress tests run by MSCI Research to gauge what may happen in the markets going forward. But first we start with a little perspective from Peter on what that word uncertainty actually means.

Peter Zangari (02:44):

Things are constantly changing, and at certain periods of time, changing more dramatically than others. In times like this, when there's the onset of a war or during a war, there is more uncertainty than risk, so to speak. And what do we mean by that? Well simply put, uncertainty means that you really can't assess risks. You can't put probabilities associated with the risks, very difficult to quantify. But when you talk about risk, by definition, you could assign probabilities to different risks that you face. And that helps you be able to manage the risk. We're in a very uncertain time, and as we all know, on a daily basis, news comes out about if and how the war will be affected, if and how governments will respond and so on.

So again, each day you can even say with each hour, news comes out, some of it truthful, some of it not truthful, which adds another dimension to the uncertainty. But as investors we need to parse through that and do our best to make a determination of what we're observing. How does it affect the markets that we invest in, how does it affect the economies that affect the markets that we in invest in?

Adam Bass (04:18):

And according to Peter, that, unsurprisingly, is what clients are most concerned about.

Peter Zangari (04:25):

Reducing risk, bringing risk levels overall down during times like this is something that I'm hearing. And it reminds me, if I go back to other events, not all crises, one of the approaches that investors take, these are institutional investors take, is they reduce the risk of their portfolio to avoid, again, being hit by large bounce of volatility, that then gives them time to reassess the exposures that they have in their portfolios.

Adam Bass (05:00):

So how is the war affecting the market so far? For that, we turned to my conversation with Thomas.

Thomas Verbraken (05:07):

Markets have been moving quite a bit, of course. Like equity markets in the beginning held study for a while, but now we see losses accumulating compared to pre-invasion levels. The MSCI USA index is

down about 5%, but emerging markets, 10. And for example, MSCI Germany is down by more than 15%. So global markets start to be affected,

Adam Bass (05:34):

But there's more.

Thomas Verbraken (05:36):

Also inflation expectations have gone up while sovereign 10 year yields came down a little bit. And then of course, in exchange rate markets, we've seen the massive depreciation of the Ruble, but also the Euro lost some against the dollar.

Adam Bass (05:53):

And more.

Thomas Verbraken (05:54):

And of course last but not least, oil prices, they've gone through the roof. But even though people, some people think it can even go higher depending on how the situation evolves.

Adam Bass (06:08):

The sanctions we mentioned earlier are taking a toll as well. MSCI, for example, recently reclassified Russia from emerging market to standalone market status, removing Russian securities from MSCI indexes. Other providers have also followed suit. And we also downgraded Russia's ESG government rating to triple C. That's the lowest possible. ESG Now, our sister podcast has an excellent episode about that. If you'd like to learn more.

Peter Zangari (06:42):

What we're observing with the Russia Ukraine war is the impact on energy, specifically the impact on oil. And more broadly, the impact on commodity prices. So you have this large spike increase in prices, not only among oil and gas, but among commodities more broadly. If you think of the metals as an example, there's collateral damage if I put it that way. If you take gas as an example, an increase in prices in and of itself is a stress, particularly for people who rely on driving for their job. So while it's painful to deal with those high prices, what it does if you have a given budget, is you'll tend to spend less on other things because a relatively larger proportion of your disposable income is going towards

gas. So that's an example of where now gas is the trigger for slowing spending in other parts of the economy.

Thomas Verbraken (07:55):

Before the invasion, markets were already concerned about inflation after the unprecedented stimulus during the pandemic. And a lot of people were talking about how monetary tightening could affect the economy. And market's growth, I would say was a little bit less of a concern.

Adam Bass (08:16):

You may recall the recent February jobs report from the US Department of Labor, which saw 678,000 jobs added in February and the unemployment rate fall to 3.8%.

Thomas Verbraken (08:28):

But now with the unfolding tragedy in Ukraine, that has clouded the growth outlook. And so for example, there is the GDP now cost from the Atlanta Fed, which estimated 0% and growth for the first quarter, down from 0.6% on February the 25th. So people are concerned that with already high inflation, also growth might be slowing down. And that's of course a cause for concern. Now, in terms of the impact on inflation expectations since the invasion, we see that they're coming up slightly. So US two year break even inflation is up more than 50 basis points, whereas the 10 year break even inflation is up around 35 basis points. But if you look at German data, we see the two year up by more than 140 basis points and the 10 year by 70 basis points. So while there are concerns of slowing growth, also inflation seems to be edging upwards.

Adam Bass (09:33):

So here's the concern. Add one part inflation to one part slowing economy, and you get something economists dread, not the R word, recession, this is the S word, stagflation.

Peter Zangari (09:48):

Stagflation is when you have inflation, high periods of inflation, or periods of high inflation, along with slowing growth entering into a recessionary period. Or in a worst case situation, a depression. It's this bad combination of high inflation and slow growth, or a negative growth. And that's a challenge. It's something that at least in the US, we've observed, historically, in the late seventies. And the federal reserve took very aggressive actions at the time to combat the inflation that we were facing.

Thomas Verbraken (10:37):

Well, I think what people are most afraid of now is stagflation. The stagflation scenario is what you hear people talking about a lot. On top of that, of course, what markets are really following closely, is how all this will affect the fed's policy and other central banks, whether it could lead to a slower hiking path or not, because that would, of course also have implications for financial markets. And of course, it's also a difficult place to be for central banks because inflation is going up, but with growth concerns, there's the risk that if you're starting to tighten the policy, that you're going to even exacerbate the slowing growth. So I think that's another reason why people are afraid of this scenario because of those trade offs which have to be made.

Adam Bass (11:32):

How has that been playing out? Has the Fed or other central banks shifted their approach since the war started?

Thomas Verbraken (11:42):

That's a very interesting question. And so it is difficult to navigate for central banks. But if we look at what the Fed chair, Mr. Powell Said recently, he sort of backs now at a 25 basis point hike in the March meeting next week, and also a subsequent series of hikes. And if you look at market data, so if you look at market implied probabilities, then you see that markets are now expecting indeed a 25 basis point rate hike, compared to 50 basis points a couple of weeks ago, prior to the invasion. So markets are pricing now a slightly lower rate hike in March. But then going forward, you still see that even though a little bit slower, there's still pricing a series of rate hikes for the rest of the year. And the expectation is six hikes until the end of the year, which seems to be consistent with what the Fed is signaling.

But if you go to Europe, there what people are expecting is that the ECB will likely postpone major policy decisions until there's more clarity. And also this is consistent with market data, which indicates that markets don't expect rate rises in the near future.

Adam Bass (13:09):

So in short.

Thomas Verbraken (13:11):

In Europe, there seems to be the expectation that the central bank will wait a little bit. Whereas in the US, they're expecting that next week, there will be a 25 basis point hike. To be well prepared, investors often rely on, on scenario analysis to see what would happen to their portfolio under a range of outcomes. So basically with the huge uncertainty nowadays, what we like to do is to look at the variety of scenarios, because no one really knows how this is going to play out. We created the first scenarios during the first weekend of the war, but since then, the situation has been evolving very rapidly. Severe

sanctions have been put in place, freezing the international reserves, excluding banks from the SWIFT system. We have defined larger shocks to account for the increased level of sanctions, et cetera. And we also expect increased volatility going forward, daily fluctuations in market levels.

What we also included in our most recent blog post is a more optimistic scenario, which entails the deescalation and central banks navigating this crisis as well, leading to a soft landing. So we wanted to take that also into account in a range of scenarios, because it's a potential outcome, of course. And I think it's one everyone is hoping for.

Adam Bass (14:48):

Under a deescalation scenario, the team found there could be a 4.75% hit to a diversified portfolio and an 8.67% hit to MSCI's ACWI index. But under the grimmer scenario where the global economy is in the grip of stagflation.

Thomas Verbraken (15:08):

We see that a diversified portfolio of global equities and US bonds and real estate could lose about 14% on researched scenarios. So this is the kind of analysis which we're doing to provide some anchor points to investors to deal with this uncertainty.

Adam Bass (15:23):

Did your analysis find that there was anywhere for investors to hide, so to speak? Or are we looking at a 2008 situation? Let me break in on myself for a second here. I just have to say, I have no idea why I was laughing there. Abject terror, maybe willful disbelief, I'm really not sure. But let's go back to Thomas.

Thomas Verbraken (15:50):

Well, the comparison of the 2008 crisis is interesting. So that was obviously a very sharp downturn. But one of the things, what differentiates the 2008 crisis from now is that at that time, sovereign bonds, nominal sovereign bonds, were providing a hedge, so they were gaining at the time the equity market was taking a big hit. Now, unfortunately under a stagflation scenario, that hatch would not be the case. So because of rising rates, because of inflation, also nominal sovereign bonds would take a hit. In terms of places to hide like inflation link bonds, they could provide some protection against this scenario, but nominal bonds would not under this scenario.

Adam Bass (16:38):

We're sort of digging into this, but is this why stagflation is such a scary word for investors?

Thomas Verbraken (16:47):

Yeah, I think that's one of the reasons indeed that you have that offsetting or that cushion against losses that nominal bonds could provide in, let's say an 08 crisis, that disappears.

Adam Bass (17:03):

The last time the US experienced a major stagflationary period was back in the 1970s, when oil price shocks worsened rising inflation during a period of high unemployment. I wondered whether we were looking at the potential for something like that again. And once again, I turned to Peter for perspective.

Peter Zangari (17:25):

Whether you're in an inflationary period, whether you are working through stagflation, the economies are different, society is different in terms of how people work, where value is created in the economy. So much changes over a span of 10, 20, 30 years, that if you come across stagflation again, or even a high inflationary period, it's unlikely to resemble, or closely resemble, what we observed in the past. We in a very fluid period. So I don't think there's any obvious area in terms of how this would play out.

Adam Bass (18:11):

It's true, things are different this time around. While energy is of course still important, the US in particular is far less reliant on oil imports than it was a half century ago. And according to Thomas.

Thomas Verbraken (18:26):

One important differences that global trade is now a lot higher than in the seventies, and that typically helps reducing inflation. But maybe one of the lessons we can take away is that if inflation is already embedded in the system, then additional shocks like energy shocks, could pile up and keep inflation elevated, which is something to be aware of.

Adam Bass (18:48):

At the top of the show, we said that despite the West's best efforts to quarantine Russia from the rest of the global economy, the uncertainty from the war in Ukraine was spilling into the markets, and spilling to markets beyond Ukraine and Russia. There's a word for that, contagion. Thomas is already seeing some of the effect in Hungary.

Thomas Verbraken (19:13):

The Hungarian currency has depreciated by about 10% since the invasion, indicating that there might be some spillovers to the region. A couple of colleagues of mine are looking into a credit default swap spreads, before the invasion and recently. And also in that data, we see that some countries have seen rises in their CDS spreads. For example, in Europe, you see Poland, Hungary, Romania, and Serbia as countries whose CDS spread has risen since the invasion. Also Kazakhstan and Azerbaijan and have seen that. So I think you definitely see in the region, in different types of market data, that there is some concern for spillover. And I think we have to closely monitor that going forward.

Adam Bass (20:10):

Can you explain a little bit about why rising CDS spreads are an indicator?

Thomas Verbraken (20:18):

Yes, of course. So basically a CDS spread, you could think of it as the price of ensuring yourself against default of a bond issuer. So if spreads rise, the cost of insurance goes up, which is an indication that markets deem it more likely that those countries might default, or at least their credit quality is deteriorating. So that's an indication of market's concern about those countries.

Adam Bass (20:52):

Peter had a different take.

Peter Zangari (20:53):

If you just put the impact of the war aside for a second, as difficult as that is, so when we look at today, what we're observing is you see a bit of a rebound from what we observed during the recent drawdown. And again, there's a lot of volatility in the markets, so we don't want to read too much into any rebound because we see on any given day, depending upon what news comes out about the developments in Ukraine, or what news comes out in terms of how a central bank or central banks may respond to the current crisis, will impact the markets. And we see that as something we should expect over the foreseeable future.

Adam Bass (21:40):

It's true, much like the rest of the world, investors will need to adjust, and readjust, and probably readjust again, based on the news that comes out of Ukraine. After two years of doing just that, as we all learned and relearned how to contend with the pandemic, we're all, well, honestly, we're all pretty tired. And all of that is real. And all of that is fair. But as we mentioned at the top of the program, though this show remains focused on helping you understand how the war impacted global markets, I

can tell you with the utmost sincerity that Peter, Thomas, Joe, me, and everyone on up to MSCI's CEO Henry Fernandez, were all too aware of the very real human toll this is taking on those on the ground in Ukraine. That's all for this week. Our thanks to Peter and Thomas, and to all of you for listening. For the latest investment insights on Ukraine, you can access the Russia Ukraine war page on msci.com. We hope to see you back here for our next episode in two weeks. Until then, I'm your host, Adam Bass. And this is MSCI Perspectives. Stay safe, everyone.

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