THOMAS MILLER INVESTMENT

Investment Commentary

Russia's Invasion of Ukraine

March 2022

Introduction

■ Russia launched an invasion of Ukraine on 24th February 2022. In addition to the human costs, Russia's invasion has triggered a series of reactions, including a raft of sanctions and financial market upheaval. This note focuses on the economic and financial market impact of the ongoing conflict and assesses the implications for client portfolios.

Financial market impact

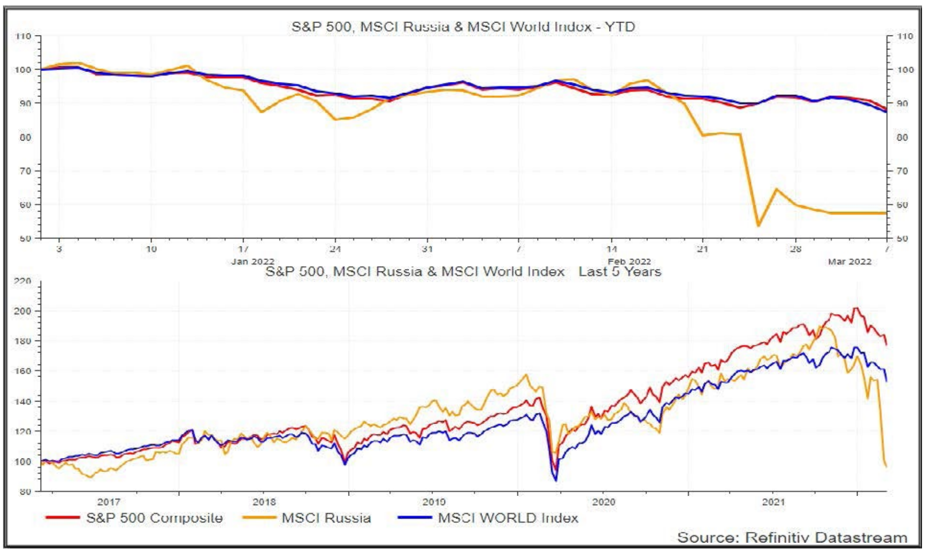
■ Major central banks (particularly the US Federal Reserve and the Bank of England) spent the last quarter of 2021 guiding investors to expect a series of rate hikes in the coming year in response to rising inflation driven by the combination of the ongoing economic recovery, rising commodity prices and disruptions to the global supply chain.

■ Market volatility increased at the start of 2022 as investors prepared for a turn in the monetary policy cycle. However, Russia's invasion of Ukraine has amplified that prevailing downside tilt in markets. At the time of writing (9th March), global stock markets have declined by 10% to 20% depending on the specific index. The worst of the losses have occurred in Russia itself, with the MSCI Russia index having lost over 70% in 2022.

■ Inevitably, the bulk of the drawdown suffered by our clients' portfolios have come from their equity allocations. However, for typical balanced multi-asset portfolios, there has not been much respite from other traditional asset classes. This is because the afore-mentioned expectation of central bank rate hikes has weighed on fixed income markets. For instance, 1-3year government bonds, typically the most sensitive to expectations of tighter monetary policy, have declined in value (about -1.2% on average) across the US, UK and Euro-zone so far in 2022. Corporate bonds have also declined as spreads have widened but index-linked government securities have outperformed their conventional counterparts. Other notable winners have included commodities ranging from crude oil (up about 60% in 2022) and gas to wheat and various precious metals. The spike in risk aversion has also boosted safe-havens such as the US Dollar and gold.

■ The decline in equity markets is illustrated in the chart below which also provides a 5-year horizon for context.

Chart: Market performance in context (2022 YTD and last 5 years)



Economic and policy implications

■ In the post-WWII period, the economic and financial market impact of geo-political crisis have tended to be relatively short-lived. Indeed, a recent paper by Deutsche Bank concluded that on average, such events have resulted in mid-single digit declines in stock markets and the markets have recovered within about six weeks. Additionally, they have typically had no lasting macroeconomic impact. The limited historical evidence has encouraged the view that this time will be no different.

■ However, geo-political risk events are rarely comparable and prevailing macro-economic conditions play a crucial role in determining outcomes. In this context, it is important to note that this particular risk episode is taking place against the backdrop of a severe supply-demand imbalance that has triggered a multi-decade rise in global inflation. By exacerbating the ongoing disruptions to the global supply chain, the primary economic impact of Russia's invasion of Ukraine (and the resulting sanctions imposed by Western governments) will be a worsening of that supply-demand imbalance and an amplification of inflationary pressures.

■ Russia supplies about 11% and 17% of global oil and natural gas consumption respectively (it supplied circa 40% of Western European consumption of natural gas in 2021). Likewise, Ukraine is a major global supplier of various agricultural commodities including wheat and barley (which have both seen sharp price spikes). Clearly, the duration of the war will have a bearing on the severity of the disruptions. Given the recent gains in commodity prices (across both energy and non-energy commodities), war in Ukraine has introduced a significant upside risk to headline inflation and downside risk to economic growth. At this point, as the war continues, there is a real possibility that Western economies would experience double-digit headline inflation rates in the months ahead.

■ This poses a significant challenge for central banks. Both the Federal Reserve and the Bank of England were expected to raise interest rates multiple times this year before the crisis ensued. They, and other central banks, are now faced with even more difficult trade-offs to make: proceed with planned rate hikes and risk crystalising the downside risks to economic growth; or delay policy tightening and risk an extended period of accelerating inflation.

■ On balance, we expect the planned interest rate rises to proceed but the major central banks are likely to be less aggressive, both in terms of the speed and magnitude of hikes, than they would have otherwise been.

Managing portfolios in an era of geo-political uncertainty

■ At this point, there is no way of knowing exactly how far Russia will go in pursuit of victory in Ukraine or how far the West will go to deter further aggression from Russia.

■ Importantly, TMI's investment process is designed to ensure that client portfolios are resilient to events such as this – we have worked with each client to determine the appropriate strategic asset allocation in line with the profile of their expected future liabilities, risk tolerance, capital and regulatory constraints and, where required, corporate credit rating requirements.

■ While we continue to seek opportunities to mitigate risk in the short term and enhance portfolio value by limiting exposure to risk assets, adding inflation protection, seeking opportunistic sector exposure and maintaining cash balances as appropriate, at this point the optimal response is to focus on long term investment objectives and implement asset allocation strategies that align with those objectives.

- For institutional investors, this means maintaining allocations to the main asset classes in line with the positions set out in rigorously designed investment mandates. We are keeping a close eye on developments and reassessing the implications for client portfolios on a daily basis.

Abi Oladimeji
Chief Investment Officer
Thomas Miller Investment
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THOMAS
MILLER
INVESTMENT

London
90 Fenchurch Street
London
EC3M 4ST
T: +44 (0) 207 204 2200

Isle of Man
Level 2 Samuel Harris House
5 - 11 St Georges Street
Douglas
Isle of Man
IM1 1AJ
T: +44 (0) 1624 645 200