Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 28 February 2022

Thinking the Unthinkable

John Wyn-Evans
Head of investment strategy

The past week has not been without incident. We are now well into day five of Russia's invasion of Ukraine, and the outcome remains unclear. Markets are experiencing increased volatility, with moves dependent upon the latest news and we expect that this will remain the case for a while yet. Intra-day trading ranges have been extreme. For example, the NASDAQ Composite Index in the United States, highly populated by technology companies, moved in a seven percent range from an initial trough to its closing peak on Thursday.

Such moves are difficult to deal with from a psychological perspective. On Thursday morning one could have regretted not selling on Wednesday. By Thursday afternoon, and even more so on Friday, one would have been regretting not buying the dip on Thursday. And on Monday morning, following new developments over the weekend, one could be forgiven for ruing not having sold the rally on Friday. As you might imagine, these are conditions in which it is almost impossible to trade, and we believe it is far more important to take a longer-term view and to act accordingly. And if that means doing nothing initially, so be it.

Market performance in the last week

Before assessing potential future outcomes, it might be helpful to look at what happened in markets last week. Had one postulated at the beginning of the week that a full-blown Russian invasion of Ukraine would lead to the key S&P 500 index (SPX) being up on the week, I suspect the response might have been one of scepticism, if not derision. But that's what happened, with SPX gaining 0.8%. Admittedly, the US was a rare beacon of green numbers on trading screens, but neither did the expected carnage materialise elsewhere (apart from in Russia itself, where the MOEX Index fell 32% in dollar terms).

There are a few probable reasons for this relatively benign outcome. First, and the one that was our central view, is that the conflict will not spread beyond Ukraine. Obviously, that is up for review. Second, is that initial sanctions were not as punitive as expected. That situation has changed over the weekend. Third is the fall in real and nominal bond yields, which provided some valuation support, especially if the market thinks that the Fed and other central banks will be forced to weaken their intention to tighten monetary policy. With some inflationary pressures rising, that's up for debate as well. And finally, our old friend "positioning", with the market having by all accounts been set up for a violent short squeeze. At least some of that must have been unwound. All of this suggests that one should not be too hasty to reach any conclusions based on daily, or even weekly, market movements.

Our UK Asset Allocation Committee had a timely scheduled meeting on Thursday morning, and the first thing we had to establish was how much further the situation in Ukraine might escalate. We admit that we are by no means experts on this subject, and therefore have to take in the widest range of opinions that we can and stitch a conclusion from them. We are lucky to have access to restricted meetings with former military figures and diplomats who now consult to investment banks and fund management groups. My latest engagement was with Admiral James Stavridis, who was NATO's Supreme Allied Commander from 2009 to 2013. We have to be cognisant of the fact that none of these experts has perfect foresight.

Russia's nuclear threat

Russia raised the stakes dramatically at the weekend by putting its nuclear forces on high alert. Nobody thinks they will actually use them, but Putin has done a lot of things that most people predicted he would not. The phrase: "Why do we need a world without Russia in it?", uttered by Putin in a 2018 documentary, is worrying, to say the least. Yes, the statement was made in the context of Russia coming under physical attack and being annihilated, which is not (as far as we know) on NATO's agenda, but it does betray a certain mentality. It's fair to say that even a limited "scorched earth" policy could end up being highly disruptive. Think of pipelines being destroyed, or crop-farming regions being contaminated.

The unfolding conflict

Even so, our current central view remains that this conflict will not spread beyond Ukraine's borders. But that view has to come with the caveat that these sands are shifting quickly. Furthermore, even if the conflict itself does not spread further, its economic effects almost definitely will, mainly transmitted through higher commodity prices, with the focus on natural gas, oil and grains.

Something else we must take into account is that events are not unfolding as we believe President Putin expected, and that will have potential implications for his future actions. There seems little doubt that his plan envisaged a swift capitulation by Ukraine's government and the equally swift installation of a puppet government, not the spirited defence that is being put up. There is a plausible theory that he saw a weak link in NATO's united front. Far from it. Germany has announced strong support for Ukraine and, almost incredibly, committed to raising its long-term defence expenditure to two percent of gross domestic product, which the Americans have been crying out for for years.

The impact of sanctions

The weekend's round of sanctions is also, perhaps, more punitive than Mr Putin might have feared. In response to Russia's latest threats, Western allies have increased the severity of sanctions, especially concerning access to the global payments system, although they still appear to be stopping short of doing anything that might cut off energy supplies to Europe.

Key western banks, including those in the US, EU, UK and Canada, have announced sanctions on Russia's central bank. This will stop Russia being able to monetise at least some of its foreign exchange reserves for Russian roubles, which undermines the supposed strength of its foreign exchange reserve position. This could be punitive for the domestic economy. One US dollar bought a hundred roubles at midday on Monday, up from eighty-three at Friday's close. The central bank has reacted by more than doubling the overnight interest rate to 20%.

This is all going to put a lot of pressure on the domestic economy. Whether it leads to sufficient unrest to undermine Putin's position remains to be seen. But one suspects and worries he wouldn't go without a fight or a final dramatic gesture.

We do believe that this situation will eventually be resolved in a manner that will not constitute the Armageddon scenario, and our current investment stance is based on that.

I'm going to leave the last word to Warren Buffett, which are taken from a quote lifted from Berkshire Hathaway's annual results statement that was released at the weekend. Such words are worth bearing in mind during a period when there is so much uncertainty. "People who are comfortable with their investments will, on average, achieve better results than those who are motivated by ever-changing headlines, chatter and promises". We remain comfortable with ours.

Economic Commentary

FTSE 100 weekly winners

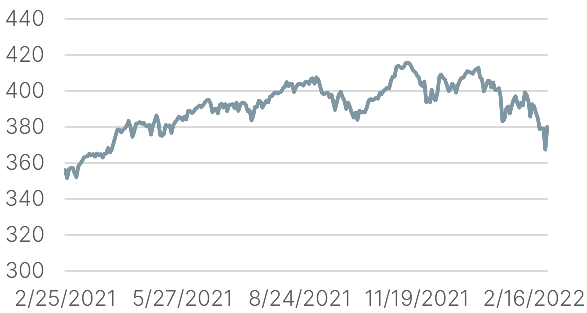
BAE Systems plc	9.3%
Pearson PLC	8.3%
Anglo American plc	5.9%
Rightmove plc	4.8%
Glencore plc	4.1%
Fresnillo PLC	4.1%
SSE plc	3.9%

FTSE 100 weekly losers

Polymetal International Plc	-31.7%
Evraz PLC	-27.7%
Coca-Cola HBC AG	-11.9%
Hargreaves Lansdown plc	-11.4%
Abrdn plc	-10.5%
Rolls-Royce Holdings plc	-9.4%
JD Sports Fashion Plc	-9.3%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months



S&P500 index, past 12 months

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.