



BROMPTON
ASSET MANAGEMENT

Ukraine commentary

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Investors keep calm and carry on as Russia invades

In the early hours of 24 February, Russia's president, Vladimir Putin, declared war on Ukraine. Volodymyr Zelensky, Ukraine's president, responded by saying his country would defend itself. Three days later, both sides agreed to peace talks but Russian nuclear forces were on high alert.

Before the invasion, Western nations said they would deploy sanctions to support Ukraine, not troops. Russia faces isolation, with its banks cut off from the SWIFT payments system. Sanctions on the Central Bank of Russia (CBR) will frustrate Russian efforts to sell foreign assets and support the ruble. The CBR raised interest rates from 9.5% to 20% to protect the banking system and tackle inflation but the economic consequences of higher interest rates may be severe and weaken domestic support for Putin. Other commentators will count the humanitarian cost while I focus on markets.

Market reaction

On the day of the invasion, global equities fell 0.59% in local currencies and rose 1.52% in sterling. Global bonds fell 0.66% in local currencies but gained 1.46% in sterling. UK government bonds, sterling investment grade corporate bonds and sterling high-yield bonds gained 0.08% and fell 0.35% and 0.67% respectively. Oil rose 2.92% in sterling and gold gained 2.98%. The news affected markets differently, with equities in the UK and Europe excluding the UK among the weakest, down 3.52% and 2.80% respectively in sterling. Equities in emerging markets and Asia excluding Japan fell 2.27% and 1.40% in sterling but US and Japanese stocks gained 3.66% and 0.36% as the dollar and yen, typically seen as safe-haven investments at times of stress, rose 2.13% and 1.63% respectively against the pound. This market reaction may seem a muted response given the scale of events. This is because markets are effectively discounting mechanisms and a Russian invasion was expected. Global equities had fallen 9.03% in sterling and oil and gold prices gained 25.15% and 4.25% respectively from 31 December 2021 to 23 February, the day before the invasion; meanwhile, global bonds fell 3.48% in sterling because of fears of rising inflation and interest rates.

The benefits of multi-asset portfolios

The divergent reaction of asset classes highlights the importance of investing via a diversified multi-asset portfolio. Brompton invests across asset classes to harness the benefits of diversification and provide some protection for investors' capital. It is dangerous to take a binary view of the likely outcome of political events when investors may have no special insight and then position portfolios to benefit disproportionately from a sole outcome. During the 2016 Brexit vote, investors expecting a "remain" vote were wrong-footed and underperformed when voters chose "leave". Brompton looks, however, for investments where there is an asymmetry to the outcomes and that may perform well in various scenarios. Brompton has, for example, invested in gold and gold equities, as appropriate to its funds and strategies, because gold, a safe-haven investment, performs well at times of stress as investors seek capital protection. Gold may also perform well in the current economic environment, where inflation is higher than interest rates. Conversely, Europe ex-UK equity allocations are low in most strategies because the invasion will be felt most acutely in Continental Europe and the region's stockmarkets did not appear sufficiently cheap to compensate for this additional risk.

The outlook – inflation

The Ukraine crisis is one reason equities have fallen since New Year. Investors also fear inflation. In January, US, UK and eurozone inflation figures were far above central bank targets at 7.5%, 5.5% and 5.1% respectively. In December, the Federal Reserve accelerated its run-down of asset purchases, which are expected to cease shortly, and pencilled in three interest rate rises for 2022 and a median interest rate expectation of 0.9% by December. The Bank of England ceased asset purchases in December and raised interest rates twice, taking them to 0.5% in

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February. The European Central Bank slowed the pace of asset purchases, which will also cease shortly, and may raise rates this year. The war may exacerbate inflationary pressures from higher energy prices, particularly in Europe. As a result of decisions taken over decades to close coal, nuclear and gas-fired power plants, some countries depend on Russian gas. Following the invasion, Germany's chancellor, Olaf Scholz, suspended plans to open the Nord Stream 2 gas pipeline from Russia. Yet the West's initial response did not extend to banning Russian energy imports. In the short term, Europe may import more US liquid natural gas. In the longer term, it may accelerate its shift to renewables while changes to the European Union's "sustainable finance" plan may result in gas and nuclear projects being classified as "green investments", a startling instance of realpolitik at odds with the European Green Deal, which aims to make the EU climate neutral by 2050.

Equities

The outlook for equities appears positive because headline inflation may not remain at the elevated levels for many more months. Prices are higher because of "cost-push", not "demand-led" inflation, supply chain bottlenecks are reducing and materials shortages may ease as economic growth slows. Savings amassed by people during Covid-19 lockdowns may have been largely spent and this, when coupled with cost-of-living increases such as higher energy bills, may dampen consumer confidence. Equities may perform well in an environment of modest inflation because businesses may pass on higher costs to customers whereas bond investments may fall in real terms. The rotation in market leadership in favour of value

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stocks has extended since New Year but Brompton continues to invest in both growth- and value-oriented investments because growth companies with high barriers to entry may be more able to pass on cost increases through higher prices than value companies. On the day of the invasion, global growth stocks rose 2.88% in sterling, outperforming the 0.31% gain by value stocks.

Bonds

As growth slows and supply chain bottlenecks and materials shortages ease, interest rates may normalise more slowly and peak at a lower level than some expect. Brompton has focused on short-duration and inflation-linked bonds, which provide some protection from rising inflation and interest rates. This strategy yielded results in 2021 and Brompton is looking to take profits and increase its holdings in conventional longer-dated bonds because investors' fears on inflation may be overdone. This dovish view may be implicit in the US treasury bond yield curve, which plots the yield against the time to maturity for US government bonds. The key US 10-year treasury bond yield is close to 2% despite rising inflation. The US treasury bond yield curve has flattened since New Year as shorter-dated bond yields have risen more than longer-dated yields, implying higher inflation may be short-lived and that investors fear rising rates may stifle longer-term growth.

Gold and currencies

Gold provides diversification and may offer some protection to capital in the event of a central bank error or an extension of the war. The multi-currency nature of Brompton's portfolios may also provide some protection for sterling investors.