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The Impact of Russia's Invasion of Ukraine on World Markets

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As a result of Russia launching a full-scale invasion of Ukraine, it is clear that world markets are initially in a full-scale 'sell' mode. These kind of panics are common when events occur where the economic and financial impacts are hard to assess, but such abrupt falls are almost always an over-reaction relative to the actual impacts. We generally recommend that investors in US and international stocks do not make precipitous moves out of their investments at a point when markets are at their worst; that's always a recipe for unnecessary losses. The medium and long-term impacts of the Russia conflict are likely to be modest on economic growth and earnings, albeit there will certainly be more pronounced effects on specific sectors. The US and EU sanctions could also experience some impact on specific sectors, but again, these will be largely contained to a handful of companies.

Let's first unpack the impact of Russia itself and the sanctions effect. Because Russia is principally a producer of energy and raw materials, the impact on commodity prices – and particularly oil prices – will initially be steep. A summary of potential impacts are as follows:

- European Markets. In addition to the impact on Russian markets themselves (down 50% in 3 days), European markets will be most affected amongst major world markets. Sanctions will likely affect some banking transactions. Only a handful of Austrian and Italian banks have any significant exposure to Russia, e.g. Unicredit, Creditanstalt, Raiffeisen, etc. The French bank Credit Agricole also announced about $20 billion of exposure, which is 'manageable' according to the bank relative to its $2.3 trillion balance sheet.

- Energy Markets. Oil prices are rising, principally as there is a risk of supply disruptions. Russia is the third largest producers of oil in the world, albeit about three quarters of that production is consumed domestically. A significant amount of natural gas consumption in Europe is Russian-supplied, a larger portion of which flows through Ukraine. European countries have 3-6 months' worth of supplies in storage wells and have withstood disruptions before and are poised to do so again if necessary.

- Sanctions. US and European sanctions are likely to be a significant hit to the Russian economy. However, the Russian economy is actually quite a small contributor to world economic growth, and apart from energy and metal prices, the threat of supply disruptions will be manageable in the medium to long term. Russia may try to 'weaponize' its natural resource supply (against its own financial interests) in the hopes of weakening sanctions. However, such a move would likely lead to increased oil production from Saudi Arabia and more marginal wells in the US. Some niche metals like palladium – critical to catalytic converters – are principally supplied by Russian mines. So gasoline powered automobile production could experience even more supply disruptions.

- Inflation. Increased energy and commodity prices will likely filter through to inflation, which was already significantly elevated as a result of pandemic supply disruptions and central bank monetary easing meant to stimulate growth.

- World Economic Growth. Depending on the level of supply disruptions, world economic growth could be negatively affected for a couple of quarters. Europe would obviously be most exposed to this impact, although the real impact will probably be more muted after an initial downdraft as alternative supply chains are ramped up for any natural resource disruptions.

- Fed Bind. The Federal Reserve will find itself in a bit of a bind. It has been signaling for several months now that it will move more aggressively with interest rate increases in order to choke off inflationary pressure. This was already negatively affecting markets. Now the Fed will have to assess whether it needs to remain accommodative to provide a counterweight to the Russian drag on economic growth at exactly a time when energy and natural resource supply disruptions will be adding to inflationary pressures.

- Tech and Growth Stocks. While perhaps counter-intuitive, tech and growth stocks may actually be less affected in the medium term than sectors like manufacturing. For months now, growth stocks have seen downward price pressure as the prospects of Fed tightening has weighed on their valuations. Higher interest rates tend to increase the risk-free rate component in equity discount rates, and this tends to have disproportionate impact on companies with more of their cash flows expected in the distant future. With Russia's invasion, there is a 'normal' exodus to US Treasuries, and this actually pushes down that risk-free rate (10-year bonds). The net effect is likely to counter some of that recent pressure on growth prices. Tech companies also do not have any exposure to resource supply disruptions. You see that impact even today, where the Dow Jones index was down more than 2% mid-day, while the tech-heavy NASDAQ was only 0.2% down.

We fully believe that Vladimir Putin is likely driven to capture most or all of Ukraine because of a quasi-Soviet empire mentality rather than for any expected economic benefits. Indeed, the sanctions will most likely have a far more negative impact on Russia than any economic gains it would receive from capturing Ukraine. This is to say nothing of the likely human cost of the war to both soldiers and civilians. Russia is now a nation of less than 150 million people with an even more severe demographic problem than in Western industrial countries. While it has deeply capable special forces with experience in places like Chechnya and Syria, the bulk of its standing army is made up of conscripts. That makes it unlikely that Putin has the resources and the will to invade deeply hostile Central and East European countries. Ukraine is roughly 50% Russian-speaking, and its cultural links to the Russian empire run much deeper for Russians than that of the East European countries which are now members of NATO.

What you should consider doing, if anything:

1. Don't panic. There is no need for a wholesale selling of US or European stocks. As we have stressed, the medium-term impact of this regional war is likely to be pretty muted on stocks and bonds. Moreover, if history is any guide, stock markets will probably recover some or all of this recent decline within six months of the invasion. It should be borne in mind that U.S. and European markets thrived for most of the Cold War even as the Soviet Union was largely entirely outside the world economic system.

2. Bargain Hunting. If you are otherwise buying certain stocks appropriate for your portfolio, a crisis like this may make prices and valuations more reasonable. Again, this only applies to investors with a long-term risk horizon who are otherwise planning those investments.

3. Potential Winners: defense stocks, oil and gas stocks, natural resource companies, Australian stock market, cash-flow-rich big tech, inflation-resilient stocks (some financials), TIPs (inflation-adjusted bonds), possibly Chinese industrial stocks.

4. Potential Losers: Russian markets (RTS index down 50% in February), Austrian and Italian banks, Hungary, emerging market ETFs, German low-end manufacturing, select US manufacturing companies, possibly the Taiwanese stock market.

About the Author

Scott Vicary worked for 14 years in private equity, of which 10 years were as a managing director for East European investments. Prior to working in private equity, Scott worked as an East European equity analyst at James Capel (HSBC), and as a financial analyst with the World Bank undertaking energy sector loans to countries in the former Soviet Union, including Ukraine. Scott received his B.A. in Russian and East European studies from the University of Pennsylvania, an M.Phil (masters) in Soviet Economics and Politics from Oxford University, and a graduate certificate in Russian translation from American University. He is fluent in Russian and has worked throughout the former Soviet states. Scott joined Sulzberger Capital Advisors as a senior portfolio manager in February 2020.

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