

SPECIAL EDITION

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WEEKLY



Wealth
Management

Perspectives from the Global Portfolio Advisory Committee

February 24, 2022

Risks become realities: Consequences of Russia's strikes on Ukraine

Kelly Bogdanova – San Francisco

The “looming” geopolitical threat has become a reality, cascading uncertainty over markets. While the situation is fluid, history shows the equity market impact could play out in short order even if the conflict lingers. We look at what the real risks to the market are, and what investors should be alert to as events unfold.

Financial and energy markets have been jolted by Russia's precision missile strikes on Ukraine and rapid deployment of troops, tanks, and armored vehicles deep into Ukrainian territory.

The Armed Forces of Russia hit many major Ukrainian army and air force bases, and either struck or landed on some naval bases. There are conflicting media reports about whether the coveted Odessa naval base on the Black Sea has been taken, a port and city very important in the context of Russian Imperial and Soviet military and cultural history. Since 2014, NATO ships, including those of the U.S. Navy, had repeatedly docked in Odessa and launched naval exercises from there.

A number of the Ukrainian military facilities that Russia targeted with missile strikes were constructed with the help of NATO countries' forces and funds, and were locations where NATO military instructors had previously trained Ukrainian troops. Stockpiles of NATO-supplied weapons were also targeted.

The Armed Forces of Belarus joined with Russia in the assaults on certain areas of Ukrainian territory, within the framework of the two countries' joint Union State arrangement, which has become much more

comprehensive since mid-2020, especially on military coordination.

Upon the news of the widespread military strikes, energy commodity prices immediately surged and equity markets sold off. As of this writing, the S&P 500 Index moved into slightly positive territory late in today's trading session, and Canada's S&P/TSX Composite Index is down only marginally due to support from the Energy sector and other commodities. The UK's FTSE All-Share Index, the STOXX Europe 600 Index, and Hong Kong's Hang Seng Index closed down 3.7 percent, 3.3 percent, and 3.2 percent, respectively, on Thursday.

These equity market losses come on top of geopolitical pressures that markets had faced for roughly two weeks prior, and selloffs before that due to ongoing high inflation trends and indications that central banks will accelerate their rate hike cycles. All told, the S&P 500 is currently down 11.6 percent from its January 3 all-time high, as of intraday trading today.

This conflict is part of a wider struggle

As we stated in our recent [geopolitical report](#), we believe the conflict between Russia and the Ukrainian

For perspectives on the week from our regional analysts, please see [pages 4–5](#).

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government is deeply rooted in a much wider struggle between Russia and the U.S./NATO.

This struggle is about spheres of influence between major military powers, NATO's expansion eastward and involvement in the former-Soviet space since the end of the Cold War, deployments and flight times of advanced missile systems in Eastern Europe, locations of short- and intermediate-range nuclear weapons, competition for energy sector market share, and more.

It is unclear how events in Ukraine will ultimately play out—there is now the possibility that the country's borders will end up being much different than they have been for the past 30 years of its statehood, or that its leadership will change.

Regardless of what occurs in Ukraine, we continue to believe that Russia is more focused on its wider, primary security interests that entail negotiating the following with the U.S. and NATO:

- The non-expansion of NATO;
- The non-deployment of NATO strike weapons systems near Russia's borders; and
- A return to the 1997 configuration for the deployment of foreign forces, equipment, and weapons on the territories of countries that were not NATO members at that time.

History as a guide to market performance

Even though Russia's strikes on Ukraine have no analogues in modern warfare—especially due to Ukraine's relationship with NATO countries—it is important to keep in mind how financial markets generally reacted to previous wars and serious geopolitical events. After all, almost all of those situations were also unique.

In the 18 post-World War II events that we evaluated, the S&P 500's selloff was limited in magnitude at 6.2 percent, on average, and typically played out over a brief period, as the table illustrates. At times the selloff commenced before the actual war/hostility started (as in this case), and at other times the selloff began right when war or the event hit. Our table attempts to take into account any relevant pre-war and pre-event periods of weakness.

While this 6.2 percent level of decline is nothing to dismiss, it's well within the bounds of a typical pullback in many scenarios that often confront markets, including those that have nothing to do with military risks.

On average, the pullbacks and corrections tended to last 30 days from the time the selloff

began until the market climbed its way back to even. This occurred despite the fact that many of the actual events lasted longer—sometimes much, much longer.

It's notable that two deeper and longer-lasting corrections were associated with events that meaningfully disrupted energy markets, weighing on economic growth—a risk in this case. The instances when this occurred, which are highlighted in orange, were in 1990 when Iraq invaded Kuwait and seized its oilfields, and back in 1973 during the Yom Kippur War and Arab oil embargo. The market declined about 16 percent in each of these cases.

Thus far, we estimate that the S&P 500 has been negatively impacted by risks associated with geopolitics and Ukraine since February 11—this is the date that we observed equity industry traders begin to write consistently about these risks. (The energy market was sending warning signals earlier, going back to late 2021 when oil prices began to surge, soon after Moscow

S&P 500 responses to select acts of war or hostilities since World War II

| Event | Start date* | Trading days to trough | Percent change to trough | Trading days back to even |
|---------------------------------------|--------------|------------------------|--------------------------|---------------------------|
| U.S. | | | | |
| U.S. spy plane shot down in USSR | May 7, 1960 | 2 | -0.6% | 4 |
| Bay of Pigs invasion | Apr 15, 1961 | 6 | -3.0% | 14 |
| Cuban Missile Crisis | Oct 16, 1962 | 6 | -6.3% | 13 |
| Gulf of Tonkin Incident (Vietnam) | Aug 2, 1964 | 4 | -2.2% | 29 |
| Tet Offensive (Vietnam) | Jan 29, 1968 | 25 | -6.0% | 46 |
| Cambodian Campaign (Vietnam) | May 1, 1970 | 18 | -14.9% | 86 |
| U.S. invades Grenada | Oct 25, 1983 | 11 | -2.8% | 15 |
| Lead-up to U.S. Panama invasion | Dec 15, 1989 | 2 | -2.2% | 8 |
| Lead-up to Gulf War (Desert Storm) | Jan 1, 1991 | 6 | -5.7% | 13 |
| U.S.-led NATO bombs Yugoslavia | Mar 24, 1999 | 3 | -4.1% | 11 |
| U.S. spy plane captured in China | Apr 1, 2001 | 3 | -4.9% | 7 |
| War in Afghanistan | Oct 7, 2001 | 1 | -0.8% | 3 |
| Lead-up to Iraq War | Feb 5, 2003 | 24 | -5.6% | 28 |
| External | | | | |
| N. Korea invades S. Korea | Jun 25, 1950 | 15 | -12.9% | 56 |
| Lead-up to Six-Day War (June 6) | May 14, 1967 | 15 | -5.6% | 20 |
| Yom Kippur War, Arab oil embargo | Oct 6, 1973 | 42 | -16.1% | 6 years [^] |
| Soviet-Afghan War | Dec 24, 1979 | 7 | -2.3% | 10 |
| Iraq invades Kuwait, oilfields seized | Aug 2, 1990 | 50 | -15.9% | 131 |
| Average | | 13 | -6.2% | 30 |

* The date attempts to capture any material pre-event impact.

[^]Other economic and monetary policy factors negatively influenced the number of days it took the market to get back to even; this is not counted in the average number of trading days back to even.

Source - RBC Wealth Management, RBC Global Asset Management, Wikipedia, National Security Archive at George Washington University, U.S. Naval Institute

delivered its formal European security proposals to Washington and NATO.)

Since February 11, the S&P 500 has pulled back 4.2 percent as of intraday trading today.

If there is some dialing down of hostilities or hints that diplomatic progress can be made—there is actually scope for this to occur—pressure on financial markets should ease. However, if tensions remain extremely high or additional military events unfold, equity markets could continue to sell off.

Energy and sanctions uncertainties are the immediate risks to equities

Importantly, energy sector risks are ever present today, particularly if sanctions hit the Russian energy sector further, or if the pipeline that carries natural gas from Russia, via Ukraine, to Europe is damaged. The RBC Capital Markets commodity team points out that there is not enough spare liquefied natural gas capacity to replace Russian pipeline gas should pipelines to Europe be cut off. Furthermore, natural gas storage levels in Europe are much lower than normal—there is little room to maneuver.

It is unclear at this stage which types of strong sanctions will be applied by Western governments on Russia, and which types of counter-sanctions Russia might implement. After months of debates about various sanctions scenarios, Western capitals still seem like they have not yet reached a consensus about whether Russia will be cut off from the SWIFT financial payments network, but it is looking increasingly possible.

Sanctions uncertainties pose additional risks for equity markets, and energy, agriculture, and metals markets, and global economic growth in general. We think this is the main concern of developed equity markets at this stage.

The economy will set the longer-term tone for markets

Ultimately, after the immediate equity market impact of the Russian military assault fades, the trend of the U.S. and global economic and earnings growth will set the tone for developed market equities going forward, in our view.

The good news is, heading into this crisis, all seven of our leading U.S. economic indicators were healthy—flashing green—and none of them were hinting of recession risks.

The current Q4 2021 corporate reporting season, which is drawing to a close, has shown solid earnings, revenue, and profit margin trends. Management teams have largely issued constructive guidance despite the ongoing inflation challenges and lingering supply-chain issues due to COVID-19.

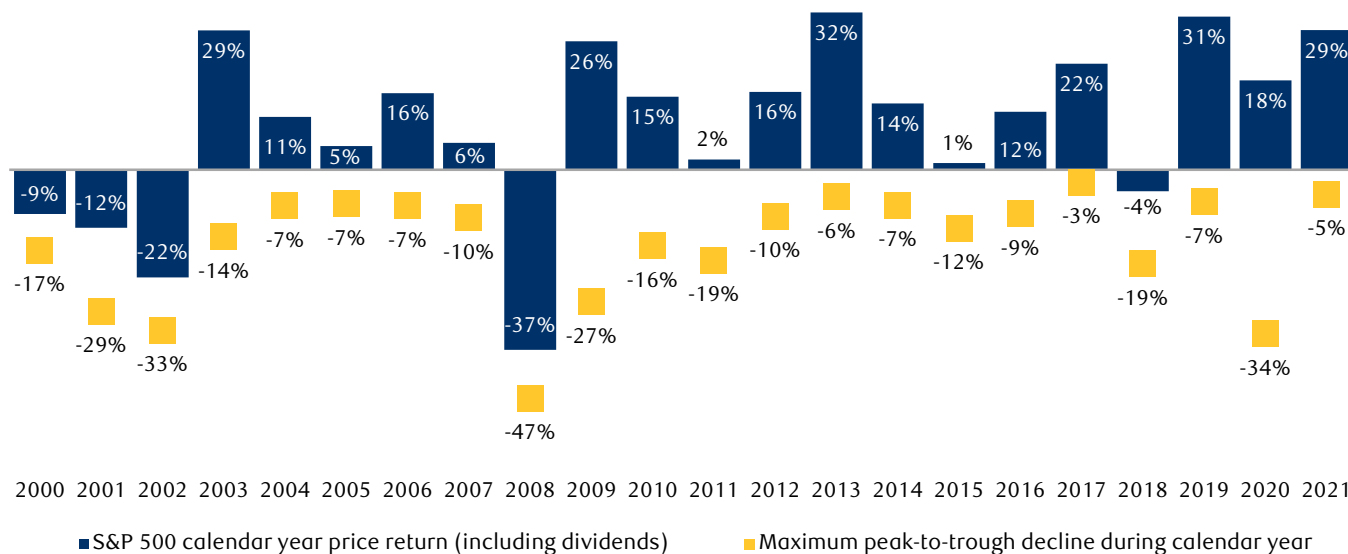
Furthermore, it's important for long-term equity investors to consider that corrections of 10 percent or more are not uncommon, even in good years. The S&P 500 pulled back by this level at some point during the year in more than half of the years since 2000, as the chart shows.

Stay alert to how the situation evolves

Events in Eastern Europe are unfolding rapidly and have the potential to impact financial and energy markets further in coming days and weeks—much could depend on the specific sanctions and counter-sanctions that are implemented and whether they impact Russia's overall crude oil supplies and European natural gas supplies.

But if history is a guide, and if cooler heads prevail in Washington and Moscow regarding sanctions and counter-sanctions, the equity market impact associated with this conflict could play out in short order, even if the ongoing dispute between Russia and the U.S./NATO lingers for a longer period.

Reality check: Pullbacks happen even in good years; since 2000, more than half of the years have included pullbacks of 10% or more for the S&P 500



Source - RBC Wealth Management, Bloomberg; data through 12/31/21

UNITED STATES

Atul Bhatia, CFA – Minneapolis

■ **Treasury bonds rallied as Russia's invasion of Ukraine sparked a flight-to-safety bid.** Yields—which move inversely to prices—are now down nearly 20 basis points (bps) from last week's highs, with 10-year U.S. government debt yields approaching 1.85%. The offsetting moves between equity and fixed income prices restored the traditional inverse relationship between the two asset classes and highlighted the importance of diversification.

■ **For the Fed, the invasion and NATO's likely response create several potential concerns, in our opinion.** Declining risk appetite and consumer balance sheets weakened by falling asset prices have the potential to constrain growth, as consumers may postpone purchases and businesses could defer investments until there is greater certainty. Traditionally, growth risks would be met with more accommodative Fed policy. On the other hand, rising food and energy prices—alongside potentially broad trade disruptions—are likely to keep inflation elevated, potentially arguing for a faster pace of rate normalization. So far, interest rate futures are reacting to the news by reducing positions that favor a 50 bps rate hike next month but continuing to price a near certainty of a 25 bps hike in March. We believe this latter outcome is the most likely, as even pre-invasion we saw a limited argument in favor of a 50 bps hike, believing that any price stability implications would be outweighed by potential complications in communicating Fed strategy.

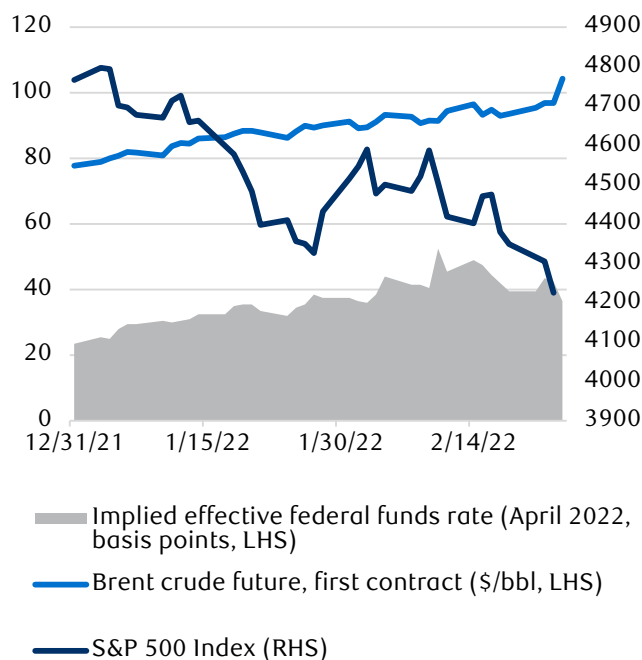
■ **Corporate bond prices are generally declining,** as the benefits of lower Treasury yields have been overshadowed by widening credit spreads and declining risk appetite. For credit investors, one of the main concerns is the potential for rising input costs, particularly in food and energy, to lead to margin contraction. The risk could be amplified if consumer sentiment drops, making it more difficult for businesses to pass on price increases. Although margin compression may materialize, we see limited scope for a broad increase in default levels, which should allow corporate bond markets to stabilize.

CANADA

Sean Killin & Richard Tan, CFA – Toronto

■ Volatility is rising yet again, driven by escalation in the conflict between Russia and Ukraine. While Canada is far from being immune, **we believe the S&P/TSX Composite is well positioned relative to global indexes.** One reason is that the Energy sector accounts for roughly 15% of the S&P/TSX Composite, and the invasion of Ukraine has caused global oil prices to surge above \$100 per barrel for the first time since 2014. Second, Russia and Ukraine combined account for a significant portion of global

Fed policy looks to thread needle of rising prices and falling risk



Source - RBC Wealth Management, Bloomberg; data as of 8:14 am ET 2/24/22

wheat and corn exports, and therefore potential supply disruptions should be supportive of crop prices and Canadian agricultural companies. This, in conjunction with the lift in precious metals pricing, may bode well for the Materials sector, which makes up approximately 13% of the index. **The S&P/TSX Composite is relatively in line with its long-term price-to-earnings average, and equity risk premiums remain favourable, in our view.**

■ **The Canadian economy has historically benefitted from rising commodity prices,** as terms of trade (the ratio of a country's export prices to import prices) generally turn positive after a commodity rally. This has implications for Canadian economic growth, typically providing a lift across the board as a result of Canada's commodity-heavy exports. A strong demand environment and the geopolitical stress incited by Russia's invasion of Ukraine have pushed the Bloomberg Commodity Index higher by nearly 20% year to date. **Rising commodity prices can, in turn, incentivize capital investment and hiring**—which would be welcomed, as output capacity has been significantly disrupted during the pandemic. While improving terms of trade can serve as a modest tailwind to the Canadian dollar over the medium to long term, **the loonie could remain under pressure in the near term** owing to the prevailing risk-off sentiment which typically bolsters the U.S. dollar's appeal.

EUROPE

Frédérique Carrier – London

- **European preliminary economic activity indicators for February point to a pick-up in growth** which exceeded consensus expectations and suggest to us the impact of the omicron wave is waning in the UK and euro area.
- **Can the euro area maintain this economic momentum in light of the geopolitical conflict unfolding on its border?** We think it is possible if Russian energy supplies, which account for some 40% of the region's energy needs, continue to flow into Europe. The recently imposed sanctions target Russia's banks and elites, but do not endanger current economic activity at this stage. The U.S. is also stopping future purchases of Russian sovereign debt and Germany is halting the approval of Nord Stream 2, a pipeline built between Russia and Germany, which is not yet operational.
- However, to the extent that the geopolitical crisis increases uncertainty regarding the future supply of oil and other commodities, and results in oil prices being elevated for longer and further supply chain disruptions, **inflation forecasts may be nudged up in the short term and economic activity forecasts revised down somewhat.** Elevated oil prices not only produce higher energy bills, they can potentially reduce overall demand for other goods. Moreover, industries that are heavy users of oil, such as the chemical industry, certain industrials, or even consumer products, may struggle to maintain their margins. In turn, commodity-linked sectors such as Energy and mining may benefit from the current conflict in the short term given the supply disruption risks.
- **Geopolitical considerations will likely weigh on central banks' upcoming decisions.** Markets have already scaled back their policy-tightening expectations for the European Central Bank, which may well decide to err on the side of caution. The risk-off move in equity markets has seen cyclical sectors underperform on the uncertainty around the implications for economic growth resulting from the conflict.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets have been trading broadly lower this week** with the MSCI Asia Pacific Index again looking to test its recent low. Following a very brief recovery on Wednesday, Asia equities were sharply lower on Thursday on news of Russian President Vladimir Putin's decision to order a military attack on Ukraine. All major markets in the region are in the red for the week, with Japan and Hong Kong leading the way lower.
- **China said it opposes "illegal" sanctions on Russia and has blamed the U.S. for escalating tensions over Ukraine**, while reiterating calls on Thursday for a peaceful resolution to the crisis. In the hours after the

Hang Seng TECH Index trading at lowest level since inception



Source - RBC Wealth Management, Bloomberg; daily data through 2/24/22

invasion started, China's envoy to the United Nations, said the "door to a peaceful solution" was not yet fully shut and urged all parties to exercise restraint. A report in The Financial Times said that financial analysts and geopolitical experts believe China will probably help Russia weather sanctions from the West, mostly through resource sector deals and lending by several state-owned banks, while seeking to avoid damage to its own economic and financial interests.

■ **The selloff in Chinese technology stocks resumed this week** with the Hang Seng TECH Index falling to its lowest level since the gauge was introduced in mid-2020. Investors thinking the worst of China's tech crackdown had passed were dealt a blow last week as new measures/developments—guidance on food delivery platforms, warnings against illegal fundraising schemes tied to the metaverse, and an inquiry into state-owned firms with exposure to Ant Financial—prompted a sharp drop in share prices. While we are turning more positive on China equities, we remain cautious on China Tech. We believe it is still too early to buy and recommend investors be selective. The tech companies are scheduled to begin announcing Q4 2021 results soon, and we see risks of earnings downgrades due to the macroeconomic slowdown and regulatory reset.

■ **Shimao Group Holdings Ltd.'s (813 HK) dollar bond losses worsened** after the Chinese property developer missed some trust payments and suffered a new credit rating downgrade. Shimao's long-term corporate family rating was slashed deeper into "junk" territory by Moody's Investors Service late Wednesday. That takes Shimao into an area that may prompt forced selling by investors unable to hold debt rated at such a level. Meanwhile, Beijing reiterated its policy stance this week that houses are for living in and not for speculation, adding that authorities would not use the property market as short-term economic stimulus and the government will "firmly" handle risks to housing project delivery caused by some developers' debt defaults.

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|-----------------------|-------|---------|--|---------|
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| Hold [Sector Perform] | 557 | 38.60 | 180 | 32.32 |
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