BROADSTONE

Briefing note – What does the Russian invasion of Ukraine mean for markets?

Following the ongoing and tragic events that have been unfolding in Ukraine over the last few days and weeks, we have received a number of queries from clients on the impact that these may have on their pension scheme assets and liabilities.

This brief note summarises the discussions that we have been having with investment managers over the last few days, including how markets have been affected and how proposed sanctions may impact Russia, the global community and ultimately pension scheme clients.

What has happened in markets?

There was initially a general 'flight to safety' in the immediate aftermath of the announcement on Thursday (24 February 2022) that Russian troops had crossed the Ukrainian border. World equity markets sold off with investors instead moving towards the historically 'safe-haven' assets of bonds, gold and currencies (specifically the US Dollar and Japanese Yen). However, we have seen a partial rebound in equity markets on Friday, with bond markets also falling back in value (to continue the trend of rising bond yields seen since the start of the year). Rises and falls in the value of bonds will be reflected in rises and falls in the value of scheme liabilities.

There has been a small reduction in liquidity in global investment markets, but the investment managers we have spoken to have confirmed that they have still been able to complete trades as and when required. The most notable change has been an increase in market volatility, as well as a rise in bid-offer spreads when transacting, meaning that trading costs have increased.

Russian equity, bond and currency markets have, unsurprisingly, been hit the hardest due to the sanctions imposed so far, but markets are still functioning and transacting at the time of writing.

Oil prices have risen above $100 a barrel for the first time in seven years, which has further fuelled rising inflation expectations.

Exposure to Russia and Ukraine

Russia represents a relatively small proportion of the market capitalisation of Emerging Market Equity indices (c.2%), and represents an even smaller proportion of the market capitalisation of World Equity indices (<c.0.5%).

Russia and Ukraine also make up a small part of the emerging market corporate bonds indices, with around 3% and 0.2% in local currency terms respectively.

The largest exposure for many pension schemes will be through any commodity holdings, with energy typically representing around one third of commodity indices, with around half of this being exposed to oil companies.

What will the impact of sanctions be?

The global community has proposed a number of additional sanctions to those already levied on Russia.

These sanctions aim to hurt and disrupt Russia's economy. However, any impact on Russia as a result of these sanctions may be fairly minor in the short-term. Russia is not as dependent on external creditors as Western countries due to its low government debt levels and orthodox monetary policy, as well as its large and diversified exports (such as oil, gas, precious metals and fertilisers) which make up a significant share of global supply.

Sanctions which impact Russia's ability to trade may result in higher commodity prices globally. This is likely to particularly hit Europe, due to its current reliance on Russian gas.

The result may be that increased inflationary pressures persist beyond this year, with inflation expectations going higher still in the short-term. This in turn could influence central bank monetary policy, and increase pressure for them to increase interest rates to combat rising inflation. As a consequence, this may result in a reduction in pension scheme liabilities. However, there may be some divergence in central bank responses where, for example, the European Central Bank may be more focused on any immediate negative economic impact that the Russian invasion might cause to countries like Germany (who are highly dependent on Russian gas supplies).

Broadstone view

Our general view is that, despite the disturbing and upsetting images we are seeing on the ground, markets are holding up relatively well. There has been no indiscriminate selling of assets as of yet, with the biggest concern for clients being increased volatility and increased trading costs. The market movements have been relatively small, to date, in comparison with those seen most recently around the start of the COVID-19 pandemic in 2020.

At times of market stress, it is important to remember the long-term nature of pension scheme investment. Diversification within asset portfolios will also help to limit any direct exposure to affected markets.

We will keep you up to date should there be any further significant developments on this situation. Our heartfelt thoughts go out to the victims of these events, and we send our best wishes to all those affected.

If you have any additional questions, please contact your investment consultant or scheme consultant in the first instance.

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