The Impact of War

March 2022

**Putin's attack on Ukraine is having wide-reaching consequences for global financial market as investors reconsider their options**

The last few weeks have been tumultuous for global financial markets as the West unites against Vladimir Putin over his invasion of Ukraine. As the world tries to assess the unfolding situation, the financial, economic and humanitarian impact is being felt by global investors and corporates as well as the Ukrainian and Russian people.

The increasing geopolitical risk led to a material change in our extra-financial risk assessment. While we have held a significantly underweight position in Russian assets, we took the decision to remove all exposure to Russia.

The market has been relatively illiquid for Russian assets, yet we believe the unpredictability of the situation has increased the likelihood of being unable to sell these positions later; even if they were to default, there may be no market to sell them at a de minimus price. We expect there to be more sellers as other investors take a similar stance, given the cloud of uncertainty and taint of sovereign aggression, and we expect the buyer base and market makers in these bonds to shrink even further.

Liquidity in Russian related names has virtually disappeared. We wanted to take advantage of what little liquidity remained on the belief that it would dry up as soon as shorts were covered. This concern is now materialising and may intensify as banks withdraw from transacting in Russian names, index providers exclude Russian securities and few-to-no buyers step in to take the other side.

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Tatjana is a founding member of the European Leveraged Finance Alliance, a member of the ECB’s Bond Market Contact Group, a regular participant at the UBS Investor Forum and a frequent speaker at investment conferences. Tatjana is a leading advocate for incorporating environmental, social and governance (ESG) practices into credit portfolios. Tatjana joined Muzinich in 2007 from Metlife Investments, where she served as an Associate Director of the Higher Return Unit. Prior to that she worked as a Senior Portfolio Manager in European High Yield for Fortis Investments and as a portfolio manager and credit analyst at Legal & General Investment Management. She has a Ph.D. from the London School of Economics, a Masters from the Kiel Institute of World Economics in Germany and an M.Sc/B.S. in Economics from the University of Vienna.
As investors we are in an unprecedented situation. To date, sanctions have been put in place on Russian companies including banks, technology, aerospace and defence companies. Meanwhile the G7 have restricted the Central Bank of Russia (CBR) from deploying its international reserves and disconnected select Russian banks from financial messaging system SWIFT. As a result, the ruble has plummeted and the CBR has more than doubled interest rates.

Rating agencies Moody’s and Fitch have joined Standard & Poor’s in downgrading Russia’s sovereign credit rating to ‘junk’ on concerns the impact of sanctions would leave Russia unable to service its debt.1 At the same time, index providers are considering removing or have already removed Russian equities from their indexes.2

Oil prices have reached an 8-year high.3 While many nations have so far tried to avoid sanctioning Russian energy companies, demand for Russian oil has waned. Western companies are also cutting ties to the country across industries including technology, entertainment, automobiles and textiles. The Russian consumer is now faced with interest rates at 20%, a weakening currency and rapidly dwindling access to Western goods.4

Food prices are also being affected, notably wheat, with Ukraine and Russia being primary producers. While the conflict is already sending food prices higher, we are unlikely to see the full impact of the conflict until later in the year.

Alongside the cost on human life, there is also the environmental impact from conflict, with the destruction of urban infrastructure resulting in gas and water leaks and water contamination, the destruction of cultural landmarks and the terrifying possibility of nuclear disaster. Once a conflict is over and rebuilding begins, there is also a knock-on effect on natural resources as demand for raw materials surge.

Germany has refused to certify the Nord Stream 2 gas pipeline, which many have welcomed from an environmental as well as geopolitical perspective - it was predicted to add 100mn tons of CO2 into the atmosphere on an annual basis.5

While Russian gas is still being sent to Europe, gas prices have soared as speculation intensifies that coal-fired plants may need to increase operational capacity to meet demand should Russian gas supplies fail.

With the greater move towards improving environmental, social and governance standards in portfolios (with more funds being classified as Article 8 under the European Union’s Sustainable Finance Directive6) the ethics of holdings companies such as Russian oil and gas producers in the current geopolitical environment has become increasingly questionable. At the same time, other ESG-based organisations such as the UN Principles for Responsible Investment are looking at what the situation means for their signatories.

At this stage, second and third order impacts are difficult to assess. Previous supply chain issues that we have already experienced due to Covid, climate change and climate adaptation could be exacerbated. Inflation, already a concern, is likely to rise further or at least remain elevated for longer. Higher oil, gas and commodity prices are likely to broadly impact corporate fundamentals as operating costs rise, putting margins under pressure. Companies such as global auto manufacturers that sell cars in Russia, and telecommunications operators that have offerings in Russia, could also be hit. Even though these companies are typically well diversified across various geographies, they have already shown significant volatility due to the impact of the crisis on their operations. As such, we continue to assess the situation and the impact on the holdings across our portfolios.

The humanitarian impact of this war can only scarcely be imagined with a whole population’s life having been upended, normal life stopped in its tracks and one having to worry about the safety and survival of children and family.

We wish for a swift end to this unfolding tragedy and peace to be restored. In the meantime, we will continue to focus on seeking out good companies with solid fundamentals that we believe will be able to service their debt, while doing our utmost to preserve our clients’ capital.

1. Bloomberg, as of 3rd March 2022
2. Reuters, as of 3rd March 2022
3. Trading Economics, as of 3rd March 2022
4. Central Bank of the Russian Federation, as of 28th February 2022
5. CNN, as of 23rd February 2022

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