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Quilter Investors

Western sanctions start to bite on Putin's Russia

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Equity markets remained volatile this week in the face of Russia's devastating invasion of Ukraine. First and foremost, our thoughts are with Ukrainians and the horrendous civilian impact of this war.

Even so, absolute moves in major stock market indices have been restrained. Indeed, between 24 February, when the shelling of Ukrainian cities began, and the close of business on 1 March, there was very little change to market levels.

This signals that markets have, so far, balanced out the negative implications the war has for inflation and economic growth with the incrementally more 'dovish' response now expected from central banks (meaning interest-rate hikes are now expected to be less severe).

The most notable moves in financial markets this week were in government bonds as investors sought safe havens. On 1 March, the yields on German 10-year bunds experienced their largest daily fall since the Euro Crisis over a decade ago. Yields on 10-year UK government gilts also saw their largest decline since the Brexit referendum in 2016 (meaning their prices rose).

Meanwhile, US bond markets are already pricing in a slower than previously anticipated rate of interest-rate hikes while in Europe, the last two weeks has seen the market pivot from anticipating that European interest rates will rise almost to positive territory to predicting that they won't move at all.

The European Central Bank (ECB) meets next week, which will provide more insight into where its priorities lie: battling inflation or protecting growth at a time when economists are predicting a possible recession in Europe.

SWIFT response

Although Mr Putin has yet to 'blink', the sanctions so far announced by the international community have created havoc in Russia's financial system.

By Monday of this week (28 Feb) Russia was scrambling to prevent a financial meltdown caused by Western sanctions imposed during the previous weekend. The ruble has crashed to a record low against the US dollar, the Russian central bank has more than doubled interest rates to 20% and the Moscow stock exchange has remained shuttered this week.

Major companies have also been quick to distance themselves from Mr Putin's Russia. This week the British energy giant BP announced the immediate disposal of its 19.75% stake in the state-owned Russian energy firm Rosneft, which was valued at $14bn at the end of 2021.

Although unprecedented, we expect to see more of such radical corporate sanctions and disposals as global companies set about the business of disentangling their first and second-order Russian interests while complex supply chains continue to be examined for impact, both from Russia and Ukraine, with obvious implications for company profit margins.

While the removal of certain Russian banks from SWIFT currently carves out energy and agriculture, in order to facilitate their continued export, it's still possible that this remaining piece of leverage will be used by either side.

Continued overleaf

Oil prices barrel away

By Thursday 3 March, oil prices were soaring again due to the dash for commodities of all kinds triggered by the Ukraine war. The prices of 'hard' commodities ranging from coal and natural gas to aluminium were surging as the Western alliance tightened sanctions on Russian companies and their owners.

Amid this, a barrel of Brent crude rose to almost $120 in early trading before prices eased slightly. The price of oil is already 20% higher than a week ago when hostilities commenced with the direction of travel clear.

Oil commentators expect only a modest increase in supply following this week's meeting of the OPEC+ cartel, while markets barely shrugged at the White House announcement on Tuesday that the US and its allies had agreed to release 60 million barrels of oil from their reserves.

Meanwhile at home, UK consumers face an ongoing cost of living crisis due, in no small part, to the disruption caused to oil and wholesale natural gas prices. Annual UK (CPI) inflation hit a 30-year high of 5.5% in January with worse yet to come for hard-hit UK households.

The UK energy regulator Ofgem is set to raise the energy price cap by 54% in April with the typical household energy bill expected to rise by more than £690, to £1,971 a year. This may yet rise further given the sharp rise in natural gas prices experienced in the past week.

Elsewhere, UK consumer confidence, and by extension UK consumer spending, are also being assailed by steeply rising food price inflation. Indeed, 'soft' commodity prices such as those for wheat, meat and coffee have been on the rise for some time while the outlook is precarious to say the least with Russia, the world's largest exporter of wheat now waging war on the world's fifth largest exporter.

The dilemma facing central banks

In his testimony to US lawmakers this week, Jerome Powell, chairman of the US Federal Reserve (Fed), indicated his support for a 0.25% rise in US interest rates at the Fed's March meeting, signalling that the central bank was steering away from a potentially larger rise much as the markets had already begun to predict.

The less aggressive path of interest-rate rises that now seems more likely across developed markets is one factor currently cushioning equity markets from falls, however, the risk of higher inflation, at least in the near term, and its ensuing implications for economic growth demands caution.

As Paul Craig, manager of the Quilter Investors Cirilium portfolio range, explains, "There's never been a more challenging macro environment for central banks. On the one hand, inflationary pressures are extremely high and likely to get worse but on the other, recessionary indicators are also now flashing red. This is a tough environment in which to be tightening [raising interest rates]".

Our portfolios in focus

Our managers have been examining the full set of implications for their holdings. They believe that they are positioned suitably for the current market backdrop and stand ready to act if the situation deteriorates further.

Ian Jensen-Humphreys, portfolio manager of Cirilium Blend range, also makes the point that most US, European and UK companies have little direct exposure to Russia or Ukraine.

"What's going to matter more for markets over the summer months," he says, "is Fed policy, company earnings growth, consumer sentiment and jobs growth. Even with an escalation in the conflict, these factors will be more important to markets over the course of 2022."

Even so, our managers are taking a granular approach to their portfolios to ensure that investor interests are best served. As Quilter Investors portfolio manager Stuart Clark explains, "In our managed portfolios we have engaged with our underlying fund managers to understand how they are approaching the situation and to actively discourage any investment in Russia at the moment. Fortunately, we haven't spoken to a single manager who was considering doing so.

"In cases where there are some limited exposures to Russian stocks in the underlying portfolios," says Clark, "we are asking those managers how they intend to deal with these positions in the best interests of our clients in light of the significant shift in geopolitical risk now associated with Russia."

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