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Market Pulse

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RUSSIA SHOCKS THE WORLD

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Over February, global equities fell for a second straight month as markets responded negatively to the news that Russia had launched a full-scale military offensive against Ukraine. The early part of the month was already negative for equities, with central banks dominating news flow; investors increased bets on aggressive interest rate hikes from central banks. The second half of the month saw attention shift to the war in Ukraine, with equity markets selling off. At the same time, commodity prices moved swiftly higher due to Russia's importance as a global commodity producer. Russia's actions in Ukraine sparked a re-evaluation of interest rate hike expectations, with markets pricing in fewer US Federal Reserve (Fed) and European Central Bank (ECB) rate hikes than originally expected. Near term global growth expectations were revised lower as oil prices moved higher and western countries launched hard hitting sanctions against the Russian regime and its supporters.

Russia/Ukraine

In the last week of February, Russia launched a military offensive in Ukraine. To date, the clearest economic impact is in commodity markets, especially oil and gas. Russia is a major player in the global commodity space and accounts for 17% of global gas production and 12% of global oil production. Combined, Russia and Ukraine also account for 25% of global wheat exports. Brent crude oil ended the month above $100/barrel, while European gas prices rose 17% to €99/megawatt hour (mwh) over the month. Fears that sustained higher commodity prices could impact global growth and inflation led to a selloff in risk assets, with safe haven assets rallying.

The overall financial market reaction to the crisis, which saw global equities fall -2.6% through the month, has been limited by the fact that Russia and Ukraine account for less than 2% of global GDP. At the same time, exposures to Russian assets within the global financial system are modest. Western sanctions on the Russian regime and its supporters are having severe negative effects on the Russian economy and the Russian ruble fell by more than 36% against the euro through the month. Europe remains particularly vulnerable to the crisis due to its dependence on Russian gas supplies, which account for approximately 25% of European gas usage. Concerns surrounding possible retaliatory actions from Russia, particularly in relation to energy supplies, have increased risk premia in European markets, which have trailed global equity indices.

Inflation

The ability for governments and central banks to offset the negative economic fallout from the Ukraine crisis could be limited by the already significant inflationary backdrop. Whether major central banks react to higher commodity prices by increasing the magnitude or pace of interest rate hikes, or whether they choose to look through energy-driven inflation pressures in a bid to support global growth is so far unclear. Some ECB council members have urged caution on monetary policy in the face of the conflict, even as inflation hit a record of 5.1% year-on-year (y/y) in February. In the US, a strong inflation reading of 7.5% y/y, its highest level since 1982, and the ongoing recovery in the labour market have kept the Fed on track to deliver its first rate-hike in March. The Fed is currently expected to raise rates six times this year, commencing in March. In the UK, the Bank of England delivered a 25 basis points (bps) rate hike in February and began quantitative tightening as headline inflation reached 5.5% y/y.

Corporate earnings

Through the month, positive earnings reports were a support for markets as fourth quarter earnings beat consensus expectations. US companies registered earnings growth of over 28% y/y, with European companies registering earnings growth of over 47%. Earnings surprises were in the region of +6% and +7% in the US and Europe respectively.

CHART OF THE MONTH

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 28 February 2022.

MARKET ROUND-UP

Equities

The MSCI AC World equity index fell -2.6% (-2.7% in €) as the Russian invasion of Ukraine roiled markets, which had already been reeling from fears of rising interest rates. European equities underperformed and fell -4.3% (-4.1% in €) due to fears that higher oil and gas prices would damage European growth. The UK outperformed, gaining 0.8% (0.6% in €), and benefitted from its relatively large weight in energy and material stocks, which were supported by higher commodity prices. Emerging markets fell -2.4% (-3.2% in €) as risk assets were weighed down by news on the Ukraine crisis; falls intensified after Russia's full-fledged invasion. Russian assets saw the sharpest falls as western sanctions hit markets hard. The US fell -2.9% (-3.1% in €) as growth stocks were hit hard on the back of more inflation focused market pricing of Fed rate hikes, while Russian actions in Ukraine increased risk-off sentiment into month end. Japan fell -1.2% (-1.3% in €) and outperformed global benchmarks.

Bonds

The Eurozone >5-year bond index returned -2.8% in February as bond markets continued their sell-off from 2021. For most of the month, markets were being driven by the outlook for inflation and potential interest rate hikes from the ECB. Late in the month, the events in Ukraine took centre stage as investors began to discount a growth impact from higher commodity prices; this led to a rally in safe-haven fixed income assets. The German 10-year yield rose 12bps, ending the month at 0.14%. Italian and Spanish 10-year spreads against Germany widened to 157bps and 98bps respectively as markets pondered the impacts of a removal of ECB accommodation and potential growth shocks following the Russian invasion of Ukraine. Investment grade corporate bonds fell -2.7% as spreads rose 41bps to 1.48%. High yield corporate bonds fell -1.4% as yields rose 45bps to 4.92% and spreads widened 29bps to 354bps.

Emerging market (EM) local debt fell -5.1% in euro terms during the month following Russia's invasion of Ukraine as yields rose over 40bps to 6.3% and EM currencies fell over 2%. EM hard currency debt fell -7.8% (-7.5% in €) as Russian, Ukrainian, and Belarusian debt fell sharply. EM hard currency yields rose to 6.6%, while spreads widened to over 450bps.

Currencies and commodities

The euro fell to 1.1205 against the US dollar, with the dollar rising due to its safe haven status in times of market stress. Commodities rose +8.8% (+8.6% in €), bringing their year-to-date return to 21.4% (22.9% in €). WTI oil was up +8.6%, bringing its year-to-date increase to 44.6%. Oil prices breached $100/ barrel during the month, reaching their highest level since 2014. European gas prices rose 17.3% to €99/mwh. In addition to oil and gas, the Russia-Ukraine conflict is also impacting fertilisers, metals and grains prices. Russia is a major producer of aluminium, nickel and palladium, all of which rose sharply on supply concerns and uncertainty around the impact of Western sanctions. Gold rose 4.0%, supported by safe-haven demand.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	-5.1	-10.7	17.1
MSCI United Kingdom	0.6	3.0	27.5
MSCI Europe ex UK	-4.1	-8.7	25.4
MSCI North America	-3.0	-6.9	36.6
MSCI Japan	-1.3	-5.0	9.8
MSCI EM (Emerging Markets)	-3.2	-3.6	5.2
MSCI AC World	-2.7	-6.2	28.1

10-Year Yields	Yield Last Month (%)	2021 Yield (%)	2020 Yield (%)
US	1.83	1.51	0.91
Germany	0.14	-0.18	-0.57
UK	1.41	0.97	0.20
Japan	0.19	0.07	0.02
Ireland	0.75	0.24	-0.30
Italy	1.71	1.17	0.54
Greece	2.53	1.34	0.63
Portugal	1.00	0.47	0.03
Spain	1.12	0.57	0.05

FX Rates	End last month	2021 Rates	2020 Rates
U.S. Dollar per Euro	1.12	1.14	1.22
British Pounds per Euro	0.84	0.84	0.90
U.S. Dollar per British Pounds	1.34	1.35	1.37

Commodities (USD)	MTD Return (%)	YTD Return (%)	2021 Return (%)
Oil (WTI)	8.6	27.3	55.0
Gold (Oz)	5.7	3.8	-3.4
S&P Goldman Sachs Commodity Index	8.8	21.4	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 March 2022.

THE ILIM VIEW – LOOKING AHEAD

Over the next twelve months, the outlook for equity markets is dependent on several factors. This includes central bank policy, growth, inflation (both expected and realised) and the evolution of the Russia/Ukraine crisis.

We believe we are still in the early to mid-stage of the current economic cycle, a period that is typically associated with positive equity markets, even though the pace of returns tends to be lower than those experienced in the initial recovery from market lows. Having grown by almost 6% in 2021, the global economy is expected to slow this year, with growth of 4.0% expected. This, however, remains well above trend growth of 2.7% and exceeds levels experienced in the last cycle following the Global Financial Crisis. Sustained higher commodity prices, particularly stemming from the war in Ukraine, or further positive inflation shocks are risks to the current growth outlook.

Equities have recently found a support on an absolute valuation basis and remain extremely attractive on a relative valuation basis with current bond yields suggesting mid double digit upside to get back to fair value versus bonds. On a medium term view, assuming the impact from the Russia/Ukraine crisis on growth is relatively limited, we can see equities generating positive returns over the next twelve months.

Even as monetary stimulus is being reduced, financial conditions remain loose. This is highlighted by real yields, which remain close to historic lows - levels that are consistent with further gains in equities. Historically, equities have, on average, continued to rise in the initial stages of a rate hiking cycle as the economic and earnings backdrop generally remain strong.

Longer term potential risks to the equity outlook include unexpected additional central bank policy tightening due to the persistence of high inflation, significant rises in bond yields, which would diminish the relative valuation case for equities, or a further deterioration in geopolitical conditions.

The persistence of higher inflation is seen as the greatest medium-term risk to markets, with the most imminent short-term risk to markets being a further escalation in the Russia/Ukraine crisis. While our outlook for equity markets is positive in the medium-long term, the array of short-term risks facing markets mean that volatility will likely remain a feature in the near term.

THE MONTH AHEAD

Economic data releases

8 March	US Balance of Trade (Jan)
10 March	ECB Interest Rate Decision US Inflation Rate YoY (Feb)
16 March	Fed Interest Rate Decision

Source: ILIM, Trading Economics. Data is accurate as at 28 February 2022.

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