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Markets Update: Russia-Ukraine Crisis

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Louise White: Today, we'll be focusing on the market implications of recent events in Russia and the Ukraine. So Peder, I might start with you. Given the awful circumstances of the last few weeks, would you share a view on how PIMCO is thinking about the implications of what has unfolded from an economic perspective and in particular, with respect to growth?

Peder Beck-Friis: Yes, of course. I think we need to be very humble in our forecast. There's clearly a lot of uncertainty out there. There's always a lot of uncertainty when it comes to macro outlook, but this amount of uncertainty when it comes to inflation, geopolitical risks, we haven't seen in a very long time.

I think the starting point is that recent events clearly add to stagflationary forces around the world. We have revised down our GDP forecast by around 1%, a little bit less in the US, a little bit more in Europe, given the proximity to the crisis. On inflation, we've revised up those forecasts by around 1-2%, at a time when spot inflation is already very high, and expectations are rising.

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I should say that the direct impact from Russia and Ukraine on the rest of the global economy is pretty limited. Russia is a fairly small economy, a little bit bigger than Spain and a little bit smaller than Italy, and Europe exports less than 1% of its GDP to Russia and Ukraine. So, that's a very limited impact. The main impact will take place indirectly. Of course, rising inflation, rising gas and energy prices will weigh on our ability to consume and you also have supply bottlenecks. Although Russia is a fairly small economy, it's a big producer and exporter of various industrials metals. We've already seen some anecdotal evidence of car manufacturers in Germany closing down, given the shortage of various inputs.

In our baseline, we remain cautiously optimistic. We still think that growth in Europe will remain positive and above trend, as reopening effects keep pushing activity higher. But certainly recessionary risks have increased.

Louise White: And John, following on from that, we might talk to the likely central bank actions that we may see in relation to rates. Do you think central banks, like the US Federal Reserve (Fed), can continue to raise rates as quickly as they may have been planning before this crisis?

John Thornton: It's obviously a huge area of focus at the moment for markets and some of the key points Peder is making are around inflation. So, we see a rate hike from the Fed this week, fully priced in by markets, with seven more to come this year, and that's more than we had before the Ukrainian invasion. So the market has said, we do need to raise rates. That inflationary pressure has stepped up to a new level. We're at 7.9% in the US. Even when we look out into 2023, market pricing is over 3.5%.

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So, what we're seeing in the market is a re-evaluation of where we're going with rate hikes. We think there is more of that to come. We've seen the statements from the Fed in relation to this and, if these inflationary pressures continue, they will definitely take action.

In the bigger picture, we have to be humble, as Peder said, in relation to forecasting how far this might go. The most likely outcome is that the Fed's support of equity markets over recent decades is probably a lot lower going forward, and further away. They are in a very difficult position with core and headline inflation being very significant coupled with a lot of the structural changes that are very material but happening over a very short timeframe.

From a European perspective, we're all very familiar with the headlines around higher energy prices and gas prices – a supply side shock. Ideally, the ECB would not raise rates with that backdrop, but they will probably have to. The market recognises that, and bond yields are rising. So, it's very hawkish out there for the moment. The flight to quality around the initial invasion has unwound and now people are back focused on inflation – and, with core inflation over 2.7% and headline inflation closer to 6% in Europe, pressure is building.

So, it's a very difficult environment for the central bankers, a very difficult policy mix, and that stagflationry theme that Peder mentioned, is going to be very dominant for the moment.

Louise White: So, we're definitely going to hear a lot more about inflation in the short and medium term. Peder, looking at the assets that have been most directly impacted by recent events, Russian assets, what factors are you looking at in this sector of the market today?

Peder Beck-Friis: Well, as it relates to either Russian or Ukrainian assets, again, they are a fairly small fraction of the total investible universe. But clearly, we have seen a lot of volatility and extreme uncertainty as governments keep adding sanctions. So, as investors, we keep learning every day what we can do and can't do. There are clearly questions around what can be traded, questions around the willingness from various Russian entities to pay and whether or not international investors can receive payments. Of course, there are also questions around whether it's even possible for certain Russian entities to pay international investors, given the assets of the central banks are largely frozen. So, I think when it comes to Russian and Ukrainian assets, we will continue to see a lot of volatility.

Let me just give you one example. Gazprom, one of the quasi-sovereign energy companies, had a payment due last week. There was uncertainty all the way to the very end, whether or not they were going to pay. In the end, they did pay. And so far, at least all the quasi-sovereign Russian entities have made payments. But there are extreme uncertainties with respect to these assets. I think the big message here, is that, yes, Ukrainian and Russian assets are largely frozen or trading at depressed levels. We have also seen some contagion to other Eastern European markets and of course to general risk assets, including equities internationally. I think it's reasonable for investors to demand, given the heightened uncertainty, a little bit more risk premium in these assets. And of course, remember we come from a period in which valuation of risk asset prices is historically very stretched. And so as these markets start discounting negative events going forward, that's an environment in which these assets tend to be fairly sensitive to the headlines that we're experiencing now.

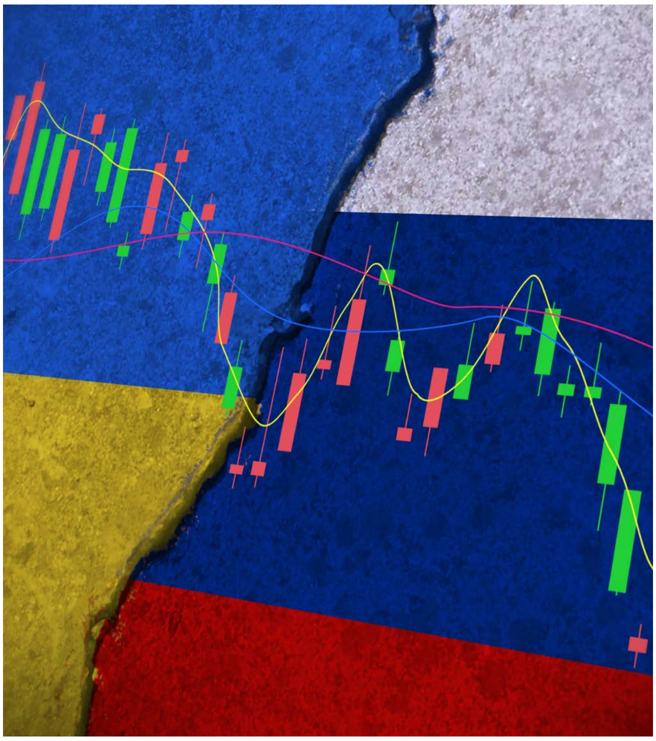
Louise White: So, a lot of uncertainty there too and continuing to unfold. John, turning to markets more broadly, which have been volatile in any event coming into the year, can we look at the various factors that are driving global fixed income markets to date?

John Thornton: We've seen long-term bond yields rise materially and quickly and we've seen inflation and inflation expectations move significantly higher, particularly in the couple of weeks after the invasion. This has led through to negative returns in many bond funds, with EM local markets being hit hard, and we've seen credit spreads widen as well. So (with) that pairing back of bond buying programmes, which has kept spreads quite low for extended periods, the good economic growth and outlook that we had before has been reevaluated. We're seeing credit spreads in Europe up to 150 basis points. So, quite high with regard to history, outside of crises.

If we see a positive outcome from an economic perspective, I'm not sure we'll see those spreads tighten materially. It feels like this environment of higher interest rates from central banks and fewer bond buying programmes, is going to see us move into this higher-spread regime as well. So, that's been a negative. The uncertainty about growth and the outlook, again, so much happening, so much being digested by markets. It's been quite a difficult period with some very volatile days with 5% sell offs in the equity market, followed by a rally into the close, and we end up positive on the day. Extraordinary moves in many senses.

One of the things we're thinking about is that we haven't seen a systemic risk event as with March 2020 when we were seeing markets collapse. There was difficulty in trading many high-quality fixed income securities, whether US Treasuries or inflation bonds, and markets were on the verge of collapsing until the central banks stepped in and stabilised the system. That isn't what we're seeing here. We're not seeing that level of stress. As Peder pointed out, the exposures directly to Russia have been fairly moderate and small in overall portfolio context, although (there have been) very significant write downs in those sectors. All the re-pricing we've seen is very much in line with what you would expect. The oil price is much higher, although it has come back a bit. Inflation expectations higher, inflation higher, bond yields higher, as we see central banks likely to respond. So, lots of it makes sense.

Where we're wondering, and where we're thinking from here is that reference to a Lehman's moment. It's not coming from the financial sector, but the level of restructuring that's likely to come in the real world is probably very significant. And again, we don't know where this is going to go. Europe's going to try to reduce its gas usage from Russia – 70% this year sounds a very significant number. We're seeing oil demand is going to be less. We're even seeing an ESG impact. Oil majors refusing delivery of Russian oil with, I think it was Shell, sort of apologising for receiving a shipment from Russia. So even outside of the sanctions, we're seeing significant moves there. The economic restructuring seems like it's going to be very material, particularly from a European perspective, and that supply chain issue that we all became very familiar with in the last 18-24 months probably feels like it's got even more material going forward from here.



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So, it's been very much a case of markets repricing what they think they know at the moment. A lot of it makes sense: spreads wider, yields higher, inflation higher, risky assets lower in general. How does it evolve from here? It's difficult to call. Again, let's use that phrase and be humble about making forecasts. But markets are digesting this news very quickly and moving quickly when this new data is coming out. And again, bring it back to inflation. Inflation's higher; what's going to happen from central bank policy and how much? So it looks like it's much more on the hawkish end and the ECB has had to come much more in line with the direction of travel from the Fed.

Louise White: So traditional and non-traditional factors driving markets at the moment. It was a really interesting discussion with so much going on. Thank you both very much for sharing your perspectives, John and Peder. Hopefully for clients, it contextualises recent events from an investment perspective to some degree. Certainly the current environment poses challenges and uncertainty for us all. We're committed in ILIM to work closely with you to meet these challenges and to work to protect your portfolios over the longer term. Thanks very much for joining us today. We hope to see you again soon. Thank you.

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