March 2022
Newsletter

The Impact of Russia on Investment Portfolios

In our February Economic Newsletter we ended with the comment, "In times of uncertainty, it is always helpful to cut through the noise and be guided by fundamental valuations, as these, not stories, are what ultimately determine investment returns." As the Geopolitical events between Russia and the Ukraine unfolded over the last week, this sentiment rings truer than ever.

Returns are Driven by Earnings

Most global economists (including almost all local asset managers) were caught off-guard in late February when Russia staged a full-blown invasion of the neighbouring Ukraine. News headlines have been thrown into an all-out panic and all eyes are trained on the escalating conflict taking place within Ukraine. Markets, however, have appeared to be wholly unaffected by the ensuing conflict, with most equity indices (bar that of Russia) registering little more than a blip on their performance charts. Our own FTSE/JSE All Share Index has been remarkedly resilient to the geopolitical events, as has our local currency, which has traded in the low 15's against the dollar for most of February.

Research by Canaccord Genuity (amongst others) suggests that political events do not tend to derail the course of economic trends and fundamental facts. With the exception of world wars, most geopolitical events have created short-term volatility in markets which was ultimately reversed a few months later. In fact, the 3-month, 6-month and 12-month equity returns following such events are overwhelmingly positive. There are some cases where there were strongly negative returns over these periods, but this occurred against the backdrops of existing recessions or bear markets such as post 9/11, after the Israel-Arab War and the oil embargo of 1973.

Canaccord Genuity also points out that until the US Federal Reserve (and the Bank of England and other main central banks) is in a position to map out future rate increases with some clarity, markets could well be buffeted by conflicting expectations. The next meeting of the US Federal Reserve takes place mid-March and could make a difference to investor sentiment. At the end of the day, the path of future inflation will determine how far central banks raise rates and there is still some uncertainty about where the peak price rises will be, how soon and how fast inflation could come down afterwards, and where it will settle late this year and next year. This may make this year more volatile than previous ones, but we should not forget that there are two components to a share price: interest rates and future earnings.

With these two components in mind, it is easier to understand why the US S&P 500 Index gained 1.5% on the day that Russia invaded the Ukraine, and then rose another 2.2% the following day. Looking at the fundamental earnings of the US S&P 500 index (a factor we have long-underscored as a key driver of index performance), the index currently offers the best value for the last two years. US forward earnings have risen steadily since the Covid crash of March 2020 and, at this stage, have been wholly unaffected by the Russia-Ukraine conflict.

Our own FTSE/JSE All Share Index ended the month of February above the 76 000 mark, after reaching an all-time high a few days earlier. From an earnings perspective, our local market also offers significant value and is currently trading at a Price/Earnings Ratio of 11 (measured by dividing the prevailing index level by the underlying earnings of the constituent companies). This is compared to a 15-year average Price/Earnings level of over 13 for our market, indicating that at its current levels the All Share Index is significantly undervalued.

March 2022 Newsletter

SPEKTRA MAKELAARS

Inside Russia

It is important to note, however, that not all economies have been spared from the conflict. Within the Russian state, the geopolitical crisis is having very real economic, as well as humanitarian, ramifications. The MOEX Index, tracking Russian equities, has fallen by over 45% from its peak earlier in February. In order to quell the losses, the Moscow Exchange halted all trading in shares and derivatives on Monday the 28th of February. As a result of the significant sell-off, the Russian rouble has dropped to nearly 118 against the dollar, its lowest recorded level since Putin took over the Russian presidency in 2000 (a time when the rouble was trading at less than 30 to the US dollar). In an attempt to cushion the significant depreciation in the currency, the Russian central bank doubled its interest rate from 9.5% to 20% on Monday. The rationale for such a significant move is to provide a very attractive yield for foreign investors. The higher interest rate aims to increase the foreign demand for the local currency, thereby causing the exchange rate to rise.

The Russian bond market was equally hard hit, when Russia's largest foreign bond (priced at $7bn and maturing in 2047) halved in value. The Russian 10-year bond yield has moved up from a level of 8.4% at the end of 2021 to 16.0% now.

The Investment Perspective

These numbers undoubtably pose a material threat to the Russian Economy, however investors should recognise that that threat is significantly reduced in the global economic context, and particularly in the global equity allocation of investment portfolios. Russia and the Ukraine combined represent less than 2% of global economic activity and 2.4% of the global population, "so their economies are not particularly material in the greater scheme of things", write Anchor Capital. Likewise, Russian Bonds account for only 6% of the JP Morgan Emerging Market Local Currency Debt Index, the most widely tracked emerging market bond index globally. Russian equities also are fairly small in comparison to the rest of the Emerging Market basket, comprising 3.4% of the MSCI Emerging Markets Equity Index, less than South Africa.

Our own asset allocation research and fundamental valuation approach to managing assets, and the approach that guides our Investment Committee decisions, is predicated on the underlying earnings power of asset classes and their relative attractiveness based on valuation metrics. We do not, and we would argue that neither should our clients, try to predict markets or the decisions of world leaders.

In a comment by US Asset Manager Sands Capital, they stated that, "This crisis is yet another reminder that macroeconomics and geopolitics are far more difficult to predict, in our view, than microeconomics. Less than a month ago, many of the experts we spoke to saw a minimal threat of invasion. We expect the situation to exacerbate the volatility already seen in risk assets globally. However, we don't foresee risks to most of our businesses' long-term earnings power, which we believe is what matters most over our time horizon."

At this stage, the impact of the Russian war has had a negligible impact on global markets and investment portfolios. While we should all expect a somewhat bumpy road ahead, we would argue that it is premature to think that this bumpy road is headed for a cliff.