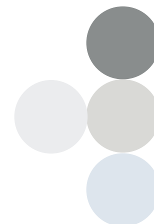


For abrdn clients only.

For professional investors only. In Switzerland for Qualified Investors only. Not for use by retail investors.
Russia and Ukraine

The war in Ukraine – updates from our asset class teams

30 March 2022

Following Putin's decision to order the invasion of Ukraine on 24 February, we sketched out a number of scenarios for how the conflict might be resolved over the medium term. Focusing on the most plausible, these ranged from:

- Putin succeeding in his original objective to overthrow the elected government and install a 'puppet' regime;
- A negotiated settlement that increased Russian influence over Ukrainian economic and security policy without a formal change in government;
- An unstable, de facto partition of the country into a Ukrainian-controlled and enlarged Russian-controlled zone; and
- Russia withdrawing to a smaller zone of control, centred on the Donbas, in return for a guarantee of Ukrainian foreign policy neutrality.

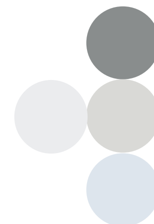
Almost four weeks into the campaign, an additional, and arguably even more probable scenario has come into view – which the Institute for the Study of War (ISW) calls 'Stalemate'. In foreign policy circles, the term 'stalemate' has a very specific meaning – it is a condition in war in which neither side can change the front lines dramatically no matter how hard they try.

We will be updating our scenario analysis soon, but if the ISW is right, there would be important implications for economies and markets. While a stalemate implies stasis, in practice it is more often associated with the prolongation of battle involving large casualties and catastrophic damage to infrastructure. This, then, is not a scenario in which the sanctions being applied to Russia would be scaled back and indeed, on the contrary, would more likely be tightened even further.

We predicated our Q1 economic and policy projections on the maintenance of the sanctions regime and the level of commodity prices that prevailed within two weeks of the invasion being sustained over our forecast horizon, which stretches to the end of 2023. We were also clear to signal the enormous uncertainty over how the war might evolve and hence its likely economic, policy and market fallout, though we did think that the risks were tilted to more adverse outcomes.

That still seems like a reasonable bottom line, and we expect commodity (and broader) markets to continue to display a great deal of volatility as investors continue to wrestle with the course and consequences of the war. Meanwhile, as Jerome Powell made very clear in his speech earlier in the week, the latest commodity shock amplifies existing inflationary pressures in the global economy and will be much harder for central banks to look through as a result.

abrdn Research Institute



Equities – focus on fundamentals

Across the Active Equities franchise, most of our equity desks have no direct exposure to Russia-listed, Ukraine-listed or Belarus-listed stocks. As per our prior update, the Global, Asian, Japanese, European, UK, North American, and Smaller Companies desks have no direct exposure. Our Global Emerging Markets (GEM) desk had some limited exposure to the region, with some funds investing directly in Russian stocks, but no exposure to Ukraine or Belarus. Reacting to the crisis, the GEM desk focused its selling activity in Russian domestic names across affected strategies, where we saw the highest risk of long-term loss of capital. Following this and an assessment of our portfolios, we can confirm that our GEM portfolios have very limited exposure to Ukraine, Belarus, Russia and associated indirect revenue streams.

Of note, having taken action prior to the market closing, remaining Russian holdings have been written down to zero. In addition, we have suspended our Eastern European equity funds in recognition of the severity of conflict's impact on local capital markets. While we deem Russian securities to be uninvestable for the foreseeable future, we retain a claim to the underlying assets in line with our fiduciary duty to our clients.

Looking ahead, the second order consequences of higher energy prices and other commodities suggest the prospect of weaker growth, more persistent inflation, and squeezed consumer spending power. These dynamics may well negatively impact corporate profitability in more cyclically sensitive parts of the market, while at the same time highlighting the attractions of sustainable, visible earnings growth. Echoing market dynamics at the start of the year, equity valuations are again weighing up the pace and extent of interest rate rises. Noting the challenges central banks face in managing inflation, the essentially flat US 10-year to 2-year yield spread points towards mounting investor concerns on the outlook for growth. As bottom-up stock selectors, we will continue to focus on the long term corporate fundamentals and the likely future impact of key events. Geopolitical uncertainty and market volatility can exacerbate the gap between winners and losers, and we feel we remain well placed to identify and select the most promising investment opportunities.

abrdn Equities Team

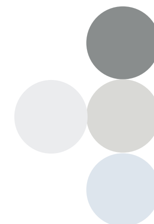
Fixed income – mounting inflationary pressure

Rates market

Our overall views remain broadly similar to when the conflict started. Economically, there will be significant pain for Russia and Europe and supply-related inflation pressures are increasing. Economically, the conflict will be very painful for Russia and Europe and will stoke additional supply-related inflation pressures. While it is difficult to predict exactly how it might affect central bank monetary policy, the reality is that low rates globally are completely at odds with tight labour markets and soaring inflation. So, the conflict, while terrible, isn't currently enough to deter central banks from raising rates, as highlighted by both the Federal Reserve and Bank of England when they increased policy rates in March. Further rate hikes are still predicted by the market over the course of 2022, which for bonds is the biggest near-term danger.

The sanctions, in particular, exclusion from the SWIFT bank payment system, will inflict serious economic damage on Russia, while also creating some disruption to trade and energy in Europe. The main economic impact of the conflict will be higher energy prices, which will cause growth to slow and stoke inflation. Other sources of inflation could include supply-side bottlenecks in materials coming from Russia and Ukraine, including for example, aluminium, platinum, palladium and chemical gases that are vital for semiconductor production. Ukraine is also a big supplier of agricultural commodities.

abrdn



Credit markets

Credit markets have repriced significantly since the conflict began, with spreads rising towards to the levels of the mid-cycle corrections of 2015/16 and 2018/19. At present markets have not priced in a recession however one cannot dismiss the risk of a direct Russia/NATO confrontation, which would likely lead to a further spike in risk premiums. In the event of a de-escalation it is likely credit spreads would rally from current levels.

Our funds have only limited exposure to Russia and Ukraine. Our global, euro and sterling investment-grade funds have no direct exposure to Russian or Ukrainian-listed issuers. We also have no material indirect exposures by way of end-markets or critical supply-chain aspects. Where we do have indirect exposure, we are assessing the extent of this and will act in the best interests of our clients and stakeholders.

Longer term, clearly there will be an indirect effect on economies from higher energy prices and other commodities, as well as increased volatility and risk.

Against this fast-evolving backdrop, stock selection will be ever-more crucial. When risk markets are uncertain, it's important to fall back on fundamental analysis and valuation, and to reference what we've learned from previous market behaviour.

Emerging market debt (EMD)

Despite the fighting showing no signs of easing up, some assets most sensitive to the war (such as Central Eastern European currencies) have rallied, with commodities selling off. Broadly speaking prices are partially reversing the moves that took place since Russia invaded Ukraine. Spreads however remain elevated across Emerging Markets (EM) and judging from the recent rate hikes seen in Brazil and Taiwan, it does not appear that the downside risk to growth has substantially affected the path for monetary policy.

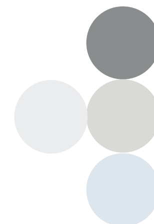
A number of restrictions have been imposed that affect EM debt markets, Russian bonds in particular. For example, US and EU investors are now prohibited from buying Russian foreign-currency and local-currency government bonds in the primary market. Certain Russian corporate/bank bonds are also affected. For instance, VEB Bank and VTB Bank have been added to the SDN list of sanctioned companies and individuals, and their US assets frozen. Additionally, a SWIFT ban has been imposed on several entities in Belarus and Russia, including on the Development Bank of Belarus and Sovcombank hindering their ability to make international payments.

Meanwhile, JP Morgan has confirmed it will remove all of Russia's sovereign and corporate debt from its widely followed EM bond benchmarks on 31 March. This includes the Emerging Market Bond Index (EMBI) and the Corporate Emerging Market Bond Index (CEMBI). On 31 March, the index market value for all Russian debt will be set to zero, reflecting a total return loss (price and accrued interest set to zero) due to market disruption. For now, assets in Belarus will remain within the index.

History suggests that most geopolitical events (including the Middle East conflicts that threatened oil production) do not leave a lasting impression on markets. We can view the situation in Ukraine in a similar light. The conflict will disrupt macroeconomic drivers worldwide, including those in developed markets where many economies rely heavily on Russian oil. However, much depends on the impact of western sanctions and whether there's a lasting increase in global commodity prices.

We continue to undertake position changes in our funds with particular care, owing to the fluid situation in Ukraine and the very volatile price environment.

abrdn Fixed Income Team



Multi Asset – conflicting forces for the global economy

Our overall views remain broadly similar to when the conflict started. Despite the unfolding conflict, central banks have limited ability for fiscal easing while underlying inflationary pressures, exacerbated by commodity supply disruption, are likely to see significant rate rises in developed markets. That said, we believe there may now be more scope for differentiation across the interest rate curve. The front-end is likely to remain under pressure from the prospect of central bank rate rises, while longer maturities may fail to reflect additional risks to growth. These conflicting forces on the global economy suggest that markets may experience a period of extended volatility, with the flow of news likely to remain unsupportive as additional sanctions against Russia are announced.

It is very difficult to make accurate predictions when the world is simultaneously experiencing a combination of events – each one of which, in isolation, is beyond the experience of most investors. However, the breadth of the investment universe is particularly important in helping to limit downside and capture upside (where this is available) at a time when traditional sources of diversification may be less effective.

Our multi-asset funds have relatively little exposure to Russia, Ukraine and Belarus and in any case had taken action in the period leading up to the Russian invasion to reduce exposures. Any direct exposure to Russia has now been written down to zero although the funds retain a claim on such assets.

Where possible, our funds aim to offset some of the inflationary pressures which have intensified due to the conflict via diversified exposure to commodities or the currencies of commodity-producing countries.

abrdn Multi Asset Team

Real estate - sector impact will be asymmetric

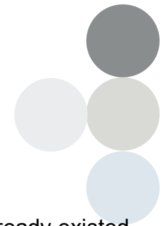
The initial impact of the conflict has materialised broadly as expected in the real estate sector. In particular, the immediate, direct impact to the asset class is insignificant owing to the relatively minor role played by Russian capital in the commercial real estate sector. Subsequent impacts are also materialising as expected, such as increased inflationary pressures triggering a response from central banks.

As one of the largest real estate investors in Europe, we have the capability of being able to assess data and deals in real time. Capital markets remain buoyant, as was before the conflict began, particularly for the favoured areas of the market. However, debt is a key feature of real estate and this cost is rising owing to actual or expected central bank policy tightening. Higher risk assets are becoming more expensive in terms of borrowing, alongside lower Loan-to-Value levels. This has been exacerbating the prime versus secondary assets divide further, as investors prefer better quality buildings.

Inflationary pressures are also feeding through into construction costs, materials, energy and wages. Pressures here could lead to less construction as costs rise, thus making development projects less viable from a return perspective. All else equal, this should further serve to contain supply in some markets. It is worth noting that such trends were already in motion before the Ukraine conflict began but potentially might be accelerated as a result. All told however, the conflict has not led to significant changes in our overall real estate view.

We remain of the view that lower economic growth and higher inflation expectations will trim the reasonable returns expected from real estate in Europe. While this is true at the headline level, the sector impacts will be more asymmetric.

abrdn



Weaker economic growth would impact the office sector, which was already under pressure. A question mark already existed over offices, given the hybrid working model that has emerged during the pandemic. Weaker growth would dampen occupier demand, which would be a further headwind for poorer-quality assets in the sector.

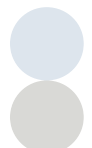
Retail could also face pressure, particularly for those areas that cater to discretionary spending. Higher inflation and weaker economic growth could pressure retailers as non-essential spending may be reduced. However, grocery-anchored retail or those areas that are tilted toward the budget-end of retail are likely to remain resilient. The Ukraine conflict could drive a further wedge between the various retail formats.

However, residential assets are likely to remain resilient, given they are seen as an essential purchase. They also have a link to inflation through rental contracts. Undersupply in this market remains an issue for many European cities. This could be exacerbated by rising construction and building costs, which might further dampen the supply pipeline.

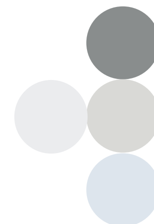
Industrial and logistics assets remain attractive, even with the potential problems the conflict could create. Supply for these assets is constrained in many markets and build-cost inflation should limit further development. However, this sector is also most exposed to supply chain disruptions, which we will continue monitoring closely.

Despite the Ukraine conflict, real estate may be seen as something of a ‘safe haven’ in the short term. Occupier markets remain relatively robust and there is no oversupply in the market. We continue to seek out sectors that should benefit from thematic structural drivers, such as rising online spending, which favours the logistics sector; and the rising propensity to rent, which favours the residential sector. We also look for assets that will be resilient as environmental, social and governance requirements become more impactful.

abrdn Real Estate Team



abrdn



Important information

For abrdn clients only.

For professional investors only. In Switzerland for Qualified Investors only. Not for use by retail investors.

Any data contained herein which is attributed to a third party (“Third Party Data”) is the property of (a) third party supplier(s) (the “Owner”) and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided “as is” and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

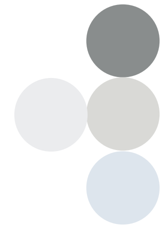
This content is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 1 January 2022)

Europe, Middle East and Africa

United Kingdom (UK): abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised authorised and regulated in the UK by the Financial Conduct Authority. **Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain,** and **Sweden**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: Aberdeen Standard Investments (Switzerland) AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market (“ADGM”):** Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only.

abrdn



Asia-Pacific

Australia and **New Zealand**: abrdn Australia Limited ABN 59 002 123 364, AFSL No. 240263. In New Zealand to wholesale investors only as defined in the Financial Markets Conduct Act 2013 (New Zealand). **Hong Kong**: abrdn Hong Kong Limited. This document has not been reviewed by the Securities and Futures Commission. **Malaysia**: abrdn Malaysia Sdn Bhd (formerly known as Aberdeen Standard Investments (Malaysia Sdn Bhd), Company Number: 200501013266 (690313-D). This document has not been reviewed by the Securities Commission of Malaysia. **Taiwan**: Aberdeen Standard Investments Taiwan Limited, which is operated independently, 8F, No.101, Songren Rd., Taipei City, Taiwan Tel: +886 2 87224500. **Thailand**: Aberdeen Asset Management (Thailand) Limited. **Singapore**: abrdn Asia Limited, Registration Number 199105448E.

Americas

Brazil: abrdn Brasil Investimentos Ltda. an entity duly registered with the Comissão de Valores Mobiliários (CVM) as an investment manager. **Canada**: abrdn is the registered marketing name in Canada for the following entities: abrdn Canada Limited, Aberdeen Standard Investments Luxembourg S.A., abrdn Private Equity (Europe) Limited, abrdn Capital Partners LLP, abrdn Investment Management Limited, Aberdeen Standard Alternative Funds Limited, and Aberdeen Capital Management LLC. abrdn Canada Limited is registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada as well as an Investment Fund Manager in the provinces of Ontario, Quebec, and Newfoundland and Labrador. **United States**: abrdn is the marketing name for the following affiliated, registered investment advisers: abrdn Inc., Aberdeen Asset Managers Ltd., abrdn Australia Ltd., abrdn Asia Limited, Aberdeen Capital Management LLC, Aberdeen Standard Investments ETFs Advisors LLC and Aberdeen Standard Alternative Funds Limited.

DH number GB-060422-168923-2