ClearBridge Investments

Ukraine Invasion Triggers Volatility, Fed Still on Course

February 24, 2022

Key Takeaways

- Military invasions have historically created an equity market low, with U.S. stocks becoming increasingly volatile over the last several trading days. Energy and defense stocks, areas directly impacted by the Russia-Ukraine conflict, have so far bucked the selling pressure.
- With inflation risks skewed even more to the upside by conflict-related commodity price spikes, the Federal Reserve will likely not deviate materially from the market's pricing of rate hikes.
- Europe is bearing the brunt of the invasion's initial impact, with higher energy costs hurting consumers and the level of sanctions pressuring European growth, with a knock-on effect for U.S. growth prospects. Such headwinds could lead to a more dovish ECB.

Technicals Suggest Short-Term Bottom

Russia's military standoff against Ukraine turned into a full-scale invasion Thursday with Vladimir Putin ordering Russian ground troops into the country and launching airstrikes on Kyiv and other cities. Military invasions have historically created an equity market low and selling has accelerated over the last 24 hours, with the S&P 500 Index falling into correction territory. Bond yields have also dropped from multi-year highs while Brent crude oil prices spiked to over $100 per barrel for the first time since 2014.

The U.S. equity market has become increasingly oversold due to the accelerating declines of the last several trading days. The S&P 500 is now well below its 50- and 200-day moving averages and other technical indicators neared short-term downside extremes in early trading Thursday before stabilising. Investor sentiment is also troughing with the American Association of Individual Investors Sentiment Survey at its lowest level since April 2013. Short-term leveraged market players, meanwhile, are at the lower end of their equity exposure.

From a macro standpoint, war in Ukraine will likely exacerbate global inflation and supply chain issues. Goods and materials that flow out of Ukraine and Russia will be halted and could exasperate supply chains issues many companies are facing for raw materials like steel for autos. Natural gas and oil price spikes will have a material effect on U.S. headline inflation and a minor impact on core inflation. Most energy price spikes are occurring in the front end of the futures curve and represent a geopolitical premium because flows have not been affected. The back end of the curve is pricing a much more benign environment and potentially lower economic activity, which could lead to lower energy prices.

With inflation risks skewed to the upside, the Federal Reserve will likely not deviate materially from the market's pricing of rate hikes from this situation. At present, the market is pricing in 5.9 hikes for 2022. We have been more dovish than consensus and continue to believe the Fed will slightly undershoot expectations. Importantly, the Fed puts more weight into core inflation ex-food and energy so higher commodity costs should not sway policymakers in a "material" way. The Ukraine situation, however, may create a more dovish rate scenario for the European Central Bank (ECB).

Invasion Poses Further Energy Supply Constraints

Energy and defense stocks were bucking the selloff Thursday as both industries' near-term prospects will likely be directly impacted by the conflict.

The Ukraine invasion is taking place at a very unfavorable time for the global economy as oil prices were already heading higher to the $70-$80 per barrel range due to recovering demand and insufficient supply. The global oil industry has underinvested in production capacity over the past several years and is thus having difficulty responding with more barrels to address the higher pricing. Large oil producing nations within OPEC+ were already showing difficulty hitting production quotas and U.S. supply has been restrained by investors' calls for capital discipline and free cash flow generation over production growth. All has occurred while crude demand has accelerated back to pre-COVID levels of nearly 100 million barrels per day.

That said, Brent crude prices could remain elevated in the $100+/bbl range until this conflict is resolved as potential energy sanctions against Russia or potential pipeline disruptions from the conflict may lead to supply disruptions. Russia supplies 10% of the world's crude oil and 30-40% of Europe's natural gas needs. European natural gas storage levels had already been well below normal levels before the Ukraine conflict and Russia's supply to the Continent is already down about 40% vs. 2021. Any other potential impacts to supply could send European natural gas pricing well above the $30+ per thousand cubic feet levels seen today. This demonstrates the need for more European nations to sign up for long-term supply visibility with liquid natural gas projects from abroad.

The U.S. defense budget has remained well supported as geopolitical tensions have risen, in the face of advanced defense technologies demonstrated by China and Russia. We believe the current conflict between Ukraine and Russia will only increase the level of urgency felt by Congress to prioritise defense spending and could re-ignite funding for overseas contingency operations (i.e. emergency funding) which declined in tandem with the U.S. withdrawal from the Middle East. In such a scenario, both core defense budget and OCO funding should support defense stocks across the board. The challenge for the U.S. will be to balance long-term strategic goals to advance technologies with nearer term needs such as land-based warfare and military presence. We would also anticipate an increase in foreign sales to allies in Europe and Pacific Rim, which should further support U.S. defense stocks.

European markets are taking the brunt of the initial impact, given the "war in Europe" headlines and the direct impact on energy supplies/costs. Natural gas futures surged as much as 40% as Germany's pledge to not certify the Nord Stream 2 natural gas pipeline further pressured a Continent already reeling from commodity inflation. Higher energy costs hurting consumers and the level of Russian sanctions will have an effect on European growth and a knock-on effect for U.S. growth prospects.

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