

# Global Perspective from the Investment Advisory Group

## Intensified Russia-Ukraine tensions reinforce international markets underweight

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### What happened

As we highlighted in our 2022 annual outlook, a major geopolitical event is brewing on the border of Ukraine, with over 100,000 Russian troops ready to invade. The U.S. and its partners in Europe are in talks with Russian counterparts to avoid military intervention. The increased geopolitical risk is weighing on markets.

### Our take

#### As long as the parties continue to talk, a full-scale invasion is avoidable

Even before negotiations started, Russia amassed thousands of troops on the Ukrainian border in the event talks do not go as planned. The Europeans are renowned for having endless negotiations with incremental outcomes in the end, like the Brexit-related talks that lasted many years. This time much more is at stake, and it looks like Russia has no intentions of being dragged into fruitless talks. Similar to the Georgia invasion in 2008 or Crimea in 2014, if Russia was fully intent on invading a part of Ukraine, it would have already done so. Russia working with western counterparts to find a diplomatic solution shows its willingness to negotiate.

#### More troops are needed for a full-scale invasion, and Russia might not have the appetite to control all of Ukraine

Geographically, Ukraine is not a small country; it is approximately the same size as Texas. The consensus among military analysts is that Russia needs many more troops than the current buildup for a full-scale invasion and to maintain control. Russia might not face any opposition in pro-Russian regions of Ukraine like Donetsk and Luhansk, which is relatively small and borders Russia. However, the rest of the country might fight against a full invasion.

#### If negotiations fail, surgical strikes or a small-scale incursion are possible

Russia may choose to use surgical strikes with high precision weaponry or airstrikes upon strategic targets. Paramilitary and cyberattacks could continue in this scenario with some amount of damage to the existing military and government infrastructure of Ukraine. In this scenario, even though it would be considered a major geopolitical event, similar to the annexation of Crimea, a longer-term solution could still be achieved via further negotiations and concessions from both sides.

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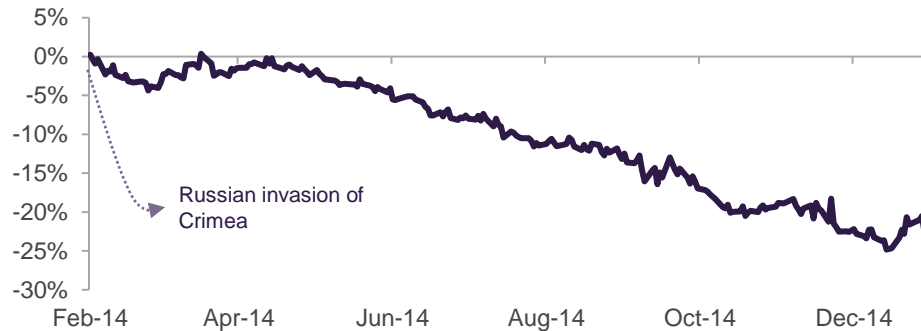
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- Are not bank guaranteed
- May lose value

## Europe's proximity and economic interconnectedness with Russia, means it has much more to lose

Europe imports almost half of its natural gas from Russia and more than a quarter of its crude oil. Titanium and aluminum used in Airbus planes (same as titanium for Boeing) are mostly sourced from Russia. Any significant sanctions on Russian trade could hurt European economies disproportionately. Prolonged conflict could force international airliners to travel to Europe by avoiding Ukrainian and Russian airspace and adding cost and time to Asia-bound flights. Russian tourists could curb their travels to Mediterranean summer destinations, leading to a drop in tourism revenues in southern Europe.

**Relative performance of MSCI Europe vs S&P 500 index following the Russian invasion of Crimea in 2014**



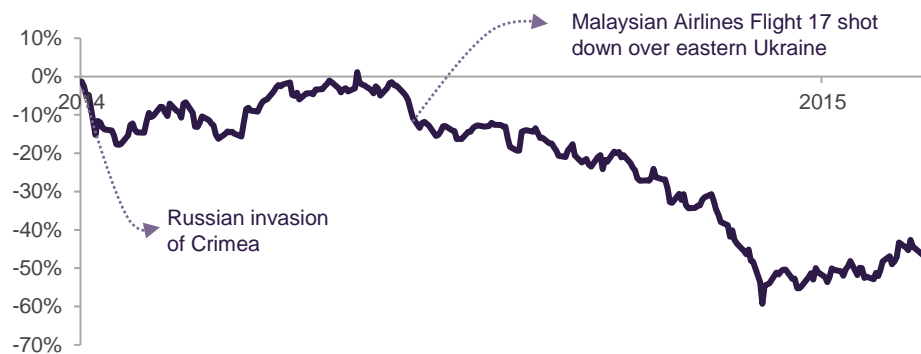
Data source: Truist IAG, Bloomberg

Over the last decade, it is hard to find a period where European stocks had a better return than stocks in the S&P 500 Index. Nevertheless, in 2014 European underperformance was much greater, with the Russian sanctions hitting European economies disproportionately.

## Russian and Emerging Markets are vulnerable too

Russia's economy is in a much better position than it was in 2014, with over half a trillion dollars worth of foreign reserves and a positive trade balance close to all-time highs. Still, a full-scale invasion of Ukraine would have some visible cost to the Russian economy, including possible economic sanctions by the U.S. and E.U. Any disruption of energy or agriculture production out of Russia and Ukraine could have a ripple effect on global pricing, which could hurt vulnerable emerging market economies.

**Relative performance of MSCI Russia vs S&P 500 index following the Russian invasion of Crimea in 2014**



Data source: Truist IAG, Bloomberg

Following the annexation of Crimea in 2014, the Russian markets performed significantly worse than U.S. markets. Underperformance accelerated after a Malaysian Airlines passenger flight was shot down in July 2014 while flying over eastern Ukraine, which became a significant turning point for Russian assets.

## Bottom Line

There is still room for diplomatic solutions, with talks continuing for longer than many anticipated. The longer the parties stay in communication, the risk of invasion lessens. Most military analysts highlight that a full-blown invasion of Ukraine could be very costly to Russia; therefore, a surgical strike to officially take control of the Donbas region of Ukraine could be the most likely scenario if negotiations fail. This would be the first major geopolitical event of 2022, but the global economic fallout could be limited if subsequent sanctions on traded goods and services from Russia also stay limited.

European markets are at more risk due to the interconnectedness of their markets with the Russian energy and commodity complex. With Russia as a member, emerging market equities and bonds could also get hit. The repercussions of higher energy and agriculture prices could disproportionately hit the vulnerable members of emerging economies. Safe-haven assets like bonds, gold, and the Japanese Yen could perform better for a brief period. Exports of Russia and Ukraine, like energy, industrial metals like platinum, palladium, titanium, nickel, or aluminum and grains could see prices rise as well.

We maintain our underweight positioning to emerging markets and to developed market equities outside of the U.S. and continue to monitor developments around this geopolitical hotspot.

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## Historical Background

### “Against whom is the NATO expansion intended?”

In 2004, seven countries joined the North Atlantic Treaty Organization (NATO), including Estonia and Latvia, which share a border with Russia. NATO’s eastward expansion in Europe raised many eyebrows in Russia, with President Putin asking his infamous question in a speech in Munich, “against whom is this expansion intended?”.

Since 2004, many ex-Yugoslavian countries have joined NATO, filling the gaps in NATO’s geographical coverage in Europe. Russian President Putin believes that now is the time to end that expansion.

### Russian invasion of Georgia

In 2008, Russia invaded the former Soviet state of Georgia, another country aspiring to join NATO. The short war ended with Russia seizing territories, ending Georgia’s hopes and sending a similar signal to Ukraine not to follow in Georgia’s footsteps.

### Maidan revolution in Ukraine

For Ukraine, a relatively calm period with Russia ended in 2014, with protestors fighting with government forces, resulting in the **toppling** of the Ukrainian government and ousting of pro-Kremlin president Victor Yanukovich. The Revolution of Dignity, also known as the Maidan revolution, brought Ukraine closer to Europe and one step closer to NATO. This left Russia

with only one choice, a quick invasion of Ukraine to protect Russia's critical military assets and signal that possible NATO expansion into Ukraine is its red line.

### **Annexation of Crimea**

After President Yanukovich's departure from Kyiv, Ukraine's capital, Russia invaded the Crimean Peninsula. The western world vehemently opposed blatant Russian violation of international law, and the U.S. and the European Union announced the first round of sanctions.

### **Troops build up for another incursion to Ukraine**

Russia assumes that NATO will eventually expand to Ukraine and request formal guarantees that the expansion will stop, which was rejected by the U.S. To have a more assertive negotiation posture, Russia started to build up a military presence for a possible full-blown invasion of Ukraine. From Russia's point of view, recent discussions with NATO members hit a dead end. President Joe Biden acknowledged that the U.S. administration expected a move in on Ukraine.

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