Sparinvest

# GEOPOLITICAL RISK PREMIUMS PRICED IN IN FEBRUARY

The effects of Russia's invasion of Ukraine in February immediately rippled across the financial markets, and we saw geopolitical risk premiums being priced in across asset classes and equity sectors. The prices of certain commodities soared in the wake of the Russian invasion.

According to MSCI ACWI, global equities lost 2.6% in local currency last month. Translated into DKK, this was a decrease of 2.5%, led by Europe, which was followed by the U.S., whereas equity indices in Japan and the other Asian countries reported a smaller decrease. MSCI Russia dropped by 36% in local currency and nearly 53% in DKK in February. Companies within Materials and Energy yielded the highest returns, and companies within Tech and Consumer Discretionaries the lowest returns in the month.

Risk premiums (ie the return an investment is expected to yield in excess of the risk-free rate of return) was also priced into European corporate bonds. Credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds widened by 42bp and 77bp, respectively, last month, resulting in excess returns of -200bp and -275bp, respectively, relative to the returns on comparable government bonds. The generally higher risk aversion did not feed through to Danish government bonds, the yield rising from 0.2% to 0.4% in the 10Y segment. Prices of oil, gas and wheat rose by 10%, 16% and 22%, respectively, last month. Russia is a key producer of these specific commodities.

### Geopolitical unrest will overshadow key indicators for a while

The conflict between Russia and Ukraine will for some time take focus away from traditional key indicators. The geopolitical conflict is a landmark event of such magnitude that it will give rise to some kind of data breach. Key indicators covering the period up to the outbreak of the conflict will be deemed worthless – and those covering the period immediately after the outbreak will be under such influence of the conflict that a prudent interpretation is necessary.

The current geopolitical conflict between Ukraine and Russia could impact the global economy through several transmission mechanisms:

- Weakened global trade, for example due to sanctions
- Economic downturn or standstill for parties directly involved
- Increased prices and low supply of certain commodities
- Generally tightened financial conditions

Russia, and Ukraine in particular, are small economies in a global context, which represent around 2% of the global economy. The two countries' trade with the rest of the world is limited. Both imports and exports make up less than 0.5% of global GDP, a scale showing that the direct effects, including trade, will be limited for the global economy.

The main economic risks relate to energy supply – Russia has a special status as major supplier of gas and oil to Europe. Both parties may be forced to use the energy area to impose mutual sanctions, which will inevitably lead to price increases and supply issues. This would be the main transmission mechanism to lower growth in economies with high energy import dependency, primarily Europe and secondarily Asia.

### Investment conclusions and asset allocation

For the time being, Russia seems to be in feeble control of Ukrainian areas, and the military conflict will

thus last a while longer. The implications going forward are two-fold: Firstly, the conflict will lead to lower confidence indicators and a downward adjustment of economic growth forecasts. Secondly, geopolitical risk premiums on financial assets will not be phased out in the near future.

Geopolitical conflicts often trigger tighter financial conditions. This could generally impact the access to and the cost of capital – even for parties who are not directly involved in the conflicts. As previously mentioned, risk premiums on equities and corporate bonds have risen in recent days. From a European perspective, this development has merely moderately tightened financial conditions, and so far the adverse impacts are considered modest. However, the usual stabilisers are setting in. German government bonds are reversing much of the recent yield rises. The ECB has said "to take whatever action needed for stability" along with the first signals of a delay in monetary tightening. Germany has spearheaded the launch of fiscal policy spending packages in the defence area. More European countries are likely to follow suit.

In their initial phase, conflicts typically has an adverse impact on business confidence. This again has an impact on confidence among investors, as stated by AAII (American Association of Individual Investors), which has hit the second-lowest level in ten years. Evidently, previous geopolitical conflicts have not left a lasting mark on risk aversion and returns. The tactical risk level is maintained in the form of a neutral allocation between equities and bonds.

Editorial deadline: March 24, 2022