

THIS WEEK WITH SADIQ



As of February 28, 2022

Ukraine-Russia Conflict: Impacts on Markets, Oil & Positioning

Weekly Commentary

Conflict Summary

- Over the weekend, Russia continued its offensive on Kyiv, Ukraine's capital city, and President Vladimir Putin put Russia's nuclear forces on high alert.¹
- Ukraine sent a delegation to the Ukrainian-Belarusian border for talks with Russian officials.²
- Russian forces have entered Ukraine, launching missile strikes and attacking on several fronts.³
- The invasion follows months of escalating tension related to Ukraine's ambition to become a full NATO member. It is currently listed as a "partner country."
- NATO-member countries have chosen to support Ukraine economically—through donations and sanctions targeted at Russia.

Sanctions Summary

- West: Western allies have excluded some Russian banks from the SWIFT payment system, effectively "disarming" the country's central bank.⁴
- Russia: The Bank of Russia more than doubled its interest rate to 20% as the ruble sank 30% on the news of Western sanctions.⁵
- United States: On Thursday, U.S. President Joe Biden announced sanctions against Russia, including freezing trillion in assets, cutting off Russia's largest banks and companies from western financial markets, and restricting exports of technology to Russia.⁶
- Europe:
 - New sanctions announced by the European Union will halt Russian banks' access to European financial markets and target Russian trade, energy and transport, among other sectors.⁷
 - The European Union closed its airspace to Russian aircraft, causing a halt to many flights in and out of the country, and said it would help Ukraine fund the purchase of weapons.⁸
- United Kingdom: Sanctions announced by U.K. Prime Minister Boris Johnson will exclude major Russian banks from the U.K. financial system, freeze the assets of Russian oligarchs, and stop exports of high-tech items and oil refinery equipment.⁹
- Canada: Prime Minister Justin Trudeau has announced that Canada's sanctions will target 62 Russian individuals and entities, and Canada will stop approving and cancel all existing export permits for controlled technology to Russia.¹⁰

Impact on Markets

Equity markets reacted sharply to news of Russia's invasion of Ukraine, and in our view, that stems from the difference between suspicion and certainty—we knew an invasion was possible, and rising tensions have been impacting markets for weeks, but it's different to see it unfold before your eyes. However, the markets reversed course later in the day and continued that momentum the next day given the sanctions were strict but without of much economic impact to other countries. What remains to be seen is what the reaction will be from the rest of the world, including China, and whether the conflict will spread. That process will play out over the next several weeks. For now though, uncertainty—including pre-existing concerns related to potential interest rate hikes by the U.S. Federal Reserve—means that markets are likely to remain on their toes.

Our suggestion is to watch the key watermark levels on major indices. For example, the S&P 500 could drop below a threshold like 4,000 points if the Ukraine/Russia crisis persists. In terms of sanctions, those already announced by the United States, Canada and other governments are likely to

Expert

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severely impact the Russian economy. That will mean some fallout across global markets because of Russia's importance to the energy sector, which could impact Europe more than other countries. But remember that Russia is not an economic superpower like China, and as such, the worldwide impact will be minimal.

Bottom line: History has shown that situations like this are temporary and markets have historically rebounded when the geopolitical situation improves, but for now, there is a great deal of uncertainty.

Impact on Oil

We've already seen supply shocks resulting from the invasion. The question is whether those shocks are temporary. We don't know how long the fighting will persist, and the longer it lasts, the longer oil prices will stay high. The other part of the equation is a potential nuclear deal with Iran, which could unlock new supply and potentially reduce dependence on Russia. But that deal is unlikely to materialize overnight. It's also unclear how OPEC will react to the situation—they want to maximize profit while oil prices are high, so rising demand could incentivize them to produce more. Our evaluation is that prices will likely remain high—and perhaps move even higher—in the short term. Increased supply could draw them back down slightly, but in the longer term, they will continue to inch upward as post-COVID reopenings continue and overall demand remains high.

Bottom line: Oil prices will remain elevated, but we're not likely to see six months of continual price increases.

Gameplan: 3 Potential Scenarios

Scenario 1: Short-lived military standoff

This would be the best for everyone, returning the global economy back to its post-COVID trajectory, where inflation is the biggest enemy, and the ammunition is central bank rate hikes to hopefully engineer a soft landing. Of course, the notion that the conflict might delay Fed action at the next meeting is very possible, but it is more likely that Jerome Powell will stay the course, as energy inflation will only compound the current price pressures experienced by businesses and consumers. The bravest might say that any market, even Russia, is a bargain at 40% with a sufficiently long investment horizon, but a more conservative approach would be to take this opportunity to add to companies that have sold off with the broader market. One approach would be to simply add to broad beta, like the S&P500 or TSX Composite, or alternately, focus on higher beta reopening plays like Airlines, Financials or Consumer Discretionary, which having been hit harder by the initial news and should outperform upon de-escalation of the conflict.

Scenario 2: Drawn out stand-off

This will be the most difficult to manage anxiety around, as waiting for the next shoe to drop on either side will effectively paralyze investors, with heightened volatility and political rhetoric. The likelihood of US or even NATO troops being deployed are low, with sanctions being primary economic, cutting banking flows and mobility among senior officials to western countries. In this scenario, Russia's energy exports will be the most critical pain point, for both sides. With Europe's current dependence upon Russia for close to 40% of its energy needs, the impact of energy inflation will be felt worldwide. In the short term, this capacity will not be easily replaced, suggesting Energy's outperformance year to date will only accelerate. This and other price inflation will erode the margins of many industries, bringing valuations of industrials and services under scrutiny, returning the focus to earnings growth, including technology and communications that are less dependent on the prices of physical inputs. This would regionally suggest the US as a more defensive market, despite the extreme valuations of certain names within the index. Riskier assets, including cryptocurrencies and more speculative stocks will probably trade sideways at best, with no clear direction to provide a catalyst. In such sideways markets, covered call strategies can be particularly effective. This scenario would be an environment where quality will outperform, as fatter free cash flows acting as a buffer to uncertain earnings forecasts.

Scenario 3: War

This is the scenario that scares investors most, the dreaded "what if?" Full scale conflict between ground troops, especially NATO or US involvement, would create the most pain for markets. This is a scenario in which economics are set aside in favour of harsh, forceful actions. Would either side risk the use of nuclear arms in the pursuit of their goals? One would like to think that cooler heads would ultimately see the folly of going down that path, but even if the conflict remains contained to conventional armaments, this scenario will also have the longest lasting impact on the global economy. Even if Russia is no longer the primary concern, it will set a precedent for other regional conflicts, and more importantly, how nations and economies restructure trade with other countries, potentially leading to a greater return to nationalistic policies on immigration, tariffs and capital flows

Portfolio Positioning

When thinking about positioning, the question to ask is: Will the Ukraine/Russia conflict prompt any long-term structural change to markets? Our answer is no, though the determining factor is how long and widespread the conflict becomes. Obviously an overweight to equities position has been detractive on a down day, but relatively speaking, our allocation to Canada and US Energy in the [BMO ETF Portfolios](#) are obvious beneficiaries of the spike in oil prices. We were underweight Europe and EM, which is also favourable should conflict continue. Our modest short of duration is lagging as yields fell modestly overnight, but it is hard to imagine that this will derail Jerome Powell's agenda headed into the expected rate increases in March. The portfolios have been building a larger cash position in the past week on heightened market volatility, which again creates opportunity to deploy capital during dips in the market over the weeks ahead. Most importantly, we are not reacting to the 24-hour news cycle.

Bottom line: Long-term structural changes to markets are unlikely, which means that there are buying opportunities. Meanwhile, we will remain vigilant and monitor developments closely, adjusting the portfolios accordingly.

As Chief Investment Officer, Sadiq S. Adatia's views directly influence the [BMO ETF Portfolios](#).

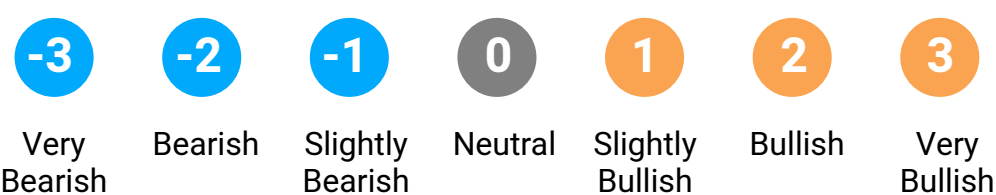
Market Update

- Russia's invasion of Ukraine came as another forceful shot to an equity market that was already grappling with persistent inflation pressure and a looming monetary policy tightening cycle.
- No bother, the S&P 500 finished the week up 0.8%, after some wild intraday swings, but still sits down 8% on the year.
- Defensives led on the week, while banks and consumer stocks lagged. The Nasdaq swung even more dramatically to finish up 1.1%, while the TSX rose 0.5%.

Asset class views, as of February 2022

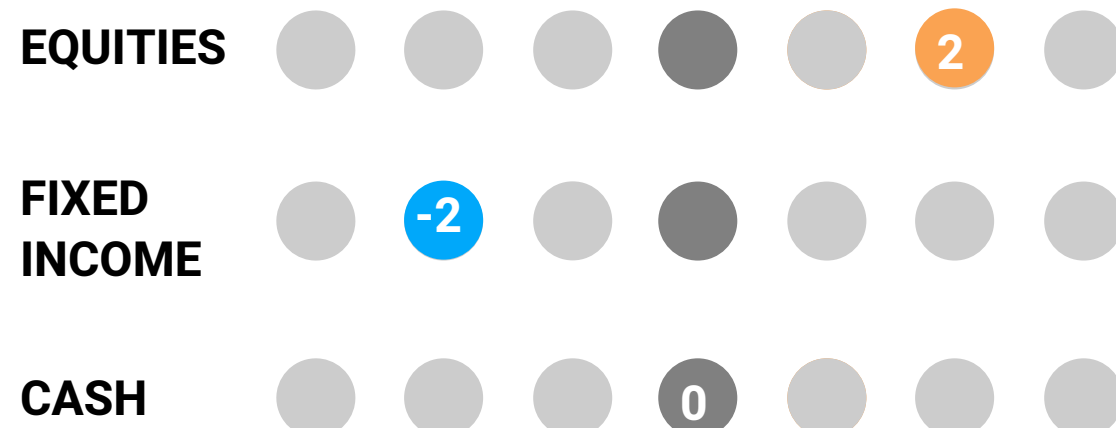
Monthly Perspectives

At BMO Global Asset Management, we recognize that asset allocation is the primary driver of long-term portfolio performance. That's why our Multi-Asset Solutions Team (MAST) has developed a simplified "Five Lenses" view to help explain what is driving their asset allocation decisions.



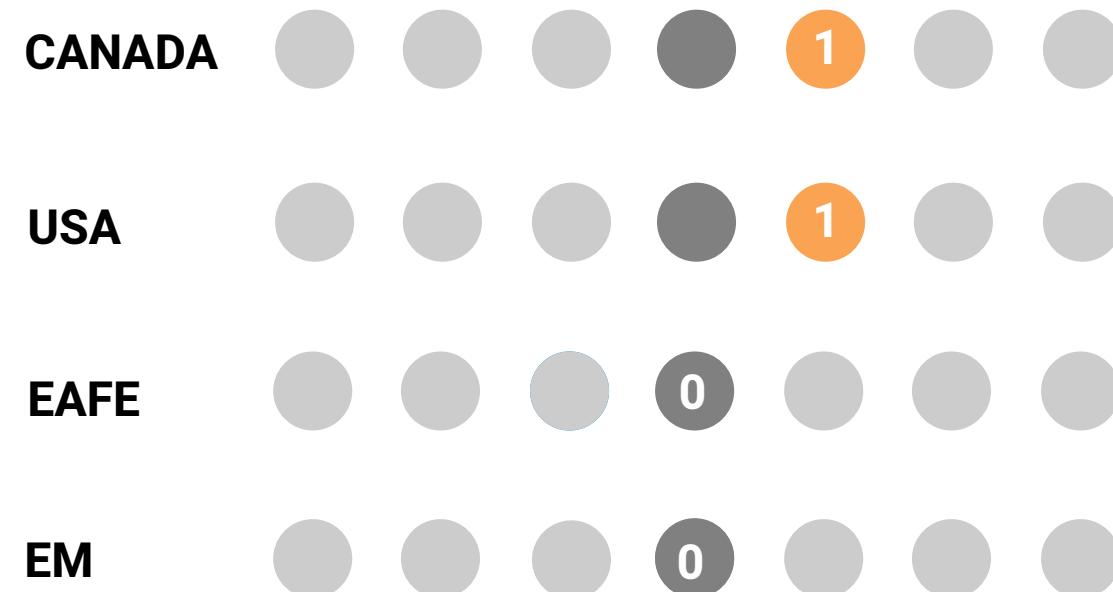
Asset Mix

- COVID-19 and Omicron are lingering but no longer posing a material threat to the economic outlook, especially in the U.S.
- We expect global growth to cool but to remain above trend in 2022 while inflation remains elevated.
- Strong earnings growth should more than offset equity valuation headwinds from rising rates in 2022.



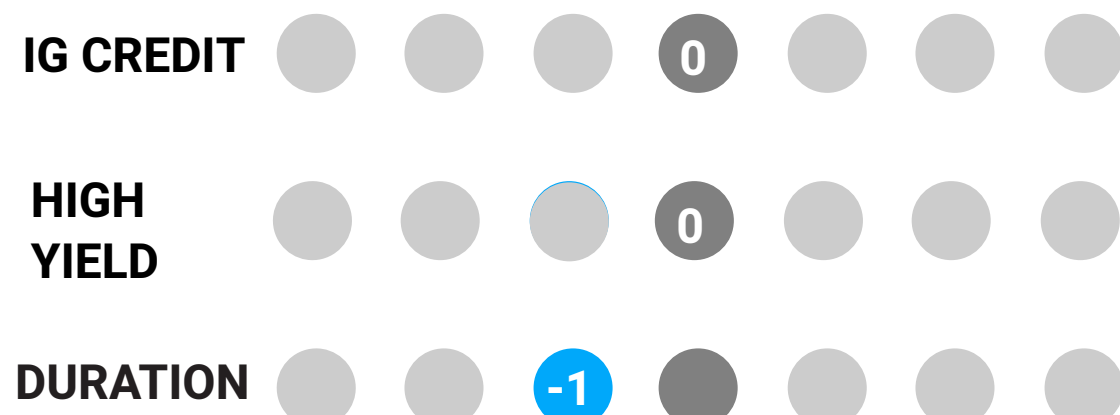
Equity

- North America continues to offer the best risk-reward outlook, especially after the weak year-to-date performance of U.S. equities. Mid-cycle dynamics and energy-driven inflationary pressure favour the U.S. and Canada.
- Although China's economic outlook remains soft, market negativity on EM and EAFE equities has probably peaked.



Fixed Income

- March is widely expected to see the U.S. Federal Reserve (the "Fed") and BoC start normalizing interest rates, probably at a fast pace throughout 2022.
- Government bonds and bond duration remain unattractive as central banks are about to hike while the growth and inflation outlook remain strong.



Style/factor

- Mid-cycle dynamics along with anxiety over Fed hikes favours higher quality stocks, whose revenues and earnings are more predictable and less sensitive to swings in economic expectations



Implementation

- Bank of Canada may hike interest rates sooner than other central banks which would support the currency, versus heavy commodity-importing currencies such as the Euro and Japanese Yen.
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Thank you for reading!

¹ [“Ukraine invasion: Putin puts Russia’s nuclear forces on ‘special alert’,” *BBC News*, February 28, 2022.](#)

² [“Ukraine-Russia talks begin on Belarus border as fighting rages for fifth day,” *Financial Times*, February 28, 2022.](#)

³ [“Ukraine conflict: Kyiv braces for Russian assault,” *BBC News*, February 25, 2022.](#)

⁴ [Stephen Chase and Robert Fife, “West to limit Russia’s access to major global payment system SWIFT,” *The Globe and Mail*, February 26, 2022.](#)

⁵ [“Ukraine conflict: Russia doubles interest rate after rouble slumps,” *BBC News*, February 28, 2022.](#)

⁶ [Michael D. Shear and Zolan Kanno-Youngs, “Biden announces new sanctions: Putin and Russia ‘will bear the consequences’ of their war,” *The New York Times*, February 24, 2022.](#)

⁷ [Ingrid Melander and Gabriela Baczynska, “EU targets Russian economy after ‘deluded autocrat’ Putin invades Ukraine,” *Reuters*®, February 24, 2022.](#)

⁸ [Emily Schultheis and Lorne Cook, “EU shuts airspace to Russian airlines, will buy Ukraine arms,” *Associated Press*, February 27, 2022.](#)

⁹ [Alex Therrien, “Ukraine conflict: UK sanctions target Russian banks and oligarchs,” *BBC News*, February 24, 2022.](#)

¹⁰ [Andrew Morrow and Steven Chase, “Western allies hit back with further sanctions against Russia as war rages throughout Ukraine,” *The Globe and Mail*, February 24, 2022.](#)

Disclosures:

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