Kenanga Investors

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Commentary on the Ukraine-Russia conflict

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Market Review:

Global markets fell as the geopolitical conflict between Russia and Ukraine has escalated to the point of full-scale invasion. Meanwhile, the global macro backdrop remains challenging, with inflation in the USA reaching 7.5% YoY in January, prompting markets to expect the FED to raise interest rates at a faster pace and also begin the reduction of its balance sheet (Quantitative Tightening).

While Russia and Ukraine are both a small in terms of global GDP (<2%), the impact to global markets more pronounced via the impact of commodity exports. Russia is a key exporter of oil & gas, aluminum, palladium and fertilizer, while Ukraine ranks among the top exporters of wheat, barley, corn and sunflower oil. Commodities rose on the back of the crisis, with Brent Oil breaching >USD100/barrel, CPO rising to RM6,718/ton and aluminum rising to USD3,357/ton as of 25th Feb.

Year to date as of Friday 25th Feb, the S&P500 is down 8%, the NASDAQ down 12.5% while Asia (Asia Ex-Japan Index) is down 5.7%. Locally, the FBMKLCI fared better, up +1.5%, given the heavy composition of domestic focused sectors such as banks and strong contribution from the plantation sector which benefited from the higher prices.

Hence while commodity producers such as plantation and energy did well, export driven sectors such as technology and manufacturing were hit hard by concerns on the geopolitical impact to demand and supply on top of previous concerns of tighter monetary policy. Supply of crucial commodities could be impacted by potential sanctions. Key western countries have announced sanctions on various parts of the Russian economy including certain banks and key individuals. The proposal to remove Russia from the SWIFT banking system is also under deliberation.

Market Outlook:

We think the main impact to global markets will arise from 1) Impact of sanctions, and 2) Disruption to the commodity trade. Looking at the reaction from Western countries, sanctions and responses are directly linked to the duration and severity of the conflict. Hence the outlook will depend on the escalation or de-escalation of conflict on the ground.

Measures that would have the most impact on the global economy would be the full sanctioning of oil & gas transactions with Russia, which could cause a further spike in energy price and inflation. For now, Western countries seem less keen on this option.

Geographically, the economic impact would be largest in Europe, as Russia contributes to about 35%-40% of Europe's gas supply. Should this be cut-off, this could trigger a recession in Europe and impact global demand.

For now our base case remains that uncertainty lingers, but much has been priced in by market. Markets are forward looking and sold-off ahead of uncertainty, and could rebound if the conflict de-escalates or a ceasefire is announced. If we look at the previous impact of war on markets, equities typically sell-off going into the conflict, but then rebound 6-12 months thereafter.

Despite this new development, we generally remain with our view set at the beginning of the year that the global recovery will continue, albeit with some dispersion among regions as the leaders of 2021 take a step back while the laggards catch up. Emerging markets such as Asia look set to pick up while developed markets such as the United States slow from a high base of growth in 2021. Considering that lockdowns persisted in several emerging Asian economies throughout 2021, these nations (such as ASEAN) should recover quicker when the re-opening prompts a resurgence in economic activity. Additionally, China's challenges in 2021 such as growth slowdown, policy tightening, property defaults and power shortages should improve in 2022. China's government policy has also started to shift to an easing bias as leaders assess the slowing growth data. As a result, there is no change to our overweight call on Asia and ASEAN (including Malaysia) overall for 2022. While this conflict is could be a drag on growth from Europe, we maintain an underweight stance for that region.

Market Strategy:

Most of the equity funds recorded negative returns YTD, dragged by overweight positions in the technology sector which were negatively impacted by both tighter monetary conditions and escalation in geopolitical conflict.

Despite that, the fundamental outlook for this sector still remains solid, with the structural trends such as rising EV usage, computational intensity of AI and proliferation of semiconductors in the Internet of Things continue to gain momentum. With oil at >USD100/barrel, we think EV adoption could be intensified and further increase demand.

While short term volatility has increased, we still believe fundamental stock picking remains the key to long term outperformance. Nonetheless we are pragmatic, and in the short term to manage risk, our funds have reduced investment levels by raising cash and controlling exposure to the tech sector. Additionally, we have been increasing investments in domestic sectors such as banks and consumer, and also external sectors that still have a positive outlook such as commodities.

Nonetheless, we think that the sell-down in global equities opens up opportunities if one takes a longer-term view. Countries and sectors that are relatively insulated from this conflict such as Asian financials, consumer and certain tech companies where fundamentals are still solid presents a rare opportunity for investment at discounted prices.

On the other hand, as investors switch to risk-off mode, demand for safe haven assets may continue to rise, hence providing upside to fixed income funds. Longer-term, whilst we expect bond prices to be predominantly driven by inflation expectations and yield movement, they provide better capital preservation in the short term.

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