Market Synopsis – February 2022

The beginning of WW3 or a passing conflict?

The Russian invasion of Ukraine. Its impact is being felt globally, and it is almost impossible to find a news channel not covering the ongoing story. While the invasion's roots start in 2014 when Russia annexed the southern tip of Ukraine (Crimea), the most important developments have unfolded over the past week.

In the early hours of the morning of 24 February 2022 Russian President, Vladimir Putin broadcasted a speech to his nation. He announced that he had decided to conduct a special military operation in order to "protect people who have been subjected to abuse and genocide by the Kyiv regime for eight years." His speech continued by stating that: "whoever tries to interfere with us, and even more so, to create threats for our country, for our people should know that Russia's response will be immediate and will lead you to such consequences that you have never experienced in your history." Minutes later the first of many missile and long range artillery attacks fell on key locations near Kyiv and Kharkiv.

However, the war has not gone to plan as the Russian leader had hoped. The Ukrainian military and populace has put up more of a fight than expected, and the West has been far swifter and harsher with its sanctions. Russia has suffered heavy casualties and equipment losses and supply lines are running dry. Peace talks were held on 28 February, but ended fruitlessly. Further bloodshed is unfortunately expected as more troops and supplies are sent from Moscow.

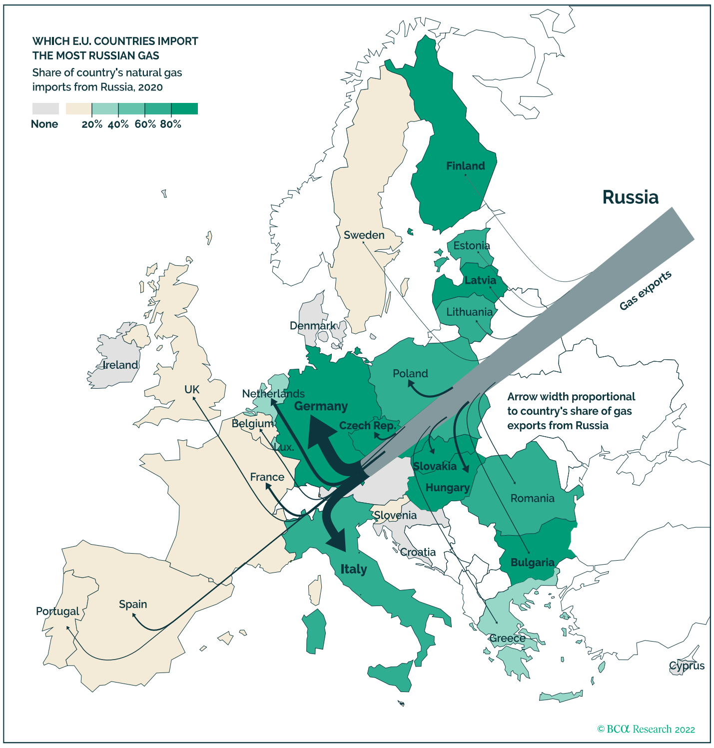
While the West is sending supplies and laying sanctions on the Russian state, these are unlikely to dissuade Putin from continuing his invasion. The current Russian president made a name for himself in 1999 by conducting a successful invasion of Chechnya, 3 years after the Russians had experienced a crushing defeat in the region. Pulling out of Ukraine now with nothing to show for his effort would be humiliating and an unacceptable option for the President. The Russians initially tried to avoid populated civilian areas, in the hopes that the Ukrainians would see the Red Army as a liberating force. As this narrative has not worked and as Putin gets more desperate, an increasingly brutal and deadly offensive is likely to unfold.

Market implications

While crass to discuss monetary concerns in the same breath as an ongoing conflict, it is our duty as analysts to do our job.

Any news out of Ukraine will impact the markets in one way or another, expect extreme volatility. Global equities are expected to underperform in the near term as a quick and peaceful resolution to the conflict becomes increasingly unlikely. North American equities may perform better than their Western European peers as Europe faces significant pressure from short term disruptions in Russian gas supplies. It makes no sense for Russia to continue to export gas until they are reinstated into the SWIFT global banking system. Central and Western Europe will be the hardest hit by the gas shortage – see Figure 1.

Unless alternative solutions can be sourced, Russia will be able to use this as leverage over the West to limit the severity of imposed sanctions. While the progress of Nord Stream 2, the gas pipeline from Russia to Germany which will double the current pumping capacity, has been put on hold due to the ongoing sanctions, production from Nord Stream 1 has not.



SOURCE: JOSH HOLDER, KARL RUSSELL, AND STANLEY REED, "HOW A UKRAINE CONFLICT COULD RESHAPE EUROPE'S RELIANCE ON RUSSIA," *THE NEW YORK TIMES*, FEBRUARY 15, 2022.

Figure 1 – Russian gas exports

The biggest player in Western Europe and the most impacted by the gas shortage, Germany, will have a large role to play in future sanctions against Russia.

Past the immediate volatility of the conflict, we still maintain a positive outlook on equities. It is unlikely that the conflict will spill over into bordering nations, as NATO has no desire to be in direct conflict with Russia. By late 2022, it is likely the world will return to the status quo, with Russia and the West spouting hateful rhetoric to one another while pursuing mutually beneficial arrangements. Even during the height of the Cold War, the Cuban Missile Crisis, the impact on US equities was brief – see Figure 2.

If the reduction in energy exports from Russia are temporary, oil prices will also return to a normalised level. While the current spot price of oil is USD 101/bbl, the end of 2022 futures price is sitting at USD 87/bbl.

Short term volatility and increased prices will benefit oil producers, but is expected to taper over the course of the year.

Global growth is also anticipated to remain above trend as pandemic related hinderances fade and global fiscal policy becomes more expansionary. Even prior to the Ukrainian conflict, the primary budget deficit in Europe was on track to swing from a small surplus to deficit – see Figure 3 on the next page.

This conflict is highly likely to result in large increases in military spending across the world, as well as increased initiatives to achieve energy independence in Europe. While longer term programs will include renewables, shorter term requirements may necessitate restarting nuclear programs.

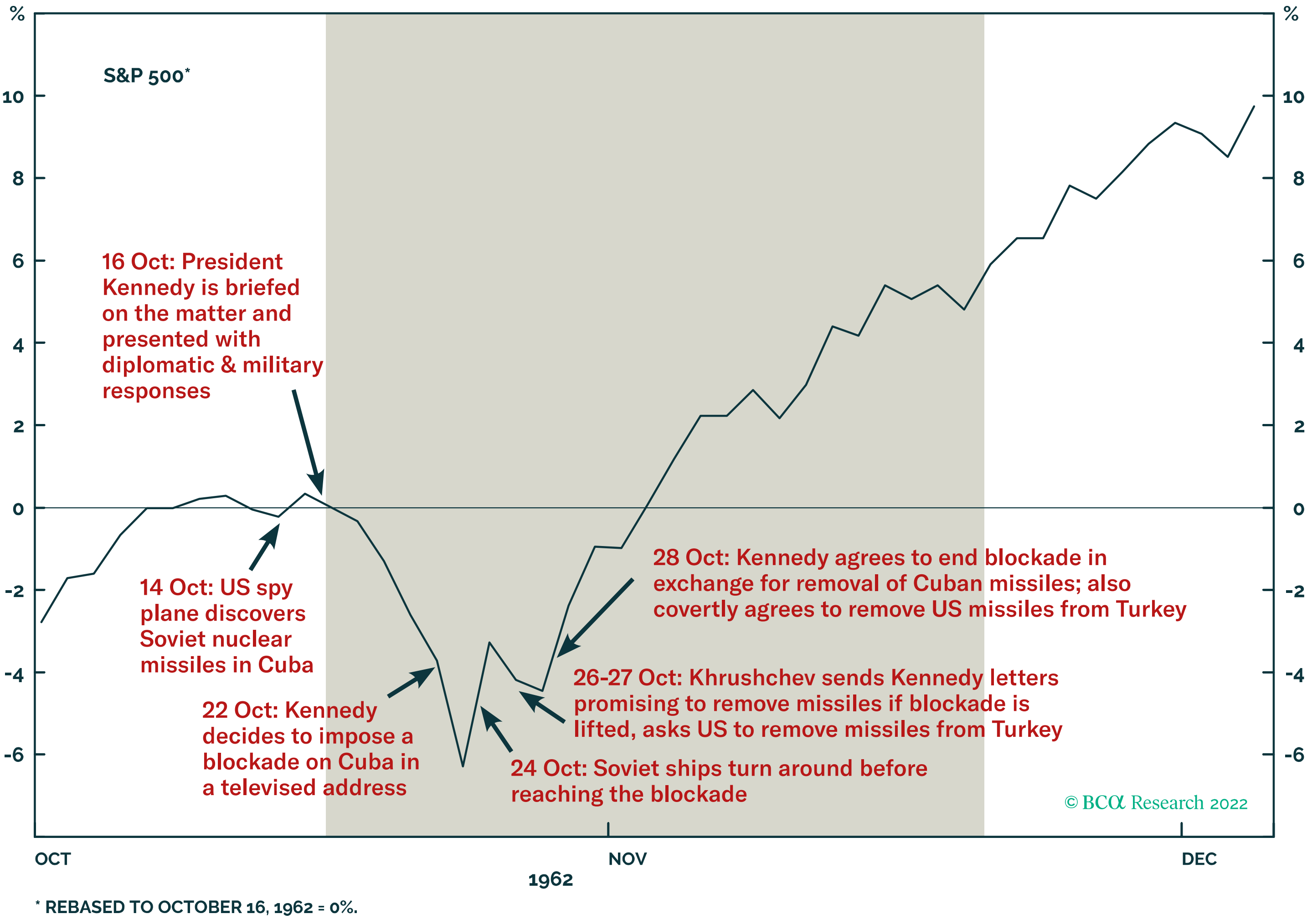
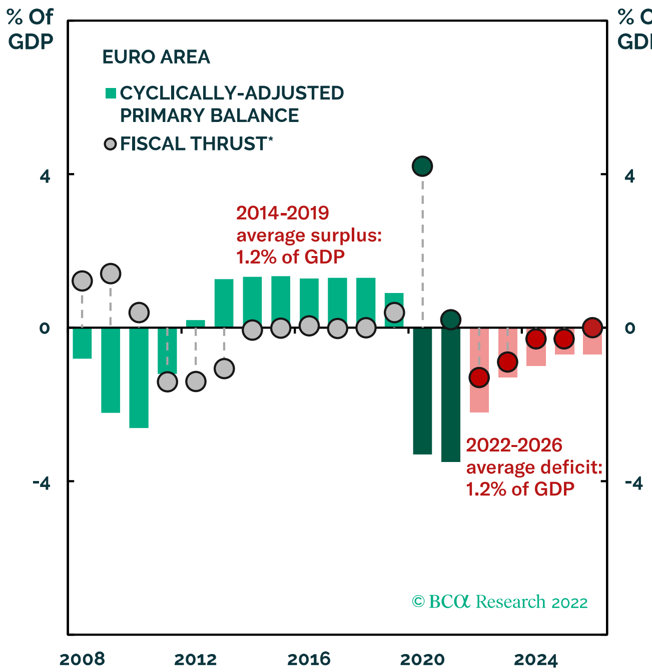


Figure 2 – The Cuban Missile Crisis's impact on US equities

Summary

The Russian invasion of Ukraine is the first major aggressive conflict in the European theatre involving a superpower since World War 2. While the outcome of the engagement will hopefully resolve quickly and with limited bloodshed, the fallout of Putin's decision will impact global geopolitics for decades to come. Sanctions on Russia from the West will put strain on both sides. The Russian stock market is still frozen after falling over 30% in a day, the Ruble has depreciated by 25%, and the Russian Central Bank has hiked interest rates from 9.5% to 20% in an emergency effort to stem funds bleeding out of the economy. While Western Europe has yet to feel much impact, years of energy dependence and lack of investment into alternative production will result in rampant energy inflation and shuddering business output once the Russian pipes close their taps. Hopefully the West can find alternative sources or outlast the freefalling Russian economy.

Over the next three to six months (depending on how long the occupation lasts), we expect high levels of volatility across the board as the situation develops and evolves. Gold and oil have already experienced rapid escalations in price that may persist for some time, but should return to more normalised levels towards the end of the year. Sectors and companies involved in weapons manufacturing and defence will likely continue their upward trajectory as people anticipate further conflict. While there may be a knee jerk reaction to underweight equities in the near term, timing the market will prove incredibly difficult. Many high quality stocks have come under pressure recently, presenting attractive buying opportunities. Following the conflicts resolution, reversals in government surpluses should bolster global growth, and more specifically target defence and energy production. The USD will likely continue its upward trajectory over the near term, but should start receding versus the EUR around midyear as the European region stabilises. The situation however remains very fluid, therefore constant monitoring of the risk are required.



SOURCE: IMF FISCAL MONITOR (OCTOBER 2021), AND EURO AREA 2021 ARTICLE IV CONSULATION.

Figure 3 – Europe's balance of payments

For more information on this Market Synopsis or to discuss solutions provided by Integrity Asset Management, please contact us at:

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Indicator	Spot	MTD	YTD	Y-o-Y
Gold	1 908,99	6,2%	4,4%	10,1%
Brent Crude	100,99	10,7%	29,8%	52,7%
USDZAR	15,3756	-0,1%	-3,5%	1,7%
EURZAR	17,2531	-0,2%	-4,8%	-5,4%
GBPZAR	20,6327	-0,3%	-4,4%	-1,9%
JSE All Share TRI	12 434,14	2,9%	3,8%	20,5%
JSE Resources TRI	6 524,18	16,1%	20,6%	36,3%
JSE Industrials TRI	17 734,69	-7,7%	-9,5%	1,8%
JSE Financials TRI	10 303,04	3,6%	7,1%	34,9%
JSE Listed Property TRI	1 582,42	-3,3%	-6,0%	22,4%
S&P 500	4 373,94	-3,1%	-8,2%	14,8%
Euro STOXX 50	8 680,99	-5,9%	-8,5%	10,0%
FTSE 100	7 418,64	0,3%	1,4%	19,2%
Nikkei 225	44 595,18	-1,7%	-7,8%	-6,9%
Hang Seng	69 689,14	-4,6%	-2,9%	-19,6%

Source: Bloomberg, as at 28 February 2022