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Mackenzie commentary on the escalating conflict in Ukraine

Seeking clarity in the Fog of War

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The objective of our commentary today is to highlight the capital market implications of the escalating tensions between Russia and Ukraine that have led to the recent invasion by Russia. Foremost, our thoughts go out to the Ukrainian people. We hope the situation improves rapidly with the least amount of humanitarian cost.

Bottom line for investors:

Uncertainty is the name of the game; risk premiums are rising – equity markets are see-sawing on the volatile situation. Bond yields are stable, providing some risk protection to balanced investors. And other safe-haven assets like the U.S. dollar and gold are also rallying.

We rely on the weight of history to guide us and temper any knee-jerk reactions. Although memories are short, capital markets have faced these situations many times in the past decades, and they eventually recover (see table for details).

Market Crisis and Subsequent Returns

Crisis	Market Low	Related Market Decline	Months to Recover	1 Year Later	2 Years Later
The Korean War	13-Jul-50	-14.0%	2	31.7%	49.7%
Cuban Missile Crisis	23-Oct-62	-26.4%	10	36.5%	59.2%
JFK Assassination	22-Nov-63	-2.8%	<1	23.9%	31.6%
1969 to 70 Market Break	26-May-70	-36.1%	21	43.7%	59.7%
1973 to 74 Market Break	06-Dec-74	-45.9%	67	33.5%	59.3%
1979 to 80 Oil Crisis	27-Mar-80	-17.1%	3	37.1%	14.0%
1987 Stock Market Crash	19-Oct-87	-33.2%	21	23.2%	54.4%
Desert Storm	11-Oct-90	-19.9%	4	29.1%	36.3%
Soviet Coup D'état Attempt	19-Aug-91	-3.6%	<1	11.1%	21.2%
Asian Financial Crisis	02-Apr-97	-8.1%	1	49.3%	72.5%
Dot-com Bubble crash	09-Oct-02	-49.1%	55	33.7%	44.5%
Sept 11th	21-Sep-01	-11.6%	1	-12.5%	7.3%
Invasion of Iraq	11-Mar-03	-14.7%	2	38.2%	49.9%
North Korean Missile Test	17-Jul-06	-6.9%	2	25.5%	2.1%
Subprime Mortgage Crisis	09-Mar-09	-56.8%	47	68.6%	95.1%
US Debt Rating Downgrade	03-Oct-11	-19.4%	5	32.0%	52.2%
Crimea Annexation	03-Feb-14	-5.8%	<1	17.7%	9.8%
China Yuan Devaluation	11-Feb-16	-13.0%	3	26.6%	43.2%
2018 Global Recession Scare	24-Dec-18	-19.8%	4	37.1%	57.5%
COVID-19 Pandemic	23-Mar-20	-33.9%	4	74.8%	-
Average		**-21.9%**	**12.8**	**33.0%**	**43.1%**

Snapshots in time of significant negative international events from 1950 to January 31, 2022, and the subsequent change in market value from the stock market low in that calendar year to one and two years after. Source: Datastream and Bloomberg. Benchmark: S&P 500 Composite, US$ return.

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Our advice is grounded in the appropriate management of risk tolerance and time horizon, with time horizon being especially key in situations like this. Having the flexibility to weather any storm is a guiding principle for prudent, well-balanced investors. With an appropriate, multi-year time horizon, the golden rule of investing remains - stick with your portfolio if it reflects your long-term goals and plans. While it is impossible to predict the future path for this conflict, our view is that elevated volatility is expected to remain, adding to the existing headwinds of looming central bank tightening, inflation, and supply chain challenges. If your circumstances cannot sustain higher volatility, then that is a reason to make a shift, not the escalating volatility itself.

Economic impact:

Outside of direct damage to the Ukrainian and Russian economies, the impact to the global economy runs through the path of the extent of sanctions and supply chain disruptions and potential damage to consumer and business sentiment (especially in Europe). These impacts would likely slow economic growth - risk premiums are expected to rise, inflation pressures grow, and supplies of key global commodities face price increases and potential shortages.

The extent of these frictions depends on the scope of the sanctions and the possibility of Russia's weaponization of commodity supplies to further their goals. At the moment, Russian energy supplies to Europe remain largely undisrupted. Thus far, except for the Nord Stream II pipeline, energy has been exempted from sanctions to avoid exacerbating the already precarious supply picture in Europe. As a reminder: Nord Stream II has not been providing any gas to Europe, so sanctions here do not remove existing supply.

There is no clear path on sanctions. All sides bear risk with degrees of negative outcomes for all parties and the global economy. Immediate damage is dictated by the proximity to Ukraine, with the U.S. and other non-European western countries experiencing the least risk. The U.K. faces less risk than continental Europe, and Germany is the most significant within Europe (owing both to its size and energy linkages to Russia/Ukraine). For Russia, oil and gas sales, as well as broader exports, are important to the Russian economy that is already suffering from the Crimea sanctions imposed in 2014. The Russian economy has had eight years to retool and adjust to these sanctions, and their foreign exchange and gold reserves are estimated at ~US$600 billion, leaving them room to bear some pain.

Equity market impact:

Markets had a rocky start to 2022 on fears over inflation, slowing growth and uncertainty over future central bank policy. The peak-to-trough declines we are witnessing are not simply a factor of geopolitics. While the escalation of geopolitical tensions further clouds the growth and inflation outlook, the global economy enters this crisis from a solid footing underpinned by solid business and household demand and activity, rebounding labour markets, and fortress-size balance sheets on the part of businesses and households.

The capital markets have faced these situations many times in the past decades, and they eventually recover. Several examples worth noting from our Market Crisis and Subsequent Returns table:

- Crimea 2014 decline -5.8%
- Desert Storm 1990 -19.9%
- Iraq Invasion 2003 -14.7%

Given the U.S.' stance to aid from a distance, with no boots on the ground, our best guess is a market reaction between Crimea and the Middle East examples. Recognize that equity markets have been selling off in anticipation of the inevitability of a Russian invasion. Equity markets are experiencing a high degree of volatility with headlines driving swings both up and down. European stock markets are the most impacted, . U.S. markets that had led the earlier year sell-off on inflation, valuation and central bank tightening fears are down, but by less then their European counterparts, at one point, the S&P 500 had entered correction territory (> -10%). Given our heavy energy exposure, Canada has been a relative outperformer.

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Bond market impact:

Bond yields that had been rising most of the year, proving to be a headache for balanced investors, have delivered the expected offset to the risk-off environment and are providing ballast to balanced portfolios. Longer-term, sanctions and supply chain disruptions pose a problem for inflation, but shorter term, the flight to safety characteristics of government bonds have increased demand for this asset class.

Commodity prices face upward pressure given Russia's footprint (see background for more). This stokes inflation fears of all the wrong kind – not demand-driven inflation but exogenous and not easily repairable supply constraints. We still see inflation retreating as the year unfolds. Should energy and other commodity prices remain elevated, the magnitude of the retreat on inflation is in question (higher for longer).

However, central banks may not react to this event, seeing the inflation as supply related (higher rates won't increase any supply). They should also be mindful of the heightened uncertainty, damage to consumer and business confidence, and the potential for slowing growth due to the 'tax' of higher inflation. Again, the geographic proximity should inform the extent of the central bank's reaction. We expect the European Central Bank should be the most cautious, while U.S. and Canadian central banks may forge ahead with rate increases but err on the side of caution, seeking greater clarity as time passes. We were already in the camp of no 0.5% hike by the U.S. Federal Reserve on March 16, and these developments tilt further in that direction. We still expect the Bank of Canada to hike by 0.25% on March 2.

Commodity impact:

Energy – Crude oil prices have spiked, but by less than one might imagine. Natural gas prices in North America are elevated but not skyrocketing. European natural gas prices are spiking sharply higher, as inventories are low. The U.S. has sought to increase liquified natural gas exports to Europe and reportedly exceeded Russian exports last month.

Russia is the world's third-largest oil producer and the second-largest natural gas producer. One-third of European natural gas consumption and more than one-quarter of its crude oil imports come from Russia. Germany typically derives 30% of crude oil supplies and >50% of natural gas from Russia.

At the moment, Russian energy supplies to Europe remain largely undisrupted. Thus far, except for the Nord Stream II pipeline, energy has been exempted from sanctions to avoid exacerbating the already precarious supply picture in Europe. As a reminder: Nord Stream II has not been providing any gas to Europe, so sanctions here do not remove existing supply. There is a risk that Russia weaponizes commodity supplies to further their goals. This would be a very costly undertaking for Russia.

OPEC will be pressured by the West to pump more and will be faced with a choice between its OPEC+ alliance with Russia and its extensive global customer base in the West (and Japan). China's decision also plays a role, and at present, they have tried to remain non-committal to any side. In the face of sanctions, Russia may seek to sell more oil to China, freeing up other global barrels previously destined for China to reroute elsewhere. An Iran deal is another potential offset. Iranian oil may come back online if a new nuclear deal can be struck. North American production remains available to come online. North American shale production has been sluggish to respond to rising prices due to producers' newfound capital spending discipline. The U.S.' Strategic Petroleum Reserves are another conduit of relief for oil prices.

Longer-term, energy security concerns complicate the move away from fossil fuels and the fight against climate change.

Gold – Gold is providing a safe haven as it often does in times of crisis. The reaction isn't what some may have wished (up ~5% YTD), but gold will likely continue to have support if outcomes remain unpredictable in the region.

Metals - Russia and Ukraine are major suppliers of palladium, nickel, platinum, and cobalt; and supply approximately 25% of the E.U.'s aluminum. These are important inputs to many everyday goods, and price increases/supply disruptions can snowball – think semiconductors, cars, planes, cell phones etc. – goods that already face supply chain driven shortages and delivery delays.

Grains - Russia and Ukraine supply significant global supplies of wheat and corn, and this could bring broader food security concerns in certain parts of the world – these can be very destabilizing, especially in lower-income countries.

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Forecasting political risk events, such as the outcome of military conflicts (e.g., Ukraine in 2022), major referendums (e.g., Brexit in 2016), or elections (e.g., Trump in 2016), is exceedingly difficult. Timing markets based on forecasts of uncertain political events involves two bets: correctly forecasting the outcome and then correctly forecasting the market reaction.

In the last several years, investors have repeatedly experienced how these twin forecasting problems can go wrong. In 2016, many investors mistakenly forecast that the Brexit Referendum would fail and that the U.K. stock and bond markets would plummet if the referendum succeeded. Similarly, many investors expected Donald Trump to lose the 2016 Presidential election and that U.S. stock markets would plummet if he did win. Both forecasts and expected market reactions turned out to be incorrect.

Our approach is to identify and reduce any unacceptable risk concentrations in our portfolios related to political risks. In the face of this uncertainty, our advice to others is to caution against making bold calls for or against asset classes.

Background:

- Russia has a current account surplus & low debt to GDP; oil is an important source of government revenue. Natural gas exports subsidize cheap natural gas within Russia
- Russia's Major Export Partners: EU & UK (45.8%), China (9.8%) – source: WTO Statistics Database 2018
- Major Exports: crude petroleum, refined petroleum, natural gas, coal, wheat, iron (CIA Fact Book 2019)
- Russia's Major Import Partners: EU & UK (38.2%), China (20.9%), U.S. (6.1%) – source: WTO Statistics Database 2018

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