Henley Multi Asset

Russia/Ukraine conflict update

Invesco Global Targeted Returns Strategy

February 2022

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Investment Risks
Changes in interest rates will result in fluctuations in value. The strategy uses derivatives (complex instruments) for investment purposes, which may result in a portfolio being significantly leveraged and may result in large fluctuations in value. The strategy may hold debt instruments which are of lower credit quality which may result in large fluctuations in value. As a portion of the strategy may be exposed to less developed countries, you should be prepared to accept large fluctuations in value.

Fabio Faltoni, CFA

Product Director, Multi Asset

“Whilst very troubling from a humanitarian standpoint, we don’t think recent events materially change any of these elements and therefore the case for most of our portfolio ideas over the longer-term.

Are the latest developments changing the GTR team's Central Economic Thesis?

No. At present we do not think events in Ukraine will prove to be something more systemic in nature. Historically, the initial reaction to increased geo-political risks and tensions is often swift and negative but investors soon move on. Typically, these types of events mark the point of peak fear for the market.

The key consideration for us, keeping in mind our longer-term perspective, is the extent to which a full-scale invasion would impact global growth, the path of monetary policy, and corporate earnings – three key components underpinning our current Central Economic Thesis.

Whilst very troubling from a humanitarian standpoint, we don’t think recent events materially change any of these elements and therefore the case for most of our portfolio ideas over the longer-term. As a result, we maintain the view that global growth will continue to slow but remain above trend, central banks will stay on course and that capital spending and corporate profitability will stay robust albeit consumer sectors will take a hit while commodity sectors will be given a boost.

Global growth will continue to slow but remain above trend

Consumers, most notably in Europe, will suffer the effects of higher oil and gas prices. However, we don’t think this is enough for global growth to take a major hit and fall below trend. We believe UK consumers will feel the burden of higher gas prices most acutely as gas consumption per capita is highest there. But those same consumers have a bigger savings buffer now to somewhat cushion the blow. Likewise, US consumers are still flush with cash so while higher gasoline prices will be unpleasant, a recession is not looming.

At the margin, these events will add support for additional fiscal measures in Europe that are designed to support infrastructure spending especially on those projects that ultimately mean Europe’s dependency on Russian energy supplies is reduced. Gearing in to that fiscal and capital spending story is something we have been thinking about for a while now.

Central banks will broadly stay on course

Recent headlines will temper immediate expectations around the path of monetary policy and interest rate hikes with the European Central Bank (ECB) likely to have the biggest pause for thought. We believed even before the recent turmoil that the ECB may be limited in how much they could tighten policy. The medium-term outlook for other major central banks is, however, unlikely to materially change. The Fed delayed action around the US invasion of Iraq, the Kosovo war, and the Arab Spring for example, but those were all periods when the case for higher rates was less strong than it is today. Thus, while the current situation reduces the chances of a 50bp hike in March, we still think a 25bp hike is likely.

Our stance is that volatility is not something we should fear, but rather be ready to exploit the opportunities that it delivers.

Capital spending and corporate profitability will stay robust especially in commodity sectors

The impact on equities has been via a hit to valuations rather than a material change to fundamentals in our view. Higher commodity prices will have a detrimental impact on the consumer but, given the makeup of European equities, there is an argument that these events could provide a boost to European corporates as commodity firms' earnings are lifted with prices. Oil at $100 a barrel is not necessarily a negative for equities. Earnings rose solidly during the period of high oil prices in 2010 – 2014 for example, including the period when Russia annexed Crimea in 2014.

In the immediate term, large cap US stocks are likely to provide a haven for equity investors as the fundamentals of those firms are very far removed from Russia/Ukraine developments. At the margin, that provides some extra support for Growth, but we maintain the view that portfolios should include a mix of both Value and Growth today.

Concluding thoughts

While our longer-term assessment of markets is little changed, shorter term, it is difficult to navigate such choppy markets, and we expect thin liquidity conditions and headline noise to keep intraday price action highly volatile. However, it is important to note that market positioning in risk assets has been pared back in recent months and looks far from euphoric. That means the pain felt in the last few days should not lead to a spiral of forced selling. Rather it could lend support to the "buy the dip" mantra that has been prevalent in markets for several years.

Our stance is that volatility is not something we should fear, but rather be ready to exploit the opportunities that it delivers. The factors that are contributing to higher volatility are supporting a rotation to Value, and while there are good reasons to believe that the recent outperformance can be extended, there is an awareness that a more nuanced approach is needed and for portfolios to increasingly favour a barbell like approach.

Does the GTR strategy have any exposure to Russian/Ukranian assets?

The strategy has three (albeit relatively small in the wider portfolio context) active long exposures to Russian centric assets. There is no exposure to Ukrainian assets.

- The strategy has been long local currency Russian government bonds, currency hedged since late October. In light of increasing tensions, in late January the team added a 3-month out of the money USDRUB call option overlay i.e. long USD vs RUB to provide downside protection.
- In addition, there is a minimal equity exposure to Sberbank that is part of our Global Income equity sleeve within our Diversified Alpha equity idea.

As of today, have any changes been made to any of these holdings?

No changes have been made to any of these positions. While Russian assets have come under strong pressure in the last weeks, we do not think now is the time to panic - large Russian FX reserves greatly limit the risk of the country defaulting on its debt obligations whilst Russian assets already appear to be firmly pricing in a rather negative scenario.

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