MARKETS IN FOCUS | Russia and Ukraine

War in Europe | Asymmetrical impacts to economies and markets

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Russia's invasion of Ukraine sets the stage for economic disruption that is widespread but uneven in its distribution across countries, economies, markets, sectors, and industries.

Here are insights and analysis from portfolio managers at three of Carillon Tower Advisers' independent asset-management affiliates on the war's potential impacts on trade, energy, commodities, equities, inflation, and monetary policy.

Cougar Global Investments

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At the moment, the Fed remains the bigger focus for U.S. investors

- **On the geopolitics:** As tensions ratchet and much of the world continues to isolate Russia, two of the most immediate concerns are direct U.S. or NATO involvement, and the potential for tit-for-tat Russian cybercrime attacks against the U.S. given the U.S. has reportedly been considering the same against Russia. In the longer term, what does this mean for China? For Russia, China and Russia seem more aligned than ever before, given their joint statement at the beginning of the Olympics. Despite a greater reaction from the world than when it invaded and annexed Crimea in 2014, Russia is seemingly more insulated today, with more foreign reserves, less debt, and more self-reliance, with the kicker that China also could help buffer sanctions on Russia through stronger trade relationships. For China, most experts think a move on Taiwan is simply a matter of time given that reunification has been an explicitly stated goal of President Xi Jinping for a few years now. If that's the case, you have to assume China is paying close attention to how this plays out in terms of Russia's moves, as well as the response from the world (and especially the U.S.), the associated economic pain, and the potential for any internal civil unrest.

- **On markets generally**: The snap response to many geopolitical events is that they tend to be temporary dips that should be bought, if you look at historical data. However, there isn't a huge database of these types of major events in recent years, and some of them intertwine with recessions, which makes for less clean comparisons. Think 9/11 in the middle of the 2001 recession, Russia taking Georgia in the 2008 financial crisis, and 1990 in Iraq. My initial reaction was to think back to the beginning of COVID, where similar historical analysis was applied using a limited dataset that included previous outbreaks of Severe Acute Respiratory Syndrome (SARS) and Middle East Respiratory Syndrome (MERS). More than two years later, we see how that played out. So I'm a little leery to call this something that will be a quick two-week reaction that looks like a blip a year from now.
- **On the market's initial reaction:** At the market's lows, traditional safe havens like the dollar and gold worked as you'd expect, and risky assets struggled mightily. Unsurprisingly, Europe was hurt worse, which makes sense. However, while U.S. bond yields fell, they didn't fall much, which may mean that bonds aren't as reliable for safety as in prior years. That makes sense given the problem of inflation. Small caps were relative outperformers, and credit spreads reacted some, but not much, so the market didn't signal a significant increase in recession risk, at least not yet.
- **Overall:** Given the initial market action, the U.S. Federal Reserve (and central banks globally) remain a bigger focus for most U.S. investors, and Russia is an aggravating factor to slowing global growth, higher-than-desired inflation, and tightening monetary policy. In terms of asset allocation ideas, gold tends to work well in these situations, and remains an unloved asset class given that it didn't meet expectations in 2021. Commodities more generally could be a good hedge, considering the growth in the number of exchange-traded funds (ETF) options. Exposure to energy or materials for a portion of portfolios also could serve this function. We have looked at defense ETFs, but one popular option has a bit too much concentration risk in its top holdings. And right now cash makes sense as a hedge rather than traditional fixed income in a rising-rate environment, though at some point rates will be high enough to switch that a bit. We've had a slight U.S. bias, but keep in mind the S&P 500 Index outperformed the MSCI ACWI ex-U.S. by almost 21 percentage points last year, the biggest performance gap ever. If oil heads north of $130 a barrel in a prolonged conflict you could see headline U.S. inflation toward 10%, which would generate its own set of headline risks for investors to digest. The bottom line is recession and tail risks are rising, most likely either inflation- or Fed-related, with a few notable geopolitical kickers to boot.

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Eagle Asset Management

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The longer the war lasts, the worse for global growth

- The Russia-Ukraine situation is incredibly fluid and narratives are subject to change quickly.
- Current events highlight the importance of diversification and asset class flexibility, and reinforce the need to own high-quality fixed income.
- The Group of Seven (G7) countries will impose heavy sanctions on Russia and potentially Belarus, but a direct military engagement or broader spill-over into other European countries is unlikely.
- Disruptions to supply chains and commodity markets will reinforce inflationary pressures in the near term.
- Even if we do see a peak in inflation early this year, as was our base case expectation prior to the invasion of Ukraine, the slowing of inflation is likely to occur more gradually and over a longer period of time.
- The longer the conflict lasts, the greater the hit to global growth prospects.
- The U.S. Federal Reserve is in an increasingly difficult situation in an effort to fight inflation without tightening financial conditions too quickly. The Fed will still raise rates in March, but could adopt a slower pace of rate hikes in the second half of the year if the conflict persists.
- Some of the best investment opportunities present themselves during periods of volatility, and a flexible mandate can capitalize on these short-lived dislocations.

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Scout Investments – Mid Cap Equity Team

Energy: The long-term thesis on oil seems unchanged – for now

- For the near term, it looks like the war will have less of an impact than one might think.
- Any near-term jump in oil prices may be temporary in the United States as the markets adjust to the situation in Ukraine, and possibly offset by additional supplies from Iran and releases from the U.S. Strategic Petroleum Reserve. But the long-term thesis on oil seems unchanged. There is too little investment in oil production and the Organization of the Petroleum Exporting Countries (OPEC) is too disciplined to stop oil prices from grinding higher. Furthermore monetary policy remains accommodative, which, at the margin, should push up commodities and inflation until the Fed tightens enough to stop them from rising.

Any correction in the oil price now could delay the arrival of demand destruction that could end the bull market in oil. Sanctions on Russia are incrementally bullish for natural gas as Germany has halted certification of the Nord Stream 2 pipeline that connects Russian gas to Germany. We remain bullish on energy stocks due to energy supply constraints and better capital discipline, including higher dividend payments and share buybacks, at selected companies.

- If Russia takes Kiev quickly, then the European Union and the United States are likely not to do much. If Kiev turns into a slower slog, then the U.S. and EU may get more involved and that would likely mean more impact on energy markets.
- OPEC and other non-member producers (OPEC+) appear to be intact. The Saudis don't appear interested in breaking rank — nor does it look like they need to.
- An Iran deal is likely very soon — days, according to news reports citing those close to the process. So that may free up Iran supplies a bit. Unrelated, but another geopolitical event in the works.
- The long-term implications are a bit tougher, but look positive for liquefied natural gas markets — as the EU and U.S. look for ways to diversify from Russian gas supplies. There is likely to be a more persistent geopolitical risk premium in oil and gas futures markets, if Russia has a firm grip on Ukraine and markets are tight.
- Oil and gas markets were already tight. Inventories were low or shrinking before Russia attacked Ukraine. This adds some uncertainty on top of that.
- We've seen some 5% to 10% moves in crude oil futures since Russia invaded Ukraine. News reports suggest that over the weekend some physical market buyers started rejecting Russian cargoes, reportedly leaving some tankers full of Russian crude with no takers. This has had the effect of raising the bid for non-Russian cargoes as refineries scramble to replace lost Russian shipments.
- Potential long-term production impacts: One could hope that these dynamics are transitory. But about a week into the invasion U.S. service company stocks sold off, and nearly all of the western majors announced they're dropping their Russian businesses. The Sakhalin Island mega project, which was being spearheaded by a large U.S. oil company that has announced plans to withdraw, is technically very challenging and large enough to impact markets in coming years if it doesn't show up on time.
- If Western majors and service companies don't return to Russia for years, that's a longer-term supply shock in the works that could last for years.

Agriculture and metals: Watch for price pressures

Agriculture

- **Corn and wheat:** Russia and Ukraine are significant global producers and exporters of both. Together both account for about 30% of the global wheat export market and about 20% of corn exports.
- **Nitrogen fertilizer:** Russia and Ukraine account for 20% of global nitrogen production and exports. Higher natural gas prices in Europe also are raising production costs
- **Potash:** Russia and Belarus are major global potash producers, accounting for about a third of global production. Belarus has already come under heavy sanctions pressures, resulting in the loss of a major export route through Lithuania that accounted for the vast majority of shipments.
- **Phosphate:** Russia is a major phosphate producer and accounts for about 10% of global exports. U.S. imports of Russian phosphate already face countervailing and anti-dumping duties ranging from 10% to 45%, which have severely limited Russian volumes into the country since enacted.

Metals

- Russia controls about 10% of global copper reserves and is a major producer of nickel and platinum.
- The U.S. semiconductor industry heavily relies on Ukrainian-sourced neon.

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Carillon Tower Advisers is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates — ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments), and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. Carillon Tower believes providing a lineup of institutional-class portfolio managers, spanning a wide range of disciplines and investing vehicles, is the best way to help investors seek their long-term financial goals.

About Our Affiliates

Cougar Global Investments is a globally-oriented macro asset-class portfolio manager that uses a disciplined portfolio-construction methodology which combines macroeconomic analysis with downside-risk management. Cougar Global's guiding belief is that the goal of investing is to generate consistent compound growth, primarily achieved by seeking to minimize loss.

Eagle Asset Management is built on the cornerstones of intelligence, experience, and conviction, driven by research and active portfolio managers. Our long-tenured investment teams manage a diverse suite of fundamental equity and fixed income strategies designed to meet the long-term goals of institutional and individual investors. Our teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

Scout Investments employ distinct investment philosophies and processes to pursue long-term capital appreciation objectives that are consistent with client goals. Our thoughtful approach to asset management extends to cultivating lasting partnerships with our clients.

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A credit spread is the difference in yield between a U.S. Treasury bond and another debt security with the same maturity but different credit quality. Also referred to as “bond spreads” or “default spreads,” credit spreads are measured in basis points, with a 1% difference in yield equaling a spread of 100 basis points. Credit spreads reflect the risk of the debt security being compared with the Treasury bond, which is considered to be risk-free. Higher quality securities have a lower chance of the issuer defaulting. Lower quality securities have a higher chance of the issuer defaulting.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.

The MSCI ACWI ex USA Index captures large and mid-cap representation across 22 of 23 developed markets (DM) countries (excluding the U.S.) and 25 emerging markets (EM) countries. With 2,336 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S.

Developed markets (DM) countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S.

Emerging Markets (EM) countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

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