PICTET
Asset Management

EMERGING MARKETS MONITOR - IMPACT OF UKRAINE CONFLICT
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How the Russia-Ukraine crisis changes the outlook for emerging market investors

We look at the significance of Russia's invasion of Ukraine to emerging market economies over the medium and long term.

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Market turmoil

Russia's invasion of Ukraine has thrown equity and bond markets into turmoil worldwide. But it is in emerging markets where the effects will be most long-lasting. For investors, this presents both fresh risks and new opportunities.

The most salient impact of Europe's biggest military conflict since the Second World War has been on commodities markets. The war has choked off supply of oil, gas and other raw materials, adding to already high inflationary pressures building across the world. Longer-term effects, however, are likely to be much more subtle. One lesson for investors is that the war is a reminder of the idiosyncratic geopolitical risks of emerging market economies. Russia's belligerence caught many observers by surprise while China's support of President Vladimir Putin has further strained Beijing's relationship with the West. At the same time, however, Russia's travails might well diminish the risk of a conflict over Taiwan.

Longer term, the developed world's concerted and unified response to Russia's aggression offers hope that governments' behaviour could be policed more effectively in future.

02

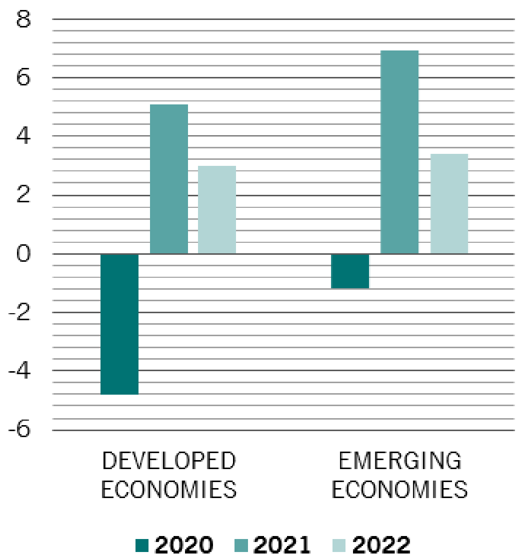
Rediscovering the commodity cycle

The effect of the conflict on energy prices was immediate and apparent. The West's unprecedented sanctions on Moscow and fears of a supply squeeze sent gas and oil prices soaring. Russia accounts for just 2.5 per cent of global GDP, but produces 13 per cent of its oil, 17 per cent of its gas and 46 per cent of palladium (see Fig. 3). We estimate that global GDP will fall 0.4 percentage points in 2022 if oil prices remain 50 per cent above pre-invasion levels, with both direct and indirect effects (see Fig. 1).

For Russia, we estimate that the war and sanctions will shrink domestic output by 6 per cent and cause inflation to hit 12 per cent. There is further risk of bank runs and a wider collapse of the country's financial system. At the same time, Russia faces external default and a balance of payments crisis.

But for emerging markets more generally, it is Russia's role as a major exporter of raw materials that is significant to their prospects (see Fig. 5). The country is a primary source of non-energy commodities, including industrial metals and timber. Both it and Ukraine are major producers of agricultural goods such as wheat, maize and sunflower oil – Eurasia and parts of North Africa are heavily dependent on Russian and Ukrainian wheat exports. As a result, many emerging market economies have been among the big losers of the price shock. While some commodity-rich nations were major beneficiaries of the price rise, those without natural resources suffered heavily. Elsewhere, some other emerging economies are finding opportunities through the Western sanctions, buying oil and gas from Russia at discounts to global markets.

Fig. 1 - Growing pains
GDP growth actual and forecast, %



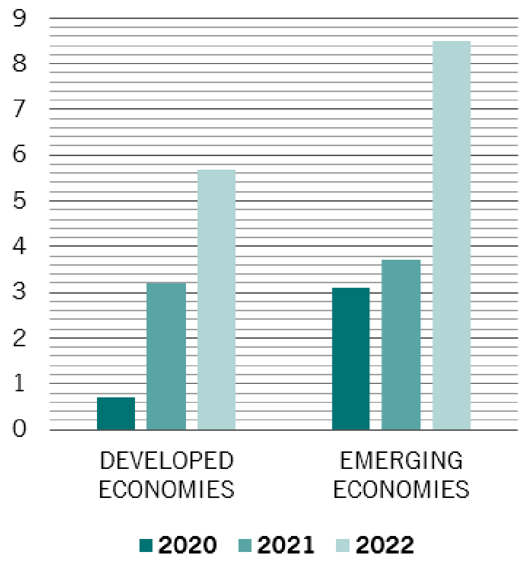
Source: Pictet Asset Management forecasts, CEIC, Refinitiv. Data covering period 21.12.2019-20.04.2022.

The inflationary consequences of these price jumps on emerging markets varies considerably by country, depending on the composition of local consumption baskets (see Fig. 2). Poorer countries, where populations spend greater proportions of household income on food and energy, are already suffering higher rates of inflation. This will affect domestic political stability – the Arab Spring, after all, was a response to jumps in food prices.

For investors in emerging market stocks and bonds, this has manifold consequences. Producers of in-demand commodities begin to look more attractive; those with a dependence on imported raw goods less so. In the latter case, rising inflation is accompanied by rising political risk.

Ultimately, having focused increasingly on growth and tech aspects of emerging economies in recent years, investors are having to rediscover more basic elements of the global economy – namely raw goods.

Fig. 2 - Up up and away
Inflation actual and forecast, %

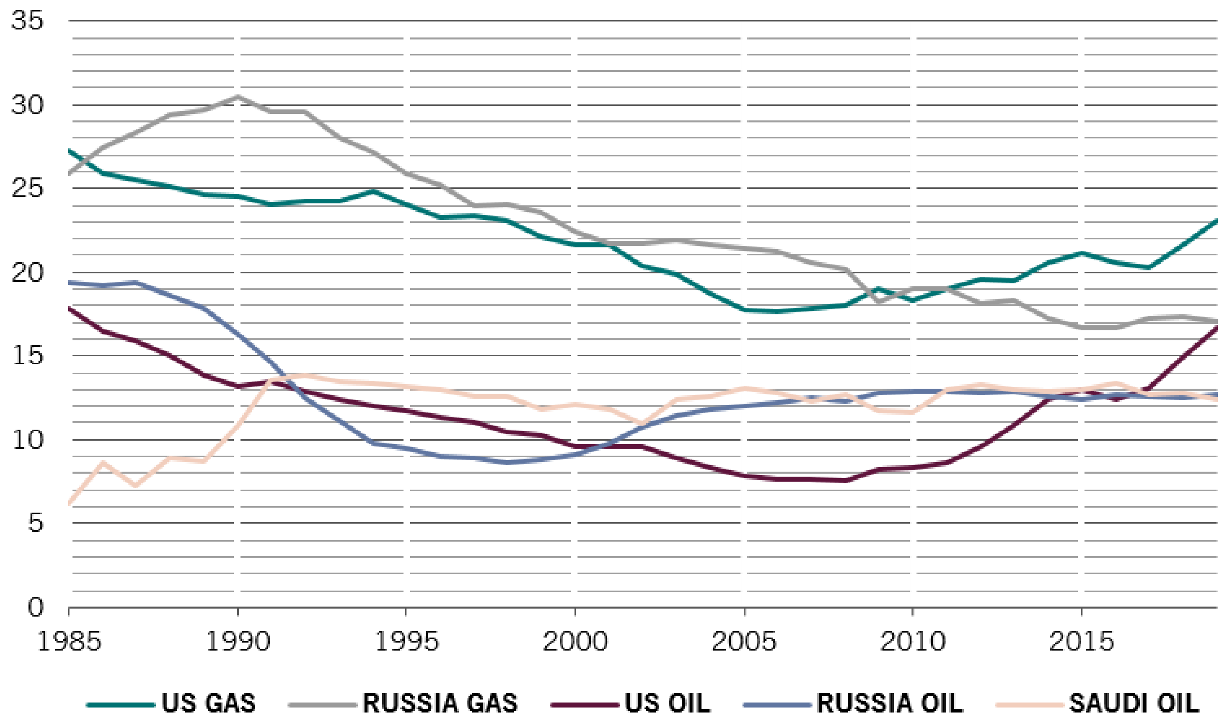


Source: Pictet Asset Management forecasts, CEIC, Refinitiv. Data covering period 31.12.2019- 20.04.2022.

The wider EM universe

The impact of the war goes beyond commodities. Tourism, for example, could also suffer as fuel prices drive up travel costs, with Covid remaining a persistent, albeit increasingly controlled, problem.

Fig. 3 - Losing dominance
Oil and gas production, % of total global production



Source: Our World in Data. Data as at 20.04.2022.

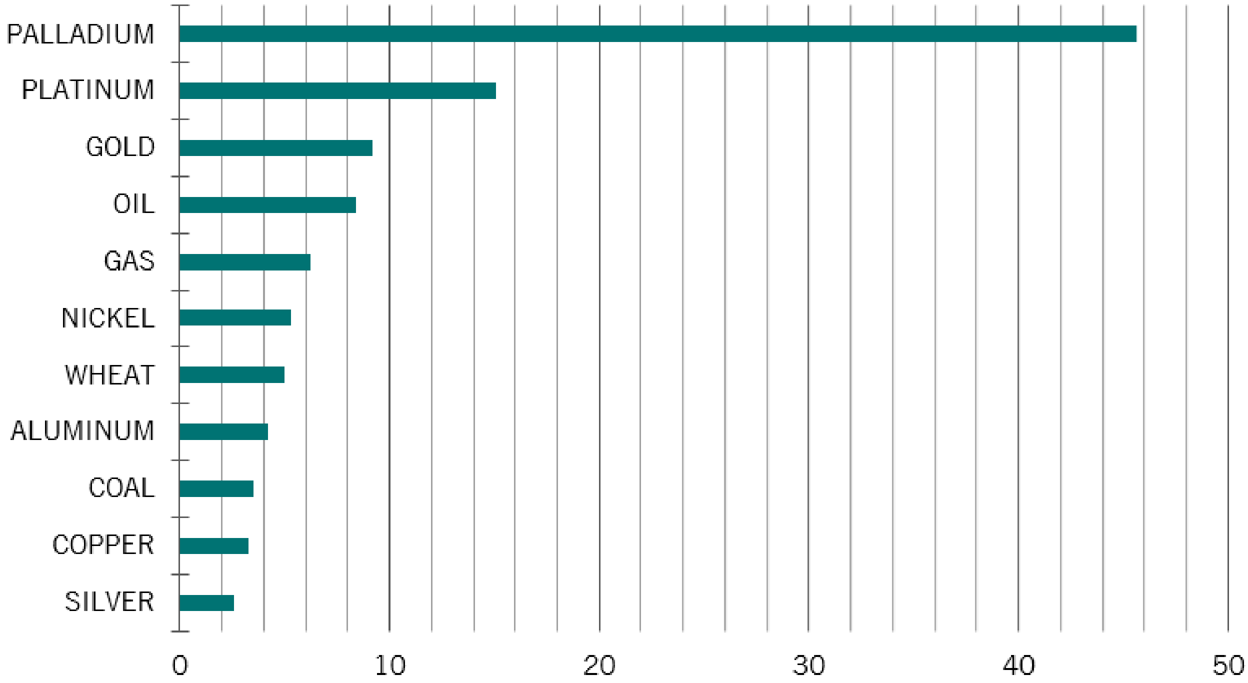
The effects will vary across different regions. Turkey, the Central and East European and Baltic states are heavily exposed to Russia and Ukraine. But Asia is relatively insulated – neither Russia nor Ukraine is a particularly significant trade partner – except through food and energy supply chain disruptions, though even here some countries will do better than others. Indonesia and Malaysia will benefit. By contrast, India and the Philippines are more vulnerable, given their dependence on commodities. At the same time, countries with few natural resources like South Korea and Singapore have strong reserves and external balances.

03

Dollar questions

Financial sanctions on Russia are effective because of the US dollar's global dominance. But the unprecedented nature of these penalties – cutting Russian financial institutions from the Swift payments system, freezing Russian central bank reserves, as well as preventing its commercial banks' foreign operations, in all covering 70 per cent of the banking sector – is a chilling sight for other emerging market governments. Russia had built up USD500 billion in reserves to avoid exactly this sort of financial vulnerability, yet could not buy immunity.

Fig. 4 - Commodity king
Russia's share of world exports by commodity, %



Source: Eurasia Group. Data as at 20.04.2022.

This "weaponisation of finance" could well push the likes of China to accelerate the development of their own payment systems and encourage producing countries to price their commodities in currencies other than the dollar. The degree to which that succeeds is another question. If Russia's invasion of Ukraine made anything clear for emerging market investors, it's the attraction of holding dollar-based assets (assuming investors don't find themselves on a sanctions list).

04

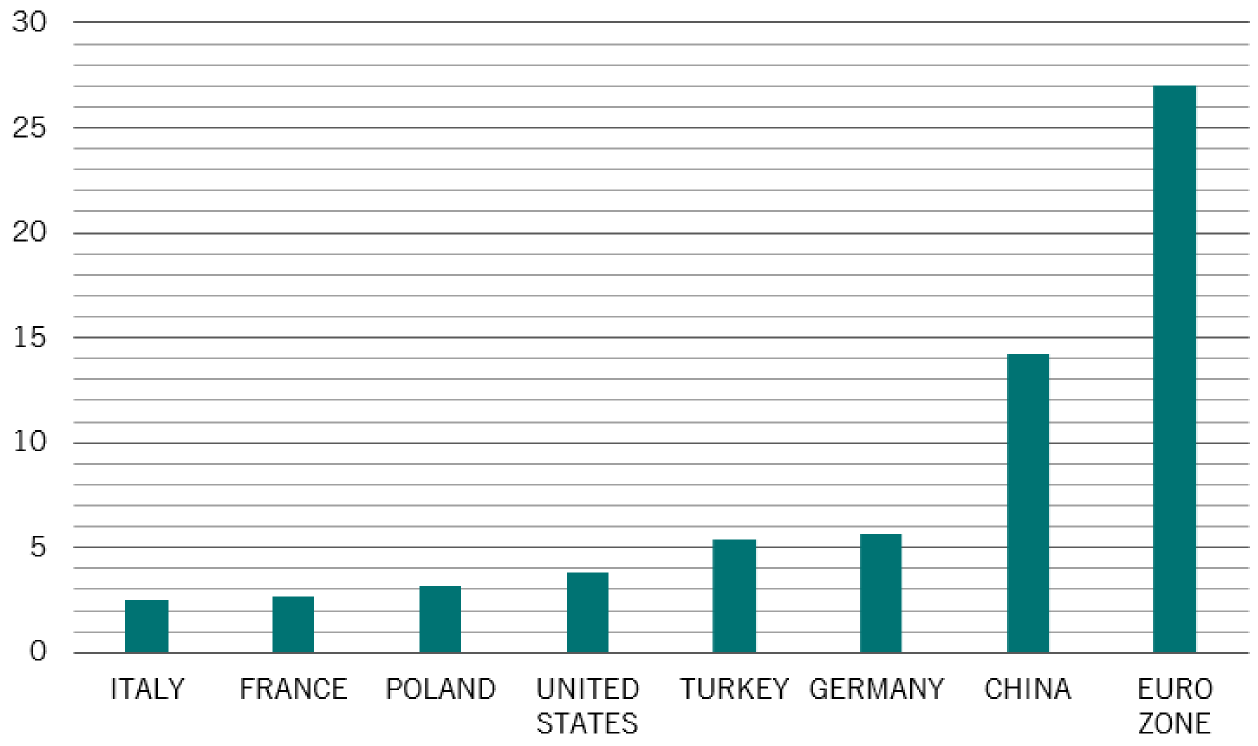
China effects

The short-term economic effects on China are likely to be relatively minimal – Russia represents only a 2 per cent share of Chinese exports, though Russia itself is dependent on Chinese goods (see Fig. 5). What is more, the war has enabled China to secure Russian oil and gas at discounted prices.

This bodes well for longer-term Chinese inflation, especially given that it is only running at 1.5 per cent. At the same time, the government set a growth target of 5.5 per cent for this year, which implies monetary easing and fiscal stimulus.

Fig. 5 - Russia needs Europe and China

Export of goods to Russia by country/region in 2021, % of total



Source: IMF DOTS. Data as at 01.02.2022.

The abiding outcome of Russia's invasion may yet be a pivot in the balance of power between the US and China. One of the only ways for Russia to interact with the world, in an environment of sanctions, is to do so through the Chinese renminbi. This could encourage other governments to look towards China as an alternative to US financial hegemony. In turn, renminbi bonds look an attractive proposition, especially since the Chinese economy appears uncorrelated with developed economies – though perhaps not in a fully liberalised capital regime.

There are, however, significant political risks associated with China. These include the government's harsh measures against a number of sectors in recent years, and a low level tech sector trade war with the US.

05
Balancing risks

Emerging market risk premia have risen in recent weeks, given the uncertainty over economic growth and inflation. In some respects, the market shift is a reminder that emerging economies remain subject to political risks that had been dormant for some time, and which traditionally are factored into asset prices.

Ironically, the apparent riskiness of emerging market indices has fallen with the removal of Russian assets as constituents. That's because Russian bonds and equities were disproportionately discounted by the markets before the war, based partially on well-known governance risks and on Russia's propensity to aggression.

This highlights an important aspect of environmental, social and governance (ESG) investing in emerging markets. Although all of these factors play their part, governance is becoming increasingly important for those seeking to invest in these countries. Meaningful engagement with governments is often frustrating and fruitless for all but the very largest investors. This leaves them facing withdrawal from markets where governance is particularly poor.

> “ It will force investors to think more deeply about governance in countries in which they invest. ”

Aside from trimming our positions in Russian assets, as liquidity permits, we responded to the crisis by focusing on the rise in commodity prices and inflation and taking relevant positions across assets. In sovereign debt, we have refocused our interest on a handful of countries, particularly in Latin America and Africa, which, in part, should gain from the commodities boom. At the same time, we have reduced positions in vulnerable countries like Turkey, Taiwan, Thailand and India.

Within emerging corporate bonds, we have responded by reducing our sensitivity to rising interest rates. We increased our position in short-dated banks and commodities credit, which should benefit at this point of the cycle, but reduced our allocation to bonds issued by consumer-facing companies, which are vulnerable to food and energy price hikes.

As for emerging equities, we own a number of stocks that give our clients exposure to commodities, including a Middle East-based fertiliser feedstock producer and a Latin American base metals miner, and have a general overweight in Brazil. We also hold positions in companies focused on solar and wind renewable energy.

In all, the Russian invasion of Ukraine leaves investors with both short- and long-term issues. Over the coming year or two, its influence on inflation and growth through squeezing commodity prices will be felt globally. Longer-term issues are muddier, depending on the degree to which developed governments take on the role of global policemen – and the response of emerging countries. The dollar's hegemony could be permanently dented. Either way, it will force investors to think more deeply about governance in countries in which they invest.

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