INFORMATION FOR INVESTMENT PROFESSIONALS

Russia-Ukraine conflict: how will it impact the US market?

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Russia's invasion of Ukraine has shocked the world and sparked volatility in markets. The invasion is causing a significant human toll that is likely to continue, and our thoughts are with the Ukrainian people and all who are impacted. Many unknowns remain with no visibility over the duration and long-term effects of the conflict. What we do know is that the conflict has materially increased the tail risks in the global economy, resulting in a higher probability of a slowdown in growth. Moreover, it is clear that there is heightened volatility in markets which, while resulting in noise and disturbance, creates opportunities for active managers.

It is worth remembering the vast majority of the US equity market is not directly impacted by exposure to Russia or Ukraine, and the combined revenue exposure of the entirety of the S&P 500 is estimated to be about 1%. So although the US is part of the coordinated global effort, in terms of sanctions, the stock market impacts for now are relatively benign, and corporate earnings are not expected to be materially affected by the crisis. Indeed, we are still expecting to see earnings growth of around 8%-12% this year.

Where are the impacts being felt?

The main impacts, therefore, will be felt through second-order effects such as energy prices and supply chain disruptions. Higher energy prices are likely to persist, and this will squeeze consumer wallets and feed through to higher input costs for some companies, while inflation risks remain to the upside. The risk of further disruption to the supply chain – already hit by the Covid-19 crisis – remains elevated as the conflict makes supply chain problems more acute at the margin. This will give further impetus to the trend of supply chain diversification and domestication.

The heightened risk environment described above means that interest rate increases could be less steep this year, but we do expect the Federal Reserve to follow through on its intention to start hiking rates in March. The potential for less severe rate increases is to the benefit of long-duration growth stocks, which have already gained from the "flight to safety" and accompanying fall in the 10-year Treasury yield, which has declined from 2% to 1.7%.

This new risk event is not taking place in a vacuum but within the context of existing questions about high valuations and the rates debate, linked to inflation. Therefore, when we look at the impact on portfolios we do not react to this as an isolated geopolitical incident but how it modifies the overall picture. Due to the distance of the US from Russia, on a number of levels, the direct portfolio impact is likely to be limited to the factors outlined above and so we have not made any changes to portfolios as a direct result of the war. We are, however, diligently diving deeper to better understand and anticipate the second and third order effects.

We do, however, remain watchful of its impact on the broader macro environment and the way this feeds through to the investment thesis and financial models for the companies we hold. As stated, we have not adjusted our bottom-up earnings outlook for this year.

Keeping an eye on the flight to safety

The flight to safety we are already seeing is centred on the US dollar, and we are already modelling what the impacts of a much longer dollar will be on holdings. Contagion from crisis-hit European banks is a risk, given the nature of the global banking system, but we have already reduced weightings in this area.

Our edge is in harnessing our research intensity to uncover those companies that we believe will continue to grow earnings, which will be key in a year marked by rising interest rates and reduced support for the economy and asset prices more broadly.

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