The Short-term Effects of the Russo-Ukrainian War on Financial Markets

Mentored and Supervised by:

Panagiotis Tsemperoulis, MSc Finance and Investment Durham University, BSc Management Science & Technology Athens University of Economics and Business

Research & Writing by CLC's students:

Nickos Vytogiannis / Ioannis Asimakopoulos / Isavella Chatzi / Spyros Damalas

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Abstract

The Russian invasion in Ukraine has caused a global financial ripple effect that has been characterized as unprecedented by many market observers. This ripple effect can be observed among all asset classes, causing drawdowns to each and every one of them. This paper aims to delve into the key factors that have affected each considered asset class and provide a generalistic perspective of the consequences of the war in financial markets.

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Introduction

As we all know the invasion of Ukraine by Russia has led to an ongoing energy, economic and refugee crisis. After a very good year in 2021 markets crashed in February 2022 as Russia's invasion of Ukraine begun. This, in turn, led to the huge increase in energy prices of the past year. It is important to realize that all indexes of stock exchanges around the world plummeted a great deal and have yet to recover to their pre-war prices. For instance, the Dow Jones index (DJI) dropped from 35911.81$ on 03/01/2022 to 32944.19 on the 21 of February of the same year. This is an almost 10% drop that can be directly correlated with the start of the war. But since then, the price has dropped even further reaching an astonishing 20% drop in the beginning of October 2022. In this paper we will dive further into the effect of the war on the equity markets, fixed-income markets, and commodities markets around the globe.

1. Equity Markets

The analysis of the equity markets is divided into three major sections: the effects of the war on the United States equity markets, those on the European equity markets and a global overview.

1.1. United States

The Russian invasion has deeply affected global equity markets and has created uncertainty and instability that has negatively impacted investor sentiment. Mainly domestic Russian banks are the most exposed to the risk. They are of course followed by European banks with local legal entities in Russia. But naturally the Russia-Ukraine war is a low earnings risk for the U.S., even though U.S. companies have low direct exposure to Russia and Ukraine.

However, a shock in energy prices among a central bank shift- to focus on inflation- could reduce investor sentiment further. Indirect risks could be more significant, such as slower growth regarding the markets and the consumers' expenses due to higher oil and food prices, supply chain distortions, credit and asset adjustments- reducing the price-, cybersecurity risks, and tightening monetary policy.

Tightening monetary policy remains the main risk for equities since central banks struggle with expected inflations. Policymakers may also consider U.S. gas tax reduction and other similar spending measures. Selected emerging market equities are expected to surpass amongst a combination of higher rates and energy prices.

1.2. Europe

In the first few days since Russia invaded Ukraine, European stock prices have decreased a significant amount, restraining the financial growth and affecting the whole region's economy dramatically.

The outbreak of this war has clearly affected equity markets across Europe. Logically, investors worry that there's going to be an increase in oil prices that will affect consumers in regions heavily reliant on energy imports that were already struggling with the highest inflation in decades, a western embargo on oil imports was being considered, sending European gas prices to the highest recorded levels.

Even though the war in Ukraine is a global economic decline, with Europe being the most exposed and affected region, the UK's stock market has retaliated slightly better than the rest of Europe, as it is benefiting from a heavy presence of energy stocks as prices for oil and gas have increased to maximum.

1.3. Global

Severe and strict sanctions sent equity markets falling all over the world. Sentiments have driven market direction so far, which led to a large sell-off. Even so, an economic shock would still destabilize markets for longer.

A strong downside for equities was expected, and on the day that Russia decided to start the invasion, this speculation quickly became reality. Developed market equities are anticipated to experience further underperformances as long as these military actions continue.

Also there has been a decrease in foreign investment. Due to the crisis, investors are wary of the dangers involved with conducting business there and find Ukraine to be less alluring as an investing option. The result has been a significant reduction of foreign investors' interest in Ukrainian stocks.

Even though it seems that earnings are remaining adaptable overall, equity indexes have been pulled down by falling valuations. Alongside the overweight positions in Japanese and Swiss equities, they remain neutral in the US and European area, but also remain conscious of the risks of overhanging equities in both places.

The war also harmed the entire Ukrainian economy and affected the stock market. The conflict disrupted trade and commerce and created difficulties for many businesses. This leads to a decline in corporate profits, which is reflected in the stock prices of Ukrainian companies. As a result, many investors lost confidence in the Ukrainian market, leading to further declines in stock prices.

In summary, the ongoing crisis in Ukraine has had a significant impact on the country's stock market. The war had a negative impact on the economy as a whole, reducing foreign investment and the value of Ukrainian stocks. The best solution is investors holding a diversified portfolio so that they can absorb the shock caused by the war better and increase their exposure to safer assets.

2. Fixed-Income Markets

The war between Russia and Ukraine actually began in 2014 with the culmination of the Crimean conflict . This conflict was actually the precursor to the war that we see happening today, resulting in economic volatility and fluctuations in the fixed income markets. These fluctuations have instigated a cascade of events.

The first thing to occur in the markets with any military conflict is an increased perception of risk. This results in investors moving away from high-risk investing and seeking lower-risk assets, such as government bonds of stable countries. The move causes a decline in demand for riskier fixed income investments, especially from the war-affected region. Since Ukraine has been invaded, there is a justified fear amongst investors that it may not be able to repay its debt. As early as August 2022, Ukraine sought the deferment of bond coupon payments until 2024 .

It goes without saying that Ukraine has experienced a severe depreciation of its currency against major countries due to the war. Currency depreciation has eroded fixed income investments, such as bonds, by eroding the value of the semi-annual coupon, or collected interest rate payments as well as the principal value of the bonds themselves when converted back into a depreciated currency.

Since a military conflict creates higher risk, this has generated higher borrowing costs for Ukraine but also for countries that support Ukraine. The higher risk also leads to inflation that can be extreme for the countries directly involved. If the percent inflation exceeds the interest paid on bonds, this will result in the coupon value face value of the bond actually being negative. Essentially the bond purchaser has lent money to the government at a loss to himself. In our case, fixed income investors holding Ukrainian government bonds would find themselves getting poorer. This is exactly why the US government has actively pumped billions of dollars into the Ukrainian economy. Despite this, Ukraine has not been able to pay its semi-annual coupons, and as a result, this has also caused out-of control inflation in the US as well as many European countries. This inflation has created a cascade effect since it now exceeds the interest rate of US savings bonds as well. Typical US governments bonds have been yielding a 3.38% return , while the current inflation rate is at 5%, above the average 2.1% . This obviously negates any bond returns.

The risk associated with the Ukrainian conflict has also led to a sharp drop in Ukraine's sovereign credit rating. As of April 6th, 2023, the S&P rating has dropped to CCC, along with a negative outlook for the foreseeable future . A lower credit rating implies a higher risk of default on loans and bond returns. Thus, for investors to take the risk and invest, they will demand a higher rate of return. This may be good news for new bonds, but it further diminishes the value of pre-existing fixed income securities.

From any reasonable investment perspective, the war in Ukraine has had a negative effect on all types of investments. Not only has it created local economic instability, but it has also had a multi-faceted domino effect on other countries. Aside from investments, supply chains have been hindered, crude oil prices have risen and grain supplies have been constricted. Unless you are an arms dealer, things are not good.

3. Commodities Markets

Since the start of the Russo-Ukrainian War February 24 of 2022 and the subsequent sanctions imposed on Russia, the commodities markets have experienced significant turbulences. Specifically, there has been a major impact on the markets of gas, oil, coal, agricultural commodities, carbon, and power.

3.1. Gas

The war led to continuous increases in gas prices which reached all-time highs. Russian company Gazprom's suspension of supplies to the EU skyrocketed prices, making Europe a premium market for uncommitted LNG cargoes while acting as the catalyst for the construction of several new LNG regasification terminals across Europe. The elevated prices helped bring more LNG to the continent, replacing most of the Russian supply. The remainder of the deficit was bridged mainly through demand reduction and most recently demand destruction.

3.2. Oil

European oil rose to more than $130/bbl. for the first time since 2008, because Russian exports, to which Europe relied on for 50-55 percent of its diesel needs, decreased dramatically. Europe tried to compensate it by importing similar grades from the Middle East, South America, Angola, and Norway.

3.3. Coal

Seaborne coal markets have been greatly affected by the war in Ukraine. There has been a reduction in Russian gas flows to Europe, a lower level of nuclear generation, and an EU ban on imports of Russian coal, as well as informal sanctions by other coal-importing nations such as Japan. This has led to an increase in European hard coal generation, which has in turn contributed to extreme tightness in the market for high-CV seaborne thermal coal of non-Russian origin. This has been reflected in record-high prices in 2022. Specifically, they rose as high as US$438/t in early March, and while they have since fallen from that peak, they are considerably above their historical long-term, pre-war levels.

3.4. Agricultural Commodities

The war has had a serious impact on the Black Sea region, which is the most vital source of grain and oilseed in the Middle East, Africa, and for many Asian and European countries. These disruptions, and Ukraine crop production losses, are affecting global grain/oilseed supply and demand. Consequently, agricultural commodity prices continue to fluctuate in tandem with the course of the war and the operation of Black Sea grain shipments. The Russian invasion has greatly reduced Ukraine crop production. More precisely, in 2022, 67 million tons of grain and oilseed crops could be harvested, compared with more than 106 million tons for the previous season, as reported by the Ministry of Agrarian Policy and Food of Ukraine. Ukraine is one of the leading grain/oilseed exporters, supplying the global market with over 60 million tons of wheat, barley, corn, sunflower oil, etc. Around 90 percent of these exports were shipped through the Black Sea. However, Russia's navy had blockaded the ports since the war started in February 2022. Hence, massive amounts of grain were stuck in the country while global markets were short of supplies. On 22 July, Russian blockades on three Ukrainian Black Sea ports were removed by the Black Sea grain initiative, brokered by the UN and Turkey, for the safe transportation of grain and foodstuffs from Ukrainian ports.

As a result, Ukrainian grain/oilseed exports rose close to the normal export pace by October 2022. The initiative was extended for 120 days in November, securing Ukraine exports over the upcoming four months. Overall, as shown by agriculture ministry data, Ukraine exported nearly 18.1 million tons of grains from July to November in the 2022/23 season, 30 percent down from last year's same period. Although this reduction increases the risk of grain shortages in global markets, expectations for production gains in Russia, Canada, Australia and Brazil should offset the issue of fewer Ukrainian supplies.

3.5. Power

European spot power prices rose with the gas surge in early March of 2022. In order to reduce reliance on Russian supplies, the return of coal and lignite plants and suspension of further decommissioning is considered.

3.6. Liquefied Natural Gas

For the global LNG market, the Russian invasion of Ukraine represents a major inflexion point that will persist for years to come. European leaders have agreed to spend hundreds of billions of euros to pivot away from Russian gas supplies and LNG is currently the only meaningful alternative. The EU hopes to ease the pressure around additional supplies by rapidly increasing import capacity.

3.7. Gold

As expected, gold prices received a boost due to “safe haven” demand. Specifically, gold spiked to above $2,000/oz.

3.8. Steel

Ukraine is a major producer of steel, and the war has significantly impacted this industry. It has led to a disruption in the supply chain for raw materials such as iron and coal, which are needed to produce steel. This in turn has resulted in a decrease in the amount of steel that Ukraine can produce, and consequently an increase in steel prices.

Summary and Conclusions

It is safe to assume that while the global stock markets have plummeted in the past few months, the commodities markets have seen a substantial increase in price since the beginning of the invasion. Depending on the commodity, the reasons vary from the higher demand such as LNG since Russia is a major exported to the European Union to steel since the Ukraine produces large quantities of it or even gold that has risen in price since it is considered to be a safe investment. It is safe to conclude that globally, the entirety of the financial markets has been gravely affected by the Russian invasion of the Ukraine, and unfortunately this trend of price drops in stock prices is bound to continue for as long as the war continues.

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