Morgan Stanley

INVESTMENT MANAGEMENT

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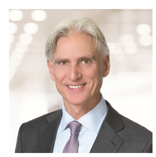
Russia – Ukraine: Risk and Investment Implications

CUSTOM SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 4 MARCH 2022



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February was marked by the escalating tensions and a full-scale Russian invasion of Ukraine. Many asset classes were already on a downward trend since the beginning of 2022, given inflation pressures, concerns over rate hikes and deterioration in investor sentiment. However, as the situation between Russia and Ukraine rapidly worsened over February, asset classes that had already sold off, such as the major developed equity regions, sold off further, with the S&P 500 moving deeper into correction territory, while the Nasdaq moved closer to a bear market.

The S&P 500 (USD), MSCI Europe Index (EUR) and MSCI Emerging Market Index (USD) declined around 3.0% over the month, with the MSCI Japan (JPY) faring slightly better, down 1.1%[1]. Unsurprisingly, Russia was hardest hit, with the MOEX Russia Index (RUB) plummeting 30.0%[1]. At the same time, the price of crude oil rose to levels not seen since 2014, due to heightened concerns over disruptions to global energy supplies. The VIX[2] ended the month at 30[3], as the conflict intensified, and international sanctions tightened around Russia.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

1. Bloomberg, 1-month performance, as of 28 February 2022.
2. VIX is used as a measurement of volatility.
3. Bloomberg, as of 28 February 2022.

Implications on inflation and monetary policy

In our team's recent market outlooks, we have highlighted our view that inflation is not transitory, but is likely to persist, at least through the first half of 2022. A prolonged conflict would keep upward pressure on energy prices, and in turn contribute to upward pressure on inflation. However, there is likely to be a notable difference between Europe and the US in this respect, given that Europe is highly reliant on imports of Russian gas, but currently has low inventories. Our view of the impact of this crisis on inflation – and any implications for our portfolio positioning - is therefore one area of active discussion within the GBaR team. The impact of the crisis on global growth and on monetary policy are other areas of focus.

Investment Implications

We entered 2022 already cautiously positioned. At the time, we were talking of Russia/Ukraine tensions as a potential near-term risk and we were therefore monitoring the situation closely, but they were by no means the only risk. For example, during January, increasing evidence of US Fed hawkishness, inflation becoming embedded, concerns over decelerating growth, and deteriorating investor sentiment, were equally important in driving our forward-looking volatility expectations. This was in an environment in which certain areas of the equity market, such as US equity stocks and large tech names, still appeared overvalued.

Our view is that the military conflict in the Ukraine is unlikely to end quickly; the situation is likely to worsen, before it improves. We therefore expect volatility to persist in the short term, so remain cautious in our positioning, in fact we felt it prudent to further reduce exposure to risk assets. Considering the above, we reduced equities further in February, from a level that already reflected caution. We believe that in the near term, this should position us well to weather the near-term market volatility. In addition, we remain underweight duration, given rising yields. We also made the following tactical changes:

Broad Global Commodities

At the beginning of February, we added an overweight exposure to broad global commodities, as an explicit hedge against an escalation in Russia-Ukraine tensions. Given ongoing signs of supply constraints within the commodity complex, we believe the downside risks to this trade are limited. We increased this position towards the end of February given our concerns at the speed with which the situation was deteriorating, and the increased likelihood of a full-scale invasion, such as we now have seen.

European Banks

At the beginning of the month, we reduced exposure to US Financials, in favour of their European counterparts. At the time our view was that European banks may benefit more from rising net interest income on higher rates, and may deliver higher capital returns, than their US counterparts. Since then, the Russian invasion of Ukraine has changed the dynamics, requiring a review of the position towards the end of the month.

UK Equities

We moved overweight UK equities, expressed through the FTSE 100, providing a blend of value and defensiveness through exposure to energy, materials, and consumer staples companies. We believe that an attractive valuation discount and lower (real) rate sensitivity, adds to the defensive character of the FTSE 100 in the current environment.

Active US Growth

For portfolios which allow active funds, we trimmed the US growth active managers, in favour of broader S&P 500 exposure, to achieve a small underweight in large and mega-cap growth stocks. With slowing growth, near-term inflation pressures, and rising nominal and real rates, we expect to see continued pressure on US mega-cap names, which still trade at substantial 12-month forward PE premiums to the broader market.

Tactical positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Financials				■	
US Energy				■	
US Value				■	
Eurozone			■		
UK				■	
European Banks				■	
European Energy				■	
Japan			■		
Asia ex Japan			■		
China Internet				■	
Emerging Markets			■		
Global Growth		■			
Global Infrastructure			■		
Global Property			■		

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit		■			
US High Yield			■		
European High Yield				■	
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■			
US Inflation			■		
German Bunds		■			
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Broad Commodities				■	
Currencies					
Euro		■			

Source: MSIM GBaR team, as of 28 February 2022. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation, or specific needs of any individual investor.

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INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

Forward P/E: Price-Earnings (P/E) is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting. Forward to price earnings (P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

MOEX Russia Index is the main ruble-denominated benchmark of the Russian stock market. It tracks the 50 largest companies on the Moscow Stock Exchange. It has the same composition as the dollar denominated RTS Index.

MSCI Europe Index: The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

NASDAQ Composite Index: A broad-based capitalisation-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX©: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market’s expectation of stock market volatility over the next 30-day period.

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