Crisis in Ukraine — 1st March 2014

As tension mounts in the Ukraine investors have become naturally nervous about the possible short term impact for markets, currencies and commodities. This month we consider previous conflicts and the ramifications for global markets. We also consider what impact this recent escalation might have for Ukraine, Europe and beyond.

"Buy on the rumour, sell on the news" is a phrase often quoted by traders looking to make a quick profit from unexpected, short term extraordinary situations such as merger announcements or political uncertainty. But does this also apply to the imminent threat of military conflict?

Various studies have demonstrated that historically **in the run-up to the onset of a military conflict, uncertainty causes markets across the world to fall.** However, when conflict does finally materialise investors tend to breathe a collective sigh of relief, typically because the selling that has preceded this news is often overdone. Two professors at Bocconi University in Milan studied previous military conflicts during the period between 1971 and 2004. Having analysed 101 internal (72) or international (29) conflicts, they measured the impact of these conflicts on the major world stock markets, the value of the US dollar and the prices of oil, gold and other commodities. They concluded that, **whilst the reaction of other asset classes such as commodities is far more varied, on average stock markets react positively to the onset of such conflict**.

This effect was clearly demonstrated during both Gulf wars (see chart below), in particular when cruise-missiles hit Baghdad for the first time on March 19th 2003 and Operation Iraqi Freedom began in earnest.

Other studies confirm that on average **the S&P 500 trades higher once conflict begins, Gold falls, oil prices decline and the US dollar tends to shrug-off the news** and reverts to its longer-term trend.

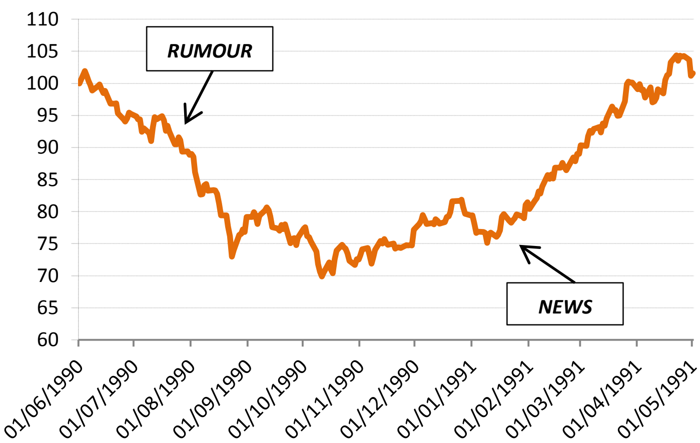
So at least as far as equities are concerned it would seem that **"sell on the rumour, buy on the news" would be a more appropriate approach for most investors.**

It has taken only 3 months for Ukraine to unravel

Nov 21:	Ukraine rejects EU Agreement and favours Russian deal
Dec 1:	500,000 set-up camp in Independence Square
Dec 17:	Yanukovych confirms $17bn bailout + cut-price gas deal
Jan 19:	200,000 defy new protest restrictions. Dozens wounded
Jan 28:	PM Azarov resigns, parliament scraps anti-protest laws
Feb 9:	Some 70,000 protesters gather on Independence Square
Feb 18:	26 killed and riot police encircle Independence Square
Feb 20:	Demonstrators charge police line, 25 protesters killed
Feb 21:	Yanukovych and opposition leaders sign a deal
Feb 22:	Yanukovych is voted out and jailed opposition leader Yulia Tymoshenko is freed
Feb 24:	Yanukovych arrest warrant issued
Feb 26:	Putin orders military drill in western Russia. Moscow grants Yanukovych refuge
Feb 27:	Pro-Russian fighters storm gov. buildings in Crimea
Feb 28:	Armed men seize Simferopol Airport, Crimea
Mar 1:	Putin granted use of military force by Russian parliament

It's usually "*buy on the rumour, sell on the news*" but when it comes to war, this is usually the other way around

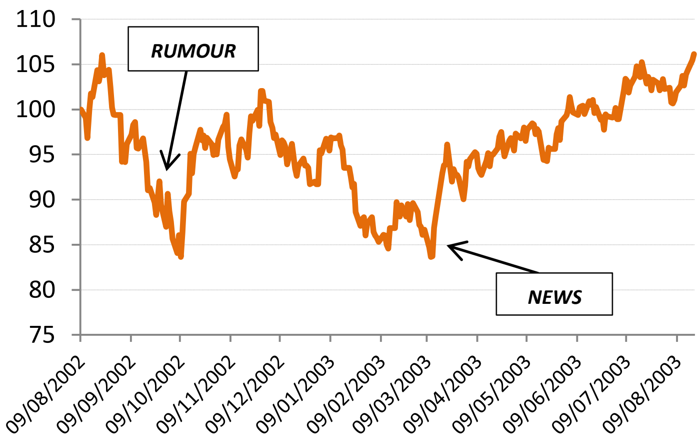
S&P 500 during First Gulf War - 1991



RUMOUR - 7 August 1990 - Operation Desert Shield begins. The first US forces arrive in Saudi Arabia

NEWS - 24 February 1991 -Desert Storm begins as coalition ground forces drive on Iraqi forces in Kuwait

S&P 500 during Second Gulf War - 2003



RUMOUR - October 10, 2002 - Congress authorizes Bush to use force against Iraq

NEWS - March 19, 2003 - Cruise-missile and bomb salvos hit Baghdad an hour after the deadline passes

How does this relate specifically to the potential conflict in Ukraine? How have various asset classes reacted in the very short term (last few weeks) and how might they be affected in the future?

In the short term the asset classes that we would usually expect to rise during a period of conflict have started to move. **Gold has risen c6.7% since the start of Feb and oil prices have spiked a more modest 4.3%.** These are typical "pre-conflict" moves but not quite as significant as you might expect.

Also until Monday 3rd March, global equity markets (excluding Russian markets) have largely ignored Russia's incursion into Crimea, partly because developed and emerging market equities have been in the midst of a strong recovery after a very poor January for very different reasons (China and QE).

Admittedly as I write, **equities have started to turn negative as the implications of a sustained occupation of the Crimea start to sink in** but so far there doesn't seem to be a sense of panic that you might otherwise expect.

This suggests that either global markets haven't had time to properly react to/assess the current situation or that other external factors such as positive US growth are counteracting the sell-off as bargain hunters scour the market for any oversold investment opportunities.

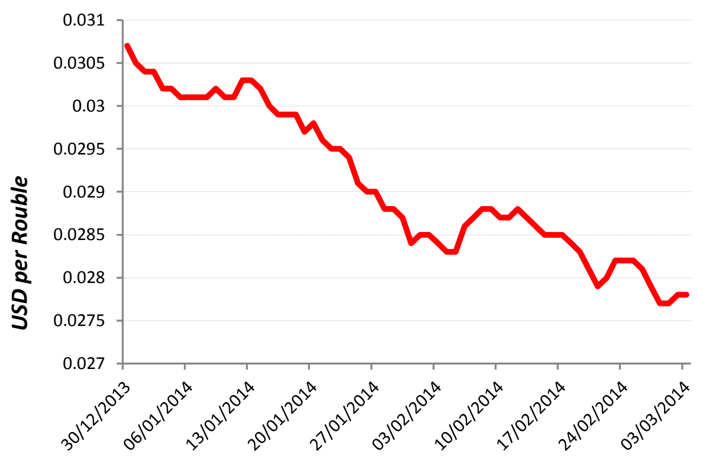
But what about the impact for Russian markets and indeed the Rouble? Perhaps unsurprisingly the Russian market has fallen over 10% since the 1st Jan 2014 (the biggest loss since November 2008) and **the Rouble has tumbled 10.7% against the US Dollar** over the same period, a horrible combination for anyone owning unhedged Russian equities.

This reaction is a clear indication that investors are very nervous about the longer term economic impact for investors in Russia. The general feeling is that Russia can ill afford a war at the moment because the economy is weak and possible international economic sanctions could be extremely painful. One respected economist believes that **the impact of war could amount to over 3% of Russian GDP,** not least because of the disruption to natural gas exports through Ukraine to Europe but also due to the disruption of the $30 billion annual export flow to Ukraine annually. **And this is all before the assessment of what longer term sanctions, including expulsion from the G8, might mean for the Russian economy.**

Alongside the impact on GDP, **a nasty by–product of a tumbling currency is often aggressive inflation and this has prompted the Russian central bank to hike interest rates to support the Rouble.**

Steering clear of Russian equities therefore seems sensible for now and it seems clear that economically, Russia has much to lose from pursuing armed conflict in the region.

Russian Rouble plummets, forcing central bank to hike rates to 7%



Ukraine itself has even more to lose if there is no swift resolution. The country has a growing current-account deficit and reserves of **foreign currency are standing at their lowest level since 2006.** Furthermore Ukraine has over $17 billion of debt due for expiry and renewal through to the end of 2015 **and this is putting Ukrainian government bonds at serious risk of default,** reflected in the yield on the government's $1 billion of debt maturing in June 2014 which traded at over 40% per annum on February 21st, an all-time high.

This assumes a material risk of default for any global banks or fund managers who own Ukrainian government debt. **European financials could be particularly badly affected and this is reflected today in continental European stock markets**, which have been the worst affected as this crisis unfolds.

Investors should expect more volatility in the coming weeks. All eyes will be on the severity of the unified response from the leaders of the G7 countries as tensions mount**. In the short term expensive safe haven bonds such as UK Gilts, US Treasuries and German Bunds have seen large inflows**, particularly as liquidity disappears in peripheral European bonds and risker equity markets.

We currently hold a zero allocation to European equities and bonds and therefore have no direct exposure to either Russia or Ukraine. Our very low exposure to riskier equities such as emerging markets will also help to insulate against a worsening of the current situation, although it is likely that our favoured developed markets, the UK and the US may both be affected, albeit to a lesser extent.

We have made a conscious decision to not, as yet, take evasive action by selling these more defensive markets because we invest on long term fundamentals and we firmly believe in the stronger relative growth prospects in both the UK and the US. **However any material deterioration in the current outlook in Ukraine may spur us to consider reducing risk**, simply due to the potential for shorter-term contagion elsewhere in financial markets. **The next few weeks are therefore crucial and we are watching carefully for a global reaction if "rumour" turns into "news".**