ARDEA Investment Management

Monthly Market Musings: Geopolitical volatility and stagflation fears

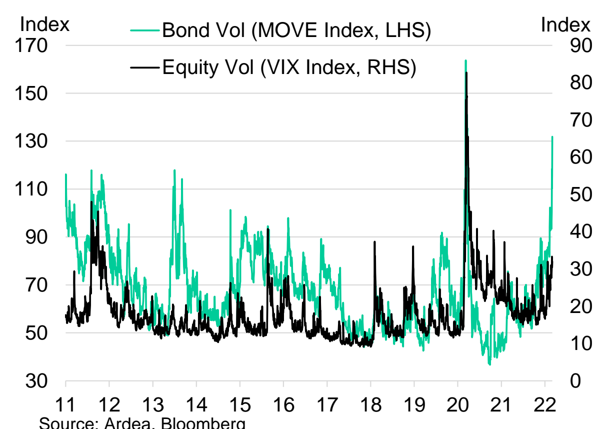
- We outline some broad implications of the Russia/Ukraine crisis for global rates markets: risk aversion, trade links, inflation dynamics and money market funding spreads.
- Surging commodity prices and risk-off sentiment are adding to market concerns over inflation and stagflation risks, particularly in Europe.
- Central banks are continuing on policy tightening paths, despite new uncertainties.

Rising volatility

Markets have been volatile over the last month. First, accelerating inflation and hawkish central banks drove higher yields. Then late in February, a broader risk-off move unfolded, as investors reacted to the threat and then realization of a Russian invasion of Ukraine.

As the first chart shows, the interplay between inflation, hawkish central banks and geopolitics has resulted in a larger jump in implied volatility for bonds than equities. While we show just the commonly watched US indices here (bond vol at the highest level since March 2020), a look at a broader suite of assets reveals even larger increases in volatility, particularly in commodities and other markets with closer links to Russia (see below for more detail).

Chart 1: Implied volatility



Source: Ardea, Bloomberg

Russia/Ukraine crisis implications for global markets

We make a few broad observations about the implications of the Russia/Ukraine crisis for markets.

1) Risk aversion

At the time of writing, sentiment is changing rapidly in reaction to headlines, driving significant daily swings in bonds and risk assets.

To the extent any historical precedents are relevant, one could observe conflicts have generally resulted in short-lived impacts on bonds and broader developed market assets. Underlying macro themes tend to re-emerge as the dominant driver of markets. There is some risk of a more prolonged reaction this time given the inflation context and the substantial response from governments through sanctions and other policy actions.

Elevated market volatility is likely to persist until there are signs of de-escalation.

2) Direct asset price and growth impacts

Russian assets have seen massive falls – the ruble has fallen 56% against the USD since the start of February, Russian equities are at March 2020 lows, bond yields have surged, while sovereign CDS is pricing heightened risk of default.

The direct growth impacts are, on some measures, limited. The Russian economy accounts for <2% of global GDP. Allocations to Russia within EM fixed income indices is modest at around 2-5% and has fallen over the last decade.

However, what developed rates and equity markets are really worried about are the other sources of contagion from the crisis - through financial conditions, private sector credit exposures, commodity markets and inflation. These are significant spillovers and are not distributed evenly across major bond markets.

Notably, European economies are more trade exposed to Ukraine and Russia than the US. For example, Germany has 0.8% of GDP export exposure to Russia, while for the US this exposure is just 0.1% of GDP. Moreover, Russia is a major source of European energy imports, accounting for around 41% of natural gas and 27% of crude oil imports (see here for details).

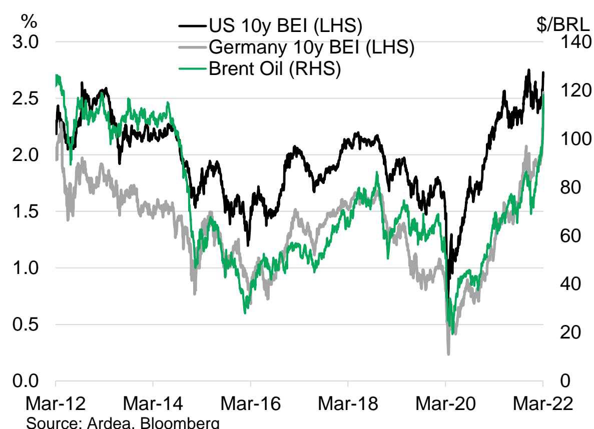
3) Inflation

The crisis is exacerbating existing inflation pressures, reducing the capacity of bonds to benefit from safe-haven flows and for central banks to provide a put for risk assets by moderating hawkish messages.

The clearest sign of this impact is the surge in commodity prices over recent weeks. Oil prices have jumped over 30% since the start of February to a new high since 2014 of $124/brl (Brent futures) at the time of writing. Agricultural commodity prices are also rising.

In turn, bond market pricing for inflation has lifted sharply, especially in Europe where the 10y German BEI is at a decade high of 2.6% (Chart 2). An even bigger jump in inflation is priced into the shorter end of curves, implying some normalization over the long run (which is of limited comfort for investors given the experience of the last year).

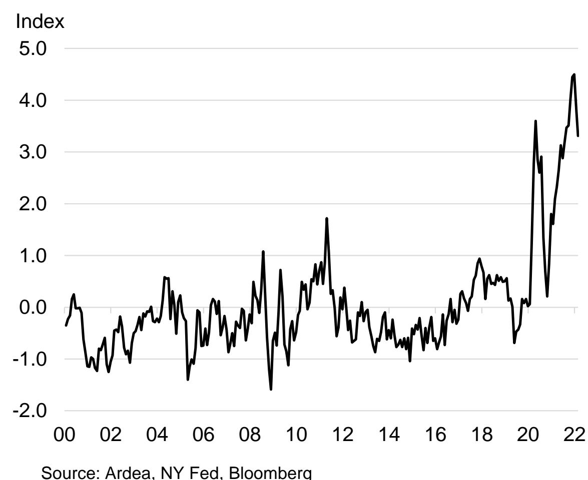
Chart 2: Oil prices and BEIs



Source: Ardea, Bloomberg

Reports are also emerging of disruptions to supply chains as a direct result of the conflict. The impact of these disruptions is harder to gauge in real time than for commodity prices. Chart 3 shows a new index that proxies global supply chain pressures (number of standard deviations from normal, higher = more pressure). As of the end of February, the index remains historically extreme, but still below the peak of late 2021.

Chart 3: Global supply chain pressures index



Source: Ardea, NY Fed, Bloomberg

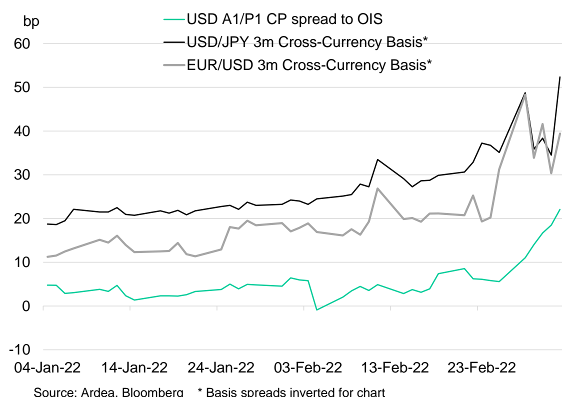
4) Funding markets

Governments around the world have imposed sanctions on Russia, including limiting access of institutions to global payment systems (SWIFT) and to foreign reserves.

There are a few implications and uncertainties for markets stemming from these policies. With Russian institutions limited in capacity to lend in USD and EUR funding markets and general

uncertainty rising, some widening in key funding spreads has emerged. This is coming through via CP markets in the US and in cross-currency basis (Chart 4).

Chart 4: Funding spreads – cost to raise USD



Source: Ardea, Bloomberg * Basis spreads inverted for chart

These spreads can move due to precautionary concerns about liquidity or credit. In the post-2008 era, liquidity and technical money market factors are typically bigger drivers of spreads than credit (due to improvements in global bank and market regulations, capital positions, etc). So far, moves in funding spreads have been contained but are worth watching given their importance to the broader plumbing of the financial system. The experience of multiple episodes of money market funding pressures over the last decade means central banks have a range of tools to support liquidity in the system, such as USD swap lines (in addition to the massive volume of bank reserves in the system following post-COVID QE). These measures could be ramped up if conditions deteriorate significantly.

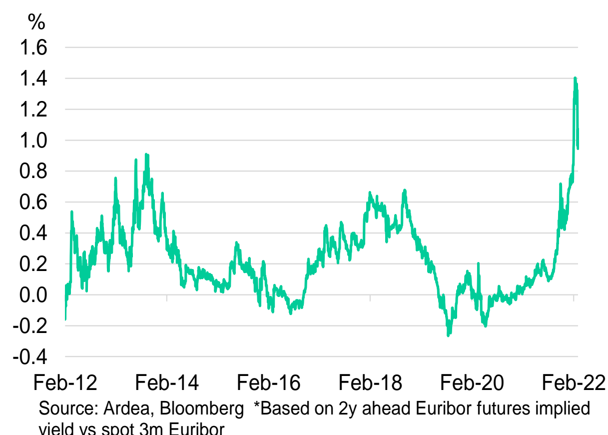
Beyond funding considerations, some analysts have questioned the potential longer-term implications of recent actions on the status of the USD within foreign reserves. The implication is that if western countries can limit sovereign access to offshore USD, then some countries may decide to diversify further away from USD (which has implications for currency and fixed income markets). While this is a longer-term risk, it is likely to be of less focus for investors near term given the nature of the current crisis and sheer magnitude of USD dominance within global reserves (even after the diversification into other G10 currencies and CNY over the last decade).

Central banks still on the tightening path, stagflation risks rising

Leading into the Russia/Ukraine crisis, central banks were either already tightening policy or preparing investors for upcoming policy hikes. Depending on how conditions unfold, the crisis could moderate this path, but higher rates are still on the way given the surge in inflation. So bond yields could still rise further over the medium to long term, notwithstanding any further jump in risk aversion (we also discussed the broader inflation and central bank backdrop in our last monthly update and 2022 fixed income themes notes). There are likely to be variations in central bank reactions given the aforementioned differences in sensitivity to growth and inflation shocks.

Early February saw a big repricing in EUR rates, after the ECB failed to talk down the risk of a 2022 rate hike. Chart 5 shows the amount of ECB tightening priced 2 years ahead reached the highest level in over a decade.

Chart 5: Change in 2y ahead EUR 3m deposit rate



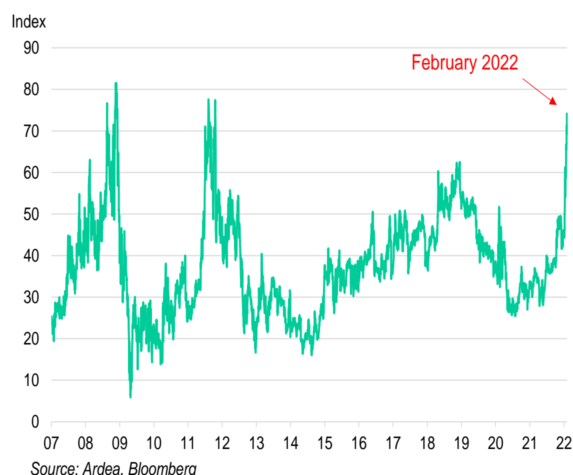
Source: Ardea, Bloomberg *Based on 2y ahead Euribor futures implied yield vs spot 3m Euribor

As outlined, the risks from the Russia/Ukraine crisis are more significant for Europe than other G10 central banks, so the pace of market-implied

tightening has moderated over the last week. However, the sharply higher energy prices have intensified focus on stagflation risks in Europe, with headline inflation over 5% y/y (and core at 2.7% y/y vs a 2% ECB target) even before the recent surge in commodity prices. So tighter ECB policy is on the way even if the crisis delays the start. The ECB's March meeting and upcoming inflation reports will be important signals for fixed income markets.

The impact of both heightened macro and geopolitical uncertainty has spilled over into broader EUR interest rate market conditions. Some other measures of EUR rates market stress and market depth have deteriorated significantly in recent weeks. Chart 6 shows EUR swap spreads to Bunds experienced a sharp, crisis-like jump to March 2020 and earlier sovereign crisis levels (the shorter history €STR swaps vs bond spreads also widened sharply).

Chart 6: EUR 10y swap vs Bund spread

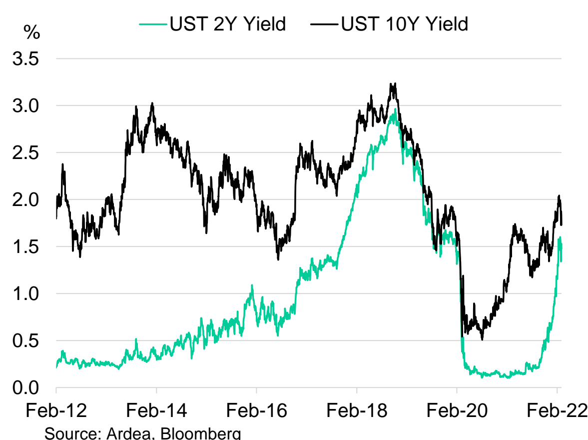


The US market, with lower relative exposure to Russia and Ukraine, saw less extreme dislocation than EUR but still significant volatility. We discussed in last month's update the risk of 50bp rate hikes following upside surprises in US inflation data. Investors have since pared expectations to 25bp moves following the rise in geopolitical uncertainty.

The Fed is still widely expected to deliver its first rate hike of the cycle in March. While this would be a very well flagged policy move, the backdrop of high inflation, uncertain geopolitical outlook and risk asset vulnerability is likely to see rates market volatility remain elevated. These forces are also continuing to drive significant moves in yield curve shape. For example, the widely followed US 2s10s curve has continued to flatten sharply – as 10y yields were weighed by global developments and the 2y yield continues to be relatively more impacted by rate hike expectations (see last month's market update for more detail on yield curves and recession risks).

Other central banks are also continuing policy normalization paths. The BoE and BoC hiked rates in February and March respectively (both to 0.5%). The RBA is expressing more patience, with inflation pressures rising but so far comparatively better contained than in the US and Europe.

Chart 7: US 2y and 10y yields



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