

CAPITAL MARKET REACTION TO WAR IN UKRAINE

By Dr Roelof Botha, Joint Managing Director, GOPA Group SA (7 March 2022)

Two decades ago, the delegates at the annual gathering of the World Future Society, whose historical members include Carl Sagan, Alvin Toffler and Peter Drucker, were convinced that another World War would not occur, but if it did, the cause would be related to a shortage of water.

This esteemed organisation can be forgiven for not reckoning with the unwarranted military aggression of a *de facto* Russian dictator in the person of Vladimir Putin, who has served as the country's head of state for more than 22 years.

Although Putin initially implemented market-friendly economic reforms (including much lower tax rates) that saw Russia enjoy a period of relatively high and steady GDP growth during the beginning of the new millennium, the country's economic advances came simultaneously with the virtual destruction of free media, threats to civil society and an unmitigated corruption of the justice system.

Threat to peace started with Crimea

Russia's annexation of Crimea in 2014 (which was condemned by the United Nations), prompted most of Europe and the United States to impose sanctions on the country. Combined with lower oil prices, this led to a recession from which Russia still has not fully recovered.

According to Nobel laureate Paul Krugman, Russia's president is demonstrating illusions of grandeur in attempting to recreate the czarist empire, a view shared by the Chancellor of Germany and that seems entirely warranted when considering Putin's threat of nuclear retaliation for the unprecedented array of sanctions being imposed on Russia.

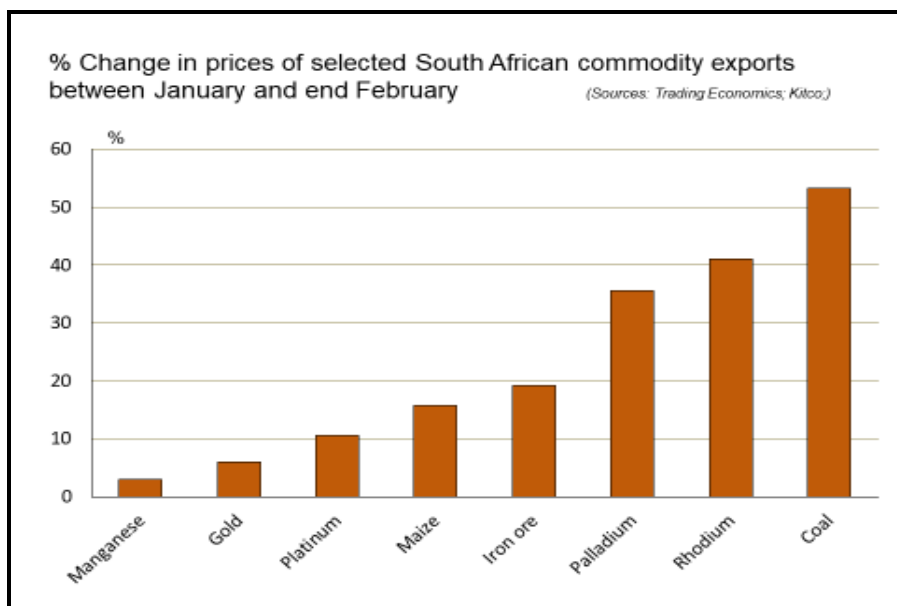
It is no surprise that capital markets around the globe have been spooked by Russia's invasion of Ukraine, with several emerging market currencies and equity markets starting to feel the impact of the latest financial instability, especially via heightened volatility.

Market reaction has nevertheless not been uniform, with equity markets and bond yields in Europe taking a substantial hit, whilst the US and emerging markets such as Brazil and South Africa have been less affected.

Over the past four weeks, Germany's DAX lost 16% of its market capitalisation, but in the US, the Dow Jones and the Nasdaq indices had lost only between 5% and 6% and Asian stocks only declined by between 2% and 3%. Brazil's Bovespa gained 2% and the JSE is down by less than 2% over the past four weeks.

Commodity markets have moved in the other direction, with energy prices predictably rising rapidly. Russia is a major exporter of both oil and gas and Europe relies on Russia for around a quarter of its oil and more than a third of its gas supplies. Russia is also the world's largest exporter of wheat and the prices of grain commodities have risen since the beginning of the year.

Although South Africa will undoubtedly feel the pinch of more expensive grains, fertilisers and oil, the country stands to gain from the spike in various of its export commodities since January, a trend that has picked up in the wake of the war in Ukraine.



Tighter monetary policy halted

Importantly, the nature of risk-off sentiment has changed abruptly, which will continue to unsettle currency markets. Instead of the prospect of higher interest rates driving stronger demand for the US dollar, its attraction is now linked to the relative weakness of the Euro, which has come under pressure due to the comprehensive financial sanctions being imposed on Russia.

Apart from a predictable sharp drop in the value of the Russian rouble and the more or less traditional weakness of the Turkish lira and Argentine peso, most currencies of note held steady against the dollar over the past two weeks, including the rand. Some concern nevertheless exists over likely contagion effects in the wake of a barrage of sanctions aimed at crippling Moscow's financial system and economy. Visa and Mastercard are the latest major financial services companies to suspend their operations in Russia.

According to a report by Oxford Economics, there is a liquidity risk of missed payments due to the freezing of Russian-controlled dollars. Major Russian banks have also been removed from the crucial SWIFT interbank messaging service, which could lead to large overdrafts similar to the situation that existed during the start of the Covid pandemic.

Commentary by Credit Suisse noted that the consequences of excluding Russian banks from SWIFT are real, which should force central banks to re-activate daily U.S. dollar-funds. As a result, the Federal Reserve in the US could end up postponing its promised quantitative tightening.

The ICE U.S. Dollar Index, a measure of the US currency against six major rivals (with the heaviest weight afforded to the euro), rose by almost 100 basis points during the first week after the start of the invasion, reaching its highest level since June 2020 and signalling a continuation of dollar strength combined with Euro weakness.

Although uncertainty over the outcome of the war in Ukraine will prevail well into the future, foreign exchange markets have remained quite stable. The South African rand was virtually unmoved against the US dollar over the past four weeks, but has strengthened against European currencies. The local currency is bound to remain resilient as a result of rising commodity prices, which promise to continue boosting South Africa's export earnings.