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Our investment outlook in light of Ukraine uncertainty

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The invasion of Ukraine has shaken financial markets, which were already navigating inflation and central bank monetary tightening risks. Investors should remain cautious yet prepared for investment opportunities that may arise.

Russian armed forces' invasion of Ukraine has added a level of geopolitical uncertainty to financial markets not seen since the second world war. Investors should stay defensive while also being positioned for opportunities the market volatility may create.

While the response of markets outside Russia has been relatively modest and orderly so far, the risks are mounting. The resulting commodity price increases are effectively a tax on production – raising the possibility of stagflation[1] – while the unprecedented step of excluding Russia from the financial system brings its own hazards.

Markets were already facing a challenging situation even before Russian armed forces invaded Ukraine on 21 February 2022. After years of bull markets, central banks were moving to end ultra-loose monetary conditions[2] and tighten policy to tackle inflation at a time when asset price valuations were high.

The invasion may now delay some of the planned central bank tightening, while also raising the risk of renewed economic turmoil.

Key takeaways:

- Investors may want to consider a defensive stance, including safe-haven assets like gold and longer-term government bonds
- Equity portfolios should remain diversified across both themes and styles, such as growth and value
- Within fixed-income portfolios, there might soon be opportunities to return to a neutral position on duration and to increase corporate credit risk.

This article is a summary of insights from our March 1 webcast on the Russian forces' invasion of Ukraine.

"We prefer to remain defensive for now," Gregor MA Hirt, Global Chief Investment Officer (CIO) Multi-Asset, told investors during an Allianz Global Investors webcast on Ukraine on 1 March.

"We had started to reduce risk in our Multi Asset Fundamental Investment Committee before the crisis, based on our expectation of stronger action by central banks. In recent weeks we have moved into further safe havens, increasing gold and – tactically, given our view on inflation – adding some longer-term government bonds. On the cyclical side, we have commodities that are adding

1. Stagflation: a period of high inflation, slow economic growth and high unemployment.
2. Loose/easy monetary policy: economic shorthand for how central banks expand the supply of money (via low rates, asset purchases and more) to stimulate economic growth. Also known as expansionary or accommodative monetary policy.

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value, both due to inflation and fears about the military aggression leading to disruption."

It's often said that investors should buy on the sound of gunfire, but Mr Hirt thinks such an approach is too simplistic. For instance, it did not apply in the 1973 Yom Kippur War, which drove up commodity prices and inflation in a similar way. Mr Hirt does see some opportunities emerge, though, such as US high-yield bonds, as the country's economic growth remains resilient.

Back to basics in equities

Within equities, Virginie Maisonneuve, Global CIO Equity, said there are several key areas of focus:

- How inflationary pressure will affect growth prospects and pricing power for various companies
- How the crisis-induced "supply shock" to energy and other commodities may affect a shift in competitiveness for countries and companies
- How Europe might accelerate its renewable-energy transformation and reconsider its energy policy within the context of national security
- The role of China in the global economy, given its divergent monetary policy stance as well as its geopolitical influence (eg, its relationship with Russia)

"In this volatile context, and with the reduced visibility that we are seeing, we are looking at using relative price strength and weaknesses for pair trades in the portfolios," said Ms Maisonneuve. In addition, the team is actively reviewing "secondary Russian exposure" names – that is, companies listed outside Russia that might only have small exposure to Russia, but their share prices may have been affected disproportionately by market fear. Given the current environment, cyber-security companies are among the other opportunities to consider.

The Ukraine crisis is likely to mean that the pace of rate increases by US and European central banks slows, Ms Maisonneuve noted. She expects the US Federal Reserve to tighten by 25 basis points rather than the 50 that was previously widely anticipated at its next meeting, while the European Central Bank is likely to raise rates just once in 2022 rather than twice, which had been the consensus.

In this volatile environment, it's back to basics. Ms Maisonneuve believes that equity portfolios should be widely diversified across themes such as areas of technology and sustainability, as well as the styles of growth and value. In terms of growth, she asserts: "You want quality growth stocks with tangible growth, pricing power, earnings and profits."

An inflection point for fixed income

AllianzGI's fixed-income portfolios have been defensively positioned since the beginning of 2022, reflecting the difficulty of navigating markets at an inflection point characterised by rising inflation and tighter monetary policy, as well as the developing geopolitical crisis. With portfolios currently using just 40% of their risk budgets,[3] though, there is capacity to carefully add risk.

"Having been underweight interest-rate duration[4] last year, we've very recently moved our portfolios to be closer to neutral headline duration, and are we looking to buy in bond markets where they have priced in a lot of interest-rate rises – for example, in the US," explained Julian Le Beron, CIO Core Fixed Income. "We have been positioned quite defensively in credit as well and are close to price levels where we plan to add spread risk to our portfolios, whether that's investment-grade credit or high yield."

Emerging-market bond indices needed to be carefully watched, said Mr Le Beron, in case any index providers move to drop Russia from their benchmarks. If they do, investors will have to decide what to do with any holdings of Russian bonds in an environment of thin trading liquidity.

The potential reaction of central banks to higher inflation and the coming squeeze on real incomes, also needed to be taken into account, said Mr Le Beron.

"We believe that the Fed will be forced to raise interest rates to address the short-term inflationary pressures, which means that the yield curve could flatten as the risks of the policy error grow," he noted. "We're concerned about the growth outlook on a more medium-term perspective. That's one of the reasons why we've been looking to move back towards a neutral position on interest-rate duration, given these concerns about growth."

Such shifts in investment portfolios may need to be considered by investors seeking out opportunities amid the market volatility. But their overall approach should remain defensive in the short term.

3. Risk budgets aim to distribute the risk of a portfolio among various asset classes with the objective of maximising total portfolio returns while minimising the total portfolio risk.
4. Duration is a measure of a bond's interest rate risk. In general, the longer the duration of a bond, the more sensitive it is to interest rate changes.

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Data as at 31 December 2021