Principal®

• GLOBAL INSIGHTS • GLOBAL INSIGHTS •

Russia/Ukraine conflict:
A sustained market impact?

Seema Shah , *Chief Global Strategist*

:::: FEBRUARY 24, 2022

After weeks of build-up and intelligence warnings, Russia launched a full-scale invasion of Ukraine, unleashing what may end up being the largest European conflict since World War II. The United States, Europe and NATO allies have condemned the move and responded with economic sanctions. While U.S. sanctions have so far been limited, given the escalation in Russian actions, there will inevitably be a more strident western response in the coming days. European sanctions, on the other hand, have been more forceful, with Germany stopping approval of the Nord Stream 2 pipeline, which would have carried Russian natural gas into Europe.

Although difficult, during a rapidly developing geopolitical conflict, investors are best suited to stay level-headed, considering that fundamentals are ultimately the driver of long-term investment returns.

A tough start to 2022

The escalation in the conflict has seen risk markets retrench further, with sharp falls in global equity markets and a widening in credit spreads. Broadly, commodity prices have risen, with Brent crude oil prices pushing above $100 per barrel for the first time since 2014. Ten-year U.S. Treasury yields, which just a week ago had broken above 2%, have fallen below 1.9% as investors retreat to safe-haven assets.

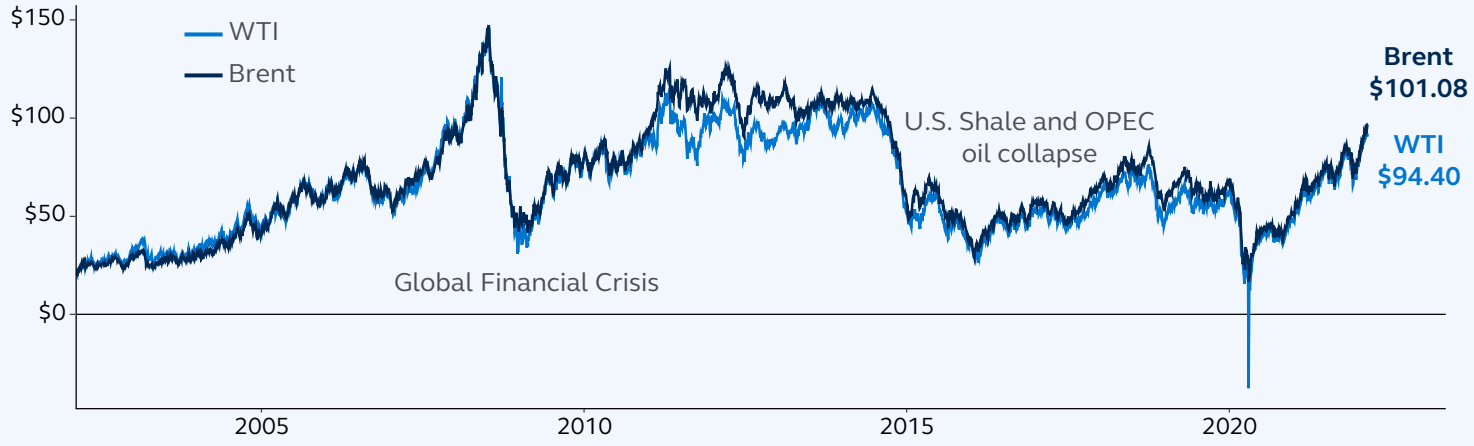
With the S&P 500 now in correction territory, this has been the second worst start to the year for U.S. equities since 2000. Yet, these moves are not solely (or even mostly) driven by the Russia/Ukraine tensions:

- Equity declines began in January and were, at least initially, driven by inflation concerns and expectations for significantly sharper central bank tightening.
- Energy prices had been rising steadily throughout the pandemic recovery and in response to lower-than-expected OPEC+ production.
- Concerns around Federal Reserve (Fed) balance sheet reduction caused credit spreads to start to gap out in early January.

The Russia/Ukraine situation is certainly significant—but it has simply compounded these already challenging market conditions.

Global oil prices

WTI and Brent Crude, oil price in USD, January 2000 – present



Source: Clearnomics, Principal Global Investors. Data as of 2:00pm ET, February 24, 2022.

The geopolitical conflict playbook

By their very nature, geopolitical developments are fluid and so it will be difficult to predict exactly how the conflict in Ukraine will play out over the coming days, weeks and months. Past geopolitical shocks, however, can provide investors with a sense as to how markets typically respond, and the duration of that response.

Over the last 60 years, geopolitical events have often been short-lived and have rarely had a sustained significant impact on equities. The median sell-off has been around 7%, typically taking around three weeks to reach a bottom and an additional three weeks to recover prior levels. What's more, after three months, the market was on average, 4% higher. Steady positive economic growth, corporate performance, monetary policy and valuations matter much more than short-term market uncertainty so, in the longer run, it's the underlying economic backdrop that will dominate market trends.

When central banks have responded to rising oil prices by tightening monetary policy, the equity market sell-off has been more prolonged. During the oil embargo of 1973, for example, the Federal Reserve (Fed) hiked interest rates aggressively to counter the inflationary impact. As a result, bond yields soared and the subsequent equity market sell-off took several years to recover.

By contrast, during the two Gulf wars, the Fed refrained from tightening monetary policy and the economic backdrop remained solid. Although equities sold off sharply, within nine months, markets had fully recovered and even gained meaningfully. It's also worth acknowledging that during the 2014 episode in Crimea, there was little direct impact on oil prices. Similarly, the 2019 drone strikes against Saudi Aramco by Iran and others, which knocked out 5% of global oil production overnight, saw only a short-lived reaction in oil markets. Thus, the more medium-term direction of energy prices can be difficult to predict.

Market reaction to geopolitical crises
S&P 500 performance in past geopolitical shocks

Events	Key dates	S&P 500 selloff starts*	Days of selloff	Days to recover from bottom	Selloff	30 days from key date	90 days from key date	180 days from key date
Cuban missile crisis	10/14/1962	10/15/1962	8	10	-7%	7%	15%	22%
1973 Arab–Israeli War (1st oil crisis)	10/06/1973	10/12/1973	46	2246	-14%	-11%	-13%	-19%
Iran hostage crisis	11/04/1979	10/05/1979	33	75	-10%	5%	12%	4%
Soviet–Afghan War	12/24/1979	12/17/1979	17	7	-4%	7%	-5%	7%
Iraqi invasion of Kuwait	08/02/1990	07/16/1990	38	174	-17%	-11%	-10%	5%
September 11 terrorist attacks	09/11/2001	09/11/2001	10	34	-12%	-2%	4%	5%
2003 invasion of Iraq	03/19/2003	03/21/2003	10	22	-5%	5%	12%	14%
Military intervention in Libya	03/19/2011	03/08/2011	8	14	-5%	3%	1%	-9%
Annexation of Crimea	02/27/2014	03/07/2014	7	18	-2%	-2%	4%	8%

Source: Bloomberg, Principal Global Investors. *Peak level around key dates. Data as of February 23, 2022.

Underlying macro strength, but with risks

As with past geopolitical episodes, the economic and market context, and central bank response, hold the key to what investors should expect. Consider:

- Current Russia/Ukraine tensions are taking place while risk assets valuations are particularly expensive, rendering markets vulnerable to geopolitical developments and, therefore, potentially exacerbating volatility.
- Investors are preparing for the Fed's imminent rate lift-off as it attempts to get back ahead of the inflation curve.
- The underlying U.S. economy remains strong, supported by resilient consumers, solid corporate profits and healthy balance sheets.

While concerns are reasonable, and the U.S. economy could struggle if the Fed had to tighten monetary policy beyond the six hikes that the market is currently pricing in, economic fundamentals, and the strength of corporate balance sheets are more important for long-term investors than any geopolitical shocks.

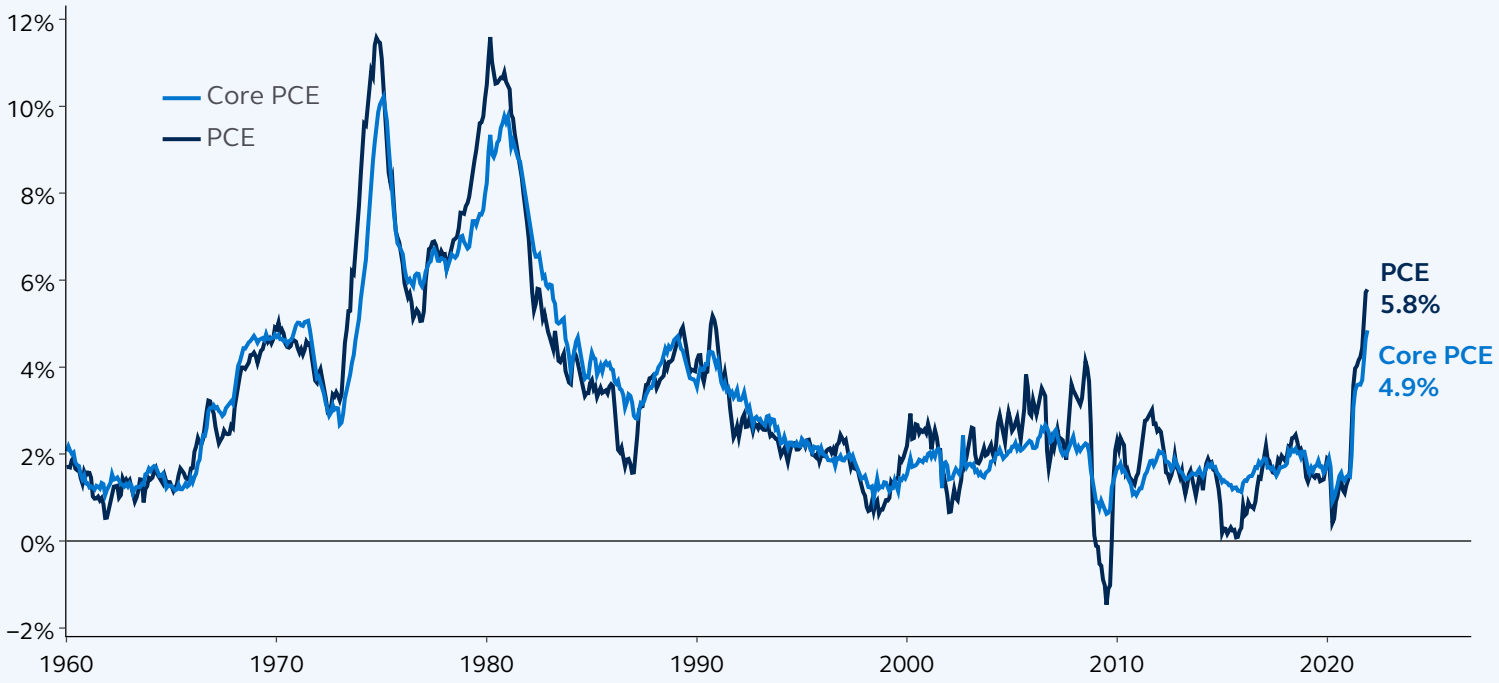
A heightened central bank dilemma

Modern day central banks would ordinarily "look though" energy inflation driven by geopolitical shocks. However, with inflation already running so high and growing concerns around wage price dynamics, investors are concerned that there will be considerable pressure on central banks to tighten policy more aggressively.

For policymakers, it becomes a matter of prioritization, and it is likely that they will refocus on the risks to growth, rather than the risks to inflation in the short-term. That is not to say that central banks will postpone policy tightening until uncertainty fades, rather the Federal Reserve and other central banks are unlikely to be shifted from their planned policy tightening path.

Ultimately, the long-term path for risk assets will remain broadly unaltered: a modest path higher—but one that could be hit with significant volatility and uncertainty.

Personal consumption expenditures (PCE) inflation
Year-over-year change, 1960 - present



Source: Clearnomics, U.S. Bureau of Economic Research, Principal Global Investors. Data as of December 31, 2021.

Investors: stay level-headed

History shows that it has been a mistake to make dramatic shifts in portfolios in response to geopolitical crises. Properly diversified portfolios are designed to handle these periods of uncertainty.

U.S. and global economic growth remain stable and although a sustained rise in oil prices would weigh on economic growth, the impact should be tempered by continued consumer resilience and healthy household and corporate balance sheets. At the same time, central banks are unlikely to shift their focus or accelerate tightening in response to the geopolitical conflict.

Thus, while near-term market movements may be choppy and further losses are possible, the constructive macro backdrop should, in time, stabilize conditions. Investors would be well suited to stay invested, but with a focus on factors that should remain relatively resilient through the near-term volatility.

Energy

After years of underperformance, the energy sector will likely outperform as both a geopolitical and inflation hedge, rising each time the conflict escalates. Furthermore, given the structural supply shortage facing the industry over the coming years, energy could perform strongly regardless of the developments around Russia/Ukraine.

Quality

The story remains the same—market conditions are inevitably becoming more challenging and geopolitical risks, coupled with inflationary pressures, mean that companies with robust balance sheets, strong business models and pricing power will be the beneficiaries.

U.S. over Europe

Although the trade impact on the both the U.S. and Europe will be limited (Russia accounts for less than 1% of their exports), Europe is significantly more exposed to any energy disruption. As a net energy exporter, the U.S. is less vulnerable to a rise in oil and gas prices. Europe, however, is a net importer—over 40% of EU gas and 20% of EU oil originates from Russia. Any disruption of the supply of oil and/or gas will have a significant impact on energy prices across Europe and, therefore, on growth and inflation, leading to a preference for U.S. based investments.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

Important Information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

This document is intent for use in:

- **The United States** by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- **Europe** by Principal Global Investors (EU) Limited, Sobo Works, Windmill Lane, Dublin D02 K156, Ireland. Principal Global Investors (EU) Limited is regulated by the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). The contents of the document have been approved by the relevant entity. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (EU) Limited ("PGI EU") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGI EU, PGIE or PGI EU may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland.
- **United Kingdom** by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA").
- **United Arab Emirates** by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organization.
- **Singapore** by Principal Global Investors (Singapore)Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore.
- **Australia** by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS License No. 225385), which is regulated by the Australian Securities and Investments Commission. This document is intended for sophisticated institutional investors only.
- This document is marketing material and is issued in **Switzerland** by Principal Global Investors (Switzerland) GmbH.
- **Hong Kong SAR (China**) by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- **Other APAC Countries**, this material is issued for institutional investors only(or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
- Nothing in this document is, and shall not be considered as, an offer of financial products or services in Brazil. This presentation has been prepared for informational purposes only and is intended only for the designated recipients hereof. Principal Global Investors is not a Brazilian financial institution and is not licensed to and does not operate as a financial institution in Brazil.

Insurance products and plan administrative services provided through Principal Life Insurance Co. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities are offered through Principal Securities, Inc., 800-547-7754, Member SIPC and/or independent broker/dealers. Principal Life, Principal Funds Distributor, Inc., and Principal Securities are members of the Principal Financial Group®, Des Moines, IA50392.

MM12774 | 2052951