Russian Sanctions

What Investors Need to Know

MARCH 16, 2022

Geopolitical disruption can create market volatility in the short run, but based on our analysis, markets generally tend to recover within a few weeks. The one important exception to this rule is when structural disruptions develop in energy markets, which can have important spillover effects into the multiasset-class universe. Regarding the current crisis in Ukraine, policymakers are doing everything they can to avoid major disruptions to energy markets, even as oil sanctions and other restrictions against Russia are implemented. In this market commentary, we focus on recent sanctions against Russia and the potential implications they could have for investors.

Over the past few weeks, the U.S. and its allies have expanded sanctions on Russia, and while at first these measures focused on the financial services industry, the scope has quickly escalated to an outright embargo of Russian oil and other energy imports. The list of formal sanctions has been growing at an increasing rate. In our view, these developments could exacerbate supply chain disruptions that were catalyzed by the pandemic. Several multinational companies have also begun to "self-sanction" by phasing out operations in Russia as well. Current sanctions fall into four broad groups:

Financial Industry

- Access to the SWIFT international payment system has been revoked for Russian banks, including the country's central bank, but only to the degree it does not impact energy payments. While it is not a blanket SWIFT ban, it is an impactful move. Therefore, the Federal Reserve (Fed) must remain ready to engage in foreign exchange swap lines should there be a near-term dollar shortage as a result. The magnitude of these sanctions is greater than previous sanctions against Iran or Libya as Russia is the 11th-largest economy in the world.
- A variety of major financial index providers such as MSCI and Bloomberg have removed Russian securities from their indices. For example, in MSCI's case, it removed Russian equities from its emerging markets index and now classifies them as a "standalone" index. Bloomberg similarly removed Russian bonds from its fixed income indices.

Oligarch Wealth Freeze

- Several countries have frozen assets, seized property and imposed sanctions specifically on Russian oligarchs with the intent to apply pressure on potential allies of Russian President Vladimir Putin.
- Several countries, including the U.S., U.K. and Canada, have increased collaboration to thwart attempts to evade sanctions through means such as golden passport bans and blocking Russian aircraft from their respective airspaces.

Energy

- On March 8, the U.S. formally embargoed Russian oil, natural gas and coal. It was the second country to do so after Canada, which also announced an oil ban on February 28.
- We view these actions as symbolic in nature as the U.S. only imports approximately 3% of oil from Russia, and Canada imports none.
- In sharp contrast, Europe imports more than 40% of Russia's total oil production, and some European nations rely heavily on imports from the country. For example, 30% of Germany's oil supply is from Russia. Even Norway, which some view as a major oil producer, still imports approximately 25% of its oil from Russia, making it extremely difficult to enact embargoes in the near term. However, the U.K. has pledged to phase out Russian oil by year end; Russian oil accounts for 8% of its total demand.

Commerce

- Many multinational corporations across a variety of industries are severing business ties in Russia, including closing stores and removing products.
- TikTok, the most visited website in the world in 2021, suspended video uploading and livestream functions in Russia.
- The International Chess Federation has banned tournaments from occurring in Russia and Belarus, and FIFA has banned Russia from international soccer.

The ultimate effectiveness of these sanctions to pressure Russia to end this conflict is unknowable, but a swift end to the country's assault on Ukraine is imperative as the humanitarian crisis worsens considerably every day.

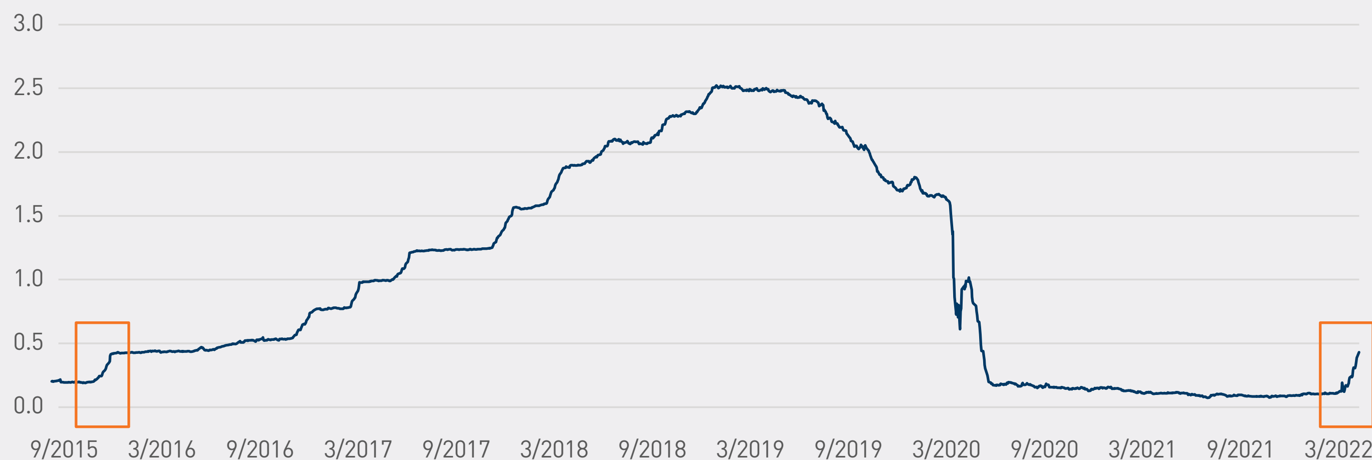
Bond Market Signals

From an investor's point of view, the impact of sanctions on the global financial system are most likely to surface in short-term Treasury and money markets as they are often the first to signal stress.

Recent headlines have highlighted how LIBOR and commercial paper spreads are widening to levels not seen since March 2020. One-month LIBOR spreads have increased from 19 basis points (bps) the day before the invasion began to 43 bps as of March 14. In comparison, 3-month LIBOR has recorded a similarly substantial move, increasing from 47 bps to 88 bps over the same period. However, we believe concerns about these instances of spread widening discount what was already underway well before the Ukraine invasion began — the market reaction to imminent Fed rate hikes. In fact, a similar move occurred in 1-month LIBOR during November-December 2015, right before the Fed began its last rate hike cycle (Figure 1). In our view, these moves highlight the anticipation of higher rates and do not suggest systemic stress in the plumbing of the U.S. financial system. While volatility in the Treasury market, as measured by the MOVE Index, recently reached levels not seen since March 2020, we continue to believe much of the current market volatility is being driven by investors adjusting to changes in monetary policy from the Fed.

Figure 1. 1-Month LIBOR (%)

Short-term fixed income adjusting to rate hikes, not geopolitics



As of 3/14/2022 | Source: Bloomberg, L.P.

The Path Forward

We strongly believe global markets are not signaling systemic risk concerns about the Ukraine invasion. In our 2022 market outlook, we observed the business cycle is slowing, but still growing. Leading indicators such as ISM new orders and building permits continue to support that case.

From a market-based lens, a cyclical sector like Energy, which is sensitive to economic growth, would not be one of the best performers within the S&P 500® since the invasion began if the market expected a severe slowdown in the business cycle. Nor would the S&P 500 have a forward price-to-earnings ratio of 18 times, which is above its long-term average. In fact, if geopolitical headwinds dissipate, or if central banks moderate their decisions to tighten financial conditions, we expect it would be a net-positive for equities. Regardless of the path forward, we expect the high-volatility regime that markets have been in for more than two years to remain in place for the foreseeable future.

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