Investors weigh long-term impact of Ukraine war with no end in sight

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The war in Ukraine, with its mounting atrocities, is also demonstrating the fog associated with it – the lack of visibility of what is actually happening – extends to the financial markets, casting a pall over many portfolios.

"There are a lot of factors going on outside the war that are affecting markets, but the war is definitely the elephant in the room," says James Barrie, investment advisor with the Cash Management Group at Canaccord Genuity Wealth Management in Vancouver.

He wrote an analysis for clients in the war's early days, illustrating the immediate impacts that included higher energy prices, which have exacerbated already high inflation from the pandemic.

Yet, beyond the initial upheaval of elevated energy prices, sanctions and many North American companies ceasing operations in Russia, uncertainty still weighs on investment strategies with the conflict further widening pre-existing cracks in the global economy.

"Some investors may be thinking, 'Okay, once this war ends things will go back to normal,' but that's likely not the case," says Paul de Sousa, senior vice president and senior investment adviser at Sightline Wealth Management LP in Toronto.

Decades of increasing trade ties with Russia and other former Cold War foes like China – in part to reduce the likelihood of conflict – have "been unravelled in a few months."

Mr. de Sousa is not the only financial professional who holds this view.

Notably, BlackRock Inc. chief executive officer Larry Fink wrote in a March letter to shareholders that "the Russian invasion of Ukraine has put an end to the globalization we have experienced over the last three decades."

Already, many global asset managers – especially those with emerging market exposure – are facing headwinds, says Patti Dolan, senior wealth advisor and portfolio manager at Wellington-Altus Private Wealth Inc. in Calgary.

"One of the big bond holders of Russian bonds was PIMCO," she notes.

PIMCO, one of the world's leading fixed income managers, is thought to have more than US$2-billion in exposure to Russian sovereign debt, potentially at risk of default due to sanctions.

What are the indirect impacts?

While it's likely some Canadians' portfolios also took a hit as a result of direct Russian exposure, it's more likely investors are feeling indirect impacts given Russia, as one of the world's leading commodities producers, is deeply challenged in its ability to reach foreign markets.

"It's not that Russia has announced it won't be exporting commodities," says Maria Solovieva, an economist with TD Economics, who co-authored a report on the war's impact in March. "Right now, it's more sentiment; there is an expectation of problems."

And investors have reason to be nervous.

Russia is the second-largest producer of ammonia, urea and potash in the world. It is the second-largest global producer of natural gas and the third-largest for oil. It is also the sixth-largest producer of coal, and the fifth leading manufacturer of steel. Furthermore, Ukraine and Russia account for about 30 per cent of global wheat exports.

Yet, economic modelling forecasts uneven effects with "higher impacts on Europe, and less impact on Canada and the U.S.," Ms. Solovieva adds.

However, global growth will slow, the International Monetary Fund (IMF) recently forecast. It projects economic growth will fall to 3.6 per cent this year and next from 6.1 per cent in 2021. The IMF noted Germany and other European nations would be most affected due to their reliance on Russian energy. It also predicts inflation close to 6 per cent for the rest of 2022.

"The longer you see elevated price impacts, the more economic pain there will be," Ms. Solovieva says, adding high inflation will likely dampen consumer confidence.

Already, central banks have indicated a faster path for higher interest rates than just a few weeks ago.

Opportunities in energy and defence space

But not all of the war's economic impacts are negative for investors, particularly portfolios holding Canadian energy companies.

Ms. Dolan of Wellington-Altus points to Vermilion Energy Inc. VET-T +0.80% increase, which saw its share price rise in part because it had purchased a large natural gas play in Ireland.

"This was an unintended consequence that happens to be on the positive side," says Ms. Dolan, a responsible investment specialist.

If anything, the war highlighted Europe's energy dependence on Russia, she adds. In turn, the war could serve as a tailwind for renewables.

"Now with the shortage of energy in Europe, countries are looking at options," she says.

Investment in liquified natural gas facilities and pipelines would be among those.

"But not too many companies are going to invest huge amounts of capital in what could be a stranded asset," Ms. Dolan says. "There still has to be the transition, but at this point, investing billions into a pipeline may not be very practical."

Defence sector companies also are likely to see more growth if the war continues, she notes, as the U.S. and allies look to restock supplies sent to Ukraine and bolster their own defences.

"It's one thing to say you're going to spend money on defence, but where is the money going to be deployed?" she cautions, noting a XAR-A +0.02%increase has yet to see a significant uptick.

Immediate impacts aside, the war appears to have changed the calculus of globalization, not just with Russia but with China, India and other emerging markets that have continued to trade with Russia while failing to criticize its invasion and alleged war crimes.

"It's like a new version of the Cold War that's emerged," Mr. Barrie of Canaccord says.

Now, with the U.S. focused on reducing reliance on supply chains from China, the traditional tilting of portfolios toward U.S. and Canadian markets is unlikely to change. But significantly reshoring manufacturing faces many barriers, he adds.

"This is not a one- to even five-year timeline," Mr. Barrie says.

Still Mr. de Sousa says a "blueprint to re-establish" manufacturing capacity seems to be established.

"Because labour here is much costlier than in China, it's a tall task and could further the inflation narrative."

He adds that in the meantime, orienting portfolios toward commodities, their producers, and transportation companies is likely to provide a hedge to inflationary pressures.

Of course, as the war rages, the only certainty is uncertainty, Mr. de Sousa says.

“Definitely prepare for volatility,” he adds.

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