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NCRAM Flash Commentary on Russian Invasion of Ukraine: Contained Impact on NCRAM Portfolios

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After massing troops and military equipment along the Ukrainian border for several weeks, on February 21st Russian President Vladimir Putin provocatively recognized the independence of breakaway republics Donetsk and Luhansk in eastern Ukraine. Putin also committed to inserting peacekeeping troops in the region to protect ethnic Russians. In the early hours of February 24th, Putin escalated to a full-scale invasion of Ukraine from Russia, Belarus and Russian-controlled Crimea. Russian forces launched attacks by air, land, and sea on more than a dozen Ukrainian cities, destroying more than 70 predominantly military targets and killing dozens of Ukrainian soldiers and civilians. The attacks sparked a massive movement of Ukrainian refugees fleeing toward neighboring countries, while others sought shelter within Ukraine. Putin has expressly declared that the objective of the operation is to oust the Ukrainian government.

The West and NATO allies reacted with a new round of sanctions against Russian elites, state-owned industries, and Russian banks. The US and allies stopped short of sanctioning Putin directly or removing Russia from the SWIFT payment system, which would have required international consensus to implement, though US President Biden signaled the option is still on the table. Biden also deployed additional US troops to Germany and Poland, raising the specter of direct US military involvement in the event Putin's forces veer into NATO member countries.

Even as our thoughts are with the Ukrainian people and our Ukrainian and Russian colleagues and their families, we must assess potential impacts on our portfolios as we seek to help our clients navigate this significant geopolitical risk.

US High Yield

The market responded to the Russian invasion with a sharp selloff in risk assets, and a rally in government bonds and energy prices. Before the end of the trading day, panic selling reversed, with Treasuries and oil giving back much of the day's gains, after President Biden's comments reassured the market that his administration is focused on energy security and offsetting inflationary impact.

One of the most critical factors will be the ramifications for already elevated oil and natural gas prices, but we think the impact in the US is likely to be limited. The energy market remains well-bid due to fears of potential disruptions, and geopolitical premiums have increased. We will continue to closely monitor production and demand trends and watch for signs of more material disruptions to supply, particularly with regard to natural gas.

In sectors most exposed to consumer sentiment, most companies have so far maintained adequate pricing power, but if inflation remains persistently high without wages keeping pace, we could see some negative impact on discretionary spending, and in turn on consumer products companies and retailers.

Any slowdown in economic activity could reduce the Fed's zeal for monetary tightening, but the futures market continued to price in the equivalent of six 25 bps rate hikes this year. Historically, energy price shocks have tended to nudge monetary policy in a more dovish direction, but this time, we see a scenario where the Fed's hands are tied with inflation at 40-year highs. An aggressive pace of rate hikes to constrain inflation could soften the growth outlook later this year.

The US high yield market had held in relatively well so far this week, but was down roughly 50 bps on Thursday, as measured by the ICE BofA US High Yield Constrained Index (HUC0). Spreads widened by 21 bps on the day to 394 bps, and the index yield-to-worst increased 14 bps to 5.86%. Our strategies broadly continue to perform well versus market on a MTD and YTD basis. Overweight positions in Energy and recent efforts to reduce portfolio risk helped performance on Thursday. Importantly, we have no exposure to Russia and Ukraine in our US high yield strategies, so we don't expect any meaningful direct impact on our portfolios. Key risks to the high yield market going forward include a potential reduction in risk appetite lessening investor demand for the asset class, and elevated energy prices driving further inflation and quelling economic growth.

The situation in Ukraine remains tense and volatility is likely to remain elevated. There continues to be significant uncertainty on the near-term outlook, but we believe our current positioning will mitigate downside risk while enabling us to capture alpha opportunities.

European High Yield

In Europe, the ICE BofA European Currency High Yield Constrained Index (HPC0) spread widened by 30 bps to 443, and the yield-to-worst increased 24 bps to 4.49%. NCRAM's European high yield strategy broadly moved with index performance, and is still performing strongly MTD and YTD. Our European high yield portfolios have zero direct exposure to Russia or Ukraine compared to around 0.54% in HPC0. However, credits with some business in those countries and Eastern Europe in general sold off slightly more than the market overall. While the ECB had recently begun to indicate a shift in policy toward tightening later this year, some ECB members indicated that the conflict may delay this tightening policy.

A key risk factor to watch in Europe is the development of commodity prices. Higher oil and natural gas prices will be a drag on European growth, with no mitigating benefit for the European high yield market given relatively limited exposure to commodities in the benchmark. Higher commodity prices will continue to push inflation on the continent, complicating the ECB's task. Our trading activity YTD has taken into consideration the inflationary environment, and we will be monitoring closely for further developments in key European economies.

Emerging Markets

In emerging markets, the overall impact on NCRAM's portfolios is relatively limited, due to a large underweight exposure in Russian credits that so far has offset losses in our exposure to Ukrainian sovereign and corporate bonds. NCRAM portfolios have small or no exposure in Russia, while in Ukraine our positioning is neutral for corporate bonds and overweight in the EM hard currency sovereign strategy. Russian bonds are down at least 40 points, Belarus bonds are down 50 points, and Ukrainian bonds are down 30 points since active hostilities commenced. Emerging markets hard currency sovereign bonds, as measured by the JPMorgan Emerging Markets Bond Index Global Index (EMBIG), fell -2.42% on February 24th, with high yield credits underperforming with a -3.08% decline. We expect the impact of our benchmark-relative positioning to be net positive based on Thursday's price action. Our underweight stance in Russia has been a positive contributor for relative performance year-to-date, and we have avoided credits either already sanctioned or with greater potential for further sanctions.

Key to watch now is whether a new round of sanctions beyond the measures already announced materialize with further escalation on the ground. In NCRAM's view, Russian sanctions will likely benefit global commodity producers and countries producing oil, natural gas, aluminum, and nickel. Market impact on other EM sovereign and credit markets Thursday was relatively limited. As the conflict puts pressure on oil prices and potentially on inflation, Fed policy will likely continue to be the main market driver for EM outside of the Russia/Ukraine conflict.

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