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The Russia-Ukraine Conflict – What to Expect?

Russia has officially declared war against Ukraine (**Fig 2**) amid its decision to join NATO which was aimed to counteract the threat of post-war Russian expansion in Europe. The launch of military invasion includes missiles, tanks, artillery and jets.

Although the outcome of the war remains uncertain, we can expect few possibilities:

1. Pro-Russian Eastern Ukraine (**Fig 1**) becomes federal subjects of Russia, similar to the case of Crimea;
2. Russia fully controls Ukraine; and
3. Russia retreats from the war due to significant economic sanctions.

Fig 1: Percentage of population that identified Russian as their first language

Source: The Washington Post

We think the resolution for Crimea is the most likely outcome for Eastern Ukraine as the area can serve as a line of demarcation between the Europe and the Russia. Furthermore most of the people in Eastern Ukraine are Russian who welcome the intervention of their "mother land" on Ukraine.

Fig 2: Area of conflicts between Russia and Ukraine

Source: Wikipedia

Economic Significance of Russia and Ukraine

With 146 million people and a massive nuclear arsenal, Russia is a transcontinental giant as well as a major source of the oil, gas, and raw materials that keep the world's factories operating. However, it is a modest participant in the global economy, compared to China, which is a manufacturing powerhouse with sophisticated supply lines. The most significant impact of the conflict between the two nations is perhaps the energy commodities. Through the Nord Stream 1 pipeline (**Fig 3**) and the Ukrainian network, Russia currently supplies 40 to 50% of Europe gas demand. Germany imports half of its natural gas from Russia, much of which passes through Ukraine, earning them a US$7bn transit fee. This equates to an estimated 4% of Ukraine GDP. As one of the top three major oil exporters, supply of crude oil might be impacted. In response, crude oil has surpassed US$100/bbl for the first time since 2014.

Fig 3: The Nord Stream 1 supply line

Source: AlJazeera

Ukraine's economy relies heavily on grain exports. Much of Ukraine's wheat and grain is bound towards West Asia and Africa, where food imports are largely reliant. Over 40% of Ukraine yearly corn and wheat exports are bound for the Middle East or Africa. If Ukraine exports are disrupted, global food security is a major concern. On the far west however, US wheat accounts for less than 10% of the wheat consumed in those areas.

Malaysia to Benefit

Malaysia being a net oil & gas exporters will benefit from higher crude oil price. For every US$10/bbl increase in oil price, the Malaysian government is expected to receive addition RM7.5bn in revenue. The budget 2022 was based on US$66/bbl. With the current oil price of US$100/bbl, our Ministry of Finance may receive additional RM26bn revenue. The higher export revenue will raise our current account surplus and strengthen the ringgit which will make Malaysia an attractive investment avenue for foreign investors.

Risk of Extended War

The political risk of the war has caused global equity markets to plunge. US has declared that it is not going to fight Russia inside Ukraine. As Ukraine is not a member of NATO, there is no legal obligation for NATO to defend Ukraine. As such, the Russia-Ukraine is probably confined to Ukraine and will not extend to NATO. Some military supports will probably be received by Ukraine.

We do not believe Russia will penetrate deep into Ukraine. Most likely Russia will liberalise Eastern Ukraine like they did with Crimea in 2014. The main intention of Russian invasion of Ukraine is to prevent Ukraine from joining NATO which will mean bringing NATO missiles at its boarder. As such, we may interpret Russia invasion as a defensive move to prevent a possible Russia-NATO war.

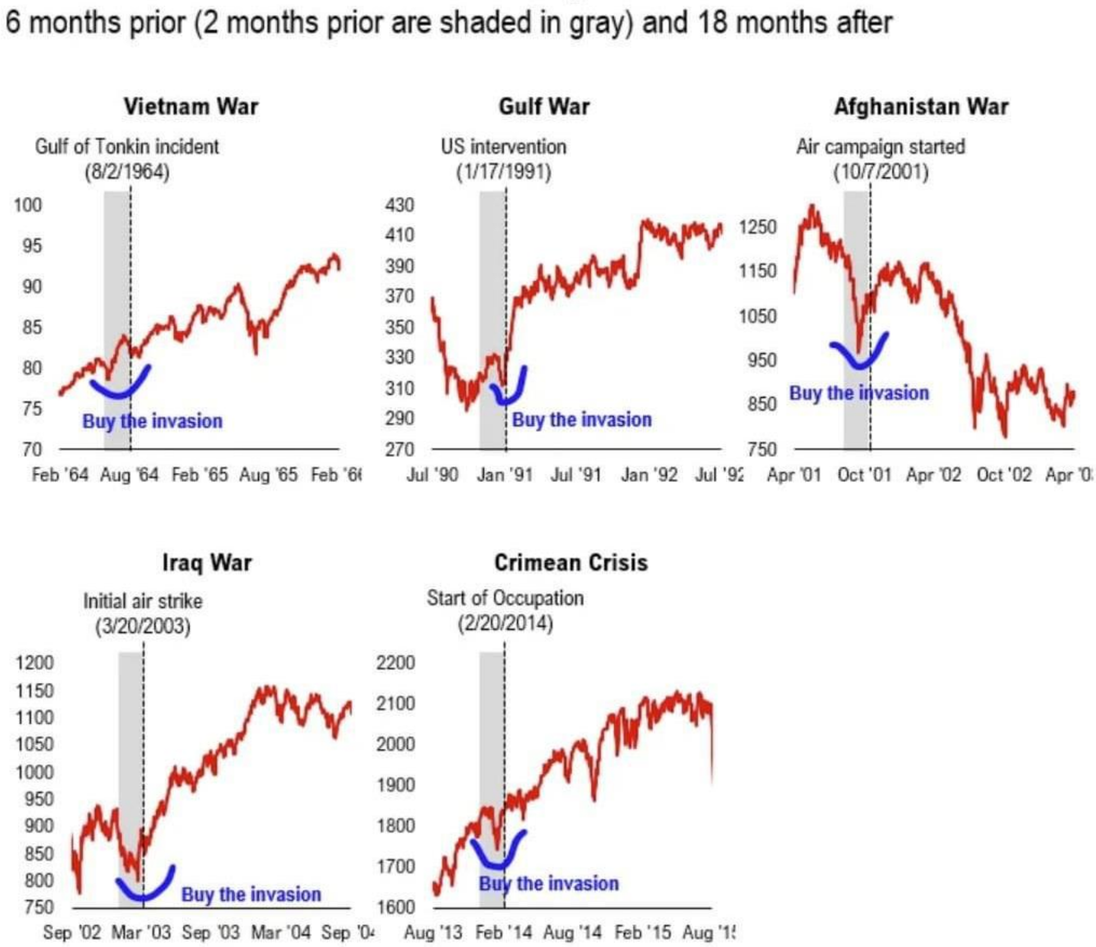
Past Stock Market Reactions Towards Wars

Looking at the impacts of past wars on the stock markets, they do not seem to last very long. Most sell down on the stock markets were temporary (**Table 1**). Market tends to bottom when war started (**Fig 4**).

Table 1: Past performance of S&P500 during war events

Event	Event Date	Start of Selloff	Duration of Selloff (Trading Days)	Duration to Recover Prior Level (Trading Days)	Size of Selloff (%)
WW-II Pearl Harbor	7-Dec-1941	4-Dec-1941	17	201	-10.8
Israel Arab War/Oil Embargo	16-Oct-1973	29-Oct-1973	27	1475	-17.1
Invasion of Grenada	25-Oct-1983	10-Oct-1983	22	304	-6.3
9/11 Attacks	11-Sep-2001	10-Sep-2001	6	15	-11.6
2014 Crimean Crisis	20-Feb-2014	21-Jan2014	6	7	-4.4
2022 Russia-Ukraine War	22-Feb-2022	11-Feb-2022	Ongoing		

Fig 4: Market always rebounded post invasions



Source: Fundstrat, Bloomberg

Nevertheless, the conflict has added more complication to the already uncertain market due to expectation of US rate hikes. We are concerned that the war will trigger even higher inflation caused by the surge of commodities prices, especially the energy prices. The ‘red hot’ inflation has been a major issue troubling the Federal Reserve (FED). Under the easiest monetary environment, the FED has no more room to stimulate the economy, thus, if the war caused a drag to the economy, stagflation will occur. Nevertheless, we believe such scenario is unlikely as we perceive the Russia-Ukraine war is an “isolated war” and not an extended war. Russia just want to show they are serious on the risk of Ukraine joining NATO of which US has never opening decline such possibility. If President Biden had declared that the US and NATO would not accept Ukraine into NATO, the current war would have been avoided.

Recommendations

As we see the impacts of previous wars to the stock market had been short-lived. The S&P500 has fallen over 12% from the peak in Jan 22 and is currently trading at the forward 12m PE of 18.8x, near its mean. We advise long-term investors to stay calm and focus on the fundamental of the companies rather than the short-term jitters happening thousands of miles away.

We recommend long term investors to take advantage of the market sell down to accumulate (buy gradually) on good fundamental stocks that that have stayed firm recently. As crisis provides opportunities. Stocks sold down by jittery investors due to change in sentiment are generally the best to buy. For short term investors, we recommend to have more cash in hand or to temporarily shift to a safe-haven asset such as gold.

For Phillip Capital Management Sdn Bhd

Nona Salleh
Executive Chairperson