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CIBC CAPITAL MARKETS

EQUITY RESEARCH

February 27, 2022 **Industry Update**

The Ukraine Situation Remains Unpredictable

Equity Volatility Likely To Continue

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Sector:
Portfolio Strategy

Our Conclusion

The situation in Ukraine has unfolded in a more worrying fashion than we expected. The scale of the invasion is more extensive and the risks are greater. This argues for continued equity volatility, and likely additional price weakness.

This conflict is the first in some time that will likely be inflationary rather than deflationary given the importance of Russia (and Ukraine) in commodity markets. Price pressures were already mounting globally, so central banks will likely be less accommodative than in the recent past. Indeed, one could conclude the conflict would argue for more rapid interest rate increases to control inflation. Tech stocks and the S&P 500 remain vulnerable, and Canadian equities are likely to continue outperforming.

Key Points

The invasion of Ukraine by Russia is occurring at a difficult time for central bankers. Inflation had already become more ingrained, and the limited action to date has raised questions on whether the Federal Reserve was “behind the curve” even before the conflict started. So far, the invasion has further bolstered commodity prices and could intensify supply chain challenges.

Russia and Ukraine are responsible for about one fifth of global exports of several energy and agricultural commodities. So far, the invasion has not caused major specific disruptions to production, but that remains a real possibility as long as fierce fighting continues.

Western nations are announcing additional sanctions, with this weekend seeing a more aggressive initiative on restricting some Russian banks to the SWIFT interbank system. The situation remains volatile, and we are unclear what Russian President Putin hopes to achieve – or how prepared he is to use more extreme tactics in furtherance of his goals.

News of a meeting between Russian and Ukrainian officials raises the possibility of some de-escalation in the short term. We would view this as a brief respite and would be cautious of any equity strength. The better economic conditions for Russia arising from high commodity prices seems to have emboldened senior Russian officials in dealing with NATO.

In times like these, we should remind ourselves the capital markets implications of the conflict discussed in this report are substantially outweighed by the personal toll on Ukrainians, many of whom are facing extremely hostile conditions. Our hearts go out to those caught in this terrible situation.

All figures in Canadian dollars unless otherwise stated.

For required regulatory disclosures please refer to "Important Disclosures" beginning on page 6.

Why Ukraine Turmoil Matters More Than It Did In 2014

A look back at the market reaction to the Russian annexation of Crimea in 2014 can lead many to a sanguine view of the current Russian invasion of Ukraine. Of course, the scale of the conflict this time is clearly more meaningful, and the West has become more transparent in its preparedness to apply harsh financial sanctions. But more importantly, the implications are more tangible because the global economy and capital markets are in very different places than they were in 2014.

2014 looked like much of the post-GFC period

The environment in 2014 was one that largely existed since the Financial Crisis. Interest rates were low, inflation was benign and the Federal Reserve was very accommodative. U.S. shale oil production was rapidly increasing, but at the time the belief was OPEC would adjust production to support oil prices. The macro environment currently is very different (see table in Exhibit 1), with inflation levels being much higher. U.S. Core CPI is now 6% compared to less than 2% in 2014, while the comparison for Headline CPI is even more stark.

Inflation pressures are very different currently

Exhibit 1: Select Indicators And Commodity Prices – April 1, 2014 And February 24, 2022

Economic Indicator	April 1, 2014	February 24, 2022
S&P500 Level	1,886	4,289
S&P500 Forward P/E	15.3x	18.9x
US 10Y T-Note Yield (%)	2.76%	1.97%
Fed Funds Eff. Rate (%)	0.08%	0.08%
US Core CPI (% year over year)	1.6%	6.0%
US Headline CPI (% year over year)	1.6%	7.5%
Fed Balance Sheet ($billions USD)	$4,244	$8,911
Oil (WTI, $/Bbl)	$99.7	$93.0
North America Nat Gas (HH, $/MMBtu)	$4.3	$4.6
Europe Natural Gas (EEX, $/Mwh)	$21.1	$135.1
Wheat ($/bu)	$6.9	$9.3
Corn ($/bu)	$5.1	$6.9

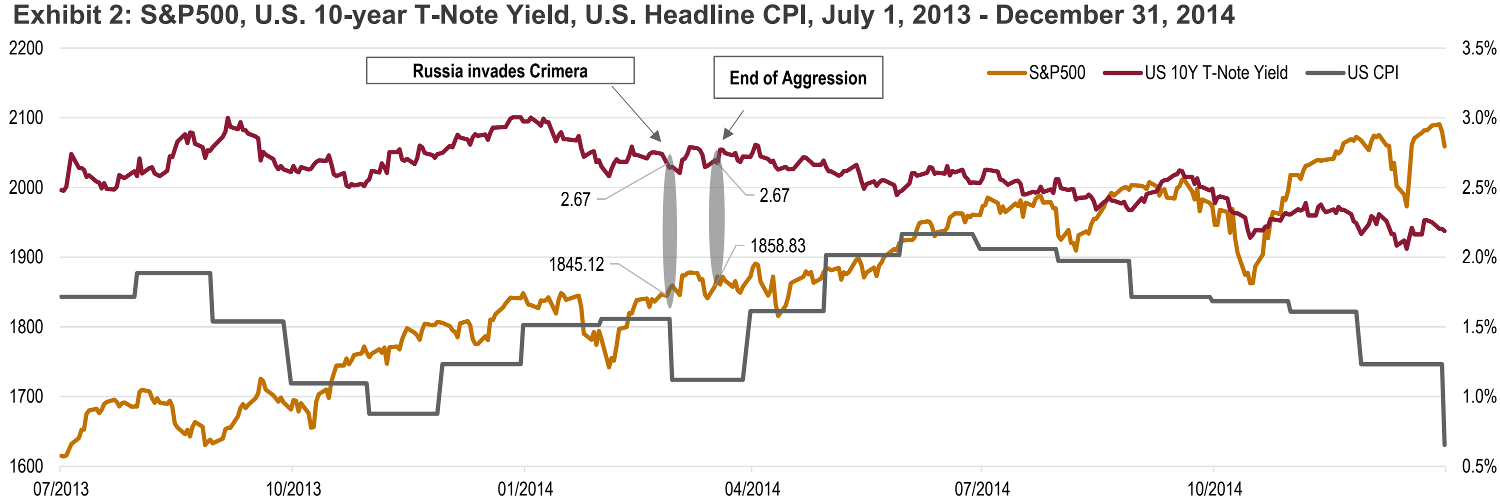
Source: FactSet, United States Federal Reserve and CIBC World Markets Inc.

As a consequence of higher inflation, the Federal Reserve does not have an accommodative stance – indeed, it has indicated a need to raise rates and to unwind balance sheet holdings. Note, the Fed's balance sheet has doubled in size since 2014 (see Exhibit 1).

Inflation was under control and interest rates could fall

As we show in the line chart in Exhibit 2, the invasion and annexation of Crimea had little effect on equities, as the 10-year U.S. government bond rate continued to decline, ending 2014 about 70 bps lower. Headline CPI remained relatively controlled, though some additional strength in WTI prices saw the CPI reach marginally above 2%.

Exhibit 2: S&P500, U.S. 10-year T-Note Yield, U.S. Headline CPI, July 1, 2013 - December 31, 2014



Source: Bloomberg, FactSet and CIBC World Markets Inc.

Russia Is A Major Commodity Player

Global commodity supermarkets

Russia remains a relatively small economy (11th largest in the world and 1.7% of global GDP) and Ukraine is significantly smaller. Where both countries punch well above their "weight class" is, however, in commodities. As we show in the table in Exhibit 3, Russia is both a significant player in Energy markets and in a variety of soft as well as hard commodities.

Exhibit 3: Russian Federation And Ukraine - Select Commodities As A Percentage Of Global Production And Exports

	% Of Global Production			% Of Global Exports		
Commodity	Russia	Ukraine	Total	Russia	Ukraine	Total
Wheat[2]	10%	4%	14%	17%	12%	29%
Oil[2]	17%	0%	17%	25%	0%	25%
Palladium[1]	44%	0%	44%	22%	0%	22%
Ammonia[1]	11%	2%	13%	21%	1%	21%
Urea[1]	8%	2%	9%	16%	4%	20%
Potash[1]	20%	0%	20%	19%	0%	19%
Corn[2]	1%	3%	5%	2%	16%	19%
Platinum[1]	14%	0%	14%	16%	0%	16%
Natural Gas[2]	13%	0%	13%	12%	0%	12%
Steel[1]	4%	1%	5%	7%	4%	11%
Aluminum[1]	6%	0%	6%	6%	0%	6%

Source: World Bank, Statistics Canada, World Steel Association, USDA, USGS, OEC, IFA, BP Statistical Review of World Energy, Refintiv and CIBC World Markets Inc.

Note 1: Superscript 1 and 2 are using data as of 2020 and 2021, respectively

Note 2: Belarus Potash Production & Exports were 17.6% and 21% of global, respectively

Note 3: Global Ammonia production is based off global Nitrogen production

Note 4: Urea production and export are based off regional estimates

Roughly one-fifth of global exports of many commodities

We note that in the two commodity areas which hit all consumers (food and energy), the combined Russia and Ukraine share of global exports is quite high, roughly 20%. This includes wheat and corn, as well as the building blocks of many fertilizers (ammonia, urea and potash). Note the natural gas figure in Exhibit 3 can be misleading given the more localized nature of gas markets. European dependence on Russian gas is more meaningful as 35% to 40% of the continent's gas comes from Russia (natural gas represents about a quarter of Europe's total energy use). In addition, Belarus – which has been a staging ground for the some of the attacks – is also a major player in fertilizer markets.

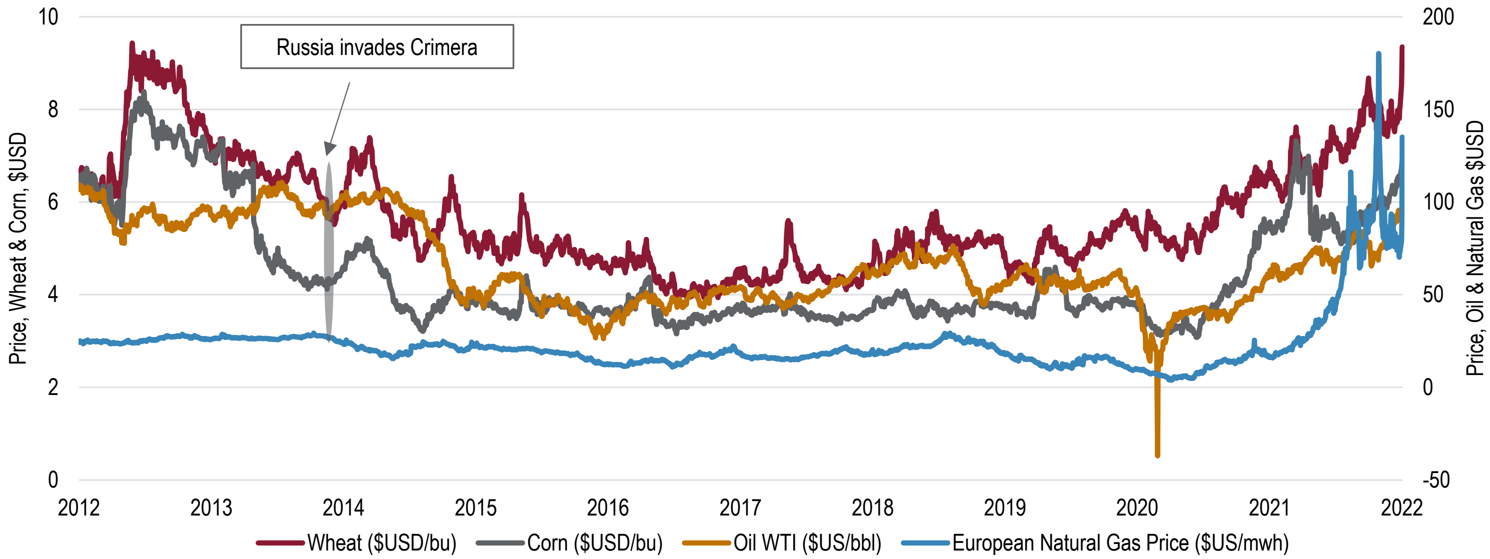
The Possible Impact Of Sanctions On Trade Flows

As was well telegraphed in advance of the invasion, a host of nations have responded with sanctions on Russia and Russian individuals. Not surprisingly, these have been developed so as to inflict pain on Russia and its economy, while minimizing the disruption they would cause on Western allies. So far, these sanctions do not appear to have materially affected the flow of commodities.

Commodity prices are already in an upswing

Regardless, as we show in the line chart in Exhibit 4, prices for a variety of food and energy commodities have risen. Even before the conflict in Ukraine, prices for many of these commodities were already elevated given strong demand from a recovering global economy and various supply challenges. In the past few days, despite no obvious current impact on production and export from the conflict, the market is certainly incorporating additional risk premium into pricing. This seems appropriate – a military conflict in Europe certainly could cause logistics and operational issues. For example, flow of natural gas through Ukraine pipelines could experience collateral damage as the military action continues. The Ukraine is reporting the Russians have already blown up a natural gas pipeline in Kharkiv, although how significant this pipeline is remains unclear.

Exhibit 4: Price - Wheat, Corn, Oil (WTI), EU Natural Gas (EEX), February 2012 - 2022E



Source: FactSet and CIBC World Markets Inc.

So far the sanctions have only been oriented to financial entities, technological transfers and targeted individuals. No sanctions have been aimed at energy, mining or agricultural firms. In the short term, the targeting of Russian banks should be the most meaningful as it can disrupt money flow for imports and exports.

The sanctions so far, are unlikely to affect Russian resolve

In the long term, the export controls on items using U.S. technology look to have the most potential impact, though it will be difficult for the Department of Commerce to fully police the flow of such products, particularly if some countries (possibly China) do not support the action. The sanctions on individuals are unlikely to bother high-ranking Russians – were they ever planning a vacation to Orlando, or did they really keep their wealth in a U.S. bank branch?

SWIFT restrictions seem to be limited to “some” banks

From our perspective, the bigger concern on sanctions would emerge if a tit-for-tat process developed. Were the West to embrace the U.K.’s call to deny Russian access to the Society of Worldwide Interbank Financial Telecommunication (SWIFT) system **entirely**, an aggressive reaction by Russia is certainly possible. It could delay or even withhold export of its products. Though such a move would likely be temporary (and different buyers for Russia’s commodities would likely surface, freeing up other supply), this would almost certainly cause another bout of raw material price inflation. On the other hand, the Russians appear to have worked with the Chinese to develop alternative payments systems, so the Russians might be prepared to accept limited SWIFT access – cognisant that their current account remains buoyed by strong revenues from commodity exports.

The conflict also raises the potential for additional supply chain disruption. As we saw in late 2021, production issues in Asia caused significant dislocations on U.S. West Coast ports – though some of this was the interaction of excess demand and dilapidated port infrastructure. To be clear though, global supply chains do not need additional commotion in the movement of seaborne goods, and freight rates were already spiking.

Cyber risk is rising

There is also the risk of increased cyber attacks from Russia. In early 2020, Russia penetrated thousands of organizations across the U.S. private and public sector (SolarWinds Hack) and took down the Colonial Pipeline system in a ransomware attack in May of last year. We could see additional attacks to key European infrastructure, but this also likely just increases the potential cyber response from Western allies.

Of course, we have little insight into Putin’s goals in initiating this conflict. News of a possible meeting with both Ukrainian and Russian officials at the Belarus border raises more questions. One scenario that could reduce risk in the short term would be a deal that sees Russia annex more Ukraine territory (as it did with Crimea), and accept a standstill. Alternatively, Putin may have underestimated the extent of responses from Ukraine and Western allies, and may become increasingly volatile as his domestic challenges mount. This remains a deeply worrying scenario.

Inflation, Interest Rates, And Equities

We believe the poor performance of equities so far in 2022 is largely due to the spike in interest rates, and a reasonable concern the trajectory of inflation will warrant aggressive moves by central banks. Higher rates affect higher-multiple (growth) stocks, and this is why the big U.S. tech stocks have borne a significant proportion of the pain.

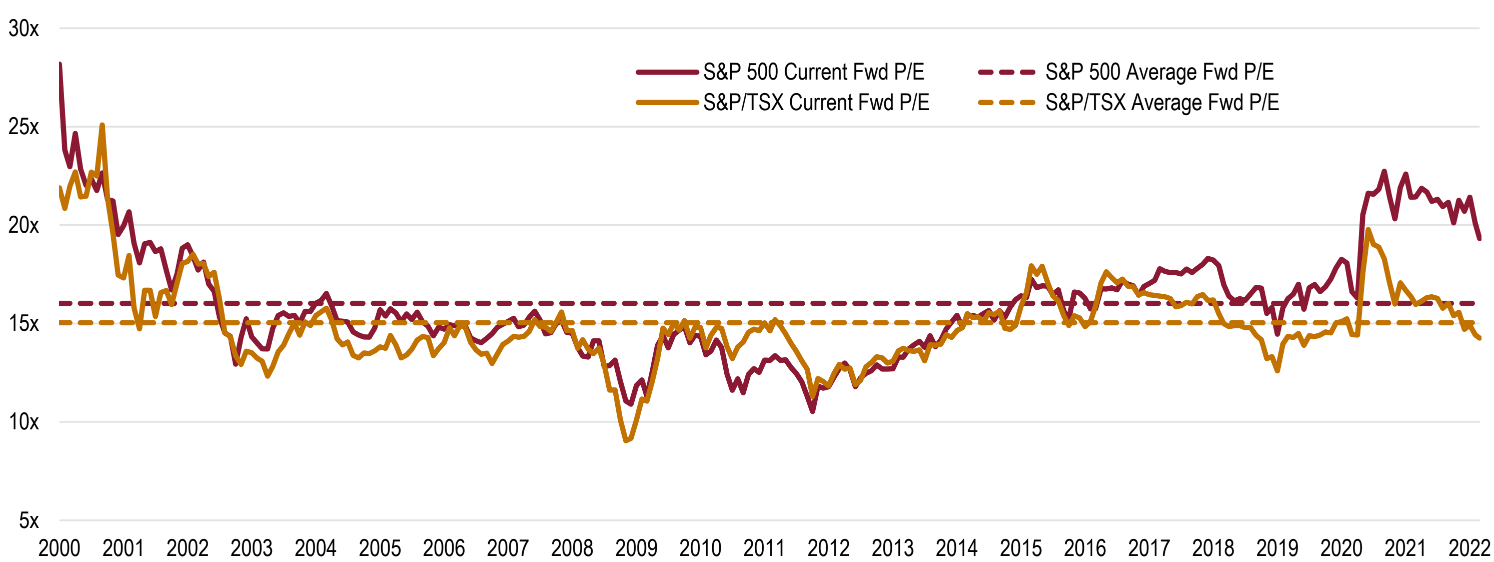
Does the conflict argue for less rate increases, or more?

Historically, geopolitical events have generally been either more disruptive to demand (9/11 as the prime example) or have been focused almost exclusively on oil (various Middle East conflicts). The issue with this situation is its potential to cause supply issues, with little impact on demand. This would mean that as opposed to previous times, when the Federal Reserve could argue that cutting rates was an appropriate reaction, the conflict in Ukraine would argue for *additional* interest rate increases!

In the end, we continue to argue for Canadian equities over U.S. equities – and for reduced exposure to technology stocks. Some of the benefit of these views has already occurred, but there is likely more to come. As we detailed in our recent report (**link**), we think the S&P 500 has become too dependent on Tech stocks and these face additional challenges from taxation, deglobalization and regulation.

Secondly, the potential for higher energy prices should be an uplift for Canadian equities given the sector's size (15% for the TSX compared to 3% for the SPX). Finally, and as we show in the line chart in Exhibit 5, Canadian equities remain relatively cheap when compared to their longer-term average, while U.S. equities are still relatively expensive.

Exhibit 5: S&P/TSX And S&P 500 - 12 Month Forward P/E, 2000 - 2022E



Source: FactSet and CIBC World Markets Inc.

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