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FM Financial Investment Update

War in Ukraine

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War in Ukraine impacts investment risk, but perhaps not long-term returns

Share markets, over the longer term, have provided materially higher returns than many other investment categories such as bank deposits and government bonds. The reason share markets are priced in a way to create these higher returns is because investors require a certain level of compensation for taking risk. Generally, share prices will not be bid up beyond a "fair value" that allows for this return premium to be earned. However, when either the perceived or actual risk increases, more compensation is required and share prices adjust downwards, allowing future returns to be higher and provide adequate compensation for the higher risk.

As the past 3 years have demonstrated, risk can come in many different forms and the source of risk is almost impossible to predict. The Russian invasion of Ukraine is the latest such risk to materially impact share market values. For those directly impacted, the fear and tragedy caused by war is palpable. For investment markets, the impact is less clear. Past military conflicts have often been associated with an immediate decline on share markets, as the perceived risk of holding equities is increased. However, this initial sell-off has often been followed by a relatively rapid recovery as investors conclude that the long-term impact on company earnings is minimal. **Arguably, there has been no geopolitical related event that has materially impacted equity markets for any significant length of time since the oil crisis of the 1970s.**

Hence, often in the past, investors who have discerned that investment risks associated with military attacks are more perceived, than actual, may have been rewarded by taking advantage of cheaper equity market valuations. However, although historical patterns may provide some reassurance that the latest equity market decline will be quickly followed by recovery, it would be dangerous to assume this as a certainty. The Russian invasion is differentiated from other more recent military incursions in that the intentions of the invading force are largely unknown, with the possibility that their targets may go well beyond just Ukraine. In addition, the breadth of commodity supply impacted by the military conflict is significant – not only covering oil & gas, but also a range of other rare earths and minerals important to many supply chains.

From a broad macro-economic perspective, it would appear that the Russian invasion will add to already high global inflationary pressures, with particularly significant impacts on energy and selected commodity prices. The supply response from other commodity producers may alleviate this pressure over time (and in the case of oil this could happen relatively quickly). However, medium-term **inflationary risks are unambiguously heightened by the conflict**. Although bond markets are yet to show any material reaction, higher inflation could place further upward pressure on interest rates, even though central banks may be less inclined to take immediate action in a period of heightened uncertainty.

Notwithstanding the huge uncertainty generated by Russia's actions, it is not clear that the invasion will necessarily significantly lower global economic growth, nor be detrimental to broader company earnings. None-the-less, equity markets have fallen over the period leading up to the invasion, as well as declining immediately following confirmation of the invasion. However, volatility has been high across markets and there have already been some signs of recovery and stability. Complicating the assessment of share market movements is the recency of the correction taking place in second half of January, when rising inflation and bond yields were seen to be the catalyst for decline. However, the gradual Russian military build-up on Ukraine's border may have also been an influencing factor over this period.

The accompanying table shows the movement on various sub-classes of equity markets between the 1st of January this year and the time of writing (25th February 2022). As indicated, the movement has been significant and quite uniform across the sub-classes shown. Australian equities and global infrastructure stand out as the 2 asset classes least impacted. In addition to being geographically isolated from the military conflict, the relative outperformance of Australian equities could be explained by the higher resource and energy exposure – which potentially stands to benefit from higher commodity prices and supply shortages elsewhere. What is less clear is the rationale for Australian mid-sized and smaller companies falling by more than the broader average - given there is strong resource sector presence in this part of the market. This trend hasn't been the case globally, where smaller companies have tended to fall in line with the broader market average.

Equity Market	% Change (1st Jan to 25th Feb 2022)
Australian (ASX 200)	-5.0%
Australian Midcaps	-9.6%
Australian Small Caps	-8.7%
Global - Broad (hedged)	-9.7%
Global Small Caps	-9.3%
Global Infrastructure	-5.4%
Australian Listed Property	-9.5%
Global Listed Property	-9.7%

Source: FE Data. Variuous representative ETFs.

Given the significance of the movement on equity markets over recent weeks, much of risk stemming from the Russian invasion of Ukraine has already been built into share prices. Although further escalation of this associated risk clearly cannot be ruled out, the balance of probability as informed by past experience of military conflict would suggest that **maintaining equity market exposure through these periods is the most appropriate course of actions**. For those investors with a higher risk appetite looking to potentially capitalise on a period of market weakness, the relative risk and return opportunities presented by the Australian equity market, particularly in the mid to smaller company range, may standout for investment consideration.

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