UniCredit

Letter from Chief Investment Officer Germany

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The war in Ukraine is causing tremendous suffering to those involved, with the very ideals of peace, freedom and prosperity on which the European Union is based, and which the Ukrainians look forward to joining in the future, now seemingly under threat.

The response of the West and the EU to the Russian invasion of Ukraine, consisting of humanitarian, political and military aid alongside broad and harsh sanctions against Russia, was immediate. For the first time, the Union agreed on investments worth billions in defense and energy security and, last but not least, is developing a plan to jointly fund these initiatives.
The war is also a considerable shock to markets. It comes just two years after the last major crisis, the coronavirus pandemic, from which we are only just recovering both in terms of public health and the economy. The main transmission channel through which the Ukrainian conflict is hitting markets is the rapid rise in energy prices, especially oil and gas, as we consider possible supply disruptions. **Given the high dependence of European energy supply on Russia, this is fully understandable. In addition to energy costs, however, other commodity classes also play an important role.** Important industrial metals such as palladium and nickel, as well as agricultural materials and fertilizers are worth mentioning at this juncture. Their prices are also rising rapidly. Trade restrictions play a less important role from a macroeconomic perspective, as the export volumes of European goods and services to Russia and Ukraine are comparatively low.

Further increases in energy and commodity prices are hitting the global economy at a time when inflation concerns were already a major challenge for financial markets – in the USA, but also in Europe. This puts the central banks, above all the European Central Bank and the U.S. Federal Reserve, in a somewhat difficult position. On the one hand, they want to scale back pandemic-era ultra-loose monetary policy and had already signaled corresponding steps at the beginning of the year. **On the other, the main inflation drivers – namely rising energy costs and supply chain bottlenecks (which are particularly crucial for Europe) – cannot be influenced by monetary policy measures in the short term.** Moreover, the war in Ukraine and resulting sanctions are now slowing the post-COVID economic recovery. Finally, in response to the new strategic challenges with regard to defense and energy security, we're likely to see a substantial investment outlay in the short term.

The central banks' dilemma is that sharply rising yields as a result of an excessively tight monetary policy would make it more difficult to find a structural way out of the energy crisis and Europe's pressing security architecture problem. Too loose a monetary policy would trigger worries about a solidification of price dynamics to the point of a wage-price spiral. The first signs of such a development are already visible in the USA, which suggests a much more stringent monetary policy approach for the Fed this year than its European counterpart.
At a more granular level, this means that bonds in particular are likely to be subject to dynamics that are difficult to predict. The tension ranges from declining yields with the flight to safe havens, to the prospect of tighter monetary policy with rising yields, without real yields escaping their negative terrain. In addition, investment programs will have to be financed on a large scale, which is likely to lead to supply pressure on the bond side. In this context, it will be interesting to observe how the ECB positions itself with regard to the scale back of its bond-buying programs in the long term.

For equities, the picture looks less complex. In the short term, stringent risk management is certainly warranted in view of the high risks and low visibility that accompany the tense security and energy environment. However, should the fog lift and the economic situation prove to be reasonably stable, equities should be well-supported. However, the returns investors expect should reflect the subdued growth environment.

A key lesson can be drawn from the current crisis: the answer to the strategic challenges posed is technological progress and targeted investments. The same was true during the pandemic. Furthermore, a considerable portion of the investments needed now fit into the big picture regarding action on climate change. So why not do the right thing even faster? I would like to conclude with one final insight that has struck me during these troubled days: the European idea is alive and stronger than it has been for a long time.