March 11th, 2022

Since Russia first invaded the Ukraine, there's been no shortage of headlines and commentaries trying to make sense of the situation. This is a tragedy that from a humanitarian standpoint that can't be made sense of and our hearts go out to the people of Ukraine and those impacted. From a market standpoint, the common thinking is that geopolitical risks, aka war, historically haven't been associated with significant corrections in the market. So far, the market reaction has been consistent with the historical experience, with the S&P 500 down only about 1% since the start of the conflict and the S&P/TSX Composite Index up close to 4%, despite the heightened daily volatility.

Given the obvious challenges of predicting how these types of conflicts play out, we look to financial market indicators to give us a better sense of the potential risks in the market. And in this respect, the most obvious indicator is oil. Since the start of the Russian invasion, oil has rallied roughly 18%, which is even more impressive considering it had already rallied 21% from the start of the year to the beginning of the conflict.

While we don't know what will happen to energy markets over the coming weeks, we do know that oil shocks can result in higher inflation and sometimes lower growth. Inflation was already rising, although strategists generally viewed this as temporary on the expectation that the covid related supply chain disruptions and reopening pressures were the primary causes that would eventually self-correct. But as the Russian-Ukraine conflict intensifies, consensus views are moving towards inflation becoming more structural in nature. There are growing risks this will change consumer behaviour, causing inflation to be longer lasting than initially expected. Much of this has to do with the fact that as the world's 3rd largest exporter of oil, Russia has taken a material amount of oil production capacity offline, resulting in significantly higher oil and gas prices. This also explains the significant outperformance of energy equities, and the broader S&P/TSX Composite Index vs US counterparts on a YTD basis.

While there are beneficiaries to higher oil prices, the consumer certainly isn't one of them given gas prices reflect movements in the oil market. So far in 2022 prices paid at the pump have gone up 30%, one of the fastest paces on record. This, in addition to food price increases, will put strain on the consumer as higher bills divert dollars away from discretionary spending and potentially slow economic growth.

The other factor we're closely watching is the overall health of the European economy, to which Russia supplies about 40% of Europe's natural gas, 25% of their oil imports and 45% of their coal imports. While the European Commission has indicated plans to cuts their dependence on Russian energy well before 2030, the short-term impacts will be costly as Europe and other global markets see higher energy prices follow. As well, food prices will likely become an issue for the region given the interruption of supply out of the Black Sea which has driven grain and oilseed prices to levels not seen since 2008. Investors to date have priced in significant risk, evidenced by the performance of the Stoxx 50 which is down 17% YTD, one of the worst performing markets across the global universe.

While commodity prices are just one indicator, we are mindful that they could be telling us inflation may be more persistent than previously expected. From a long-term perspective this hasn't changed our view of the equity market. As a result of potential near term impacts however, we have reduced our exposure to European markets in favour of the Canadian market and as well we have added inflation and risk hedges with sector allocations to energy, consumer staples and utilities, while still maintaining our overall long-term target levels to equities. There is no direct exposure to Russia in any of the three Equitable Life Active Balanced Portfolios which includes Equitable Life Active Balanced Growth Portfolio Select, Equitable Life Active Balanced Portfolio Select and Equitable Life Active Balanced Income Portfolio Select.