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Russia/Ukraine Conflict and Implications on Sector Views

Russia's invasion of Ukraine, the biggest conventional military attack in Europe since World War II, has wide-ranging implications for economies and markets around the world. Notably, the conflict has increased commodity prices, which will likely keep inflation higher for longer. This can lead to broad turmoil mostly in the region but with implications across the entire world.

Russia represents only about 3% of global GDP and comprises just 0.3% of the MSCI ACWI Index. As a result, direct exposure to Russia's economy and Russian equities is reasonably limited with the S&P 500 Index providing around 0.1% direct sales exposure to Russia. However, Russia produces about 10% of the world's crude oil supply, making it the third-largest producer of global oil. Also, Russia produces 17% of the world's natural gas supply. It is the world's second-largest producer of natural gas and provides Europe with about 40% of their natural gas needs.

Because of Russia's role in the energy space, oil and natural gas production can't be replaced easily, which complicates a potential strategy of a full cut-off of Russian fuel. BofA expects Brent crude prices to increase to between $110 and $120 per barrel, barring any potential damage to infrastructure that affects output.[1]

This conflict also presents risks to metals and food supplies, which will keep up near-term pressure on consumer prices. Russia is a big supplier of palladium and aluminum. Palladium is needed for automobiles, electronic components, jewelry, and dental fillings, among other products. While Ukraine is a big producer of wheat and corn.

As higher energy prices amplify inflationary pressures, they could dampen consumption and real economic growth. Europe is more exposed to these risks than the U.S. Limited income expansion in Europe relative to the U.S. over the past decade, coupled with a weaker Euro, makes higher crude and gas prices more painful for consumers. Currently, the EUR/USD is at $1.125. While U.S. consumers may be hit with higher energy costs, we expect a minimal impact on the supply side because the U.S. is energy independent. Higher for longer energy costs though would push out long-term breakeven inflation. And if it's pushed out too long, then it could weigh on consumption and GDP.

Market Implications

From a corporate profit perspective, the S&P 500's direct sales exposure to Russia is about 0.1%. So, the direct impact on American companies' top and bottom lines is expected to be minimal.

However, the indirect implications are much more pronounced given how connected the U.S. is with Europe. Disruptions from this war and the higher energy prices that result could significantly dampen Europe's growth outlook while weighing on corporate profits. Lower demand from European consumers could have an adverse impact on American profits, as Europe contributed about 14.5% of S&P 500 revenues in 2021.[2] Europe is likely to have sufficient energy in the near term as winter comes to an end, but if restrictions continue into next winter, energy rationing is possible.

Putting it all in perspective, aside from commodities, Russia doesn't play much of a role in the global economy. The U.S. doesn't rely on Russia for components in the supply chain like it does with China. Using history as a guide, U.S. markets typically recover earlier from geopolitical events due to their safe haven status.

For positioning, investors should be ready for volatility as events unfold and focus on more defensive sectors of the economy. The Energy sector could see more upside, but exceptionally high prices are likely unsustainable. Please see below for our current sector views.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit Communication Services. The sector is a potential future beneficiary of the development of augmented reality and metaverse.	An increase in interest rates will adversely impact the discount rate applied to future earnings and cash flows. Higher rates could encourage a rotation from Growth to Value, which would negatively impact sentiment.	**Underweight**
Consumer Discretionary	Consumers adapted to the pandemic by increasing their use of online ordering and delivery and in-store pickup.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping is a risk to margins if companies are not able to pass inflation pressures to the end consumer. This sector is adversely impacted by supply chain disruptions, especially the semiconductor shortage in the automotive industry. Delays in shipping by sea and heightened costs in air freight are headwinds.	**Underweight**

Consumer Staples	In the event of an economic downturn, Consumer Staples could be a safe haven for investors due to its low correlation with economic cycles.	Inflation will negatively impact margins for companies that cannot pass through rising material costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly. Higher transport costs by air and sea may negatively impact company margins.[3]	**Market Weight**
Energy	Escalated tensions with Russia, a large natural gas exporter to Europe, could lead to elevated energy prices globally. The U.S. has largely reopened and continues to make progress against COVID-19. Also, crude demand is poised to benefit from a global reopening and improved growth.	The Energy sector depends on global demand and mobility. Consequently, this sector is one of the most sensitive to rising COVID-19 cases. The Omicron variant and travel restrictions are negative for this sector. A reduction in Chinese economic growth could reduce oil demand. Confidence in a return to normal life could lead to higher production, increasing supply, and lowering prices.	**Overweight**
Financials	The Financial sector benefits from improving economic growth, higher interest rates, and a steeper yield curve. Strong balance sheets, attractive valuations, and the continued cyclical rebound underpin the case for bank performance.[4]	High cash levels and low loan demand are hampering revenues, although loan growth turned positive recently.[5] A peak in the economic growth rate could offset the favorable rise in interest rates. A decline in interest rates or a flattening of the yield curve is detrimental to the sector.	**Overweight**
Health Care	Demographics favor the Health Care sector due to the aging global population and the	Drug pricing pressure remains a risk, though the legislative process is slow, and no meaningful legislation	**Overweight**

	growing middle class in emerging markets. Booster shots to combat Omicron appear to be a boon for pharmaceutical manufacturers and care providers.[6]	is currently expected to be passed.	
Industrials	The Industrials sector is a beneficiary of rising GDP, interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift towards automation infrastructure spending will be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance.[7] Supply chain issues could be a major headwind.	**Market Weight**
Information Technology	Companies in the Software names should benefit from higher CAPEX as firms look to boost productivity amid rising wage inflation.[8] The increased adoption of key disruptive technologies like cloud computing, cybersecurity, and cleantech are likely to continue after the pandemic.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation. Rising interest rates would negatively impact long-duration growth sectors like Technology.	**Market Weight**
Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage should be beneficial to lithium and battery technology.	Significant supply chain bottlenecks could dampen economic growth. Increased regulations, especially those focused on preventing climate change, are a potential negative.	**Market Weight**

	The Materials sector is a beneficiary of rising inflation leading to higher raw materials prices.		
Real Estate	The office, retail, and hotels segments could benefit from the economic reopening and an increased focus on a return to normal. Strong demand for residential REITs is translating into higher single family and multi-family rents. The Real Estate sector has the potential to be a source of inflation-protected yield.	Uncertainty about a full return to the office and flex working situations may reduce demand for office space. A fast rise in interest rates, which increases the cost of financing, is a risk if costs cannot be passed along to tenants.	**Market Weight**
Utilities	It benefits from resilient fundamentals and is a defensive hedge.[9] The preferred sector in recessionary environments due to the inelasticity of goods & services.	The potential for increased climate-related regulations over time may detract from the sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Market Weight**

Footnotes:

[1] BofA Securities, *EEMEA Conference: Russia / Ukraine: Global Implications*, 2/24/2022
[2] FactSet, *SPY GeoRev*, 2/25/2022
[3] FactSet, *Earnings Insight, 10/22/2021*
[4] BofA, *The RIC Report: Get paid to wait*, 1/11/2022
[5] Schwab, *Sector Views: Financials*, 1/25/2022
[6] CDC, *CDC Expands Covid-19 Booster Recommendations,* 11/29/2021
[7] BofA, *The RIC Report: America is Still Exceptional,* 9/14/2021
[8] BofA, *The RIC Report: Get paid to wait*, 1/11/2022
[9] BofA, *The RIC Report: Bullish Stock Splits, Bearish Rate Hits,* 02/08/2022

Definitions

Capital Expenditures (Capex): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

MSCI ACWI Index: The index is designed to represent the performance of large and mid-cap companies across 23 developed and 25 emerging markets. It covers approximately 85% of the free float-adjusted market capitalization in each market.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.