GLOBAL LONG-TERM UNCONSTRAINED

MARTIN CURRIE

MARCH 2022

For institutional, professional and wholesale investors only

RUSSIA/UKRAINE CONFLICT: MARKET OUTLOOK

As the tragic crisis in Ukraine continues to unfold, we offer our viewpoint on the potential market impacts, both near and longer-term.

The Russian invasion of Ukraine is leading to tragic human loss of life and devastating consequences for many innocent people. We send our moral support to the Ukrainian people and our thoughts are with all the people affected. Below are our views about the market during this crisis period covering the following areas:

- Geopolitics
- Volatility
- Macroeconomic outlook
- Implications of sanctions
- Inflation
- Corporate earnings outlook
- Monetary policies
- Geographic viewpoint

We conclude looking at the likely winning and losing sectors and our thoughts on the market opportunities.

Geopolitics

Geopolitical risks are now at the forefront of investor's minds: near term and longer-term implications

The Russian invasion of Ukraine was unexpected by the market and has led to an increased focus on geopolitics. NATO's resolve has been tested by the Russian leader Vladimir Putin, with NATO coming out of this more unified and stronger than before. Putin, given his unpredictability, is at risk of inflaming the situation, which makes the risk of a broader conflict an increased probability. Increased defence spending by NATO countries is likely to be a trend for some time in a context of growing geopolitical risks.

Expansionist territorial claims by Russia have the potential to increase the market's attention on China and its' territorial claims in the South China Sea, a risk that we believe the market has not been discounting properly. At the same time, China might be holding the key to a de-escalation of the conflict in Ukraine, through the potential role as a mediator or through diplomatic pressure on Putin.

The situation is highly unpredictable at this stage, one could paint bleak scenarios of escalation and broadening of the conflict. Therefore, ongoing de-risking action by investors is likely in the near term, notably in relation to geographic exposures.

Macroeconomic outlook

Macroeconomic momentum could be impacted negatively. This could mean an increased probability of a move into slowdown in the economic cycle, favouring Quality and Growth, away from Value. The probability of a stagflation remains low but is rising, notably in Europe.

Armed conflict in Europe is likely to negatively impact consumer and business confidence in the near term. We believe this could spill over into weaker economic momentum in Europe, and to a lesser extent globally. Additionally, energy supply disruption could add to near-term downward pressure to economic momentum in Europe, whilst at the same time contributing to yet higher inflationary pressures.

Given the relatively low weight of Russia in international trade, we do not believe that this short-term negative impact on confidence will have a lasting impact on economic momentum. This is providing the conflict doesn't spread into other territories.

Whilst we continue to see stagflation as a low probability event, we are increasing that probability to 10-15%. This is from less than 5% when we wrote our 2022 Outlook report in early December last year. Stagflation risk is clearly higher in Europe than other geographies at this stage.

In our view, armed conflict brings an increased risk of the economic cycle shifting from expansion to slow down. This would typically favour Quality and Growth styles, away from Value, whilst earnings momentum will remain an important contributor to style leadership in this environment.

"Given the relatively low weight of Russia in international trade, we do not believe that this short-term negative impact on confidence will have a lasting impact on economic momentum. This is providing the conflict doesn't spread into other territories."

Inflation

Inflationary pressures could further increase, and last for longer. Food price increases have consequences notably for emerging markets.

The Ukraine-Russia armed conflict has the potential to fuel more inflation globally, as a result of the higher oil prices and disruptions to energy supplies, but also in soft commodities given the Ukraine's and Russia's sizeable agricultural production. Soft commodities price increases risk leading to pronounced increases in food prices, which have the potential to impact countries where food is a bigger proportion of consumer baskets, notably emerging markets. This could lead to increased social tensions further down the line.

This increased inflationary pressure will further add to the elevated and longer lasting inflation that we have been going through, and which could last beyond the middle of 2022. With US dollar strength seen as a flight to safety, and given the potential central banks differential in rates, this could also add to inflationary pressures for the European region.

> The Ukraine-Russia armed conflict has the potential to fuel more inflation globally, as a result of the higher oil prices and disruptions to energy supplies, but also in soft commodities given the Ukraine's and Russia's sizeable agricultural production.

Monetary policies

Monetary policies likely to continue to normalise despite the uncertain geopolitical backdrop, although magnitude of rate rises might be reduced

We expect the Fed to keep on its path towards normalisation of monetary policies. Although the magnitude of rate hikes might be slightly diminished whilst they assess the impact on economic momentum. The ECB is also likely to continue to normalise, although it might delay its first hikes given the proximity of the crisis. We still expect them to be raising rates in 2022, but this is likely to be weighted to the second-half of 2022.

Given ongoing elevated inflationary pressures, and the potential for more inflation from spiking energy prices near term, it will make it more difficult for central banks to hold back from tightening, despite the growing geopolitical uncertainties.

Volatility

Volatility likely to remain elevated for some time

Unfortunately, it is difficult to foresee a rapid resolution to the Ukraine-Russia conflict, or indeed to the broader tensions between Russia, NATO and the EU. As such, volatility and an elevated equity risk premium are likely to be the conditions that investors will need to accept for the time being. Investors also need to consider that FX market volatility could lead to pressure on some emerging markets currencies.

The increased volatility coupled with the market pullback has opened up the opportunity for good entry points into the market for longer term investors. This is providing we don't head into a scenario of economic contraction, which we believe is highly unlikely at this stage.

Implications of sanctions

Sanctions against Russia and potential consequences

The SWIFT ban and freeze of financial assets are leading to consequences for investors and financial institutions exposed to Russia with:

- Increased risk of financial contagion notably for some of the European banks, although systemic risk remains low, and given that European banks have a strong enough capital base to withstand the impact of a write down of asset values related to Russian exposure
- Increased risk of some stranded Russian assets for corporates needing or wanting to divest such assets, and investors looking to exclude Russia from their investable universe, and;
- Corporates with revenues in Russia, will be unable to repatriate any cash flow from operations in the country

Russia has a low underlying weight in terms of revenues and profits for the MSCI Europe Index, and even lower for the MSCI World Index. We estimate Russian revenues to represent 1.1% of the MSCI World Index, 1.4% of MSCI Europe, and 0.5% of MSCI North America[1]; we estimate a similar weight in terms of profits as well. Disruption in energy supplies, notably access to Russian gas by European nations is likely to push the EU to re-examine its transition path to greener energy supplies. This in turn could bring back the debate about nuclear energy being a potential part of the energy transition.

> We believe that Quality and Growth companies are likely to come back in focus for investors.

Corporate earnings outlook

Earnings momentum likely to be even more critical for investors, given the lower earnings growth outlook

As stated in our 2022 outlook, earnings growth expectations for this year were pedestrian, after a sharp recovery year in 2021. Current geopolitical developments are leading to downside risk in economic momentum as we flagged in the macro section, and therefore will put more downside risk to earnings growth expectations, notably if the climate of uncertainty perdures. In such an environment of higher inflation, lower economic growth, and lower earnings growth, there will be an even higher emphasis in the market on corporates with consistent growth, higher structural growth profiles, and that have pricing power to protect their margins from the higher inflationary pressures. We believe that Quality and Growth companies are likely to come back in focus for investors, given that such companies tend to emanate more of these characteristics of consistent growth, higher structural growth profiles, and stronger pricing power.

Geographic viewpoint

European and Asian equity markets valuations remain more supportive than US equity valuations, which explains our preference for these regions over the US

The Ukraine-Russia conflict carries more risk of negative impact on economic momentum in Europe, and is leading to an increased risk premium attached to European equities relative to other regions.

This crisis is likely to further widen the valuation spread in developed markets between US and EU equities in the near term, whilst uncertainty about the potential developments in the conflict remain. Selective exposure within geographies on companies with a lower risk of negative impact on their earnings momentum from the spillovers of the conflict, is in our view likely to be an important focus for investors.

[1]Source: Martin Currie as at 28 February 2022.

Winners and losers

Sectors likely to be supported near term, whilst conflict and uncertainty perdures

Defence sector – increased defence spending commitments by governments

Alternative energy – higher commitment for alternative energy sources and energy infrastructure, notably LNG

Oil & gas – higher energy prices supportive for the sector

Soft commodities, fertilisers and agricultural machinery – related to increase price of grains

Cyber security – corporate focus on increasing spending on cyber security to reduce cyber attack risk

Quality and more defensive areas of the market – flight to safety

Consistent growth stocks – based on ability to grow despite higher risk of weaker economic momentum

Sectors likely to be pressured near term

Industrial Cyclicals – on concerns about economic momentum

Luxury goods – potential fear of weaker trading (Russian consumer is a low exposure in general)

Financials – lower rates expectations will weigh, alongside with impact from sanctions on some of the European bank exposures to Russia

Our thoughts on market opportunities

- Armed conflicts are highly unpredictable and increase risk premia in markets, which investors will need to capture into their expectations
- Risk of conflict escalation is not negligible - such scenario would lead to a bleak downside risk to equity markets
- Ultimately, elevated risk premia and risk aversion, at a time when equity markets have had a sizeable pullback, can present good entry points for longer term investors, providing there is no conflict escalation
- Less monetary tightening as a result of the risk of weaker economic momentum is likely to be supportive for quality growth stocks

It is not easy at this stage to see an easy resolution to this conflict, with potential risk of escalation leading to a worsening impact on markets in the near term. It will be critical to be highly selective on exposures, focusing on fundamental analysis, and assessing the risk of fundamental deterioration in any corporate, based on their:

- specific industry exposures
- end-markets, and;
- geographic presence of operations and production bases

The importance of having a detailed assessment of corporates' underlying geographic exposures

- The devastating Ukraine invasion highlights the importance of assessing corporates' underlying geographic exposures
- Our proprietary database permits us to assess geographic exposure of revenues, profits and productive capacities of corporates in which we are invested
- This analysis permits us to assess exposure to Russia and Eastern Europe on an underlying basis, and to specific countries in Eastern Europe
- Our strategies have no direct quoted exposure to Russia or Eastern Europe, and have low exposure to both Russia and Ukraine in terms of underlying revenues, profits and production bases

Finally, and to reiterate, our thoughts and support goes to the Ukrainian nation and innocent Ukrainian people affected by this tragic and violent crisis.

Zehrid Osmani
Head of Global Long Term Unconstrained Equities

Important information

This information is issued and approved by Martin Currie Investment Management Limited ('MCIM'), authorised and regulated by the Financial Conduct Authority. It does not constitute investment advice. Market and currency movements may cause the capital value of shares, and the income from them, to fall as well as rise and you may get back less than you invested.

The information contained in this document has been compiled with considerable care to ensure its accuracy. However, no representation or warranty, express or implied, is made to its accuracy or completeness. Martin Currie has procured any research or analysis contained in this document for its own use. It is provided to you only incidentally and any opinions expressed are subject to change without notice.

This document may not be distributed to third parties. It is confidential and intended only for the recipient. The recipient may not photocopy, transmit or otherwise share this [document], or any part of it, with any other person without the express written permission of Martin Currie Investment Management Limited.

This document is intended only for a wholesale, institutional or otherwise professional audience. Martin Currie Investment Management Limited does not intend for this document to be issued to any other audience and it should not be made available to any person who does not meet this criteria. Martin Currie accepts no responsibility for dissemination of this document to a person who does not fit this criteria.

The document does not form the basis of, nor should it be relied upon in connection with, any subsequent contract or agreement. It does not constitute, and may not be used for the purpose of, an offer or invitation to subscribe for or otherwise acquire shares in any of the products mentioned.

Past performance is not a guide to future returns.

The distribution of specific products is restricted in certain jurisdictions, investors should be aware of these restrictions before requesting further specific information.

The views expressed are opinions of the portfolio managers as of the date of this document and are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. These opinions are not intended to be a forecast of future events, research, a guarantee of future results or investment advice.

Some of the information provided in this document has been compiled using data from a representative account. This account has been chosen on the basis it is an existing account managed by Martin Currie, within the strategy referred to in this document. Representative accounts for each strategy have been chosen on the basis that they are the longest running account for the strategy. This data has been provided as an illustration only, the figures should not be relied upon as an indication of future performance. The data provided for this account may be different to other accounts following the same strategy. The information should not be considered as comprehensive and additional information and disclosure should be sought.

Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.

For wholesale investors in Australia:

Any distribution of this material in Australia is by Martin Currie Australia ('MCA'). Martin Currie Australia is a division of Franklin Templeton Australia Limited (FTAL), (ABN 76 004 835 849). Franklin Templeton Australia Limited is a wholly owned subsidiary of Franklin Resources, Inc., and holds an Australian Financial Services Licence (AFSL No. 240827) issued pursuant to the Corporations Act 2001.

MARTIN CURRIE

Martin Currie Investment Management Limited, registered in Scotland (no SC066107)
Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300),
Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES

Tel: (44) 131 229 5252 Fax: (44) 131 222 2532 **www.martincurrie.com**