INVESTMENT STRATEGY

Heightened geopolitical risk could keep markets on edge in the weeks to come, and while there is a real possibility that the threat of economic sanctions will deter Moscow, we cannot ignore the possibility that Russia will invade Ukraine if all involved parties fail to find common ground to continue talks. We think that investors should remain focused on events as they unfold.

This edition of *Global Insights* examines the conflict playing out between Russia and Ukraine.

- We assign a small, but nonzero probability that Russia will invade Ukraine with a major military force.
- We believe that an armed conflict in Ukraine would likely be restricted to skirmishes between Ukraine and pro-Russian separatists in Ukraine's Donbas region.
- The US and Russia have agreed to keep talks open, but Russia’s demands are broadly viewed as nonstarters.
- While it is difficult to price geopolitical risk, we expect Russian equities and bonds to struggle in the near term.
Heightened geopolitical risk could keep markets on edge in the weeks to come given reports that Russia is bolstering its forces in Donbas, a pro-Russian separatist-controlled region on Ukraine’s eastern border. The recent flare-up follows a tense year in which Russia allegedly amassed over 100,000 troops on Ukraine’s border in response to the country’s inclusion in NATO-led military exercises.

For many, this evokes memories of Russia’s annexation of Crimea in southeast Ukraine nearly eight years ago. While we do not believe that the annexation of Donbas is likely, it is important to understand the history of Russian interference in Ukraine and other former Soviet republics in order to provide context around the ways in which Russian aggression against Ukraine could affect global markets.

A short history of Russia, NATO and Ukraine. Following the unexpected collapse of the Soviet Union in the 1990s, many of the newly liberated and now independent states turned to the North Atlantic Treaty Organization (NATO) for security. In fact, nearly half of NATO’s current 30 member states are former Soviet-controlled countries (see Exhibit 1). In 2007, the US-friendly nations of Georgia and Ukraine applied to join NATO. The following year at the 2008 NATO summit in Bucharest, NATO leaders promised Ukraine and Georgia they would one day become members of NATO. Moscow, threatened by the possibility of having a Western military alliance along an important transit corridor, invaded Georgia in 2008.

We recommend that investors remain focused on events as they unfold. Geopolitics will likely be the main driver of returns in Eastern Europe. Below, we consider different outcomes and their potential impacts.

Potential Outcome (highly unlikely): Russia invades Ukraine; NATO and the US respond forcefully. We assign a small, but nonzero probability that Russia invades Ukraine with a major military force. For starters, a majority of the Russian public does not think that Russia is headed in the right direction. We interpret this as evidence that support for action in the Donbas region of Ukraine, following the annexation of Crimea, is low (see Exhibit 3). Furthermore, a December 2021 survey conducted by the Levada Center highlighted that Russians are largely positive toward the people of Ukraine. In fact, only 25% of respondents in a March 2021 survey thought that the Russian-occupied territories along the Ukrainian-Russian border should become part of the Russian Federation. Even as the US weighs providing more military support, an April 2021 YouGov poll reported that 69% of Americans believe it is important to have friendly relations with Moscow. Considering these together, there appears to be little current support for a full-scale war.

Ukraine, presently a NATO partner, is unlikely to be admitted to the organization anytime soon. All NATO decisions are made by consensus among member countries, and policy specifies that unresolved territorial disputes weigh against admission. Given the territorial dispute between Russia and Ukraine, the possibility of a wider conflict between NATO members and Russian forces is unlikely because Ukraine is not a member of the alliance. That being said, Russia could face a wide array of sanctions, which could deter it from further aggression in the region. For example, Russia suffered economic sanctions following the annexation of Crimea in 2014, which contributed to its financial crisis from 2014 to 2016 (see Exhibit 2).
Evidence suggests that Russia would pay a high price for attacking Ukraine. First, the loss of life on both sides would be considerable. According to the Council on Foreign Relations, the ongoing armed conflict in eastern Ukraine has already resulted in more than 13,000 casualties and 1.5 million displaced people. A full-scale war could see these numbers balloon. Second, a military escalation against Ukraine is counterproductive to Russia’s stated goal—a legally binding agreement that NATO will not enhance its presence in the eastern part of the alliance. Although it is highly unlikely that the US will send troops into Ukraine, defensive military aid to Ukraine has been ongoing. In fact, the US has provided $2.5 billion in support of Ukraine’s forces since Russia annexed Crimea (see Exhibit 4). Finally, US Senate Democrats recently introduced the Defending Ukraine Sovereignty Act, which, among other things, would authorize $500 million in supplemental emergency security assistance to Ukraine in the event that Russia invades.

A full-scale invasion of Ukraine will likely be avoided, in part because Russia does not want to jeopardize Nord Stream 2. Nord Stream 2 is a multibillion-dollar Russian-owned pipeline that, when operational, will transport natural gas to Europe. Should Russia attack Ukraine, Germany’s new chancellor has reiterated that he will halt the already built, but not yet approved pipeline. Given that the pipeline could carry 55 billion cubic meters of natural gas to Europe every year, a full-scale invasion could derail a major revenue source for Moscow (see Exhibit 5).

Potential Outcome (likely): Escalation along the Ukrainian border; US imposes economic sanctions. Conflict in Donbas has been continual since 2014. That being said, an escalation of aggression from Russia toward Ukraine would have significant consequences. It’s hard to know for sure what actions the US might take, but economic sanctions aimed at Russian individuals and entities are a top US foreign-policy tool. Economic sanctions can take many forms. As we detail, they can prohibit certain types of transactions and entail trade restrictions. In fact, trade restrictions were particularly damaging to Russia’s economy during the annexation of Crimea (see Exhibit 6).
In response to Russia’s 2014 invasion of Ukraine, the US has already imposed economic sanctions on 735 people and entities. Recent media headlines suggest that the US is prepared to levy more sanctions that could harm Russia’s financial system. For example, financial regulators could place additional restrictions on Russia’s fixed income market. An April 2021 executive order already prohibits: 1) participation in the primary market for ruble or non-ruble denominated bonds issued after June 14, 2021 and 2) lending ruble or non-ruble denominated funds to the Ministry of Finance of the Russian Federation, the Central Bank of Russia and the country’s National Wealth Fund. Should regulators extend restrictions to the secondary market, active managers and passive strategies could be forced to sell out of Russian fixed income positions.

President Biden has also floated the idea of depriving Russian bank access to the SWIFT (Society for Worldwide Interbank Financial Telecommunication) system. SWIFT—an electronic payment system run from data centers located in the US, Netherlands, Switzerland and Hong Kong—is used by banks and other financial institutions to securely send and receive information. If Russia’s financial system were to be cut off from the global interbank payment system, its financial institutions would be severely impaired. That being said, Russia has systems in place to limit disruptions to its economy. According to Morgan Stanley & Co. Research, Russia’s national payment system has grown to 24% of all domestic card transactions. There are a few operational limits, but it would shield the economy from bearing the brunt of financial isolation. However, removal from the SWIFT system would be damaging and would likely weigh on economic activity, thereby further slowing growth. Messaging around this option is mixed and would require broad buy-in from participants in the system for execution.

Potential Outcome (unlikely): Either Russia concedes to US and NATO demands or the US and NATO concede to Russian demands. Russia’s ongoing refusal to pare back the number of troops at the Ukrainian border reflects its national security strategy of state and territorial integrity. In December 2021, the Russian Foreign Ministry called for an end to NATO’s eastward expansion, limits on NATO’s military activities in Eastern Europe and a guarantee that Ukraine will not join NATO. At the moment, it seems that Russia’s demands are nonstarters. Promisingly, as long as US and Russian diplomats agree to keep talking, negotiators can keep the two nations away from the effects of an unchecked escalation.

Investment Implications

First, our analysis overall shows that drawdowns in assets tied to Russia’s economic activity involved painful losses over short horizons. Although it is difficult to price geopolitical risk, we analyzed returns for different asset classes during key periods of Russian turmoil (see Exhibit 7). We believe that for Russian assets, this time will be very similar. While a full-scale war would see Europe impacted more broadly, the market seems to be pricing in a more digestible outcome, given the 1.8% decline from an all-time high for the MSCI Europe Index compared to the nearly 25% decline for the MSCI Russia Index since last fall. Pulling these together, we get the sense that much of the near-term risk is nearly fully priced into Russian equities, whereas Europe and the US could still be vulnerable to headline risk.

Continued on next page
Second, we are struck by Europe’s reliance on Russian natural gas and therefore we anticipate greater volatility in this commodity market, potentially exacerbating the continent’s energy crisis. European gas prices will remain highly sensitive to supply from Russia. In fact, Russian majority-owned Gazprom supplied nearly 30% of European demand in 2020, according to MS & Co. Research’s strategists.

Third, we see signs that some of the geopolitical premium is already embedded in the price of Brent crude oil, which is just off its highest level since October 2014. In the days following the World Health Organization’s classification of Omicron as a variant of concern, Brent crude declined 16%. The recent run-up, even as the Omicron variant remains a threat, demonstrates that some of the geopolitical premium is already embedded in oil prices.

Finally, over the long term, the decline in Russia’s asset prices may prove overdone. While it might be tempting to attribute recent weakness in European equities to Russia-Ukraine tensions, we see the nearly 5% week-over-week decline in the MSCI Europe Index as part of a global rotation out of riskier assets that have been in decline since the start of the year. For now, we see the relative calm in the EUR/USD currency pair pricing a more limited spillover effect of Ukraine-Russia tensions on the broader European market.

<table>
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<tr>
<th>Geopolitical Event</th>
<th>MSCI World</th>
<th>MSCI Europe</th>
<th>MSCI Russia</th>
<th>Brent Oil</th>
<th>EUR/USD</th>
<th>RUB/USD</th>
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</thead>
<tbody>
<tr>
<td>Annexation of Crimea</td>
<td>1.1%</td>
<td>-1.0%</td>
<td>-53.4%</td>
<td>-45.0%</td>
<td>-8.0%</td>
<td>-49.0%</td>
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<tr>
<td>Eastern Ukraine Hostilities</td>
<td>9.3%</td>
<td>5.9%</td>
<td>-20.1%</td>
<td>-18.5%</td>
<td>7.2%</td>
<td>1.6%</td>
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<tr>
<td>Skripal Assassination Attempt</td>
<td>-2.8%</td>
<td>-1.4%</td>
<td>-19.3%</td>
<td>5.8%</td>
<td>0.5%</td>
<td>-8.9%</td>
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<tr>
<td>DASKA Introduced</td>
<td>-14.1%</td>
<td>-15.3%</td>
<td>-8.0%</td>
<td>-30.1%</td>
<td>-1.5%</td>
<td>-8.6%</td>
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<tr>
<td>November Troop Build-Up</td>
<td>-5.2%</td>
<td>-0.3%</td>
<td>-31.0%</td>
<td>1.7%</td>
<td>-2.6%</td>
<td>-9.6%</td>
</tr>
<tr>
<td>Average</td>
<td>-2.3%</td>
<td>-2.4%</td>
<td>-26.4%</td>
<td>-17.2%</td>
<td>-0.9%</td>
<td>-14.9%</td>
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Charts You Can't Miss

Exhibit 8: Ruble Weakness Reflects Elevated Risk


Exhibit 9: Higher Energy Prices Could Support MSCI Russia Index


Exhibit 10: Geopolitical Woes Have Rattled Russian Equities

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 21, 2022

Exhibit 11: Russian Bonds Have Sold Off Absent Major Breakthrough in US-Russia Talks

Note: 2021 is an estimate.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 21, 2022
Exhibit 12: Soaring Energy Prices Stoke Unrest in Kazakhstan

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

Current Readings From Our Quantitative Framework

<table>
<thead>
<tr>
<th>Value</th>
<th>Quality</th>
<th>Momentum</th>
<th>Capital Use</th>
<th>Overall</th>
</tr>
</thead>
</table>

**Top 5**
- Japan: Industrials
- Europe: Energy
- Japan: Communication Services
- Japan: Energy
- Japan: Financials

**Bottom 5**
- Europe: Real Estate
- Asia Pac ex Japan: Health Care
- UK: Health Care
- UK: Real Estate
- Asia Pac ex Japan: Consumer Discretionary


Ongoing Development Spotlight

Soaring energy prices drove thousands of citizens of Kazakhstan to protest in the streets. The anti-government protests saw a swift response from Kazakhstan officials. Aided by Russian troops, the government has generally quelled the unrest that swept the country at the start of the year. Kazakhstan, while not an OPEC member, has large oil reserves. In fact, petroleum accounts for more than half its exports. While Kazakhstan's natural resources, geographic isolation and strong Russian ties help make it fundamentally different from Ukraine, recent unrest could provide insight into future tensions, especially as populism and nationalism rise. – Brad Fulton

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021
GLOBAL INSIGHTS

Disclosure Section

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

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