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Ukraine crisis: impacts on European markets

European equities | March 2022

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Across Europe, market reaction to the Ukraine crisis has been strong but justified – European banks and other stocks with exposure to Russia have fallen by more than 30%. We do not believe there is systemic risk for the larger European institutions, but there may be further loan losses across the continent. European banks have significant excess capital – enough to prompt share buybacks – so while banks could lose equity, it should not represent a solvency risk.

Inflation and interest rates

Before the Russian invasion Europe was expecting the first European Central Bank (ECB) rate hike later in 2022. That is likely to be pushed back. The 10-year US Treasury yield has dropped only 20 basis points, however, indicating concern about inflation. We are monitoring the inflation outlook and any impact on interest rates in the longer term will be factored-in to our decision-making. Higher inflation, driven by energy prices, can increase cost pressures on companies. We look for stocks with solid pricing power and these, after some short-term dislocation, should continue to thrive – certainly more so than weaker competitors.

Interest rates are a key issue. In the US, the Federal Reserve is on track to deliver well-signalled hikes, but the ECB has been less keen. Firstly because higher interest rates will not cure higher energy prices and, secondly, because higher interest rates compounded with higher energy costs would be unpalatable for consumers (voters!) and would threaten recession.

However, if interest rates were to move to much higher levels – although our base case is that this is unlikely and has been delayed – it would impact the valuation of markets overall. The sustainable long-term compounders we favour are well placed to navigate the new environment in operational terms, but valuation impacts are a risk.

In our European equity portfolios we have no direct exposure to Russian, Belorussian or Ukrainian stocks, though indirect effects are impacting some banks and energy stocks. Even our indirect exposure is low and in line with the benchmark.

In addition to the obvious hit from energy prices, Europeans may experience a food price shock, and this could undermine the expected consumer upturn. This was the first year in a decade that Europe was expected to outgrow the US, with respective forecasts of 4% and 3.5% GDP growth[1], although Europe's forecast is boosted by the ending of pandemic restrictions – the US has already enjoyed this uplift. European consumers were expected to be the main drivers of this growth, spending the significant savings accumulated during the pandemic.

[1] Columbia Threadneedle Investments, 28 February 2022

sources believed to be reliable, but accuracy and completeness cannot be guaranteed. This document and its contents have not been reviewed by any regulatory authority.

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