Manulife Investment Management

Investment Note

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Escalating geopolitical tensions over the past weeks saw the US warn that Russian military action against Ukraine posed an “immediate” threat. In this investment note, our Emerging Markets (EM) Debt team and China Fixed Income team share their latest assessment of how a conflict might impact the broader EM Asia universe and China.

The Russia-Ukraine crisis and its implications for EM Asia and China

Our assessment in terms of market volatility and risk

In such a multi-dimensional subject, with sovereignty coming under threat, it is challenging to develop a one-case-fits-all-outcome, and any future market volatility and price action will likely reflect developments. In the event of a conflict, it could involve further escalation, leading to a breakdown in diplomatic deliberations followed by military action. Coupled with this would be any subsequent response from the Western allies and reactive measures such as sanctions. The length and magnitude of these sanctions would depend on the severity of the escalation. Markets have been building in a geopolitical premium at this stage, with fundamentals taking a step back. But, so far, the situation has been either regionally or locally contained.

We naturally expect to see broad risk sentiment being compromised in the event of a conflict with safe-haven trading taking the lead. Initial uncertainty surrounding the severity and extent of the episode would trigger increased volatility. In our view, spillover will also be evident in the commodity complex feeding into oil and natural gas, as these are centerstage.

A potential spillover impacting other parts of EM, especially Asia and China

When we assess such externalities that could shock individual markets beyond their domestic borders, we need to be mindful that any knock-on effects will ripple out globally. Such a shock has the potential to force synchronised monetary policy action and derail, at least temporarily, the current path towards normalisation across developed and emerging markets.

In the least appealing scenario, broad risk sentiment will come under pressure until we see greater clarity on the severity of the situation. This will be most evident in the commodity channel that will, in turn, disproportionally affect the importing nations. Oil, for example, is already carrying US$5-$10 of premium that reflects the uncertainty surrounding Ukraine-Russia tensions.

In regard to China, the meeting between President Putin and President Xi, which took place just before the opening ceremony of the Beijing 2022 Winter Olympics, reflects the importance of this relationship for both parties, specifically, in economic terms.

From an energy perspective, we saw an enhanced relationship that will see Russia deliver an additional 200,000+ barrels of crude oil per day to China, plus a boost in Russian natural gas exports to China.

Safe havens for fixed-income investors within EMs

Initially, we expect to see little or no discrepancy across the EM complex in the event of a conflict, given the nature of the external shock. However, fundamentals will play a more prominent role once the dust settles. Indeed, in terms of resource producers, we expect to see the stronger, export-driven economies lead the way. At this stage, we need to be aware that some central banks across EMs (primarily outside of Asia) have been undergoing an aggressive tightening journey that is well ahead of the US Federal Reserve. These moves have been introduced to tame powerful inflationary dynamics, that can extend even further on the back of continued upward pressure on energy prices. We believe this environment could reinforce the diversification benefits that select fixed-income assets within the EM-debt universe can offer.

China fixed income as a potential safe haven

China is an evident pick from an Asia-centric perspective given its already desynchronised (relative to other major economies) business cycle. This reflects the People's Bank of China's (PBOC) supportive monetary policy stance as China prepares for its 20th Party Congress, which is set for autumn 2022.

In the event of a conflict, there will likely be "flight to safety" trade with risk assets, including a selloff in China's US-dollar-denominated credit market.

That said, the performance of local currency Chinese government bonds (CGBs) and policy bank bonds should be relatively stable (within the EM debt universe), as Chinese sovereign bonds have performed well over the past few years when there have been instances of broad market volatility, such as the COVID-driven March 2020 market sell-off. In contrast to the US and Europe, the PBOC is currently *easing* its monetary policy, which will likely support the performance of CGBs – even in a more volatile market environment. As global investors are broadly underweight in China bonds, we believe that medium-term flows to the asset class will remain positive.

Investors also need to be aware of the potential impact on oil prices and inflation as a result of rising tensions between Russia and Ukraine. Indeed, over the past 18-24 months, onshore China bonds have performed relatively well in US dollar terms on an unhedged basis when US inflation has been rising. This points to the potential of the asset class to be a hedge against rising inflation for global investors.

In summary, Chinese sovereign bonds have the potential to provide investors with relative stability and to act as a safe haven within the broader EM debt universe.

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