

# Ukraine crisis: Portfolio perspectives from London

Transcript from March 4, 2022

**Tim Buckley:** Hello, I'm Tim Buckley, Vanguard's CEO, and I'm joined by Nick Eisinger here in London. And Nick is the Co-Head of our Emerging Markets Fixed Income team.

Nick, with Russia's invasion of Ukraine, we have the tragic loss of life, of humanitarian crisis. We've seen extreme sanctions. We've also seen the markets react. Russian securities, whether equities or fixed income, have plummeted. In the coming days and through next week, we'll see a lot of the Russian securities drop out of the major market indexes, first on the equity side, and then eventually on the fixed income side.

If we go beyond, if we look beyond kind of the immediate impact in the markets, if we look broadly at EM, the world you live in, what are the knock-on effects? You haven't really seen the same reverberations you might have expected with the outbreak of war in Ukraine.

**Nick Eisinger:** Yes, thank you, Tim. We're talking contagion to a broader emerging market universe. So far, pretty limited. Much more limited, for example, than the contagion effects post-COVID news. In many ways, much more limited around previous episodes of say taper tantrum from the Fed.

Now that doesn't necessarily mean that we're going to stay there because I think what we need to follow is whether there's an escalation of the situation on the ground, how that plays out. That has particular poignance for the Central East European regions, some of the ex-Soviet Union countries, for obvious reasons, for geographical reasons. Economic linkages, obviously, with Russia are very strong there as well, as, indeed, are some political linkages.

The other big factor, which is both in emerging market and the global factor is the price of oil, which is continuing to spike as we speak. That'll help some emerging market countries, oil exporters. But on balance, if it's going up quickly, it has big ramifications for global growth as well. And that's generally not good for emerging markets.

So when we observe the credit universe in EM right now, we see some early signs of contagion. We see some bonds selling off on a risk-adjusted basis. But we certainly don't observe that, a big ramping up of the risk factors that are priced into that market at the moment.

**Tim Buckley:** You deal in risk all the time. You deal with emerging markets. You deal with a lot more risk than most fixed income investors. There are always tail risks. The market's got the intentions of Russia wrong in invading Ukraine. How do you think about tail risks, and as you develop a portfolio, because you won't be right on all of them?

**Nick Eisinger:** Of course. So tail risks, you know, it's useful to sort of think of the definitions. A remote probability event but has very material implications to, in this case, portfolios.

And we really like to get away in the way we manage emerging markets from this concept of, "My base case is this" or "My base case is that," because, inevitably, those are wrong.

But the tail risk, in this particular instance, you know, is something you could not rule out. And so we spend a lot of our time interrogating alternative scenarios. We try to stress test the portfolio. Most obviously, at its most proximate set of events, so Russia and Ukraine exposures, as well as beyond that; and we come out of those stress tests, big collaboration with the risk group and our team and our own knowledge and our own sort of foresight, if you like, and experience. And we come up with a number, or at least we did back in November, that we thought was unacceptable for our portfolio and unacceptable that our clients should be bearing. And so from around November time, we started to really dial back in some of these exposures.

And the other interesting angle here is that had we got that wrong, we don't actually think we would have necessarily lost out that much because particular Russian credits at that time were looking pretty expensive, to be frank with you. So there was some asymmetry, if you like, about disengaging from some of those trades.

The other thing that's closely associated with this is how you size trades in portfolios. So there's going to be situations where you think you have to be particularly active. Part of our world, you have to be involved in some of these trades. But you want to size a portfolio based on that downside risk. And really what I mean by that is you don't want a position to destroy your fund to such a degree that you're never going to come back. And more importantly, your clients will never come back. So we spend a lot of our time thinking about concentration, correlated risks, downside scenarios. Of course, we think about upside scenarios as well. But it really shows you, I think, there is a very important consideration. You know, we do this weekly and then, more often than not, under situations like this, we do it with a lot more depth as well.

**Tim Buckley:** Nick, your title says Emerging Markets, but I know your expertise goes far beyond that. Let me hit the developed markets. Anything you worry about there? You know, the Fed has stepped back from a 50-basis-point increase. Now that was what the market had priced in, and Chairman Powell essentially committed to a 25, at least his intentions for a 25-basis point increase. Does that worry you at all? Are there fears that we're falling behind of inflation in some of the developed markets?

**Nick Eisinger:** Yes, great question, Tim. I think that's currently what the broader global market still focuses on, despite what's going on closer to home, for us at least.

So I think a lot of the rate hikes from the Fed are priced into the market. That would typically imply that as Powell goes in March, 25 basis points most likely, the market shouldn't be overly concerned and trade particularly badly on that.

The next question, of course, is what does it take for Powell to pivot the other way? And so it wasn't very long ago the Fed pivoted to normalization. Sorry, guys, the tide's going out. This is enough. We think it would take a pretty big shock that has the global ramifications for Powell and the FOMC to really step back. The biggest vex is, obviously, the oil price, a big spike and a prolonged spike in oil prices. The issue there really being what that does to the economic cycle.

So we know that one thing you want to avoid when you run risk is recessions, and at the moment, you know, we still feel pretty comfortable; but the recession is a long way out. But, obviously, there are certain global shocks that can happen to bring that forward. So that's the one thing I think at a global level you look at. So that's the Fed's dilemma, and perhaps it's not that much of a dilemma right now.

The ECB, back in Europe, however, I think faces a bigger dilemma. The ECB is much closer to potentially some bigger restrictions on energy, which has big inflation implications, at a time when inflation and core inflation across Europe is already high. We did see a mini pivot from the ECB similar to what the Fed was telling us, that it's coming out of some of this QE. It's going to start normalizing policy over time. That's a much harder battle for it to fight at the moment.

Notwithstanding, we would still see the ECB as embarking from a gradual tightening path, less telegraphed perhaps, I'm afraid, but nonetheless, I think that's where things are at the moment. And this is a difficult situation because, you know, the monetary support is arguably going out at the margin; and you've got a whole host of global risk events. But as I said, at the moment are somewhat contained; but we should not dismiss the risk that they could become uncontained in the foreseeable future.

**Tim Buckley:** Nick, as always, thank you for the insights; and thank you for taking great care of our clients' money. And to all of our clients, thank you for your continued trust in Vanguard.

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