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SKY Harbor Weekly Briefing

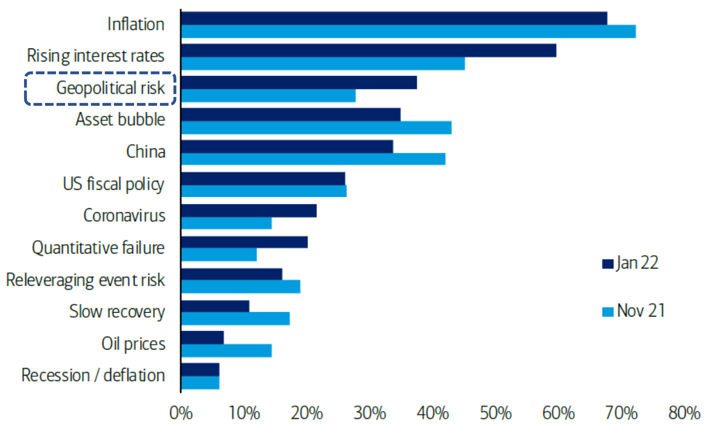
SKYView: Geopolitical Threats

Market volatility remains elevated, a function of corporate earnings surprises, the rebalancing of Fed rate hike expectations, and rising geopolitical tensions. With regard to geopolitics, President Biden's decision to send an additional 3,000 US troops to Poland, Germany, and Romania – a move aimed at bolstering NATO defenses in Eastern Europe as 100,000 Russian troops amass along the Ukrainian border – underscores the lack of progress made thus far through diplomatic channels. While the odds of a full-scale conflict remain low, we nevertheless find it prudent to analyze historical market reactions to prior geopolitical events. In this *Weekly Briefing*, we focus on the magnitude and duration of prior selloffs due to exogenous shocks.

According to the most recent BofA Merrill Lynch credit investor survey – a bimonthly questionnaire in which institutional investors identify dominant risk factors in the market – **geopolitical risk poses the third most significant concern on the horizon, moving up sharply relative to November '21 results**. Undoubtedly, a number of threats have contributed to elevated volatility thus far in 2022, but the intensifying standoff along the Ukrainian border is perhaps most worrisome. And, while military action is not a foregone conclusion at this point in time, the odds of escalation (intentional or otherwise) likely rises as troop counts build.

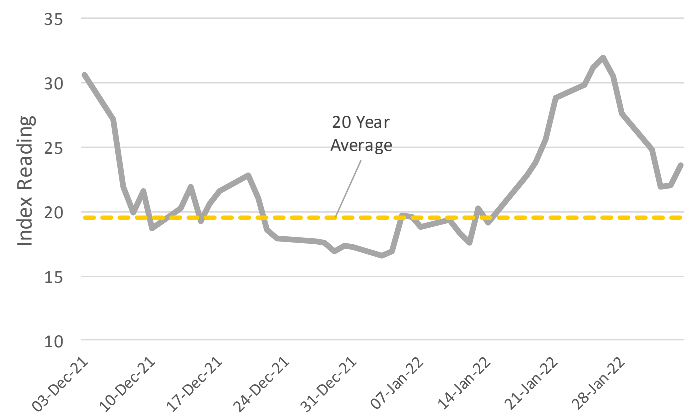
Geopolitical Risk Rising in BofA Merrill Lynch Investor Survey

January '22 survey date



Volatility Remains Elevated

Chicago Board Options Exchange Volatility Index

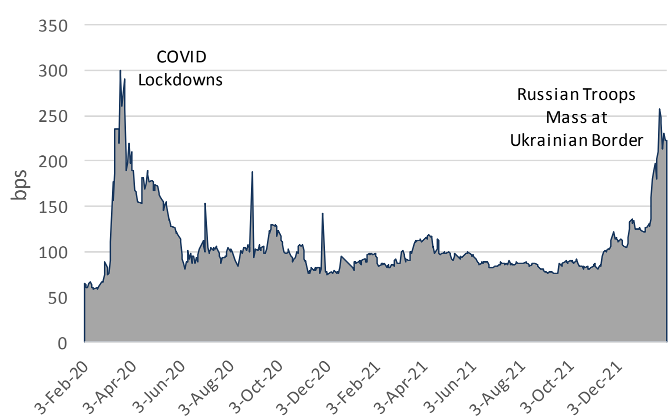


Source: SKY Harbor, BofA Merrill Lynch, Bloomberg

Global markets have already reacted to heightened tensions, with Russia 5 Year CDS approaching levels not seen since the onset of the pandemic. Along with a depreciating Russian Ruble, most key exports have been impacted, with prices expected to rise further should an escalation of tensions occur. Financial sanctions could also be imposed by the US and EU, though sensitivity surrounding the Nord Stream 2 pipeline and dependence on Russian energy in general – particularly during winter months – add complexity to the situation. **What is clear is that crude oil, natural gas, palladium, and aluminum prices could rise further, with wheat potentially inflecting, adding further pressure to raw material cost headwinds already impacting many corporations**.

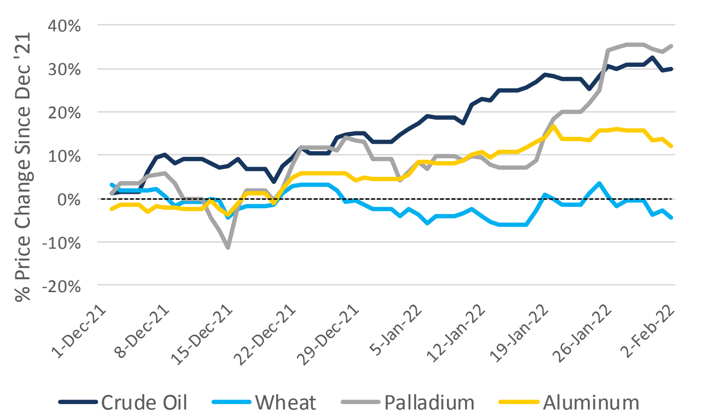
Russia 5 Year CDS Has Climbed

daily data, trailing 2 years



Commodity Prices (Mostly) Rising Among Major Russian Exports

daily data, price change since December 1, 2021

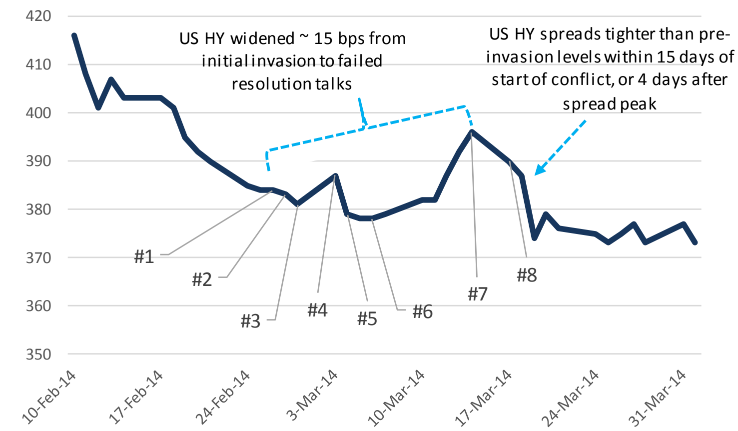


Source: SKY Harbor, Bloomberg, ICE, Chicago Board of Trade, New York Mercantile Exchange, London Metal Exchange

In our view, the best way to gauge the spillover risk for high yield is an examination of how the market reacted to the Russian annexation of Crimea back in 2014. As demonstrated below, and using various media sources to put together a rough timeline of events, we can see that spread tightening of the ICE BofA US High Yield Index (ticker H0A0, our proxy for US high yield market risk) came to a halt upon the initial seizure of Crimea's parliament and Council of Ministers buildings by masked gunmen on February 27, 2014. Spreads continued to widen as then-Prime Minister Mohyliov was overthrown, and peaked on or about March 14, when diplomatic negotiations between the United States and Russia ended without meaningful progress. **At its worst, high yield spreads widened ~ 15 bps, a relatively modest reaction given the risk of armed conflict escalation**. Furthermore, spreads had recovered to their pre-conflict tights a mere four days after the peak.

Russian Annexation of Crimea

summary timeline



Source: SKY Harbor, ICE Data Indices, Wall Street Journal, CNBC, Wikipedia, BBC

Events Key

generally accepted timeline of events

#1	Masked (presumably) Russian gunmen take over Crimean parliament building
#2	Crimea's parliament holds emergency session, Anatolii Mohyliov removed as Prime Minister
#3	Armed men seize control of Simferopol International Airport and, later in the day, Sevastopol International Airport
#4	De Facto PM Sergey Aksyonov asks Russian President Putin to provide assistance; announces date of self-sovereignty referendum
#5	Military standoff between Ukrainian marines and Russian/Crimean forces
#6	Supreme Council of Crimea votes to formally re-accede as part of the Russian Federation
#7	US / Russian officials meet in London for negotiations, no progress made
#8	The Treaty on Accession of the Republic of Crimea to Russia is signed

We are aware, however, that all conflicts play out in unique ways, with the ultimate impact either cushioned or exacerbated by prevailing economic conditions. For example, supply chains are in a more tenuous position now than they were in 2014, potentially magnifying the impact trade sanctions and reduced output may have on downstream industries. At the same time, the build-up of tensions has been better telegraphed to the market this time around, the aging of risk factors usually resulting in less severe market reactions.

With all of this in mind, we generated a list of significant geopolitical events, all occurring in the last two decades so that their associated impacts can all be measured against a high yield market of similar size and depth. First, a word of caution – not all of these events were discrete / single-day occurrences, not all were complete surprises, and not all have clearly delineated start and end dates. As such, quantifying the magnitude and duration of spread change required some judgement on our part. Nevertheless, we are confident that data presented in the tables below represent a consistent measurement approach. Ultimately, **we find that shocks to risk assets stemming from geopolitical events – with the exception of the 9/11 attacks – have typically been short-lived, and more often than not resulted in less than 20 bps of spread widening**.

Spread Pressure From Geopolitical Events Have Typically Been Short-Lived

estimated spread reaction and time to recovery

Single Day / Discrete Events				Multi-Day Events			
Date	Event	Est. OAS Reaction (bps)	Est. Time to Recovery (days)	Date	Event	Est. OAS Reaction (bps)	Est. Time to Recovery (days)
Apr '13	Boston Marathon Bombing	4	6	Sep '01	9/11 Attacks	196	53
Nov '15	Paris Terror Attacks	15	4	Mar '03	US-led coalition invades Iraq	12	8
Nov '15	Turkey Shoots Down Russian Jet	6	7	Feb '11	Libya / Arab Spring	64	36
Jun '16	EU Referendum (Brexit)	74	13	Jan '14	ISIS Captures Fallujah	3	5
Jul '16	Failed Coup in Turkey	3	4	Jul '17	N. Korea Successful ICBM Launch	41	44
Apr '17	Retaliatory Missile Strike in Syria	21	11				
Sep '19	Saudi Aramco Drone Strike	2	4		**Full Set Median**	**14**	**8**
					Full Set Mean	**37**	**16**

Source: SKY Harbor, Bloomberg, ICE Data Indices

Geopolitical risk factors are on the rise, most notably due to the build-up of troops along the Russian-Ukrainian border. While the odds of a full-scale conflict remain low, we are nevertheless aware that already precarious supply chains could become further disrupted and raw material cost inflation could accelerate if a diplomatic resolution isn't reached. Fortunately, exogenous shocks stemming from geopolitical events over the last two decades have proven less destructive than anticipated. In fact, our full set median implies 14 bps of spread widening and OAS recovery within an eight trading day period, a relatively manageable move should any eventual escalation remain within the normal bounds of historical market reactions.

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