As tensions ease and Russian troops in Crimea, Ukraine are ordered to return to their barracks by Russian President Putin, Allianz Global Investors reviews the situation in Ukraine and the Crimea and considers possible scenarios ahead, the impact on markets and investment strategy within the current market environment.

Ukraine crisis dissipates as tensions cease:

Following the recent invasion of Russian troops in Crimea in Ukraine, we have seen an escalation of tension between Russia and the West with concern mounting that current events could trigger a major war. At Allianz Global Investors we don’t however, believe that this scenario is likely to develop, born out by the recent orders from Putin to his troops in Crimea to return to their barracks and his latest emphasis on military force being unnecessary. European equity indices have since rebounded with investors clearly relieved at what appears to be, at least in the short-term, a de-escalation in tensions between Russia and the West.

At the end of the day, investors should remember that any serious conflict was set to unfold as Russian troops initially marched into Crimea - which was not the case. We should however be prepared for the fact that Russia may wish to continue to exercise control over events in Crimea and may therefore be reluctant to give up control back to Ukraine. We do not believe it likely that Putin will seek to expand troops into further parts of Ukraine, but we should be aware that Putin has made Russian intentions to protect its interests and borders where necessary very clear in the past; the current situation in Crimea is simply an illustration of this in practice by Russia.

While the Western world may react with sanctions and warnings to Russia, in reality the West has no appetite for a war with Russia. Indeed, as winter draws to an end in Europe, we should remember how dependent much of Western Europe is on Russian gas. It is also not in Russia’s interest to ignite a war, leading as it would to capital flight, a weaker currency and higher interest rates. So the likelihood is that Russia will either choose to leave troops on the ground in Crimea, or to withdraw them, but all without any war occurring, although we can expect Russia to continue to want to have influence in Crimea.

On the financial side, the International Monetary Fund is leading a programme to set up financial support for Ukraine with a team from the Fund having just commenced on a 10-day review and fact-finding mission.
Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors may not get back the full amount invested.

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Source: Allianz Global Investors, March 2014

The impact on markets and investment implications:

Against this background, and as the crisis pans out over the next few weeks, giving rise to increased market volatility, our investment strategy at Allianz Global Investors is to take advantage of attractive buying opportunities on market dips. From a broader perspective in the short and medium term, we believe that investors should consider in particular the following points when considering investment risks and opportunities:

- The market is currently pricing in a further deterioration in the situation with an increase in risk premia across developed markets as well as in those directly affected.

- Should Russia’s aims prove to be more limited than the worst fears and/or Crimea (and other eastern parts of Ukraine) break away following a referendum, the current elevated risk premia may be short-lived (though there will likely be longer term risk premia effects for Russia).

- Long-term investors should consider the opportunity to exploit emerging market currency weakness, in both US-dollar and local currency, with prospects for more attractive long-term returns still intact despite short term weakness. The energy and financial sectors are the most exposed to the crisis in our view. In terms of the energy sector, we have so far seen only a relatively small increase in the oil price since the beginning of the political turmoil in the Ukraine. Within the financial sector, financial institutions with exposure to Ukraine and/or Russia are likely to be most impacted, with the overall exposure of US and European banks to Russia at around US$220 billion, according to the Bank of International Settlements – low relative to GDP. So far, we haven’t seen any market signals (e.g. rising swap spreads) pointing to a significantly rising threat.