What Sunday's Crimea vote means for markets

By William L. Watts March 14, 2014

Ukraine, the U.S. and the European Union contend the referendum is illegal. But most analysts see little prospect for long-lasting market turmoil barring a significant escalation of tensions or violence, with the U.S. and Western powers in position to do little beyond imposing sanctions on Moscow.

A vote in favor of rejoining Russia would likely be followed by a round of U.S.- and European-led sanctions against Moscow. But that scenario is already "baked in the cake" from a market perspective, said Ed Lalanne, strategist at Macro Risk Advisors, a New York firm that advises institutional investors.

U.S. stocks tumbled Thursday, posting their biggest declines in more than five weeks. While analysts cited jitters over Ukraine as a factor, investors are also weighing signs of a slowdown in China and gauging the Federal Reserve's effort to scale back monetary stimulus. Reports Thursday that Russia had massed troops and armored vehicles on Ukraine's eastern border didn't help the tone.

Stock index futures were mixed Friday, while European and Asian stocks lost ground. Gold was flat while oil futures edged slightly higher.

Equity markets in the U.S. and elsewhere are unlikely to react much to Sunday's expected result, Lalanne said. That said, any sign Russia is preparing for military action with designs beyond the Crimea to other predominantly Russian-speaking portions of Ukraine or a round of heavier-than-expected Western sanctions that prompt a harsh response from Moscow would be likely to create turmoil.

Indeed, Russ Koesterich, chief investment strategist at BlackRock, the world's largest asset manager, noted that while events in Ukraine temporarily sent markets reeling earlier this month, it took less than 48 hours for stocks to find their footing and hit new highs. "Does this suggest that events in Ukraine don't matter to markets? The short answer is no," Koesterich said, in a note. "However, investors are unlikely to respond to the events in Ukraine without a significant escalation in violence or clear evidence linking the events to the global economy, such as a disruption of oil or gas markets."

With that in mind, here's a look at how markets could react to Sunday's vote:

Energy

Let’s start with oil and natural gas. Both jumped in late February and early March as tensions rose and Russian-backed forces took control of the regional parliament and swarmed Crimea. Memories of how Russia twice shut off natural-gas exports to Ukraine in the last decade were briefly revived. But Nymex WTI crude has since sunk back below $100 a barrel, while gas futures have also retreated.

Nymex April crude futures (NMN:CLJ4) were up 50 cents, or 0.5%, at $98.70 a barrel in recent action.

“On the oil side, Crimea is a mild form of risk premium supportive to U.S. crude and slightly supportive to Brent,” said Richard Hastings, macro strategist at Global Hunter Securities.

Meanwhile, the U.S. government on Wednesday announced it would make a “test” sale of oil from the Strategic Petroleum Reserve, a move some commentators viewed as a warning to Moscow, though many industry observers dismissed the measure as a purely technical operation.

“If commentators were right in seeing this as a signal to Russia, we would tend to say that this signal will be too weak to reach the Kremlin. It would be a different story if crude exports were to be allowed (temporarily), as this should effectively pressure the Brent/Urals complex by helping Europe to decrease its dependence on crude imports from the East,” wrote analysts at JBC Energy.

If there is a market likely to do something “crazy” in the aftermath of the vote, it’s crude oil, Lalanne said, emphasizing, though, that any strong reaction remains unlikely.

Gold

The yellow metal is a traditional safe haven. It’s advanced 2.5% this week, contributing to its 2014 rebound, but analysts remain reluctant to tie recent strength to worries over Crimea — April gold futures (CNS:GCJ4) edged higher Thursday and added another $1.10, or 0.1%, to $1,373.50 an ounce on Friday. Gold is up around 2.6% for the week. “The Crimea situation may be an ancillary, emotional facet to the price of gold, but I tend to believe that the price fluctuation [Thursday] is more so related to economic and market results,” said Adam Koos, president and portfolio manager at Libertas Wealth Management Group.

Emerging markets

If problems in Crimea are going to have an immediate impact, emerging markets would seem a logical place to start. But the run-up to the vote is offering little sign that fears have spread beyond Russia and Ukraine, who are dealing with significant economic problems of their own.

“If we go by asset performance over the past few weeks, the Ukraine crisis has been broadly dismissed by global emerging markets,” wrote analysts led by Benoit Anne at Societe Generale, in a note.

"Of course, there has been significant differentiation across markets, but, essentially, the market stress has been confined to Russia and Ukraine," they said, noting that even the Polish zloty (ICAP:EURPLN) (ICAP:USDPLN) , which is viewed as a proxy hedge for Central Europe, has slipped only 2% since the start of the crisis.

Ukraine as a whole, meanwhile, is confronting a dire situation and is seeking an International Monetary Fund bailout.

Markus Schormer, chief economist at PineBridge Investments, said Ukraine faces a steep recession, a situation comparable to the plight faced by Cyprus last year. And, much like the Cypriot crisis, the contagion risk is likely to be minimal, Schomer said, in a note. "Ukraine's problems are unique to its geographic situation, and the most affected economy other than its own is likely to be Russia, which holds Ukrainian debt and whose banks own large stakes in their Ukrainian competitors," he said.

Fixed income

Bond investors aren't likely to leave their positions on the table going into the weekend. But a vote to annex Crimea to Russia won't necessarily drive Treasury prices higher and yields lower, given that such an outcome is already largely expected by the market, said Jonathan Lewis, chief investment officer at Samson Capital Advisors.

The more important factor will be how the involved parties respond and the specifics of when the conflict plays out.

Treasurys surged on Thursday, dragging down the yield on the 10-year Treasury note (ICAPSD:10_YEAR) by 9 basis points to 2.647%. The 10-year yield was down less than half a basis point early Friday to around 2.642%.

"When you are looking at a conflict, there's no one day where it occurs," Lewis said. "It seems reasonable that people are position squaring going into the weekend."

Foreign exchange

It's not so much the outcome of the vote that will trigger a reaction in currencies but rather how officials in the United Nations, U.S. and European Union respond, said Brad Bechtel, managing director at Faros Trading.

That includes "the extent [to which] they become very vocal about the next steps," he said.

In that scenario, expect movement in the currencies of neighboring countries, including Poland, Hungary, Turkey and Russia. "Those are the primary emerging-market currencies that are right next to the situation and very vulnerable to the reactions," he said.

Worst case

Of course, investors must be wary of complacency. And the Crimea is undoubtedly reasserting itself as a global geopolitical flash point, so it pays to remain aware of the risks.

While most analysts doubt Putin would attempt to up the stakes by pressing for control of other Russian-speaking regions of Ukraine beyond Crimea, that possibility can't be totally dismissed.

"Much is at stake this weekend," said **Bernard Baumohl, chief economist at the Economic Outlook Group** in Princeton, N.J., in a note.

Will Putin "double down and unleash war against Ukraine? Such an act raises the specter of a direct military confrontation" between the U.S. and Russia, **Baumohl** said. "Or will world leaders, and, particularly, Putin's fellow oligarchs, who worry about losing access to their wealth outside their country, pressure him to seek a diplomatic solution to this crisis?"

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