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FIRST ANALYSIS

Institute Alert

News or events that may affect your investments

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Russia, Ukraine, and global markets: Changes accelerate

Key takeaways

- In just the past week, Moscow has increased markedly the uncertainty in Eastern Europe and in the North Atlantic Treaty Organization (NATO) capitals.
- We do not have a way to determine how a political leader may decide between options that carry complex historical, economic, and geopolitical meanings. For its part, NATO's incremental sanctions also complicate the task of sorting out the economic impact.

What it may mean for investors

- We favor patience and staying close to our current tactical guidance, which we believe aligns well with the regions and investment styles that should outperform through this uncertain period.

Since our last report a week ago, events in Moscow and in the separatist territories of the Donbass region (southeastern Ukraine) have changed the calculations for both sides, and for NATO.[1] First, the separatist groups began shelling Ukrainian troop positions with heavy artillery, in violation of the Minsk Accords.[2] Second, the Kremlin recognized the Luhansk and Donetsk People's republics (LPR/DPR), in Eastern Ukraine, as sovereign countries. Both actions undermine the Minsk II Agreement that Russia and Ukraine signed in 2015 and that, until this week, Russia had demanded that Ukraine follow to keep peace in the region.

What happens next in the region is difficult to forecast. Ukrainian troops still hold much of the disputed regions. Until now, Russian military support has helped the separatists to maintain a low-level insurgency against those Ukrainian troops and to encourage the separatist leaders to oppose pro-Western initiatives from Kyiv. Now that Russia recognizes the breakaway regions as sovereign states, the Kremlin takes Russian influence even closer to Kyiv. Moreover, the deaths of any civilians or separatists could trigger a full Russian military invasion of Ukraine, under the pretext of restoring the peace.

1. Please see "Russia, Ukraine, and Global Markets – rising tensions", February 15, 2022.
2. "Donbas conflict zone re-escalation likely aimed to coerce Ukraine into agreeing Russian conditions for conflict resolution", by Alex Kokcharov, Janes, February 21, 2022.

We also consider that President Putin intends more modest, tactical goals. Russia has held influence in these breakaway regions since 2014. The Kremlin could de-escalate the conflict while claiming increased regional control and leverage over Kyiv, for example. Mr. Putin also could be trying to see how NATO reacts as he increases the uncertainty about his intentions. He has demanded publicly that NATO stop expanding into countries that border Russia. Increasing the invasion uncertainty could test whether NATO's diverse national interests splinter into impasse or watered-down sanctions.

We do not have a way to determine what a single political leader may decide. Our last two reports laid out the case for why a full-scale invasion of Ukraine would be very costly for Russia, and why Russian President Putin may de-escalate from here.[3] For now, the direction of change suggests more conflict, and we believe the risk of full invasion is rising.

A measured response by NATO countries

Germany has suspended the certification of the Nord Stream 2 pipeline, putting on hold the inception of Western European gas import through that source. Suspension is not cancellation, so this is an intermediate step. President Biden's penalties include sanctions on wealthy Putin supporters (the oligarchs), and a freezing of assets at two, state-owned banks. Other U.S. measures prohibit U.S. investment in the self-proclaimed separatist republics, and cut off Russia's government from raising money and from trading its debt on U.S. and European markets. These sanctions should be a persistent drag on Russia's economy, but they do not yet attempt to cut off Russia's financial system from Europe and the U.S. markets. More sanctions could be in store if an invasion broadens to the rest of the country.

Limited impact on global markets — so far

Despite its physical size, Russia has a relatively small economy and its largest trading partners are China and Europe.[4] There is little direct trade between Russia and the world outside of Europe and China, so both the sanctions on Russia and damage to sentiment likely will fall squarely on the European economies. Russian sanctions are likely to reduce Russian commodity exports (especially energy) into Europe, while any fighting likely weighs on European household and business sentiment and economic growth in 2022.

The fallout for European economic growth depends on how long hostilities may last. Russia's 2014 annexation of Crimea was relatively short and had only a temporary negative impact on the European economy and equity markets. Any Russian invasion of wider Ukraine could become a long struggle, especially to pacify the Ukrainian population.

By contrast, the inflation impact is likely to spill over into the global economy. Reduced Russian gas flows already are forcing European factories and utilities to substitute petroleum, boosting oil demand, even as reduced Russian oil supply further tightens global oil inventories. In turn, higher energy prices should stoke inflation, moreso in Europe, and somewhat less in the U.S. and Asia, which tap more diversified energy sources. Also, Russia is among the world's largest exporters of fertilizer, while Ukraine is among the world leaders in grain exports. Restrictions on these supplies may push up wholesale food prices. Supply-chain disruptions could extend inflation pressure via the auto sector, if auto makers struggle to replace Russian supplies of platinum and palladium for catalytic converters, which reduce auto emissions.

Aside from inflation, any invasion would likely hit global market sentiment. Even if the direct impacts would fall largely on Europe, U.S. markets could overshoot to the downside. Yet, we do not believe that even a Russian invasion of Ukraine would generate a new U.S. economic recession.

3. For the first report in the series, see "Russia, Ukraine and Global Markets – Looking Ahead", February 15, 2022.
4. For details, please see "General Profile: Russian Federation", United Nations Conference on Trade and Development, February 23, 2022.

Investment implications at this time

We favor patience and staying close to our current tactical guidance, which we believe aligns well with the regions and investment styles that should outperform in this uncertain period.

Equities: Global equity markets have come under strain recently from the combination of inflation pressure and tension at the Ukraine-Russia border. In fact, equity benchmark indexes recently have traded below important support levels for the first time since 2020. Sentiment has been weak and has struggled to see through these uncertainties. We think it will take a little more time for markets to find their footing, mainly because the Federal Reserve is preparing to withdraw liquidity. However, while global market trends appear oversold, we believe equity markets will find their footing, particularly in the U.S. The basis for our view is that we expect the U.S. economy to post above-average growth again in 2022.

Our equity themes favor moving up in market capitalization and quality (that is, focus on firms with strong balance sheets and good earnings prospects); underweight defensives (the economy is not in a recession); and strike a balance between cyclicals and growth. To be specific, we favor:

- U.S. over international markets
- U.S. large- and mid-cap equities over small-cap equities
- Quality sectors (Information Technology and Communication Services) and cyclicals (Financials and Industrials) over defensive sectors (Utilities and Consumer Staples)

Fixed income: Any incursion in Ukraine may aggravate inflation and pressure long-term rates higher. However, if European conflict extends and U.S. fixed income becomes a perceived risk haven for European investors, then, on balance, U.S. long-term rates may steady and limit the room that the Federal Reserve has to raise short-term interest rates. We retain a preference for playing defense in fixed income. This entails allowing long-term maturities to mature and reallocating into intermediate maturities, preferred securities, and municipal bonds.

Commodities: We also have favored commodities since the spring of 2020 and reiterate that preference under the current circumstances. To reiterate, the global economic upshot of the current crisis in Ukraine is likely to center on the impact that rising commodity prices have on aggravating global inflation. Considering the potential impact on energy, agricultural, industrial metals, and precious metals, we favor a broadly diversified overweight to commodities.

Cash management: The S&P 500 Index is roughly 10% down from its all-time high. That is significant — but investors should recognize that the current index level is roughly double its March 2020 low point. Maintaining slightly higher cash balances during heightened periods of uncertainty can often provide added comfort for investors while not deviating materially from their long-term investment plan. As these uncertainties clear, we expect there to be time to resume a disciplined approach to putting cash to work.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **Municipal bonds** offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. **Preferred securities** have special risks associated with investing. Preferred securities are subject to interest rate and credit risks. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. The **commodities markets** are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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