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FIRST ANALYSIS
Institute Alert

News or events that may affect your investments — March 4, 2022

Global Investment Strategy Team

Q&A: Investment implications of latest events in Ukraine

Key takeaways

- Markets are still evaluating how Russia's invasion of Ukraine and the resulting sanctions may impact the global economy and market returns.
- New rounds of sanctions this week have raised questions about how these measures may raise commodity prices or otherwise affect the U.S. and international economic outlook.

What it may mean for investors

- Our outlook remains that the direct economic impacts outside of Russia should fall most heavily on Europe, but the indirect impact via higher commodity prices and additional inflation is set to be a global problem. We review the potential impacts on markets and our guidance.

Questions on the economic implications

Recession risk: How could Russia's invasion of Ukraine affect global gross domestic product growth (and the U.S. in particular)? Do you expect any European countries to enter into recession?

We believe the global economy's reopening and a gradual easing in supply-chain disruptions should prevent a global economic recession. Also, Europe's relatively high COVID-19 vaccination rate has allowed that economy a fast start as COVID-19 restrictions ease. Still, we expect that every global region will experience some slowdown, either as a direct effect of the invasion (Europe), or via the indirect effects from higher commodity prices and inflation (every region). What's more, Europe's economy is heavily oriented toward manufactured-goods exports, which magnifies the continent's exposure to Russia. The European economies should post growth this year but we believe they will face more economic stress than the rest of the world, and Europe's risk of recession is rising.

In the U.S., we expect the impending spring weather to reduce COVID-19 risk and spark a burst of economic activity. High-frequency and other economic data show the economy regained momentum by late January, somewhat sooner than expected, and the spending surge should sustain the economic expansion. Higher food and fuel prices and the unintended consequences of sanctions on Russia may slow the U.S. economy later in the year. While the risks have assuredly risen, we still expect above-average economic growth in 2022 — and no recession.

Inflation: What impact could Russia's invasion and the West's financial sanctions have on inflation? Beyond food and energy, what other potential areas of the economy could see a spike in prices?

The invasion and the sanctions on Russia are likely to raise inflation via higher costs to produce food and many manufactured goods. Russia is at or near the top of global exports in oil, several industrial metals, and fertilizer. Ukraine is a large grain exporter and produces 90% of the neon gas used to produce semiconductors, which are already in short supply globally. Large price increases for aluminum, palladium, lithium, and nickel are likely to pass through to higher prices for products such as electric vehicle batteries and stainless steel. Rising energy prices should add upward price pressure on energy-intensive, petrochemicals-based goods, including plastics. Russia is the world's largest exporter of fertilizer, and restricting these sales should crimp crop yields and raise food prices.

Financial sanctions: Crippling for Russia, yes, but what are the potential risks to European and U.S. economies? What are the potential risks to the Financials sector? And what should we make of the FBI warnings of cyber threats to the U.S. economy?

The unknown impact on financial linkages creates potential spillovers from the sanctions into the global economy. For example, Russia's central bank has a significant presence in the global market, which could be disrupted amid the freeze on its assets and any subsequent unwind by the bank's counterparties. Keep in mind that the August 1998 Russian default led to the unraveling of Long-Term Capital Management, but that the Federal Reserve (Fed) and other large banks contained the ripple effect on other parts of the financial system.

Payments systems and water and power utility systems are likely high-profile targets of cyberattacks. Such attacks already are on the rise between Russia and Ukraine, and the U.S. government has named Russia as a source of cyberattacks.[1]

Some of the disruptions stemming from the sanctions have added to market volatility today, but may be resolvable in the coming weeks. For example, Russia is still exporting energy, but an estimated 70% of Russia's oil exports may be on hold because of uncertainty among traders and shippers of Russian oil over how the various sanctions apply to their operations.[2] Until these companies understand how the sanctions will operate, the sanctions may add to volatility in financial markets.

Questions on our outlook for equities

Technical support levels for the S&P 500 Index: In volatile markets like this, what technical support levels are you watching? And how do you use technical charts in your short-term guidance?

While such strong uncertainties continue around Russia's next actions in Ukraine, and around the possible impacts of sanctions and Russian retaliation, the S&P 500 Index technical picture still shows a downtrend — that is, the index is making lower highs and lower lows. We would take it as a positive — but not conclusive — sign of improvement if the index, on down days, can hold above price levels that have been recent floors or supports

1. For details, please see "Russia Cyber Threat Overview and Advisories", U.S. Cybersecurity & Infrastructure Security Agency, March 3, 2022.
2. Russia Oil Shunned Even Without Sanctions, Sparking Supply Panic, Bloomberg News, March 1, 2022.

(4,116 and 4,222). But it is important to remember that the index could continue to range between the support and resistance price levels, and that more bad news could still push the index to lower levels. As the uncertainties begin to fade or clarify, we would look for the index to break above levels that recently have served as ceilings or resistance (4,464 and 4,540). As the fog around these questions finally begins to clear, we would expect a new uptrend, which would show itself as the index makes higher highs and higher lows.

Corporate Earnings: Do you expect to see downward revisions in corporate earnings estimates as companies in certain sectors halt business with Russia and we see renewed supply-chain issues? Does $120 per barrel oil impact first-quarter 2022 earnings negatively? Any change in guidance?

We reiterate our preference for U.S. Large Cap Equities, and note that the S&P 500 Index has less than 1% revenue exposure to Russia. Upward revisions in Energy and Information Technology earnings largely have offset downward revisions in Utilities and Real Estate. Lower-quality small-caps are seeing negative earnings revisions as rising rates and higher input costs challenge smaller-sized companies. International earnings also are revising lower with the softer prospects for the European economy, and in emerging countries that heavily rely on commodity imports.

Equity guidance: Would your guidance be to selectively buy the dips or wait and see?

We favor patience, inasmuch as we never favor jumping in trying to time the bottom of a correction. As the discussion around the price trends illustrates, pullbacks of this magnitude are extremely difficult to predict and even harder to execute around. Considering the potential for additional uncertainty, some investors with shorter horizons may choose to hold some extra cash here. Investors with a long time horizon may consider making a plan with an investment professional to put cash to work in a disciplined, patient, and incremental way — that is, to dollar-cost average[3] into high-quality U.S. equities at these levels, particularly where the portfolio is under-allocated to equities. Our high-quality preferences include U.S. over international markets, U.S. Large and Mid Cap Equities over small-cap stocks, and a balance in sectors between growth and cyclicals.

Questions on fixed income and the dollar’s value

The Fed and interest rates: How do the invasion and the sanctions change the way the Fed and European Central Bank may need to fight inflation? How are central banks guarding against raising interest rates by too much?

In a determined effort to ease inflation, Fed and European Central Bank policymakers seem prepared to tighten monetary policy as necessary. In Washington, D.C. on March 2, Fed Chair Powell’s congressional testimony underscored that the Fed will use all its policy tools to combat inflation. We expect the Fed to begin raising interest rates at its March meeting and to commence reducing its balance sheet shortly thereafter. However, inflation has typically responded to policy with a time lag, so we expect the Fed to try to counter inflation as it evolves.

Our fixed-income guidance: What do you think about selling into the recent rally in U.S. Treasuries to liquidate fixed-income holdings and reallocate to equities, where you are more favorable long-term?

We believe that yields can increase further across maturities. Our view is that higher short-term rates will reflect the series of Fed hikes we expect this year, while longer-term yields likely will increase given the expectation for high inflation and a still above-average growth. We prefer to position defensively in fixed-income, favoring intermediate maturities.

3. A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

Even with a defensive approach, many investors still need to generate income. High-yield spreads recently have risen relative to U.S. Treasuries, and we believe the economic expansion and a modest rise in long-term interest rates will support credit and spread-oriented asset classes and sectors. Floating rate and leveraged loans may enjoy strong demand and positive inflows as inflation rises, although we caution that these assets have a low rank for repayment if a company faces bankruptcy. Preferred securities are another yield-oriented fixed-income sector that could continue to benefit from the sentiment for risk appetite.

U.S. dollar: What does the spike in the U.S. dollar imply for equity asset classes and guidance?

The comparatively stronger U.S. economy and the greater gains we anticipate in U.S. interest rates should allow the U.S. dollar to add somewhat further to its recent gains by year-end. The dollar's likely advantage over the euro and the pound add to the reasons why we continue to prefer U.S. equity and fixed-income markets over their Developed Market ex-U.S. counterparts.

Questions on commodities and alternative investments

Oil and gold: What are the implications of $100+ per barrel oil? Impact on gasoline prices? Is the Organization of Petroleum Exporting Countries (OPEC) likely to raise production? Potential for a supply shortage? Is gold a good place to wait out uncertainty?

The invasion accelerated recent gains in oil prices, and the two most widely followed oil benchmarks — West Texas Intermediate and Brent — reached over $110 per barrel on March 2 for the first time since 2014. As oil prices approach $130 per barrel, the U.S. national average gasoline price should register at $4.60 per gallon, up from $3.65 today. Fortunately, recent wage gains and close to full employment allow consumers to afford these higher prices more easily than in 2014. We believe that prices would need to increase to over $150 per barrel for oil and $5.30 per gallon on gas to undercut household spending significantly.

Supplies are tight and we do not expect OPEC to increase production, beyond the small and previously planned increase of 400,000 barrels per day (roughly 0.4% of daily global consumption). Still, the U.S. is the largest oil-producing country and an outright U.S. shortage is unlikely. Europe is at much greater risk of a shortage as it imports the majority of its oil, with a large percentage coming from Russia.

The price of gold recently rose from $1,791 per troy ounce on January 28 to $1,920 today, as gold has recaptured interest as a perceived safe-haven asset. We expect gold's price to rise further as investor concern grows around geopolitical and inflation risks. An exchange-traded fund that holds physical gold is an easy way to gain exposure that generally incurs less fees than buying, shipping, and storing the physical coins or bars personally.

Alternatives: What insights do you have into hedge fund exposure, and where you see the big institutional money moving in the markets?

Hedge funds have largely maintained their cautious positioning in light of the geopolitical tensions and inflationary pressures. Long/Short equity managers have increased their short positions. The Equity Long/Short and Macro strategies remain the most active.

Directional Long/Short managers in February rotated into North America and out of Asia amid escalated geopolitical tensions and continued performance challenges. In fact, developed market Asia saw the largest risk unwind since May 2013. From a sector perspective, hedge fund managers were net buyers in February, led by flows into Information Technology, Health Care, Consumer Discretionary, and Materials. The Communication Services and Financials sectors were the only net-sold sectors.

We believe macro strategies remain a bright spot, with indications that trend following and discretionary macro funds should generate mid- to high-single digit returns this year. Most trend following macro models have switched to a short equity position to coincide with long U.S. dollar, short positioning on bond and interest rate futures, and long commodities.

Risks 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. **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. **Floating rate (or leveraged loan) securities** are generally below investment grade quality ("high-yield securities or "junk" bonds) and should be viewed as speculative. Investors should review their ability to assume the risks associated with investments which utilize such securities. **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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Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

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