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An escalation of sanctions and the conflict

Key takeaways

- As the violence in Ukraine intensifies, the U.S. and other countries have added tougher sanctions on Russia.
- The fluid military situation and the new measures against Russia imply that the path for energy prices should remain the key for the economic and market outlook in the coming days and weeks.

What it may mean for investors

- Last week, we wrote that we favor patience, insofar as we never favor jumping in to try to time the bottom of a correction. 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 longer time horizon may consider beginning to dollar-cost average in at these levels, particularly those who find themselves under-allocated to equities.

The situation

Leaders from the United States, Canada, the United Kingdom, and the European Union announced over the weekend a new round of additional financial sanctions against Russia in an attempt to further isolate and deter aggression within Ukraine. German chancellor Olaf Scholz has also agreed to provide Ukraine with military weapons to further support the Ukrainian resistance against Russian invasion.

The escalation of further sanctions is centered on the partial removal of certain Russian banks from the SWIFT messaging system, a system used by banks around the world to move trillions of dollars through the financial system. It is unlikely that this will be a full ban, as efforts are being made to maintain an open channel for energy transactions, which are vital for Western Europe.

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Concurrently, Western leaders are coordinating efforts to target reserves of the Central Bank of Russia to prevent these reserves from being used to undermine and soften the impact of previously imposed sanctions. In addition, Western nations renewed efforts to step up the enforcement of freezing the assets and banning the golden passports of select Russian individuals within Western countries' jurisdictions. In response, Russian President Putin has announced he is putting Russia's nuclear forces on alert, and Western governments, including the U.S, are taking precautions to respond to growing concerns about potential retaliatory cyber-attacks emanating from Russia.

While the partial expulsion from SWIFT and reserve targeting of Russia have been options on the table for the Western allies since the invasion began, the latest move does represent a much more strident and punitive attempt to wall off the Russian economy and individuals from the global financial system. There is precedent for using similar financial isolationist measures against countries like Iran, Venezuela, and North Korea; however, Russia would certainly represent the largest single global economy to have these measures levied against it.

Overnight, the Bank of Russia raised its key policy rate from 9.5% to 20%, the ruble plummeted, and Russian citizens began withdrawing deposits rapidly from Russian banks. International rating agencies placed Russian debt on review, with Standard & Poor's already cutting Russia's credit rating to junk.

Key risks

Beyond the ongoing human tragedy happening within Ukraine today, many geopolitical and economic risks are fluid and still escalating. While not a comprehensive list, we see four primary risks investors should monitor:

1. **Disruptions to oil and gas shipments from Russia:** Clarity on whether the latest round of sanctions will be levied against or exclude Russian oil and gas shipments will be key to determining if commodity price remain stable or spike. For its part, Russia could decide independently to stop shipping oil and gas to parts of Europe as retaliation for the latest sanctions. This is a point President Putin has made in the past — that shutting off access to SWIFT could lead to Russia stopping or scaling back its export of oil and natural gas to Europe.
2. **SWIFT and central bank reserve targeting:** We expect these actions to send reverberations through Moscow and the Russia economy. The Russian ruble will likely fall even further, and these new actions quickly initiated a run on Russian banks, as Russian citizens hurried to pull funds from banks now cut off from the global financial system.
3. **Growth pressure:** The good news is that U.S. economic growth has been accelerating heading into this Ukrainian invasion, and this reduces the near-term risk of a recession or a stagflation shock from this type of an event. Russia's economy unto itself is not large enough to create a global recession, but the transmission mechanism into Europe through higher energy costs, elevated inflation, and new geopolitical risks denting confidence and sentiment bears watching as conditions continue to unfold.
4. **Inflation durability and monetary policy effects:** Stated bluntly, inflation is now running at a rapid pace in many countries, and a number of central banks — including the Federal Reserve and the European Central Bank — have been setting the stage to return monetary policy to a more neutral position. The Russian invasion now complicates this backdrop. Debates will ensue about whether policy action should fight inflation or ensure that growth does not slow precipitously from supply or geopolitical shocks. Recent experience instructs us that central banks have opted to support growth in the face of such shocks; however, when those previous shocks occurred (March 2020, November 2018, and August 2011), they

have had the luxury of stable periods of historically low inflation. During those periods, the probability of an inflation overshoot from extra accommodative policy was low. That is not the case this time around. We should expect central banks to continue on their path to fight inflation by tightening policy — even if the pace may be slowed slightly from the events of the Russian invasion. At a minimum, the invasion will further stoke and elongate inflationary pressures, especially to food and energy prices.

Potential implications for markets and investors

As the circumstances continue to unfold, we expect that investors will be challenged to make sense of volatile markets that are likely to shift with the news cycle. Historically, geopolitical events have created good buying opportunities, such as the Gulf War in 1990, Iraq in 2003, and Crimea in 2014. Most U.S. equity indexes are already in correction territory, down 10% or greater from previous all-time highs. We believe this Russian invasion will ultimately also create a similar buying opportunity.

The tricky question for investors is timing —how much lower could markets move before finding a final low for this correction? The bad news is that we have done a lot of technical damage to charts and previous support lines that won't be easily repaired in the very near term. The good news is that we believe the direct earnings impact for many U.S. companies is somewhat limited; most sectors are insulated from the market consequences of Russia's invasion of Ukraine. Therefore, the risk is not direct exposure, but rather indirect exposure. Slower global demand, higher energy prices, and an acceleration of supply-chain disruptions from Eastern companies may create a headwind for 2022 earnings growth, margins, and multiples. Investors with a long time horizon may consider beginning to dollar-cost average in at these levels, particularly those who find themselves under-allocated to equities. In our view, it is never wise to attempt to time or find absolute bottoms in markets —they are extremely difficult to predict and even harder to execute around.

We believe energy prices will be key in the near term. If major supply disruptions ensue by either Russian choice or because of sanctions, then this could be a difference maker for markets. This is not our base case, but needs to be watched closely. Two important points for awareness are that it does appear that Western leaders are making efforts to ring-fence the energy sector from global sanctions, which could help insulate global markets and economies from an unwanted supply shock. In addition, history teaches us that energy spikes are generally not a good predictor of recessions. Thus far, energy price movements have remained within previous ranges that have not proven problematic for growth. Unless conditions change materially for the worse on the ground in Ukraine, investors should plan for interest rates and the U.S. dollar to continue their upward path. Interestingly, U.S. rates have been very sticky through this crisis. This suggests to us that the trend remains higher and that the strength of the U.S. dollar will be path-dependent on how aggressive the Federal Reserve gets in raising rates, compared to other global central banks, over the rest of this year and next.

We will continue to monitor the conditions closely as geopolitical events unfold. To be clear, we expect the invasion will generate powerful and lasting geopolitical reverberations likely to alter energy policy, particularly in Europe, for years to come. Even as risks and uncertainty have consumed attention globally, markets have weathered the latest storm well with little additional change in existing trends. It is important for investors during times like these to avoid extrapolating worst-case scenario outcomes into rash changes within their portfolios. The situation remains complex and fluid, and we will continue to make every attempt to provide clarity by being simple without being simplistic within our guidance. Stay tuned.

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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.

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