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HOW RUSSIAN SANCTIONS AFFECT PORTFOLIOS AND THE DOLLAR

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A negotiated cease-fire between Russia and Ukraine appears to be unlikely in the near term, which likely will lead to escalated sanctions from Western nations. Bottom line: we believe investor anxieties will remain elevated, with continued market pressures from global growth and inflation.

Western sanctions against Russia are disrupting global supply chains and impairing industries and companies worldwide. In response, some U.S. companies are taking preemptive actions, including self-sanctioning, in anticipation of further sanctions or as precautionary measures.

We believe the U.S. dollar will remain the world’s dominant international currency in the foreseeable future because of its highly liquid financial market, its rule of law, and its transparent regulatory system. Our view is that challenges from other national currencies, gold, and nontraditional assets will remain nothing more than that in the foreseeable future.

Overview of potential future sanctions on Russia

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Escalating measures

Although Turkey has attempted to broker a cease-fire between Ukraine and Russia, a deal to end the fighting in the near term appears remote. As a result, Russian aggression has intensified, while the U.S. and its allies have proposed or announced additional sanctions on Russia. Some recent examples include the following:

- Efforts to expel Russia from the World Trade Organization.
- G-7 countries working to prevent Russia from obtaining financing through the International Monetary Fund and World Bank.
- The United Nations General Assembly voting to suspend Russia from the Human Rights Council, the first country to be kicked off since Libya in 2011.
- The Biden administration banned imports of Russian oil and natural gas, though only 8% of U.S. imports of oil and refined products come from Russia.

Russia's GDP is expected to contract 15% as a result of massive economic sanctions.

The EU is aiming to reduce gas imports from Russia by two-thirds through the end of 2022 and eliminate them by 2030.

The U.S. and its Western allies have been working together to ensure implementation of the sanctions against Russia and maintain unity. However, if and when the harsh measures taken against Russia are eventually removed could be a source of compromise. Secretary of State Antony Blinken recently stated that the standard for lifting sanctions would be an irreversible withdrawal of Russian military forces, while other U.S. politicians have insisted that President Putin leave office. A general consensus is that the chances are low for a compromise on sanctions removal.

The sanctions' impact on Russia to date and potential additional measures are likely to cause serious harm to its economy. Russia's gross domestic product (GDP) is expected to contract 15% in 2022, wiping out 15 years of growth.[1]

Three factors that we believe will drive future sanctions

Looking ahead, there are three key factors that could have a significant influence on the duration and severity of future sanctions against Russia.

1. *Potential war crimes:* The discovery of alleged atrocities in Bucha, a town outside of Kyiv where Russian forces pulled back in recent days, has horrified the world anew. President Biden said Russian President Putin could face a war crimes trial, and the U.S. along with its allies may escalate sanctions.
2. *Energy sanctions:* The European Union (EU) currently relies on Russia for about 40% of its natural gas and 25% of its oil. An outright ban of

1. Institute for International Finance, Bloomberg News, March 24, 2022

Russian petroleum products could cripple the economy of mainland Europe. Nevertheless, the EU is aiming to reduce gas imports from Russia by two-thirds through the end of this year and eliminate them by 2030. EU countries remain divided regarding a total ban of Russian oil and gas, but they are moving toward that eventuality — which would further isolate Russia both politically and economically.

3. *China:* Beijing has refused to condemn Russia's actions in Ukraine, most recently opposing a UN resolution to suspend Russia from the Human Rights Council. China has purchased Russian oil and coal in yuan, effectively helping Moscow obtain a source of foreign exchange in lieu of U.S.-led asset freezes on nearly half of Russia's central bank reserves denominated in dollars.

In response, the Biden administration has cautioned Chinese officials against giving Russia military or economic assistance — a direct warning of potential consequences for Beijing, including a threat of U.S. sanctions. How China navigates its position through the Russia-Ukraine war is likely to be fluid yet could be hugely significant for the success of the Western sanctions and Russia's ability to prosecute the war.

What it means for investors

The chief of NATO recently stated that the war in Ukraine could last several years,[2] while General Mark Milley, chairman of the U.S. Joint Chiefs of Staff, told the Senate Armed Services Committee that the war is "going to be a long slog."[3] The bottom line for investors is that the conflict likely will increase uncertainties and elevate the potential for downward pressure on global growth and upward pressure on inflation.

In this scenario, we favor patience for long-term investors and an emphasis on quality in equity allocations but defensiveness in fixed income for tactical investors. For investors with a long-term horizon, we favor patiently adding incrementally to bring their equity holdings up to long-term target levels. For investors with a tactical horizon of 6 to 18 months, we recently reduced cyclical equity exposure by downgrading Emerging Market Equities and U.S. Small Cap Equities.

By reallocating from these asset classes to U.S. Short Term Taxable Fixed Income and U.S. Intermediate Term Taxable Fixed Income, we favor reducing overall portfolio risk while maintaining our preference for U.S. (over international) equities and for higher-quality equity holdings. In particular, we have a favorable rating on U.S. Mid Cap Equities and a most favorable rating on U.S. Large Cap Equities. Among equity sectors, we favor Health Care, in addition to our most favorable rating on Information Technology. For investors of all horizons, we favor holding a broad-based, long-term target allocation to Commodities as a way to help hedge against potential inflation in the future.

Key takeaways

- We believe that a prolonged war in Ukraine will elevate the potential for protracted inflation pressures.
- The discovery of atrocities in Ukraine means that the U.S. and its Western allies will probably need to keep developing escalatory sanctions against Russia.
- We favor patience for long-term investors and an emphasis on quality in equity allocations but defensiveness in fixed income for tactical investors.

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2. Barron's, April 6, 2022
3. CNN, April 7, 2022

Circumnavigating Russian sanctions

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Sanctions and self-sanctioning

Western sanctions against Russia are disrupting global supply chains and impairing industries and companies worldwide. In response to the restrictions, some U.S. companies are taking preemptive actions, including self-sanctioning, in anticipation of further sanctions (see "Overview of Potential Future Sanctions on Russia" in this report) or as precautionary measures. In fact, several U.S. firms started to pull back from Russia and diversify supply chains following the annexation of Crimea in 2014 to prepare for potential disruptions in the region.[4]

Near term, the sanctions and self-imposed restrictions could lead to higher costs and revenue losses for some industries and profits for others. Longer term, the traditional and renewable energy industries may benefit as embargos on Russian energy imports could sustain higher energy prices and incentivize Western producers to increase production at a measured pace over the coming years, likely beginning in 2023.[5]

Shifting supply chains

The sanctions against Russia are reshaping global flows of raw materials and reconfiguring supply chains. U.S. energy companies are conforming to the ban on Russian oil and natural gas imports. Although the U.S. has no formal sanctions on Russian metal imports, some American companies are boycotting metals purchases from Russia. Certain U.S. airline manufacturers have suspended titanium purchases from Russia, relying on inventories and other sources.

Banks traditionally have been key enforcers of sanctions. Financial institutions are especially sensitive to abiding by sanctions, having paid hefty fines in the past (See Sidebar 2). From lessons learned in Crimea, U.S. banks were prepared for the new sanctions; yet, many are unclear about the specifics and the intricacies of imposing them. Although the U.S. Office of Foreign Assets Control (OFAC), the overseer of sanctions compliance, has published instructions to help companies navigate the directives, the regulations total nearly 14,000 words, with regular updates.

European corporations, including the region's largest steelmaker, are also attempting to cut their dependency on Russia's commodities like iron ore and coal. In response, Russian commodity producers may look to reroute exports of coal from Europe to China. China, in turn, will likely import fewer commodities from Australia.[6] Russian steelmakers are also poised to pivot

Currently, the U.S. is sanctioning over 400 Russian elites, Duma members, and defense companies in coordination with the EU and G7.

Source: WhiteHouse.gov, March 24, 2022

U.S. banks spent roughly $35.2 billion on sanctions compliance and anti-money laundering controls in 2020; that figure will likely increase with the Russian sanctions.

Source: Reuters, February 24, 2022

4. "Boeing Suspends Buying Titanium From Russia, Assures of 'Sufficient Supply,'" CNBC, March 7, 2022
5. See "Sector Insights: Potential Sector-Level Impact of the Russia-Ukraine War," March 11, 2022, for more detail
6. Bloomberg, March 22, 2022

exports away from Europe to emerging markets across Asia, the Middle East, and Latin America. But such shifts may pose challenges, as many of these markets already have domestic or Chinese competitors. Moreover, many global shippers have ceased transporting Russian goods.[7]

Economic and investment implications

Russia, Ukraine, and Belarus are key suppliers of energy and industrial commodities. Energy companies could benefit from higher commodity prices, displaced trade flows, or sanctions that intend to isolate Russia economically. Higher oil prices are favorable in the near term for most subindustries within the Energy sector. We currently hold a neutral rating, meaning that we favor market-weight allocations to the U.S. Energy sector.

The near-term impact on the Industrials and Materials sectors may vary. Some firms, like defense contractors, could benefit from elevated geopolitical risk, while others, like coatings, could see higher input costs. Crude oil and natural gas are significant cost drivers for coatings, industrial gases, and specialty chemicals. We currently hold neutral ratings on both sectors.

Although Ukraine and Russia are not large manufacturers of semiconductor chips, both countries are large manufacturers of gases (including neon and argon) and precious metals that are used by manufacturers of microchips, smartphones, and electric vehicles. We have a favorable rating on the Information Technology sector, where we believe the strength of the balance sheets and sales prospects are stronger positives than the additional expense of rising chip production costs.

As the sanctions persist, tactically, we prefer U.S. large caps with strong balance sheets and taking a defensive stance within bond holdings if rates continue to rise as we expect. In Commodities, we advise remaining fully allocated up to strategic targets. Alternatives, for qualified investors, can potentially help buffer volatility.

Key takeaways

- Western sanctions against Russia are disrupting global supply chains and impairing industries and companies worldwide.
- Due to the sanctions' complexities, some U.S. firms are taking proactive steps, including self-sanctioning, in anticipation of further restrictions or as precautionary measures.
- The sanctions and self-imposed restrictions could lead to higher costs and revenue losses for Industrials and Materials firms and net benefits for Energy companies. For most other sectors, we believe the near-term impacts will largely depend on company-level exposure to Russia and Europe.

7. "How a Russian Steel Giant was Unplugged From the Western Economy," WSJ, March 25, 2022

Dollar dominance on the world stage to continue

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Ode to the dollar: Why we believe it will remain the world's go-to international money

Sanctions against Iran, North Korea, and now Russia seek to punish these governments by limiting their access to U.S. dollars. In turn, penalizing these governments via their dependence on dollars in trade has opened the question of whether many countries may simply stop using the dollar. For the foreseeable future, we believe that no other currency or international asset can replace the U.S. dollar in fulfilling three principal roles of a credible international currency: a) a store of value for accumulated international reserves and financial wealth; b) a medium of exchange; and c) a unit of account or standard to measure the value of goods, services, and international payments.

The U.S. dollar accounts for 59% of total international reserves and is a part of 88% of all foreign exchange transactions.

Source: International Monetary Fund Q3 2021 data

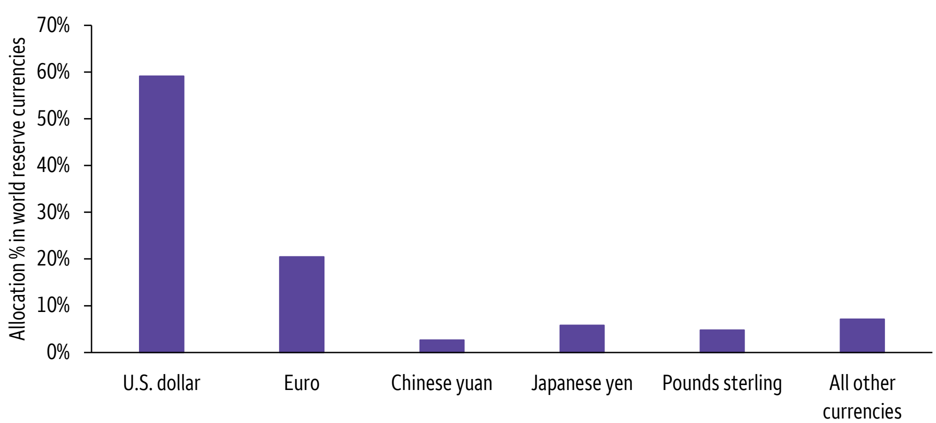
The dollar's enduring dominance in the foreseeable future

The chart below shows the dollar accounted for a majority of global currency reserve holdings in 2021. Even more striking, the dollar is involved in 88% of foreign exchange market trades, according to the Bank for International Settlements. Dollar lending nearly doubled in the decade to 2021, to $13.4 trillion, more than triple the $4.1 trillion equivalent in lending denominated in euros last year.[8] As a result, the $28 trillion U.S. Treasury market is 47% held by foreign investors.[9] In addition, foreign direct investment to the U.S. jumped 114% last year, to $323 billion.[10] Dollar strength cements foreign demand for U.S. assets, underpinning its role as a store of investors' wealth and reserve value.

Foreign investors own 47% of the $28 trillion market for U.S. Treasury securities and a still-sizable 29% and 16% of U.S. corporate bonds and equities, respectively.

Source: USA Spending Data Lab July 2021 data

Chart 1. U.S. dollar dominance in global reserves



Sources: International Monetary Fund and Wells Fargo Investment Institute, data as of Q3 2021

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8. "Foreign Exchange Turnover in April 2019," Bank for International Settlements, September 16, 2019
9. USA Spending Data Lab, data as of July 2021
10. "Global Foreign Direct Investment Rebounded Strongly in 2021, but the Recovery Is Highly Uneven," UNCTAD, January 19, 2022

Alternative currencies face challenges to rival the dollar

Our view is that a recent Saudi decision to accept the Chinese yuan as oil payment won't pose an existential threat to the dollar. The move only touches on its role in payments, not as a store of value or as a unit of account. Likewise, we believe talk of commodities substituting for the dollar and other foreign exchange as a store of value in international reserves overlooks their price volatility, a fundamental weakness in that role. We also see slow progress toward the yuan's rise as an international currency because of government manipulation, a lack of transparency, capital controls, and the yuan's continued peg to the dollar.[11]

Using a basket of currencies also has been floated in years past as a replacement for the dollar. However, the basket would only be as strong as its weakest part. Moreover, these multicurrency systems inherently are less efficient and more costly because of the multiple exchanges often needed between currencies in the basket to execute transactions.

Discussion of a dollar substitute more recently has shifted to global diversification from "inside money" — like the dollar and other national currencies embodying central bank liabilities capable of asset freezes and other financial sanctions — to gold, industrial commodities, cryptocurrencies, and other "outside money" escaping direct central bank control and circumventing sanctions and other restrictions. However, less traditional outside alternatives assets must first overcome concerns about security in exchanges and, more generally, the test of time. Moreover, each of these assets suffer some combination of price volatility, problems of acceptance, and liquidity limiting their use as a store of value and unit of account.

Investment implications

The U.S. currency's secure role as the world's dominant money also permits greater scope for investors wishing to avoid currency risk in investment portfolios. Reducing or eliminating that dimension of risk can allow a greater focus on interest rates, credit quality, and duration (interest-rate sensitivity) in managing fixed-income portfolios, not to mention as company and economic fundamentals affecting corporate profitability in the equity.

Key takeaways

- A rare combination of U.S. economic size, market liquidity, and currency convertibility cements the dollar's position as the dominant global currency.
- Challenges to the dollar's key-currency role have been limited to its functioning as a transactions vehicle, not as a store of asset value in finance or as a measure of value in global transactions.

11. "Commodities on a Path to Replace Currency Reserves, Pozsar Says," Bloomberg, April 1, 2022

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. 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. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of **small and mid-cap company stocks** are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions. **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. **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. **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. 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. **Currency risk** is the risk that foreign currencies will decline in value relative to that of the U.S. dollar. Exchange rate movement between the U.S. dollar and foreign currencies may cause the value of a portfolio's investments to decline. **Alternative investments** are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment.

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