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# MARKET SIGHTLINES

## Russia Tensions and Uncertainty:
### Relevant Data Points

By Michael O'Keeffe, *Chief Investment Officer*


Over the last week, I've been writing this Sight|Lines on the situation in Ukraine, and each time I've begun a draft, the situation has changed dramatically. It's now Thursday as I write this, and overnight Russia invaded Ukraine, with markets initially selling off, but recovering later in the day. We are in a period of increased uncertainty with a wider range of potential outcomes. Investors are grappling with questions that will fuel volatility until the situation becomes clearer. How long will the conflict last? Will Ukrainians and the West fight back? If so, how will Putin retaliate?  What will be the economic impact? Will the Federal Reserve (Fed) change monetary policy?

In this week's Sight|Lines, we share some thoughts and initial analysis of the implications of Russia's invasion of Ukraine.

**Russia Invades Ukraine…and the West Responds**

Following the breakup of the Soviet Union, Ukraine has oscillated between the influences of Russia and the West. A turning point was Russia's 2014 annexation of the Crimean Peninsula, which sparked a rise in public support among Ukrainians for Western alliances such as NATO and the European Union. Russia's President Vladimir Putin has justified this week's invasion by saying that the U.S. and its allies crossed its "red line" by expanding the NATO alliance. The Ukrainian government has declared martial law and called for international support, including harsher sanctions. The U.S. and EU have already imposed some sanctions, but thus far they've been limited in scope and economic impact. European allies and President Biden today promised more "severe sanctions," which will likely deal a larger blow to the Russian economy.

**Russia's Role and Impact in the Global Economy**

Russia's presence in the global economy is somewhat muted. Its GDP totals $1.7 trillion (2021 estimate), representing about 3% of global GDP. Its economy is highly dependent on the export of commodities. It is the world's third-largest producer of oil, the second-largest producer of natural gas, and the largest exporter of wheat.

The conflict has the potential to impact Europe the most out of any region given its proximity to and trade relations with Russia. The impact would be primarly through higher commodity prices, but consumer confidence, business investment, and financial conditions may also be affected.

Russia is Europe's most important provider of oil and gas. Typically, about 25% of the EU's oil imports and 40% of its gas imports are from Russia. Conversely, the EU is the largest destination for Russian goods, with close to 40% of exports going to the EU. This is a double-edged sword as Russia's economy depends to a good degree on

Europe, and in turn Europe depends on Russia's oil and gas. Taken together, the potential impact depends on the intensity of the conflict and the degree to which supplies are restricted.

The U.S. has limited direct exposure to Russia, so any economic impact is expected to be less pronounced. Russia and Ukraine combine for well under 1% of U.S. imports and exports. Revenue exposure of companies in the S&P 500 is about 1%. As with the EU, the conflict may impact the U.S. through higher oil prices, tightening financial conditions, and weakening confidence. The U.S. imports about 7% of its oil from Russia. A sustained rise in energy prices would push inflation higher and potentially weigh on GDP growth, but the U.S. may release oil from the Strategic Petroleum Reserve to stem the rise in prices. Overall, we expect the impact on U.S. GDP growth and inflation to be limited.

### Fed Policy

Historically, the Fed has opted to delay major policy decisions during times of geopolitical uncertainty, but given elevated inflation, traders are pricing in a 0.25% hike in March and six rate hikes for 2022. Of course, rate hikes are designed to slow demand to help reign in inflation, but doing so in a period of geopolitical uncertainty may be problematic. A big risk to the markets is a scenario where sustained higher prices slow consumer spending, financial conditions tighten through market volatility and Fed policy, and businesses postpone investment. This would lead to a slowdown in economic growth and could adversely affect corporate profits.

### Our Outlook

Through the volatility of 2022, we've maintain a modestly positive view looking forward, holding the view that economic growth will continue as we are still in the first half of this economic cycle. The Russian invasion and related uncertainty has added risk to the situation, but at this point we remain positive in the medium-to-longer term. Despite these challenges, we see earnings and economic growth continuing in 2022 as COVID restrictions ease, supply chain issues resolve, and consumer spending remains strong. We see this next stage of the market cycle is usually driven by the quality of earnings rather than multiple expansion. So, we are focusing further on quality in our portfolios.

We do expect volatility to continue given gepolitical risks, pandemic uncertainty, and the unknowns of the upcoming midterms. The Fed is looking to tighten just enough to rein in inflation, and if the situation with Russia settles down, we expect the S&P 500 ending the year higher from here as valuations have been already reset.

### Conclusion

The Ukraine situation is changing rapidly, and we'll be focused on the West's response to the Russian invasion, adjusting our analysis and outlook accordingly. We invite you to join our client webinar on Monday, February 28, 2022 at 2:00 p.m. Eastern time. I will be joined by Brian Gardner, Stifel's Chief Washington Policy Strategist, and Lindsey Piegza Ph.D., Stifel's Chief Economist, to discuss the situation and related implications.

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