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MARKET SIGHT LINES

Russia-Ukraine War and Volatility: Market Crisis…or Resilience?

By Michael O'Keeffe, *Chief Investment Officer*

The S&P 500 is down about 4.8% year to date, and off about 5.4% since its last record on January 4, 2022. Since then, investors have been assessing a number of factors that are driving near-term market performance, including uncertainty surrounding the pandemic, higher inflation, an increasingly more hawkish Federal Reserve (Fed), and geopolitical risks/tensions. On that last point, of course, we've been keenly focused on the tragic war in Ukraine. Russia's invasion one month ago caught most by surprise, and while the loss of life and destruction is in primary focus, we have also had to process how this tragedy impacts the economy and markets here and abroad.

In this week's Sight|Lines, we check in on the market performance of U.S. equities since the start of the war, compare that to some past geopolitical events, and also briefly discuss the implications for other equity markets and asset classes.

First, the Numbers

We expected this year to be volatile given the various balancing acts in play and the wider range of potential outcomes. Through February 18, the S&P 500 had declined 8.6%, and the volatility index (VIX) rose 61% since the start of the year. On February 21, President's Day here in the U.S., President Putin announced Russia's recognition of "the independence of two pro-Russian breakaway regions in eastern Ukraine." Markets traded down on the worry of war, and Russia invaded on February 24, 2022. Following Russia's announcement, the S&P 500 continued to trend lower, hitting a recent low on March 8, 2022, having fallen 4% since Putin's announcement. Since then, however, the market is up about 8.5%, making up all of the losses since Putin's announcement. Despite facing uncertainties like the pandemic, inflation, Fed policy, and conflicts overseas, the U.S. equity market is showing resilience.

History Tells the Story

Figure 2 presents S&P 500 market performance during past military and geopolitical crises. For example, in the 1962 Cuban Missile Crisis, stocks fell 5%, but recovered 21% over the next six months, and 26% over 12 months. Similarly, stocks fell 5% in 1979 after the Soviet Invasion of Afghanistan, but recovered 6% and 36% over the next six and 12 months, respectively. In another non-military geopolitical event, stocks also fell 5% after the Brexit vote in 2016, only to recover 7% in the next six months, and 18% over the next year.

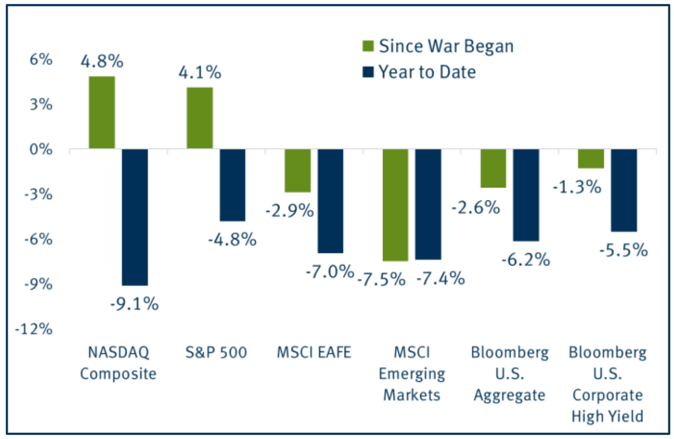
When we look at the averages for numerous historical geopolitical events, the S&P 500 has fallen 4%, on average, and then recovered, on average, 11% over the next six months and 24% over the next year. While past performance does not indicate future results, markets historically tend to recover from these shocks.

Other Market and Asset Class Performance

Figure 1 shows the performance of other equity and fixed income indexes since February 21 and year to date. While all indexes listed are in negative territory year-to-date, the two U.S. equity indexes listed, NASDAQ and the S&P 500, are both positive since the war started. The tech-heavy NASDAQ has weakened year-to-date as a result of the rise in rates and investors reflecting on elevated valuations.

Developed markets (EAFE) have lost ground since Russia took action, showing that many countries, especially in Europe, are more tied to Russia economically. Emerging markets have been led lower by China, as the country is facing rising COVID-19 cases, continued regulatory crackdowns, and the risk of more mainland firms being delisted by U.S. exchanges. Then, finally, we see the bond indexes down over the periods listed, mostly driven by higher rates related to the hawkish shift in Fed policy.

Figure 1. Capital Market Returns



Source: Stifel Investment Strategy, Bloomberg, as of March 24, 2022.

A Look Forward

As we mentioned in last week's SightLines, our base case remains positive on the economy and markets. While we're mindful of what drives volatility, we believe we are still in the first half of this economic cycle. Earnings and economic growth are forecasted to continue into 2022 as COVID-19 restrictions continue to ease, supply chain issues resolve, consumer spending holds up, and war in Ukraine subsides in the future. We see this next stage of the market cycle being driven by the quality of earnings rather than multiple expansion. So, a focus on quality is warranted.

As we navigate this environment, we will be focused on inflation and understanding if and when higher inflation starts to recede. We'll spend time focusing on how much the Fed policy shift will dampen economic growth and earnings, and the corresponding market implications. And, of course, we will continue to assess the situation in Ukraine, looking for signs of resolution or escalation.

Conclusion

As investors, we face many uncertainties during this volatile market. Inflation is running hot, the Fed is becoming more hawkish, the pandemic is lurking, and the midterm elections are approaching. Russia's tragic invasion of Ukraine has added to this uncertainty, and markets reacted. But after one month of war, the U.S. equity market is showing resilience. Our focus is unwavering, and we will share more in the coming weeks.

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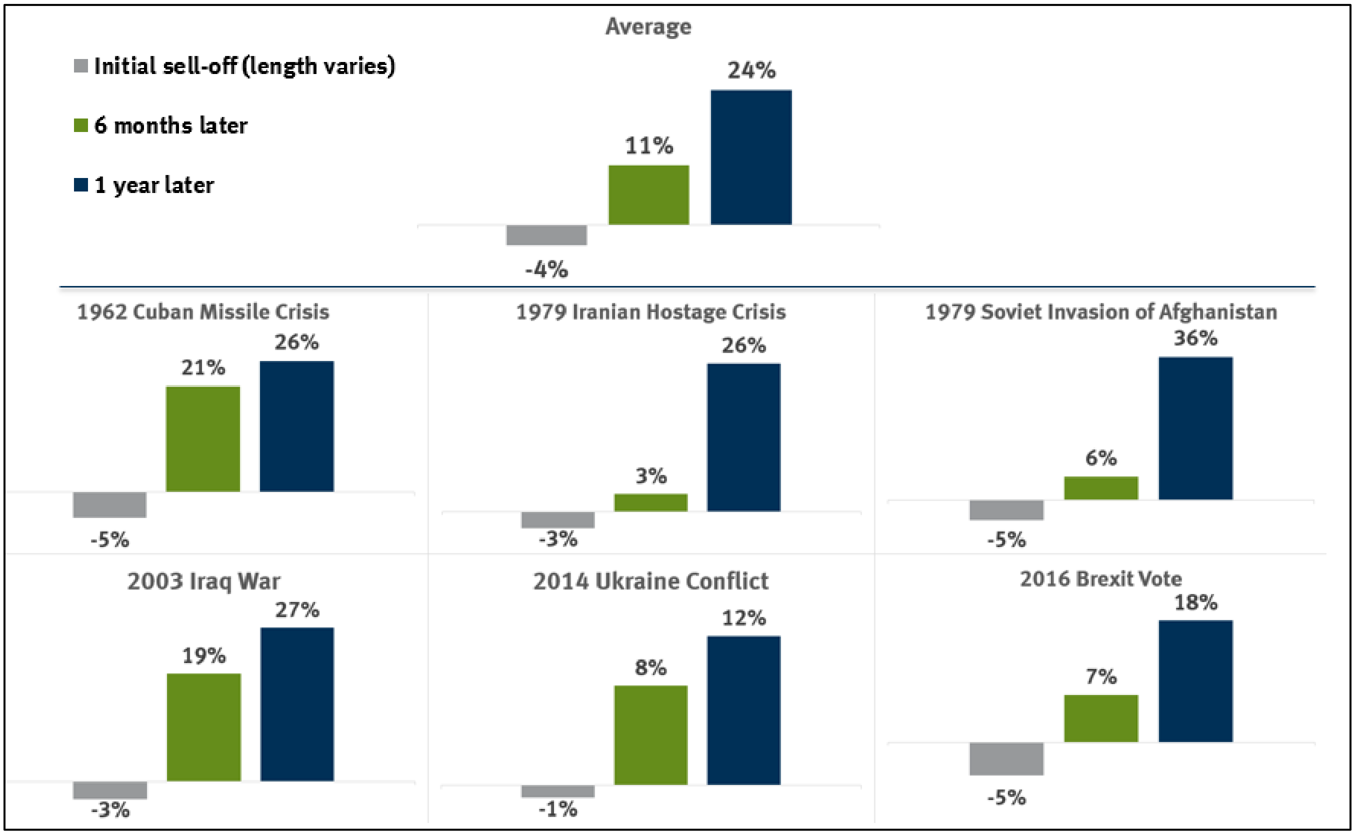
Figure 2. Market Reactions to Geopolitical Events



Source: Vanguard Investments. Returns are based on the S&P 500 Index. All returns are price returns. Past performance does not guarantee future results. Not shown in the above charts, but included in the averages, are the following events: the Suez Crisis, Berlin Wall, assassination of President Kennedy, authorization of military operations in Vietnam, Israeli-Arab Six Day War, Israeli-Arab War/oil-embargo, Shah of Iran's exile, U.S. invasion of Grenada, U.S. bombing of Libya, First Gulf War, President Clinton & President Nixon impeachment proceedings, Kosovo bombings, intervention in Libya, U.S. anti-ISIS intervention in Syria, and Arab Spring (Egypt).