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MARKET SIGHT LINES

Russia’s Invasion of Ukraine: Some Questions and Answers

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Russia invaded Ukraine just over a week ago, and Ukrainian forces are fighting back, with significant loss of life in this regrettable situation. The U.S. and other Western allies have condemned Russia’s actions, responding with severe economic sanctions designed to motivate Russia to stand down. There have been two rounds of cease-fire talks with no immediate progress, and more talks are scheduled. We’ve actively engaged clients and held a Client Webinar this week on the topic.

In this week’s Sight|Lines, we answer some frequently asked questions submitted during the webinar and by clients over the last week.

How did we get to this point?

As mentioned previously, Ukraine has oscillated between the influences of Russia and the West. Despite the overwhelming majority of voters (92.3%) voting for independence from the USSR in 1991, there has been a perpetual power struggle between nationalists in western Ukraine and a culturally Russian population in the east. There are four developments in recent history that eventually led up to the recent crisis: 1) 2008: NATO summit where it was agreed that Ukraine would eventually join NATO. Russia said this was a “huge strategic mistake.” 2) 2013: Ukraine’s President Yanukovuch (pro-Russian) says no to an association agreement with the EU. This leads to months of protests and a pro-Western government. 3) 2014: Russia annexes Crimea, sparking a rise in public support for NATO and the EU. 4) 2021: At a NATO summit, the 2008 decision was reiterated. Following months of troop buildup, Russia invaded Ukraine on February 24, 2022, justifying the action by saying that the U.S. and its allies crossed its “red line” by expanding the NATO alliance.

Why isn’t Ukraine already part of the EU and NATO?

EU and NATO admission requires a unanimous vote by member states. In the past, France, Germany, and the Netherlands have opposed Ukraine’s membership to both. EU leaders have pressed Ukraine’s government to develop anti-corruption and economic reform further before joining the EU. Of course, if and when Ukraine joins NATO, it will benefit from the treaty’s Article 5, which says an attack against one is an attack against all, meaning members will provide support as necessary, including the possibility of armed forces. Theoretically, NATO membership should deter such invasions, but it also heightens the risk for war given Ukraine’s proximity to Russia and swaying relationship between the West and Russia. This is why some have called for Ukraine to remain a “buffer” state between Russia and Western Europe.

Why won’t Europe stop buying gas from Russia or Russia stop selling gas to Europe?

Despite all that has happened, Europe remains highly dependent on Russian oil and gas. About 25% of the EU’s oil imports come from Russia, and 40% of its natural gas. In turn, EU imports contribute meaningfully to Russia’s GDP. So, while the West is imposing sanctions and Russia is looking for ways to push back, the parties will likely maintain this energy relationship. In fact, Russia ceasing gas exports to the EU could be interpreted as a declaration of war. It is also worth noting that the weakened Russia-EU relationship means the EU will look for other energy sources going forward. Over time, Germany has argued that importing natural gas from Russia helps keep the peace through economic interconnectedness.

Oil prices are way up. How will this affect inflation? The economy?

At this (or any one) single moment in time, the price of oil is less relevant to economic growth and inflation, unless the price stays elevated. A sustained rise in energy prices will impact inflation, consumer demand, and economic growth. If oil prices remain elevated, inflation indexes that include energy may rise 0.5% or more. GDP would likely decline modestly, with current estimates in the 0.10%-0.20% range. The U.S. is releasing oil from the Strategic Petroleum Reserve to stem the rise in prices, but it imports about 7% of its oil from Russia.

Do we expect to see a change in Federal Reserve (Fed) policy? Is there an increased risk of stagflation?

In his semiannual testimony before Congress this week, Fed Chair Jerome Powell cleared the air by saying he supports a 0.25% increase at the next Federal Open Market Committee meeting on March 15-16. He signaled the U.S. economy is strong enough to withstand a hike. In the days leading up to his testimony, investors speculated on the next possible action by the Fed given the ongoing war in Ukraine. The Fed has historically opted to delay major policy decisions during times of geopolitical uncertainty. But with Powell's comments, the latest fed funds futures contracts indicate a 99.8% probability of a quarter-point hike, compared to 66.3% a week ago.

Powell cautioned that the economic consequences of the war are "highly uncertain" and that "it's too soon to say" how monetary policy may be affected. The U.S. has limited direct exposure to Russia, so any economic impact should be less pronounced. But if sustained inflation slows consumer spending, financial conditions tighten through market volatility and Fed policy, and businesses postpone investment, we may experience an economic slowdown coupled with higher inflation. We view this stagflation scenario as less likely.

What do you see as possible outcomes, and under what time frame?

Given the highly uncertain nature of the current environment, we've framed out three scenarios to describe possible outcomes: *Bear, Bull, and Middle of the Road*.

The *Bear* scenario is defined by expanded military conflict, with NATO engaging to protect Ukraine. This could be triggered by, or lead to, Russia cutting or eliminating energy exports. Energy prices would climb higher, animal spirits (confidence levels) would plummet, and markets would react negatively. In this scenario, we see a severe recession in Europe and a recession in the U.S. as possible. Russia's global relationships would be strained in this scenario.

The *Bull* scenario presumes an expedited resolution of the crisis. In this case, a cease-fire is negotiated and implemented quickly, followed by a diplomatic agreement and a Russia withdrawal. Such a deal could include meaningful aid for Ukraine from both Russia and the West. In the most optimistic version of this scenario, the global economic recovery continues, with COVID receding and supply chains normalizing.

The *Middle-of-the-Road* scenario takes more time, with the war ending with concessions from Russia, Ukraine, and Western allies. For the U.S., this scenario also means limited economic effects overall, but the U.S. relationship with Russia will be strained further over the long term. The global economic recovery also continues in this scenario, with COVID receding and supply chains normalizing.

How does this situation affect the political climate in the U.S.? Abroad?

The political environment in the U.S. is very much defined by the upcoming midterms, with the Democrats fighting to keep control, and Republicans seeking to take control of at least one chamber of Congress, most likely the House of Representatives. Representatives from both parties have amplified their "tough on Russia" messaging, in some ways competing with each other. This positioning, and the progress to resolution in Ukraine, will enter into the election calculus.

Abroad, we've seen Western allies more united than in years past, and a stronger Germany, with that country moving to build up its military strength due to this crisis.

How are China's geopolitical strategy and global relationships being affected?

China and other countries like North Korea are watching the Western allies' response carefully, noting the strong unity that has developed around a coordinated response. This may make their leaders a little less likely to initiate conflict in their respective regions. But that said, China is providing Russia economic support and this event, and the West's response, is likely strengthening that relationship.

What should an investor do?

We believe we are still in the first half of a new economic cycle, and in our base case scenario, we remain positive in the medium to longer term. Earnings and economic growth are forecasted to continue into 2022 as COVID restrictions ease, supply chain issues resolve, and consumer spending remains strong. However, the 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.

Volatility will remain elevated this year given these geopolitical troubles, the shift in Fed policy, and the unknowns of the midterm elections. While we have entered a correction and may experience multiple periods of weakness during the year, we foresee the S&P 500 ending the year higher from here.

Summary

We're all seeing the tragic effects of Russia's invasion of Ukraine, and the immediate future is highly uncertain, the fog of war. World leaders are highly focused on getting Ukraine through this crisis, and we as individuals, and as investors, are watching for signs of a resolution that Russia, Ukraine, and the West will accept. Going forward, we will continue to assess the risks and related investment ideas that may help.

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