Perspectives: Special Edition

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Inside This Special Edition

After two months of stop-start diplomacy and bad-faith negotiations on the part of the Kremlin, Russia has now launched a full-scale invasion of Ukraine. First and foremost, this is a distressing situation and war is never good. Our hearts and prayers go out to the people of Ukraine.

The resurgence of geopolitical tensions has contributed to global market volatility as market participants try to figure out what lies ahead for the global economy, corporate earnings, and the path of interest rates. While unsettling, market pullbacks are par for the course and certainly not uncommon. In fact, the average intra-year drop (referring to the largest market drops from a market high to market low during the year) has been approximately 14% for the S&P 500 Index over the last 42 calendar years.[1] Remember that the attractive historic returns on stocks include many challenging timeframes, including world wars, recessions and depressions, high inflation, pandemics, terrorist attacks, and corporate scandals.

While accurately predicting geopolitics is an impossible task, the purpose of this newsletter is to articulate our views on the potential impact of the crisis on the global macroeconomic backdrop, global markets, and ultimately your investment portfolio.

For some context, the current crisis can arguably be viewed as part of a long-term strategy to pull Ukraine back within Russia's orbit, representing continuity from the previous incursions in Georgia and Crimea. It is against this backdrop that Russia's actions in Georgia (2008) and Crimea (2014) should be viewed. The decision to undertake swift and limited incursions in Georgia and Ukraine's Donbas region were Russia's way of reasserting its sphere of influence, pushing back on NATO's Bucharest promise and the strengthening of relations between Ukraine and the West. Ukraine's border with the Black Sea – most notably on the Crimean peninsula – provides unique access to both Europe as well as the Middle East. Control of the Crimean peninsula and Black Sea area has also been critical throughout military history.[2] The West has responded swiftly and in unison with sanctions on Russia. We expect Russian President Vladimir Putin to test the resolve of the West to see if they stand together.

The situation in Ukraine is likely to get worse before it gets better, implying that investors should expect further volatility in risk assets in the near term. What matters most, we believe, is the duration and escalation of the conflict. The fear is that Putin will use this incursion to provoke a wider military conflict and seize all of Ukraine.

Recent history can help to identify military escalation scenarios that we judge to be more probable. The 2014 annexation of Crimea offers one ‘model’ that Putin may prefer; this would limit the geographic scope of any conflict, and rely on local separatists to do much of the fighting, limiting the number of Russian casualties. Meanwhile, the swift five-day partial invasion of Georgia in 2008 suggests that Putin may be reluctant to become embroiled in a prolonged formal conflict against local guerrillas and occupy large cities. Moreover, Putin’s decision to order troops to cross the border may be just a very credible military threat designed to extract greater concessions from Ukraine and the West in future negotiations. In all likelihood, Russia will not withdraw troops until it has changed the government and seized key territories.

The direct effect on global GDP is likely to be small because both countries together account for around 2% of global (market-based) GDP and trade exports. In contrast, spillovers via commodity markets (Russia produces 11% and 17% of global oil and gas, respectively) and financial conditions could be somewhat larger. Europe imports about 40%–50% of its natural gas from Russia, with Germany falling on the higher end of that range.

One consequence of higher commodity prices would be unwelcome upwards pressure on inflation. Much would depend on the pass-through to retail prices and any fiscal responses. This could act as a drag on consumers’ disposable income and ultimately earnings could take a hit. However, to counterbalance the rising prices, we expect announcements of scaled up oil production from Saudi Arabia, Kuwait, UAE, Netherlands, and Norway; a collective release from the Strategic Petroleum Reserves of major energy-consuming countries; increased natural gas exports from the U.S. to Europe; and possibly a nuclear deal between the U.S. and Iran, which would free up about 1 million barrels per day of production. However the current crisis ends, it is likely to hasten decoupling between Russia and the U.S., and pressure the EU to reduce its energy dependence and cooperation with Moscow.

With that being said, markets tend to care more about economic crisis than war in the long-run. Geopolitical events have rarely left a deep scar on markets. The average equity market sell-off going back to the Israeli Arab War / Oil Embargo (1973) has been around -6.5%, and the average recovery takes about 137 days ***(see the appendix)***. The Vietnam War, Gulf War, Afghanistan War, Iraq War and Crimean Crisis all saw equities move down in the immediate aftermath of the conflicts’ beginning. But then markets moved higher in six months, with cyclicals often leading the charge. Will this time be any different? Who knows? History, as Mr. Twain informed us, may not repeat, but it rhymes.

Overall, we are not concerned about recession risks based on our base case scenario unfolding and given the strength of the macro-fundamental backdrop, but we also recognize that uncertainty has risen considerably, and with that comes a wider range of potential outcomes. There is no cause for alarm, and we believe the best course of action is to stay on the path we are on.

What will we do now? Importantly, we hold a well-diversified portfolio across different sectors, countries, regions, and currencies, recognizing that while some part of the portfolio could be impacted negatively, others are positioned to do well. We will continue monitoring the global economic situation and keep you informed of our observations and insights. We will continue to look for strategic opportunities to rebalance portfolios (which will probably mean selling bonds and buying stocks at lower prices) and harvest losses for tax purposes.

Thank you for your continued trust and support.

Your BFSG Team,

Patrick Powers, Michael Allbee, Paul Horn, Kyle Nixon, Laura Pistoresi, and Crystal Kessler.

P.S. Please join us in welcoming Crystal Kessler, CFP® to Benefit Financial Services Group. Crystal joins BFSG as a Wealth Manager / Financial Planner. She will be working with you to help you realize your short and long-term goals by delivering personalized financial plans and retirement analysis. Previously, she worked as a Wealth Advisor for a Registered Investment Advisor in San Diego, CA. She graduated with a Bachelor’s Degree in Economics from California State University, San Marcos and is a CERTIFIED FINANCIAL PLANNER™ professional. We are looking forward to the positive impact she is going to make at BFSG and for our clients.

Appendix:

Event	Start of sell off	Duration of sell off (trading days)	Duration to recover to prior level (trading days)	Size of sell off (%)
Israel Arab war / oil embargo	29 Oct 1973	27	1475	-17.1
Shah of Iran exiled	26 Jan 1979	9	34	-4.6
Iranian hostage crisis	5 Oct 1979	24	51	-10.2
Soviet invasion of Afghanistan	17 Dec 1979	12	6	-3.8
Libya bombing	21 Apr 1986	20	7	-4.9
First Gulf War	1 Jan 1991	6	8	-5.7
Kosovo bombing	18 Mar 1999	4	9	-4.1
9/11 attacks	10 Sep 2001	6	15	-11.6
Iraq war	21 Mar 2003	7	16	-5.3
Arab spring (Egypt)	27 Jan 2011	2	3	-1.8
Ukraine conflict	7 Mar 2014	6	13	-2.0
Intervention in Syria	18 Sep 2014	21	12	-7.4
Average	**1973-2014**	**12**	**137**	**-6.5**

Source: Deutsche Bank, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 21 February 2022.

Quoted Sources:

1. Source: FactSet; data S&P 500 Index price return for calendar years 1980 to 2021.
2. In 1793, Russia stumbled upon Sevastopol, one of Crimea's most strategic ports. This formed the base for the Soviet's formidable Black Sea Fleet.

Additional Content Sources:

1. BCA Research, "Russia Takes Ukraine: What Next?", 2/24/22.
2. Abrdn Research Institute, "Mapping the next steps in the Russia-Ukraine crisis", 2/23/22.
3. Natixis Investment Managers Solutions, "Market Impact of Putin's Power Play", 2/23/22 by Jack Janasiewicz, CFA®, Portfolio Manager, and Garrett Melson, CFA®, Portfolio Strategist.
4. Fidelity, Geopolitical Update with David Bridges, Senior Geopolitical and Security Analyst, 2/24/22.

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