An Update on the Geopolitical Crisis in Ukraine

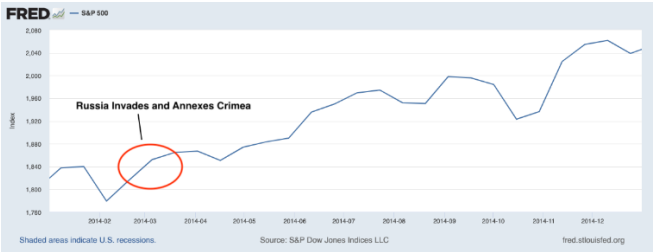
Over the past week, Russia rejected Ukrainian sovereignty, formally recognized the separatist regions of Luhansk and Donetsk, sent troops there, and then a day later invaded the entire country. Russian aggression and the declaration of war signals a rupture to the post-Cold War political order in Eastern Europe, and it could have devastating effects on Ukrainian civilians and the Ukrainian and Russian economies.[1]

But the war itself is not surprising. For weeks, the U.S. government has been warning that a Russian invasion was imminent, and it finally arrived this week. Markets have been pricing in this possibility for some time.

Market volatility leading up to this moment has been normal from a historical perspective—geopolitical crises and regional conflicts tend to hurt sentiment, create short-term uncertainty, and drive volatility. Looking back at 54 crisis events since 1907, the Dow Jones Industrial Average has fallen an average of -7.1% during the crisis period, according to global investment research firm Ned Davis Research.

But stocks also tend to bounce back once the actual fighting breaks out. The same research from Ned Davis shows that the Dow gained an average of +9.7% in the six months following a crisis. Similarly, data compiled by BMO shows that the S&P 500 has averaged an +8% return in the 12-months after a geopolitical conflict commences. The fact that stocks rallied on the day of the Russian invasion is not that surprising.

We also know that looking back at conflicts since 1925 (when reliable S&P 500 data became available)—the Korean War, Vietnam, the Cuban Missile Crisis, the Iran/Iraq War, two U.S. wars in Iraq, the list goes on and on—*it was only World War II that resulted in a bear market*. Some readers may even recall that when Russia invaded and annexed Crimea in 2014, the S&P 500 continued to move higher, and did so for years:



Source: Federal Reserve Bank of St. Louis[2]

The point here is not that armed conflict is bullish. The point is that *uncertainty* leading up to a conflict is what tends to weigh on markets. Once the conflict is averted or fighting breaks out, the uncertainty fades and markets can start to price in the effects on corporate earnings, financial markets, and global economic growth.

In this case, Ukraine's GDP makes up just 0.2% of the world's total, and the country's investable market is comprised of just two companies. This war is likely to be devastating in many ways, but the bottom line is that Ukraine – and the other former Soviet states that could get drawn into the conflict from here – are simply not big enough to cause a ripple in the global economy.

Russia is of course a different story. The Russian economy makes up just 2% of global GDP, but the country is the world's third-largest oil producer (the United States is the largest, followed by Saudi Arabia), and it is the world's largest exporter of natural gas. Russia is also a major producer of wheat, aluminum, nickel, and other metals. During a time when oil, gas, and metals markets are experiencing tight supplies and firm demand, disruptions to Russian output could drive up prices and particularly impact countries that rely heavily on Russian exports.

The United States is not one of them. Russia and Ukraine combined makeup far less than 1% of total U.S. imports and exports, and Russia's status as a major natural gas exporter does not affect the U.S., given the U.S. is also a net exporter of natural gas. In an optimistic scenario, reduced oil and gas flows from Russia could ultimately present an opportunity for U.S. oil and natural gas producers to extract and export more, becoming an even more influential player in global commodities markets.

Regardless, additional near-term pressure on oil prices appears likely, but the effect on the global economy and markets may not be as drastic as many people fear. An analysis from Goldman Sachs finds that a $10 per barrel increase in the price of oil would boost U.S. headline inflation by 0.20% while lowering GDP growth by just 0.1%. It is also worth remembering that oil prices (chart below) remained firmly above $100 a barrel from the beginning of 2011 through the summer of 2014, during which time the U.S. economy grew and the stock market went up by over +50%. Higher oil prices do not necessarily mean economic recession or weak markets.

Source: Federal Reserve Bank of St. Louis[3]

The European Union is more exposed as a result of this conflict. Russia supplies some 40% of Europe's gas, and the EU also relies heavily on other commodity exports from Russia (see table).

T1: RU exports	Nickel	Nat. Gas	Wheat	Crude oil	Coal	Platinum	Lumber	Aluminum
% world trade	22%	20%	18%	17%	16%	12%	12%	10%
Top destinations	EU	EU	EG	EU	EU	EU	CN	EU
	CH	JP	TR	TR	CN	US	EU	TR
	BY	KR	BD	JP	KR	JP	UZ	JP
	UA	CN	AZ	KR	JP	HK	JP	KR

Source: Numera Analytics

Vladimir Putin has stated that gas and other commodity exports will continue to flow, but the realities of war may ultimately affect supply in the coming months. We believe it makes sense to remain overweight U.S. equities.

All of these factors are important when weighing the outlook for global economic growth. But a recession requires trillions of dollars' worth of damage to the global economy, which Russia and Ukraine are simply not capable of delivering. After all, S&P 500 companies have only a very small fraction of 1% of revenue and profit exposure to Russia and Ukraine *combined*.

Western countries have been united in condemning Russian aggression, and the U.S., U.K., Australia, Japan, and the European Union have all already issued a 'first tranche' of sanctions. Notably, Germany has halted the approval process for the Nord Stream 2 gas pipeline to become operational, in a largely unexpected move. More severe sanctions are planned from here.

Market volatility is likely to continue as the conflict escalates and sanctions (and economic retaliation from Russia) come into view. News coverage will be constant and fearful headlines will flood the internet and perhaps your phone and your inbox. Investors should brace for this outcome now, and try to remember that the desire to react to the crisis is almost always counterproductive and costly.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. February 22, 2022. https://www.wsj.com/articles/oil-prices-approach-100-on-threat-of-ukraine-war-11645528112?mod=article_inline

[2] Fred Economic Data. February 24, 2022. https://fred.stlouisfed.org/series/SP500#0

[3] Fred Economic Data. February 22, 2022. https://fred.stlouisfed.org/series/DCOILBRENTEU

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **The conflict in Ukraine and its impact on market volatility**
- **Removing accommodations and stimulus from the U.S. economy**
- **Home-price growth new record**

Market Volatility Rises as Geopolitical Conflict in Ukraine Escalates

Global stocks continue on a volatile streak, as Russia has officially begun an invasion of Ukraine. The S&P 500 officially entered correction territory. Western countries have been united in condemning Russian aggression, and the U.S., U.K., Australia, Japan, and the European Union have all issued a 'first tranche' of sanctions. Notably, Germany has halted the approval process for the Nord Stream 2 gas pipeline to become operational, in a largely unexpected move given Germany's noncommittal stance established previously. As the situation unfolds in the coming days and weeks, volatility may continue at elevated levels – but that's not the same as saying a bear market is in the offing. Stocks are likely to feel the impact from the hit to sentiment and fluctuations in oil, natural gas, and agricultural prices. Market volatility has also historically accompanied regional conflicts in the short term. However, it is also important to remember that throughout history, there have been many regional conflicts, including when Russia annexed Crimea in 2014 (stocks moved higher that year). Volatility tends to accompany these geopolitical flare-ups, but to date, none have led to a global economic recession and bear market – with the exception of World War II. Given Ukraine is not a member of NATO, the West's involvement is likely to stay limited to economic sanctions targeted at Russia – keeping the conflict regional in nature, not global.[1]

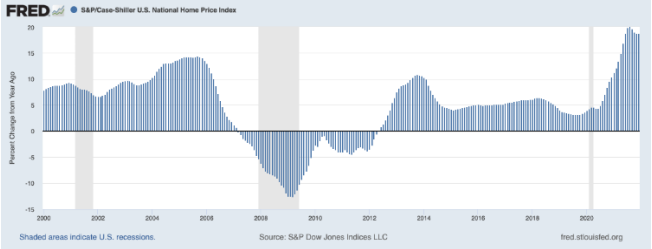
Removing Accommodation and Stimulus from the U.S. Economy

The Federal Reserve's plan to tighten monetary policy by raising interest rates, ending QE, and trimming its balance sheet gets all the attention. But there is also fiscal stimulus being removed from the economy by the federal government, a drag that could take shape in 2022. Much of the $3.6 trillion in federal spending enacted in response to the Covid-19 pandemic has run its course, and by some estimates was responsible for boosting GDP by 6%. Because that spending is returning to normal levels in 2022, the boost from fiscal spending is estimated to fall to 2%. Though this marks a clear hit to fiscal spending's contribution to GDP growth, it should be noted that the overall contribution is still positive. In other words, it's still stimulus, just not as much.[2]

The Results are in: 2021 Set a New Record for Home-Price Growth

We have written quite a bit in this space about the surge in U.S. home prices over the last year, as the pandemic and the onset of remote and 'hybrid' work nudged many white-collar workers away from cities and into suburbs (particularly millennials, who are often first-time homebuyers). The flood of new demand, which was supported by historically low mortgage rates, was met by historically low inventories – pushing up prices in the process. These factors all worked together to push U.S.

home price growth to a record in 2021. The CoreLogic Case-Shiller National Home Price Index soared 18.8% in the 12-months ending in December 2021, the highest year-over-year increase since 1987.[3]



Source: Federal Reserve Bank of St. Louis[4]

Total home sales climbed to a 15-year high, matched only by the housing boom fueled by subprime loans. There are signs the housing market will remain strong for the foreseeable future – demographics suggest many new homebuyers will enter the markets in the coming years and the backlog of homes awaiting construction are at their highest levels since 1999.

ZACKS INVESTMENT MANAGEMENT, INC.
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1 Wall Street Journal. February 23, 2022. https://www.wsj.com/articles/global-stocks-markets-dow-update-02-23-2022-11645605416

[2] Wall Street Journal. February 20, 2022. https://www.wsj.com/articles/fiscal-stimulus-is-turning-into-a-fiscal-drag-in-a-big-headwind-for-growth-11645369202

[3] Wall Street Journal. February 22, 2022. https://www.wsj.com/articles/home-price-growth-hit-record-in-2021-11645538484?mod=djemRTE_h

[4] Fred Economic Data. February 22, 2022. https://fred.stlouisfed.org/series/CSUSHPISA#0

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