



# Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY

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## Will Sanctions on Russia Trigger a Bear Market?

Stock market volatility continues to intensify as Russia invades Ukraine. Oil markets, in particular, are feeling the crunch, with the price per barrel of Brent crude topping levels last seen in 2008. In the week ending March 5 alone, crude oil prices rose by 25% and have shown little signs of abating. Other commodities markets are also feeling an impact – grain prices recently hit a 14-year high, and aluminum prices have been on the rise. Russia is a key producer of all three.<sup>1</sup>

The pressure being felt in commodities markets, combined with wall-to-wall coverage of the war, is no doubt weighing on investor sentiment and driving volatility inequities. Investors should brace for continued volatility in the coming weeks.

Bracing for volatility is largely a mental exercise, however, and is not the same thing as preparing your portfolio for a prolonged market downturn triggered by a global recession (neither of which I think is likely today). The United States economy is stronger today than most appreciate – consumer spending remains elevated, the labor market continues to add far more jobs than anticipated, and activity in the

services and manufacturing sectors continues briskly in expansion mode. I do not think the war in Ukraine or higher oil prices will derail this expansion.

Even still, I understand many investors wonder if the current Russia situation is different. Is there a point where Russian escalation and spiraling energy prices could turn the market bearish?

I have established in this space before that Russia's economy and financial system are not interconnected and big enough to cause a global financial contagion, in my view. Russia makes up around 2% of the global economy, and its trade with the U.S. amounts to less than 1% of all of our imports and exports. Foreign exposure to Russian debt is also tiny – as of the end of 2021, about \$20 billion of Russian debt was held by foreigners (largely in dollars and euros), and about \$40 billion was denominated in rubles. Compared to the trillions of dollars that trade *on a daily basis* in global sovereign debt markets, this foreign exposure to Russian debt is simply not meaningful. The risk of a global financial shock is extremely low, in my view.

The risk in the energy markets is different. Russian exports of crude and refined products accounted for about 7.5% of total global supply before the war, and a critical reality of the current energy market is that oil supplies are very tight. Removing a significant amount of Russian oil from global supply would drive already high prices even higher, which could ultimately impact consumer spending and economic growth.

My take on the issue is that Western sanctions on Russian oil are certainly not a bullish outcome, but they are also not automatically bearish. Oil markets are global, meaning that a decline in Russian supply could be addressed by shifting flows of oil from other parts of the world. Europe could buy more crude from the North Sea, Africa, and the Middle East, and the United States could ramp up production domestically (an activity that is already underway). The Russian flagship oil, known as Urals, is similar in makeup to the Arab Medium produced in Saudi Arabia and also the oil that flows from Iraq. Those countries could increase production to take advantage of higher prices and newfound demand.

To be fair though, shifting around oil supplies is a complex undertaking, requires more production from non-Russian countries, and will take time – all factors that would likely mean short-term pain if Europe follows the U.S. in enacting export controls on Russian oil. I think some of last week's market's bumpiness was tied to the uncertainty over what the U.S. and Europe would ultimately decide. Once the U.S. removed the uncertainty by making a decision, crude prices fell and the market rallied. At this stage, Europe appears to be balking at a Russian energy ban, but this will be a factor to watch closely.

The other big risk I see today is the risk of the conflict shifting from regional to global. Russia has already taken the very brazen and hostile action of invading Ukraine unprovoked, and the desire to be seen as victorious – coupled with

economic desperation – could cause Russia to escalate even further. The outcome is impossible to predict, but in my view, as long as a global conflict is avoided, a U.S. and global recession will be avoided too.

### **The Bottom Line for Investors**

It is truly disheartening to follow the developments in Ukraine as this conflict unfolds. But investors need to find a way to set emotions aside when it comes to making investment decisions in the current environment. If your investment portfolio is well-diversified and allocated in line with your long-term goals, the appropriate response right now is to do nothing, in my view.

I know that's hard. Watching coverage of the war and witnessing volatility in the markets can give all investors the urge to 'do something,' i.e., to make adjustments to your asset allocation in response to the uncertainty. But this urge will lead to errors. In the short run, the market's ups and downs are normal and natural, even when there is a geopolitical conflict driving them. In the long run, enduring this volatility is the price investors pay for equity-like returns. It's the cost of doing business.

#### **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.

<sup>1</sup> Wall Street Journal. March 6, 2022. [https://www.wsj.com/articles/how-wars-costs-reach-far-shore-to-american-farms-supermarkets-retailers-11646597823?mod=djemRTE\\_h](https://www.wsj.com/articles/how-wars-costs-reach-far-shore-to-american-farms-supermarkets-retailers-11646597823?mod=djemRTE_h)

# Weekly Market Update

Important Market News We Think Worth Considering

## IN FOCUS THIS WEEK

- U.S. import bans on Russia
- Russian ban and its impact on gas prices
- Wheat and nickel feeling price pressures
- Is a Russian debt default bad news for markets?

### U.S. Bans Imports of Russian Energy Sources

President Biden announced this week that the U.S. will immediately prohibit imports of Russian energy sources, including oil, liquified natural gas, coal, and other petroleum products. The U.S. is also barring new investment in Russia's energy sector and cutting off American financing for foreign companies that invest in the sector. The bold move coincided with a private sector exodus from the Russian energy market, with major players like BP, Shell, and Exxon all heading for the exits. These large-cap Western oil companies had all spent decades investing and establishing positions in Russia's sizable energy market, but in less than 60 hours last week, BP said it would divest its 20%<sup>1</sup> stake in Rosneft (the Russian state-controlled oil company), Shell announced an end to its involvement in the now-halted Nord Stream 2 pipeline, and Exxon said it would shut down production of a major oil and gas project in Russia's Far East. Russia accounts for about 8% of total U.S. oil imports, so the near-term impact will be significant but likely not crippling.<sup>2</sup>

### What Will Happen to Gas Prices as a Result of the Ban?

In all likelihood, U.S. gas prices will be pressured higher in the short-term. Energy markets were already tight before the ban went into effect, as strong global demand continues to bump up against constrained supply that is yet to fully recover from pandemic-induced production slowdown. Gas prices were pushed higher as traders, shippers, and banks have turned away from the Russian oil trade, and the ban appears likely to exacerbate these near-term pressures. Last week, the average price for a gallon of regular unleaded gas in the U.S. hit \$4.17 a gallon, breaking a previous record for high gas prices set in July 2008. It remains to be seen if high gas prices cause a shift in consumer behavior, which is poised to see a shift from spending on goods to spending on services. In our view, however, U.S. consumers are in a strong relative position to absorb higher prices at the pump – household net worth is at an all-time high, jobs are widely available across the economy, and wages have been rising alongside inflation.<sup>3</sup>

### Wheat and Nickel are Two Other Commodities Feeling Acute Pressure from the Invasion

Rising crude oil prices have been all over the headlines lately, but there are other key commodities feeling price pressures as a result of the war – namely, wheat, aluminum, and nickel. Ukraine and Russia together account for 30% of the world's wheat exports, and the war has caused not only production disruptions but also issues with shipping in the Black Sea. Reports this week showed that some 200 ships are stranded at Ukrainian ports, many of which would be carrying wheat and corn out to export

markets. Russia is also a major supplier of aluminum used in soda cans, aircraft, and building construction, and the country accounts for ~6% of the world's nickel supply and 17% of 'high-purity' nickel production, the kind currently used in electric-vehicle batteries. Nickel prices nearly doubled last week alone, as supply disruptions put upward pressure on prices and ultimately led to a short squeeze, where traders who had previously bet on price declines had to buy back nickel forward contracts to cover.<sup>4</sup>

### **Is a Russian Debt Default Bad News for Markets?**

The Russian government appears poised to default on some of their sovereign debt payments due later this month, a likelihood that has arguably led ratings agencies to cut Russia's credit ratings further into junk territory. Russia has rubles available in its reserves to make the coupon payments on debt, so part of the default stems from being cut off from payment systems that would enable the country to meet debt obligations. Much of this debt has already lost severe value in the past couple of weeks, given the ruble's sharp depreciation on the dollar. While an outright default sounds worrisome for the capital markets, it is not so severe when considering the overall size of Russia's sovereign debt held by foreigners – which amounted to about \$60 billion total. By comparison, the U.S. Treasury plans to auction close to \$50 billion in new debt *in the next month alone*. A Russian default will not lead to any type of financial contagion, in our view – the numbers are too small.<sup>5</sup>

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<sup>1</sup> The Wall Street Journal, March 8, 2022. <https://www.wsj.com/articles/u-s-planning-to-ban-russian-oil-imports-11646746787>

<sup>2</sup> The Wall Street Journal, March 7, 2022. <https://www.wsj.com/articles/oil-company-bp-shell-exxon-russia-ukraine-11646620145>

<sup>3</sup> The Wall Street Journal, March 8, 2022. <https://www.wsj.com/articles/u-s-planning-to-ban-russian-oil-imports-11646746787>

<sup>4</sup> The Wall Street Journal, March 8, 2022. <https://www.wsj.com/articles/ukraine-war-ships-stranded-sailors-global-supply-chain-11646754357>

<sup>5</sup> The Wall Street Journal, March 8, 2022. <https://www.wsj.com/livecoverage/russia-ukraine-latest-news-2022-03-08/card/fitch-sees-imminent-russian-default-as-it-downgrades-again-YlyD4VdcSKi7dCdYkdDu>

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