

On The Mark

Russia-Ukraine War: The Crude Awakening

March 2022

- The Russia-Ukraine war has led to higher market volatility. However, the cost of an extended war and severe sanctions are likely to choke Russia's small economy.
- Despite a small economy, Russia has a significant contribution to global commodities, which could add to higher inflation. While this creates a quandary of competing forces of high inflation and a potential slowdown in growth from higher costs, the Federal Reserve (Fed) is likely to remain focused on inflation and begin raising interest rates.
- Historically, geopolitical events have been a humanitarian disaster, but have had a short-lived effect on markets.

The Russia-Ukraine war is a humanitarian disaster. While this latest insight focuses on the impact of the war on global economies and markets, in hopes for a resolution to this humanitarian crisis, be reminded of this quote by Franklin Delano Roosevelt: "More than an end to war, we want an end to the beginnings of all war".

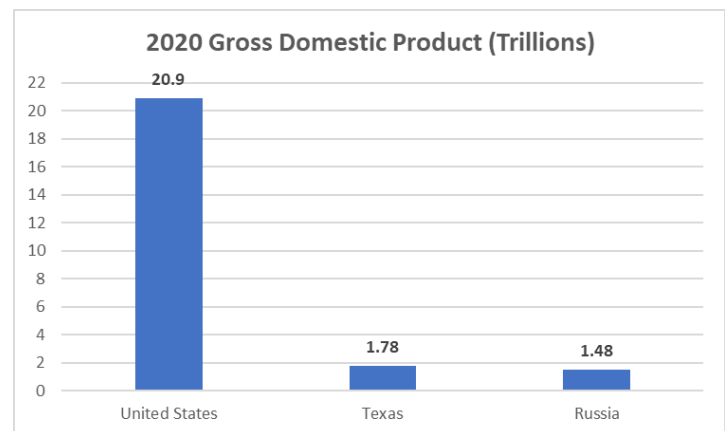
The Russian invasion of Ukraine has added to volatility in global markets in 2022. This latest volatility has led stocks to fall, while traditional safe havens like Treasuries and gold are rising. Oil prices have also spiked above \$100 for the first time in seven years¹. While this situation is highly fluid and subject to change, here are some considerations for investors to navigate the latest market uncertainty.

Russia's economy is small, and sanctions will further choke its economy

Russia's presence as a large geopolitical nuclear armed power stands in contrast to the small size of its economy. Measured by gross domestic product, the most common yardstick for measuring a country's economic size, Russia pales in comparison to the US and the Eurozone. As of 2020, Russia's GDP stood at \$1.48 trillion, in comparison

to \$1.78 trillion for the state of Texas² and \$20.9 trillion for the US economy³.

US exports to Russia total \$6 billion, which is materially insignificant given the size of the US economy⁴. In addition, with the latest economic sanctions, the Russian currency is in a freefall, and its debt downgraded to junk status, the Russian economy will be further choked⁵.



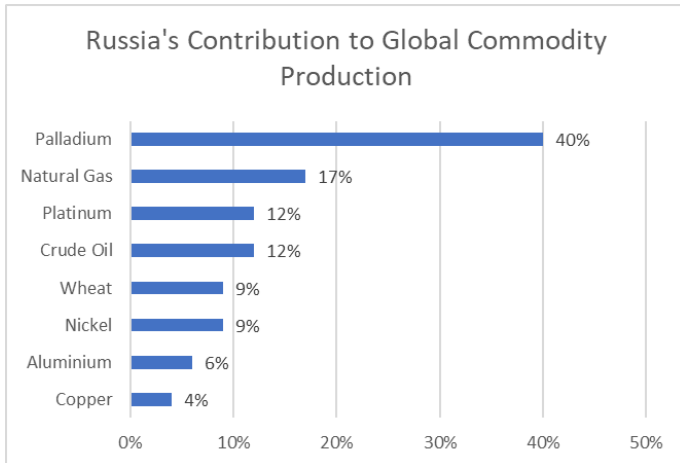
Source: World Bank, FRED

Similarly, within the stock markets, as of February 28, 2022, Russian equities represented 1.6% of the market cap weight of the emerging market index and 0.19% of the market cap weight of the global equity index⁶. Russian equities have also been in a freefall, leading the stock exchange in the country to close since last week. Further, many of the majority equity index providers have indicated they plan to remove Russian listings from key indexes next week⁷, a further blow to its economy.

Energy price spike adds to inflation pressure

Even though Russia's economic profile is small, it does significantly contribute to global commodity production. Within the energy complex, Russia supplies 17% of natural gas and 12% of crude oil⁸. This puts Russia as the world's third-largest producer of oil and second-largest producer of natural gas.

Russia also has meaningful contributions in various other commodities as shown below. As Russia's supply of these various commodities becomes constrained, this will continue to put pressure on supply chains, adding further to inflationary pressures and a drag on global growth. The threat to Europe's economy is far greater given its proximity to the region and its greater reliance on Russian energy. The bottom line is increased inflationary pressure could lead to more volatility.



Source: JPMorgan Asset Management. Should I worry about Russia/Ukraine tensions impacting markets?

Higher inflation and increased market volatility put the Fed in a bind. The Fed may hike faster than expected due to increased inflationary pressure, or it could hold off if the potential rising costs of energy slows the economy. With US inflation hitting a 40-year high and a war-related energy spike, Fed officials are limited in their options and will likely continue with interest rate hike moves at the upcoming March meeting and remain consistent with prior messaging.

Geopolitical impacts on markets are not new

The Russia-Ukraine war undoubtedly complicates the near-term market outlook. That said, history shows that geopolitical crises tend to have short-lived market impacts unless they lead to a recession. A study of historical geopolitical events shows the S&P 500 was higher 12 months later in nine of the 12 events⁹. The three instances where stocks were down a year later coincided with a recession. Today, an extended conflict increases the likelihood of a slowdown in the US economy, but the risk of a U.S. recession remains low. Cash balances for consumers and businesses remain robust and, the job market continues to remain resilient¹⁰.

Date	Select geopolitical/military events	1-month later	3-months later	6-months later	12-months later
12/7/1941	Pearl Harbor	-3.4%	-12.7%	-9.1%	0.4%
10/31/1956	Suez Canal crisis	-2.8%	-3.8%	-0.1%	-11.5%
10/20/1962	Cuban missile crisis	8.7%	17.7%	25.1%	32.0%
10/17/1973	Arab oil embargo	-7.0%	-13.2%	-14.4%	-36.2%
11/3/1979	Iranian hostage crisis	4.2%	11.6%	3.8%	24.3%
12/25/1979	U.S.S.R. in Afghanistan	5.6%	-7.9%	6.9%	25.7%
8/3/1990	Iraq invades Kuwait	-8.2%	-13.5%	-2.1%	10.1%
1/17/1991	Gulf War	15.2%	23.5%	20.6%	33.1%
8/17/1991	Gorbachev coup	0.0%	3.0%	7.0%	8.9%
2/26/1993	World Trade Center bombing	1.2%	2.5%	4.0%	6.4%
9/11/2001	9/11	-0.2%	2.5%	6.7%	-18.4%
3/20/2003	Iraq War	2.2%	15.6%	17.4%	28.4%
	Average	1.3%	2.1%	5.5%	8.6%
	% Positive	50%	58%	67%	75%

Data Source: Truist IAG, FactSet. Grey shading represents down markets where the economy was in recession at some point during the measurement period. Past performance does not guarantee future results

Geopolitical risks are sadly a wildcard in investing and nearly impossible to forecast. Amidst this uncertainty, global markets will remain choppy in the near term. This, however, should not change most investors' long-term plans. As difficult as it might be, sticking to one's investment plan and staying put with a diversified portfolio might be the best course of action when faced with uncertainty and volatility.

¹ <https://www.reuters.com/business/energy/oil-extends-gains-above-90bbl-winter-storm-sweeps-through-united-states-2022-02-04/>

² <https://fred.stlouisfed.org/series/TXNGSP>

³ <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>

⁴ Wells Fargo Economics: Some implications of the war between Russia and Ukraine

⁵ Ned Davis Research: Sizing up the U.S. economic exposure to Russia

⁶ <https://www.ssga.com/us/en/intermediary/etfs/insights/questions-emerging-from-the-russia-ukraine-conflict>

⁷ https://www.msci.com/eqb/pressreleases/archive/PR_Russia_Classification.pdf

⁸ <https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/market-updates/on-the-minds-of-investors/should-i-worry-about-russia-ukraine-tensions-impacting-markets/>

⁹ <https://www.truist.com/content/dam/truist-bank/us/en/documents/article/wealth/insights/market-perspective-02-14-22.pdf>

¹⁰ <https://www.bls.gov/news.release/empsit.nr0.h>

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