Pressure Points of the Russia-Ukraine Crisis

March 7, 2022

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As the tensions between Russia and Ukraine extend into another week, investors are feeling pressure as the continuation of the war has economists and financial market strategists and analysts questioning how this conflict will impact the global economy and financial markets. Today's ~3% decline in the S&P 500 (down ~12% year-to-date) is a testament to the burgeoning concerns. Unquestionably, there is a tremendous amount of uncertainty about what will ultimately happen. Below is our view on a number of the 'pressure points' that are emerging in the various economies and financial markets across the globe that should give investors more insight into the situation.

Pressure Point: Military Action

As Russia's war in Ukraine concludes its twelfth day, President Putin's prospects of a quick Russian victory over an overpowered Ukrainian military force have faded. The pressure from both sides continues to mount. Russia has already deployed ~95% of the troops it had stationed on the border and is seeking assistance from Syrian militants who are more experienced in urban combat. Military support for Ukraine from NATO and its allies continues, with an increasing number of war planes, anti-tank missiles, grenades, and ammunition being committed to the cause. In fact, NATO allies supplied Ukraine with more than 17,000 anti-tank weapons in just six days. With tensions high, the situation may unfortunately get worse before it gets better. The ever-present threat of 'nuclear' warfare by Russia keeps this situation incredibly fragile and fluid.

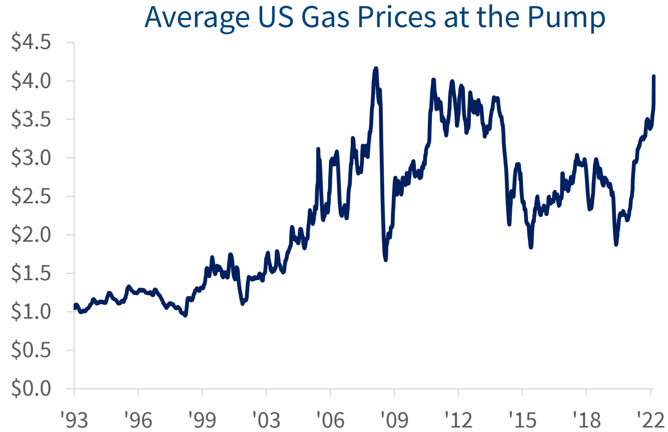
A permanent ceasefire seems elusive given the violation of the agreements to protect civilian corridors; however, the discussions between foreign ministers from both countries scheduled for Thursday may plant some seeds for a potential off-ramp. While President Putin has vowed to precede until Ukraine and NATO acquiesce to his demands, his closest advisors may caution his efforts given that Russian troops have not advanced into key Ukraine cities as anticipated and that the collective sanctions from governments and corporations in the West are having a crippling effect on Russia's economy. Some reports from the region suggest that Ukraine claiming neutrality (and not becoming a NATO member), the acknowledgement of Crimea as part of Russia, and the declaration of the Donbas region as independent may bring Russia to the bargaining table.

Pressure Point: The US Consumer

The release of recent economic data confirms that the US economy was strong prior to the Russian invasion of Ukraine. The addition of 1.1 million jobs to the economy over the last two months, a 3.8% unemployment rate, healthy manufacturing activity, and the best month of retail sales since April 2021 suggested that the economy was poised to rebound. It is still our base case that the Russia-Ukraine conflict will not spark a recession in the US, but the probability of stagflation (higher inflation, tempered growth) is on the rise as the conflict and its impacts linger. The biggest wildcard is the impact of commodity prices – particularly within the energy market.

Prices at the pump seemingly jumped overnight with the national average gasoline price rising above $4 per gallon for the first time since 2008 – up ~$1.30 over the last twelve months. On an annualized basis, that translates to an over $240 billion deduction in discretionary consumer spending. While gasoline expenditures are a small portion of overall household spending, the aggregate increase is significant as it disproportionately impacts low-income earners. The $4 per gallon price tag has also tended to be a key psychological level—with consumers inherently more cautious of spending as they see their fuel costs tick higher at the pump. Surging energy costs are a key downside risk to the US economy, as oil prices have historically surged ~50% leading into a recession. For perspective, oil has experienced a 150% climb relative to pre-pandemic levels (back to March 2020). The longer gasoline prices remain elevated, the more strain will be placed on the consumer—the biggest driver (~70%) of the US economy.

Average US Gas Prices at the Pump



Source: FactSet 3/7/2022

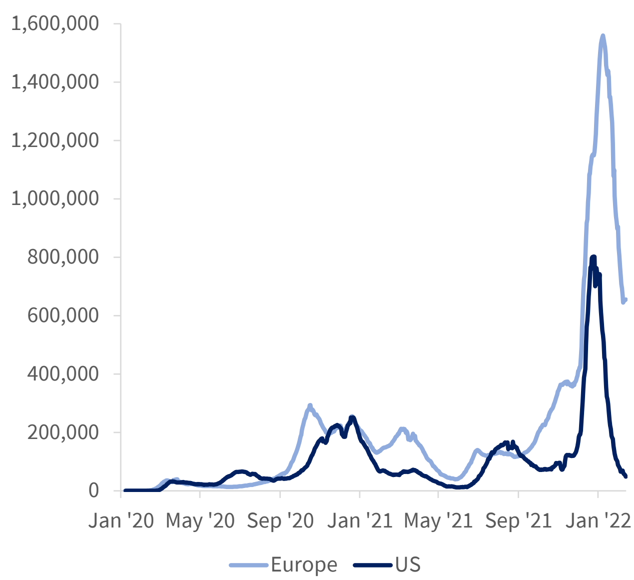
Pressure Point: Implications For Fed Policy

While geopolitical tensions remain elevated, the Federal Reserve (Fed) is set to kick off its tightening cycle in a little less than two weeks. With inflation running near a 40-year high and job growth surging, the Fed feels pressured to move away from its ultra-accommodative policy. However, the recent events do put the Fed in a difficult position. The longer the conflict persists, the more unlikely it is that the US economy will be unscathed. Inflation was already running hot before Russia invaded Ukraine, and the war-related energy shock threatens to push it even higher for longer. Chairman Powell made clear in his testimony to Congress last week that the Fed intends to control the inflation narrative, so the fed funds rate will be heading higher over the next few months. However, the uncertainty will discourage a more aggressive tightening cycle until the economic magnitude of the crisis is realized.

Pressure Point: The European Economy

Similar to the US, Europe's economy was on relativity solid footing before the Russia-Ukraine crisis began. In fact, the euro zone economy was expected to grow ~4% for the year and the European Central Bank was slated to begin rate hikes as early as the end of the year. Now, the region is facing an elevated risk of a stagflation environment and the central bank's accommodative stance may still be needed. The two reasons why Europe's economy is inherently more at risk than the US economy are 1) its commodity dependence and 2) the growing refugee crisis.

COVID-19 Cases: Europe Vs. United States

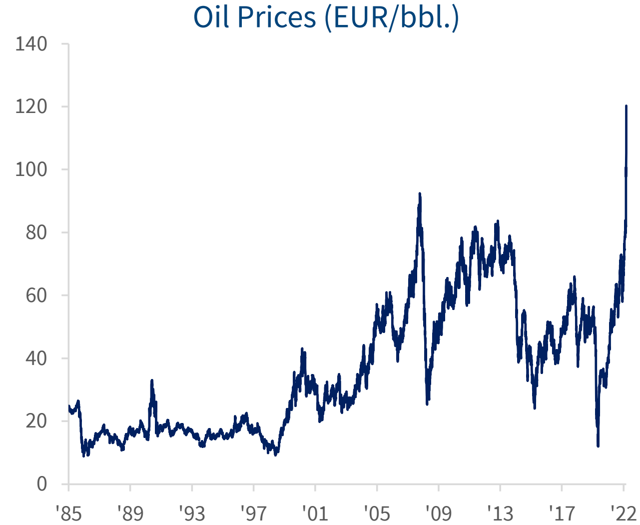


Source: FactSet 3/7/2022

While US consumers are feeling the pricing pressures at the pump, just imagine how European consumers feel. Gas prices in Europe are nearly double that of the US, and are at the highest level on record (~$7-8 per US gallon). Russia supplies ~40% of the European Union's natural gas, and more than a dozen European countries rely on Russia for more than 20% of their oil imports. While the energy dependence is evident, there are imports the region needs from Ukraine too. Ukraine is often referred to as Europe's breadbasket, as it supplies 14% of Europe's grain. While the critical planting and harvest seasons are set to begin in April, Europe's supply of grains that are critical for both its human population and livestock may be unavailable or may only be found in limited quantities at astronomical prices. Wheat prices alone have already reached a 14-year high!

Then there is the emerging refugee crisis. So far, an estimated 1.7 million Ukrainian refugees have crossed into neighboring countries, with Poland accepting more than one million refugees. The situation is expected to worsen if the civilian pass-through corridors are respected, with as many as four million Ukrainian citizens expected to flee to other regions in the months ahead. This is the fastest growing refugee crisis in Europe since World War II. In the near term, the amount of humanitarian aid flooding the region may not be enough to house, feed, and clothe such an influx of people. Not to mention, Europe is still battling the COVID-19 pandemic, and refugee camps could be a catalyst for new cases. So far in March, Europe has experienced ~600,000 daily new cases across its ~750M people. To put this number into perspective, the US is now averaging around 50,000 daily new cases across its 340M people (~6x fewer than Europe). These extremely high numbers are happening despite the heavy restrictions still in place across European countries, which continue to stress their economies.

Oil Prices (EUR/bbl.)



Source: FactSet 3/7/2022

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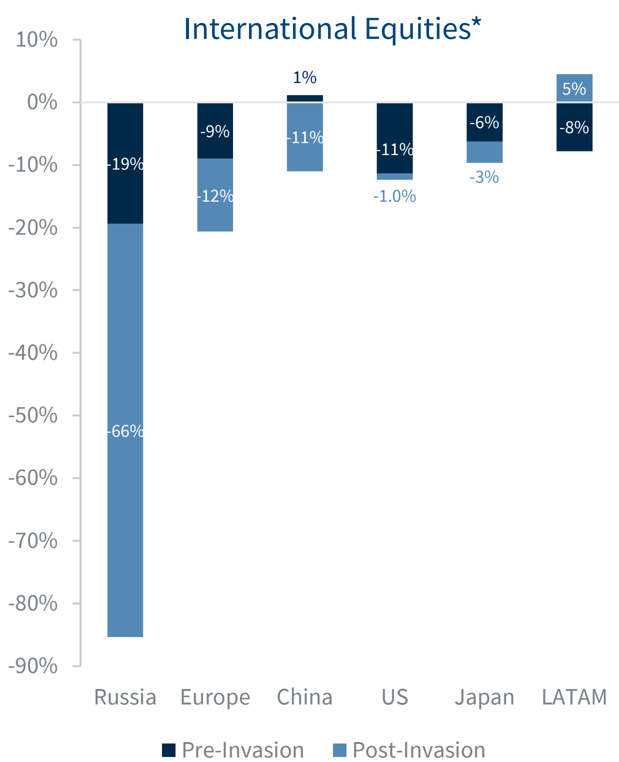
Pressure Point: The Equity Market

The uncertainty surrounding the Russia-Ukraine crisis continues to drive volatility in the equity market. But contrary to what many investors believe, US equities have not experienced a major decline since the invasion began. However, the longer the situation persists and the further energy prices rise, the greater the effect will be on consumer spending. As we've stated before, this could pose a real threat to future economic growth, and while not our base case, does increase the probability of a recession over the next 12 months. So far corporate fundamentals have been resilient, but prolonged tensions could put downward pressure on earnings forecasts.

As of now, countries closer to the frontlines have experienced greater downturns in their equity markets. Due to the breadth and magnitude of the sanctions, Russian equities have declined ~66% since the invasion. European and Chinese equities have taken the next biggest hit, with the Euro Stoxx 50 falling into bear market territory and the Chinese Hang Seng Index falling to a five-year low. More distant from the conflict, the US equity market turned negative from the start of the invasion just today (3/7/2022), while Latin American equities rallied ~4% (due to energy exposure). Looking forward, if we do not experience a recession and the US economy continues to see positive fundamentals, there should be appreciable upside for US equities by year end.



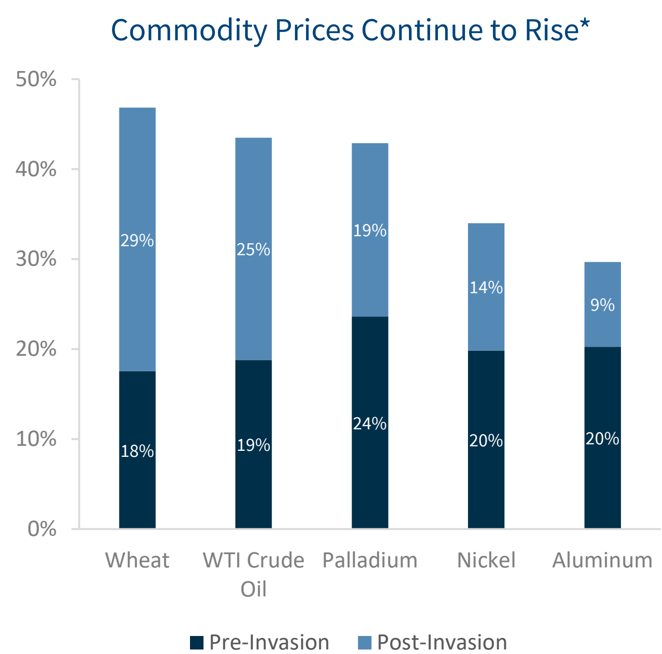
Source: FactSet 3/7/2022. *Pre-Invasion (12/31/2021-2/23/2022. Post-Invasion (2/24/2022-3/7/2022)

Pressure Point: Capital Markets

Russia has over $700 million worth of government debt payments this month, and President Putin has declared that all interest will be paid in rubles despite the sharp decline in the currency (it has lost ~50% of its value versus the dollar since the start of the year). The collective financial market sanctions implemented against Russia has impaired its operations, leading multiple credit agencies (Standard & Poor's, Moody's, and Fitch) to downgrade Russian debt further into junk territory amid the elevated risk of default. And despite Moscow keeping the Russian stock market closed since last Monday, the fallout has been felt for equities. In fact, major indices have declared Russia's market as 'uninvestible,' with FTSE Russell removing all Russian constituents with a zero value today (3/7/2022) and MSCI removing Russia from the Emerging Markets Index this Wednesday (3/9/2022). Even if Russia follows through with plans to deploy $10 billion of its sovereign wealth fund to buy equities, there will still be subsequent sell-offs as additional indices and passive and active funds reduce exposure.

Bottom Line:

The uncertainty surrounding the Russia-Ukraine crisis continues to induce elevated volatility. But based upon our assumption of no recession, much of the downside risk has already been priced into the markets. As this situation unfolds, we will continue to monitor the economic and financial market implications and keep you updated if and when these developments impact our outlook for the year.



Source: FactSet 3/4/2022. *Pre-Invasion (12/31/2021-2/23/2022. Post-Invasion (2/24/2022-3/4/2022)

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