Thoughts on Russia/Ukraine Conflict

We are now in the 13th day of the Russian/Ukraine crisis and a visible end to the conflict is not in sight. As is typical, media hyperbole has grown frenzied in recent days with increasing with talk of gasoline shortages, expanded Russian aggression against other European countries, nuclear mobilization, a Chernobyl meltdown scenario, cyber terrorism, and a multitude of others. Instead of focusing on the sensational, we have broken our commentary into three categories, namely, the economic reality of this crisis for the US, the political end game for Russia, and finally, our best guess on the what's next for the equity market.

US Economic Impact

Russia represents a relatively insignificant, 3% of global GDP. Even if they drop into a deep, protracted recession, it won't cause more than a ripple to the world economy. Furthermore, direct economic linkages between the US and Russia are negligible. US trade with Russia accounts for roughly 0.0076% of our total trade balance. Sanctions will no doubt hurt US domiciled multi-national firms that have business interests in Russia, but it will be manageable. The most notable negative for the US economy will be rising gasoline prices. As a nation, we spend roughly 5% of discretionary income on gasoline. Sustained gasoline prices at elevated levels would obviously crimp consumer spending, especially in lower income cohorts. However, it's important to keep in mind four key facts. First, tax credits could be used to offset the impact on lower income cohorts rather easily. Second, the reality is that a $40/barrel increase in oil (a 50% increase from pre-crisis levels) is estimated to reduce GDP by 0.8%. That's meaningful to be sure, but quite digestible. Third, Russia has no incentive to withhold oil from the world market. That is the only part of their economic engine that is actually working. Fourth, related to the last point, the reality is that supply hasn't been disrupted. Russian oil continues to flow. The entire move we have seen in the crude oil market has been driven by speculators. It is the fear of output changes, rather than actual disruptions that are driving the move upward. That isn't to say that fear couldn't drive it up further, but the argument that we will see sustained rises in oil prices doesn't make economic sense. It might surprise some, but the US is the largest oil producer in the world. Additionally, our largest crude oil import relationship isn't with the Middle East or Russia. It is with Canada. Russia represents less than 3% of our imports and thus it is relatively costless for the US to embargo Russian oil. US shale producers can easily offset that lost volume if they scale up. Given the economic incentive to do so, I think it is a fait accompli. Let's also not forget, there will be some positive economic offsets. As just mentioned, our domestic energy industry will benefit from increased price realization and volume increases. If our European allies want to reduce their dependence upon Russia, they may look to US imports as a potential solution to the problem. The US has a massive abundance of natural gas, for example, that can be liquified and exported. That may take time, but it could be a substantial tailwind. Additionally, this conflict has made clear to our allies the necessity of honoring their financial commitment to NATO. Given that the US is the largest global supplier of arms, that could mean considerable order flow for our domestic defense industry. Finally, the US enjoys a substantial lead in cybersecurity. Our industry participants are likely to be quite busy as other, less-prepared nations, seek to bolster their cyber defenses.

What's next for Russia

Turning our attention to Russia, let's begin with what is unequivocally clear. Putin seems to have dramatically 1.) miscalculated his military might, 2.) underestimated the magnitude of fight within his opponent, and 3.) misjudged the united resolve of the world to aggressively use exhaustive measures to punish his incursion. The sanctions that have been imposed upon Russia, thus far, are truly strangling. The Russian economy is already showing signs of deep recession. The Russian stock market has been closed since 2/25/22 when it quickly lost roughly 50% of its value. The Russian Ruble has declined over 40% relative to the US Dollar and Russian interest rates have risen to over 20%. Nearly all western Fortune 500 companies have discontinued operations within Russia, causing parts shortages and a significant increase in unemployment. It's very clear that Putin needs to head towards the offramp to stop the economic hemorrhaging, and I'm sure that he is aware. However, politically, he can't afford to leave this conflict completely defeated, and at present, he has no negotiating leverage to extract any concessions. That leaves us with a bit of game theory on how the conflict resolves itself. Our best guess is the following. Putin really has no choice but to capture Kyiv and other major cities and raise the Russian flag. To secure that victory he will likely pursue the same strategy that Russia employed in Syria. Namely, they will engage in a slow siege where he continues to shell civilian communities, starves the cities of electricity, water and food services, and eventually causes the residents to vacate. This may take time and cost his economy dearly, but it gives him a bargaining chip to get something in return for ending occupation. Our view hasn't changed in that respect. His best outcome is limited to security assurances by Ukraine that it won't become a NATO member, a recognition of the Crimean Peninsula as Russian territory, the independence of the two administrative regions of Donetsk and Luhansk, and a cessation of sanctions. In any case, he is going to emerge from this as a massive loser. He has caused untold human tragedy and his hubris is ultimately going to cost him his vice-like grip on Russian politics. The longer this conflict lasts, the greater the chances that he faces civil unrest and upheaval.

Market impact

The fascinating thing about geopolitical events, almost regardless of the conflict's duration, is how quickly the market seems to price in the bad news. In fact, if we examine the all events from 1973 to present, what we find is that on average the market finds its low within 12 days of the initiation of the conflict. Additionally, the initial downside reaction averaged -6.5%.

History points to short-lived volatility around geopolitical events

S&P 500 selloffs around geopolitical events

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**

Thus far, the S&P 500 has fallen roughly 12% from its peak, prior to the Russian invasion of Ukraine, to the low on Tuesday, 3/8/22. Of the other 12 observed episodes, only the Israel Arab War/oil embargo was worse. Does that mean we are buying this market with both hands? The answer is no. Unfortunately, this isn't the only issue facing markets. Namely, as we have been saying for the better part of the last year, the Federal Reserve has been late to address building inflation pressures. Having failed to reduce monetary accommodation earlier, they are now behind the curve, and have acknowledged that they will begin a tightening campaign in March 2022. Typically, Federal Reserve tightening cycles have been accompanied by a contraction in the price/earnings multiple that investors award to the market. The good news is that this readjustment is already in process. At its peak, the S&P 500 traded for roughly 21x projected earnings, a figure that put it in the 99th percentile of all valuation outcomes. That said, this is changing rapidly. Post the latest corrective action, we are now down to roughly 18x. That isn't cheap by historical context, but it is much closer to the average of 16x earnings.

How is Westshore Wealth positioning client portfolios as a result? Our present asset allocation mix is proving quite defensive in this latest correction. To be sure, we haven't navigated this pullback unscathed, but the combination of a heavy dose of shock absorbers and uncorrelated assets within the portfolio, as well as our tilt towards value, over growth, is leading to significant relative outperformance. We continue to migrate assets on the capital preservation part of the ledger into assets that are more inflation protected (including private real estate, private credit, and asset backed finance). On the growth side of the allocation, we have a defensive posture, but remain opportunistic. If we were to see the S&P 500 correct down to the 3,700 level, closer to historical average valuations, we would likely look to reduce our shock absorbers and get more aggressive. If, however, the market continues to experience volatility where price action resembles a saw-toothed, sideways movement, as we expect, we believe our portfolios are optimized to weather the storm.

Please let us know if we can answer any questions.