A War of His Choosing

Vladimir Putin's Russia invades Ukraine. What are the potential market and economic impacts?

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- The initial market response to Russia's invasion of Ukraine was surprisingly calm.
- Markets may have been well prepared by recent stock market declines, the ongoing normalization of Federal Reserve policy and three months of rising oil prices to endure the shock.
- No matter how dramatic, geopolitical events are often just short-term "noise" — economic impacts will ultimately drive longer-term market performance.
- Higher oil prices and the impact of sanctions will likely define the scope of the economic impact.
- It's far too early to know what happens next, but, at a minimum, Russia has injected uncertainty into a market that loathes uncertainty.
- While additional market volatility seems likely as the situation unfolds, we urge investors to take a calm and measured approach to their portfolios and avoid making emotional or fearful decisions.

If there was a red line drawn in the snow, consider it crossed.

On the morning of February 24, Russian forces initiated a full-scale incursion into Ukrainian territory with the apparent goal of forcing a regime change in the country immediately to its southwest. It wasn't exactly a surprise: Russia had been massing troops and equipment at multiple sites along the Ukrainian border for months, and an attack in one form or another had been predicted by the intelligence community since at least January. So far, the U.S. and her allies have responded with economic sanctions and materiel support for Ukraine, but the prospect of U.S. and NATO military forces entering the conflict as combatants has been ruled out unless Russian forces extend their adventurism beyond Ukraine's borders.

These events are historic, and the longer-term impacts on the post-Cold War geopolitical order are likely to be profound. We could fill pages with speculation about what those might be, but our concern is, as always, much more pragmatic: How will the conflict in Ukraine impact markets and the U.S. economy?

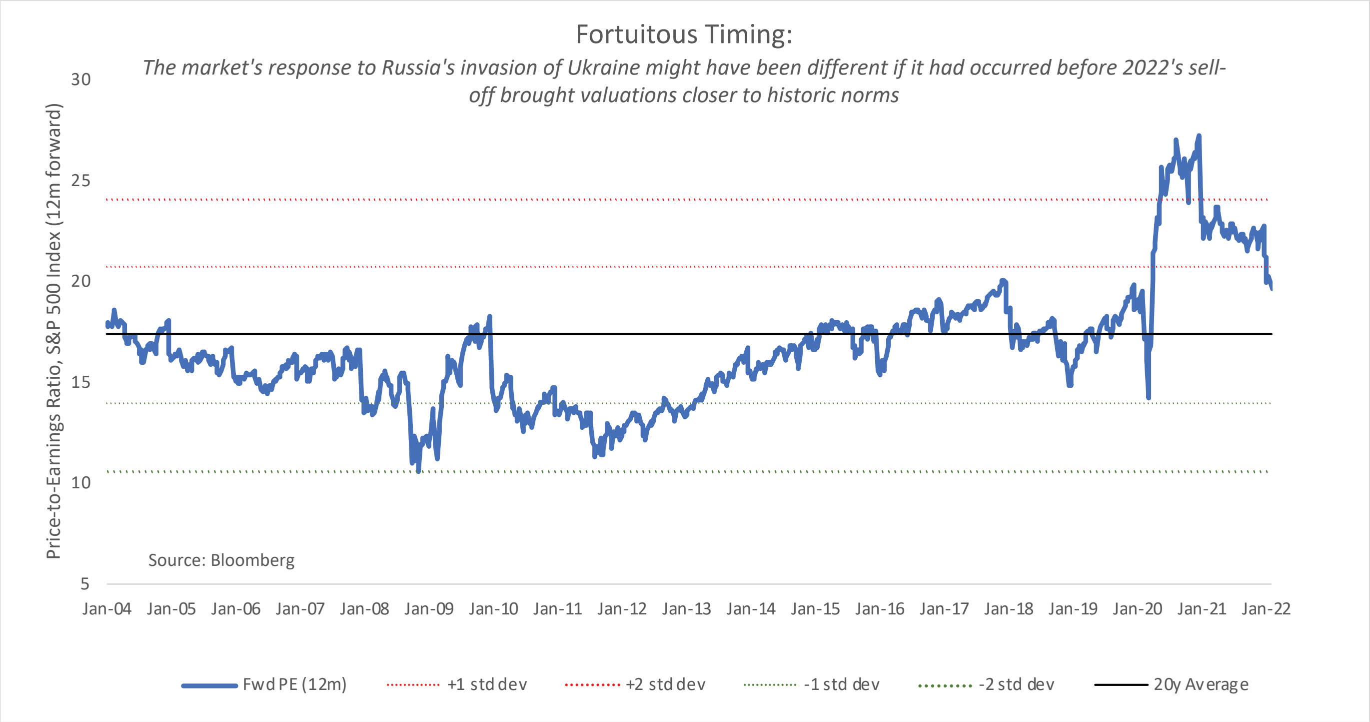
Markets: Surprisingly resilient

It's of course impossible to know for sure, but the immediate market reaction was telling. Equity markets opened lower on the day of the invasion, but the declines were surprisingly modest. A press conference by President Biden at mid-day was met with even more optimism — at least in part because the proposed program of sanctions was less severe than feared — and by the close of trading, U.S. stocks were comfortably in the green.

But the upbeat tone of stocks didn't mean investors weren't paying close attention, and it's notable that so-called "safe-haven" assets — those expected to hold up better during times of extreme stress — caught a bid. U.S. Treasury securities and the U.S. dollar (two classic examples of "safe-haven" assets) rose throughout the day in recognition of the massive uncertainty that accompanied Russia's actions. In fact, one of the few possible silver linings in all this is the modest decline in interest rates associated with the rally in treasuries, softening the pain of what has been a long and steady period of rate increases since the new year began.

Beyond stocks and bonds, other asset classes performed as you might expect: Energy-related commodities surged, led by oil (a key Russian export) and natural gas (another key export upon which Western Europe relies for a significant portion of its energy needs). Tellingly, one key benchmark for liquefied natural gas — which, unlike other forms of the commodity can be readily exported across long distances and therefore represents a potential source of spare BTUs for soon-to-be energy-starved Europe — was up nearly eight-fold.

But even commodity price pressure softened as February 24 wore on, leaving some market watchers struggling to make sense of the market's seemingly ambivalent response. One possible explanation is that financial markets were somewhat better prepared for this kind of shock than they might have been even a month or two ago. For example, equity markets have declined steadily since the beginning of 2022 regardless of anything going on in Ukraine. That, together with a robust recovery in earnings as the pandemic fades, has brought valuations much closer to historical norms than at any time since the post-pandemic recovery began. Had the Ukraine invasion happened before this rationalization in stock prices and surge in earnings began, it's probably safe to assume the response of U.S. stock markets to Russian forces crossing the border would have been quite different.



The same is true for rates and monetary policy. In November, when the Russian troop buildup first captured the world's attention, the Fed's tapering of asset purchases had just begun, and Fed-sponsored rate increases were still thought to be months (if not a year or more) away. But on the eve of the invasion, the Fed's tapering program was nearly complete, and traders were expecting the Fed to boost rates as many as seven times before the end of 2022. That undoubtedly left investors resigned to the idea that financial conditions would tighten regardless of anything that might happen in Ukraine, and it may have even caused many to question whether the so-called "Fed put" — the idea that the Federal Reserve was tracking equity markets closely and would begin to pull its punches if volatility returned — was still in place. Now, with geopolitics threatening to undermine the global economic recovery in a very real way, it feels very much as if the Fed put — possibly implying a friendlier Fed — might be back in play.

And then there's oil. While it's easier to draw a direct line between oil prices and the Russian troop buildup than it is to stock prices and rate expectations, oil prices have been rising since the end of November, with or without tensions in Europe. Once again, markets had plenty of time to get used to the idea of higher crude prices and tighter supply before Vladimir Putin made it a reality. That undoubtedly made it somewhat easier for markets to tolerate the upward shock in oil prices that accompanied the Russian invasion.

Economics: A longer-term unknown

It's tempting to be reassured by the relatively calm nature of the market's immediate response, but it's equally true that the potential for a massively negative reaction to recent events in Europe still exists. If so, economics are likely to be the root cause.

Russia is a significant producer and exporter of crude oil — representing 10-11% of global oil production and 6-8% of U.S. imports.[1] The sudden removal of even a portion of those barrels — whether by sanctions or violence — would undoubtedly be disruptive to world markets in the near-to-medium term. Moreover, oil is an input into virtually everything we consume — sometimes in the production process itself and always as part of the supply chain that brings it to us. With U.S. inflation already at its highest levels in decades, it's fair to wonder whether a continued rise in oil prices might ultimately cause economic growth in the U.S. to slow substantially through the potential impact they have on inflation.

At Issue:

Bilateral U.S. Trade with Russia and Ukraine, 2021 (top 10 products, by end-use)

U.S. Imports from Russia	$,b	U.S. Exports to Russia	$,b
Fuel Oil, Crude Oil and other Petroleum	$ 17.51	Civilian Aircraft	$ 0.88
Precious Metals	$ 2.59	Vehicle Parts and Accessories	$ 0.56
Steelmaking Materials	$ 1.64	Pharmaceuticals	$ 0.34
Fish and Shellfish	$ 1.20	Telecomm. Equipment	$ 0.33
Chemicals/Fertilizers	$ 1.18	Passenger Vehicles	$ 0.30
Milled Iron and Steel	$ 1.04	Industrial Engines	$ 0.28
Nuclear Fuels	$ 0.69	Chemicals	$ 0.27
Bauxite and Aluminum	$ 0.53	Industrial Machinery	$ 0.22
Finished Metalwork	$ 0.35	Agricultural Equipment	$ 0.21
Plywoods and Veneers	$ 0.35	Medical Equipment	$ 0.20

U.S. Imports from Ukraine	$,b	U.S. Exports to Ukraine	$,b
Steelmaking materials	$ 1.02	Passenger Vehicles	$ 0.87
Food oils, oilseeds	$ 0.13	Coal	$ 0.47
Drilling & Oilfield Equipment	$ 0.12	Agricultural Machinery	$ 0.16
Apparel and Textiles	$ 0.06	Vehicle Parts and Accessories	$ 0.10
Telecomm. Equipment	$ 0.04	Fish and Shellfish	$ 0.10
Fruits and Frozen Juices	$ 0.03	Pharmaceuticals	$ 0.09
Milled Iron and Steel	$ 0.03	Apparel and Textiles	$ 0.05
Chemicals	$ 0.03	Telecomm. Equipment	$ 0.04
Household Appliances	$ 0.02	Civilian Aircraft	$ 0.03
Vehicle Parts and Accessories	$ 0.02	Plastics	$ 0.03

Data: US Census Bureau, Dept. of International Trade Statistics

1 U.S. Energy Information Administration, eia.gov and Great-West Investments calculations.

However, oil markets are global in nature and vastly complex. Past oil price shocks have often been met with a robust supply response, whether in the form of quota-bending by OPEC member states, increased production from marginal producers or some combination of both. Moreover, the "energy intensity" of U.S. economic output — the amount of energy required to produce each additional $1 of gross domestic product — has declined by more than 40% since 1990, naturally making the U.S. economy more resilient against oil price shocks than it has been in the past. Finally, it's also no coincidence that the threat of higher gasoline prices was a featured component of President Biden's speech on the afternoon of the invasion; in addition to urging producers to refrain from "price gouging," he promised further releases from the nation's strategic petroleum reserve (a massive network of salt caverns on the U.S. Gulf Coast where emergency oil reserves are held) should they become necessary.

And then there's the question of sanctions. For now, the U.S. has refrained from what some had termed "the nuclear option" — excluding Russia from the global payments network called SWIFT, which would have effectively cut Russia off from global commerce in a very real and comprehensive way — out of concern for the damage it might do to our allies in Western Europe. In addition, sanctions enacted so far seem to have been crafted in a way that attempts to avoid some of the biggest "pain points" they might otherwise cause, including a carve-out for energy transactions denominated in foreign currency and exempting major industrial commodities, such as aluminum, from this round of sanctions.

But the impact of trade restrictions is every bit as complex and unknowable as the sudden removal of a significant amount of oil production, and the centerpiece of the Western response so far — the suspension of operating permits for the Nord Stream 2 pipeline that would carry Russian gas into an already energy-dependent Germany — illustrates exactly how far Western democracies are willing to go to express their disapproval. As Russian aggression continues to evolve, so too will the West's response.

Conclusion: Still in wait-and-see mode

So the bottom line is this: While the relatively calm reaction by financial markets on the day of the invasion was reassuring, the situation is fluid, and market sentiment can turn on a dime. Regardless of how tragic or historic these events may be, geopolitical drama is often just short-term noise, and, in the longer term, economic impacts will dictate how markets respond. But for now, those impacts are almost entirely unknowable, which naturally injects more uncertainty into a market that loathes it. That in turn suggests the coming days and weeks could see even more volatility as markets seek to find a new equilibrium. But it remains true that decisions driven by emotion and fear tend to be the wrong ones, so, as always, we urge you to carefully consider the long-term ramifications before responding to whatever uncertainty might lie ahead.

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