Russia/Ukraine: Geopolitical Events, Stocks, and Commentary

February 26th, 2022 | by Mark Barry, CFA

Following weeks of speculation, on Wednesday evening (early Thursday morning in Moscow) Russian President Vladimir Putin announced that Russia would commence a "special military operation" against neighboring Ukraine. Minutes later, missile strikes hit targets across Ukraine and Russian ground forces began their assault, launching what has turned out to be a major multi-pronged invasion of the country and the most significant security crisis in Europe for decades. Global markets reacted immediately to this news as equities sold off, bonds rallied, gold and the US dollar were bid up, and oil prices spiked.

As of this writing, heavy fighting continues throughout the country and the situation remains very fluid. Determining the precise economic and market implications of this invasion is largely impossible at this time, as much depends on factors such as how the action on the ground unfolds moving forward, the sanctions regime implemented by Western countries, and any counter-responses from Russia. What we can say with conviction is that the conflict unfolding between Russia and the West over the events in Ukraine makes for a volatile geopolitical risk environment that has created significant additional uncertainty for the global financial markets.

Following the outbreak of fighting we have heard many investors express concern about the repercussions for markets, and understandably so. While further escalation in either kinetic or other types of conflict with Russia certainly poses significant risks, in this update we wanted to provide some perspective for long-term investors regarding the impact of geopolitical events on the US equity markets. Then, in the latter half of this update we have provided some brief commentary that highlights key considerations for investors in thinking about the potential economic and market implications of continued geopolitical tensions between Russia and the West.

Keep a Long-Term Perspective: Stocks Usually Take Geopolitical Events In Stride

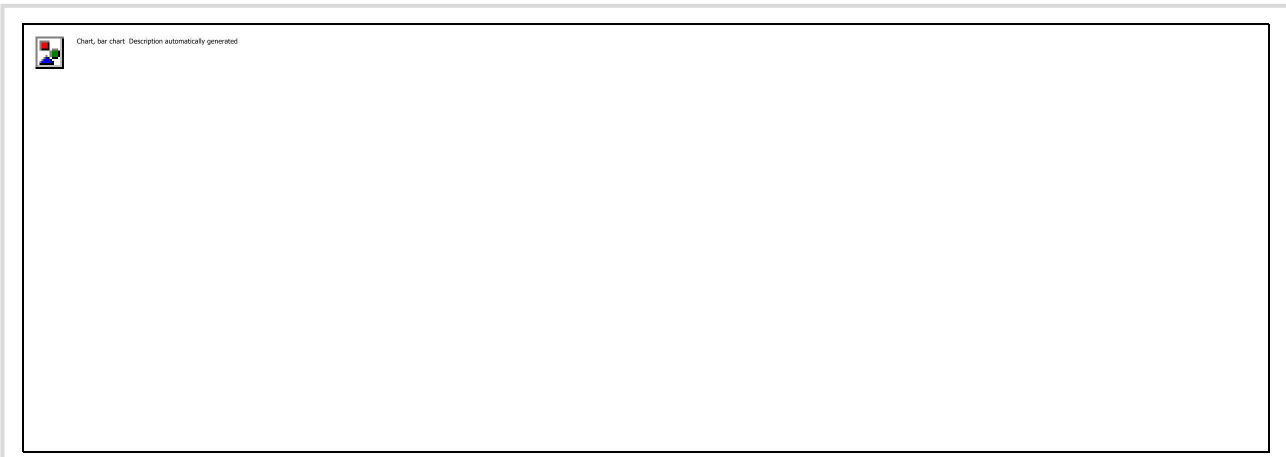
The immediate market reaction to major geopolitical events is often violent, as investors sell first and ask questions later. This pattern was evident on Thursday, as US equities weakened in early trading before recovering into the close and rallying further the next day. Taking a look at the table below, you will find that the market drawdown following major geopolitical shocks has been on average about 5% with a fairly quick recovery in most cases. While it is certainly possible that a given geopolitical event results in a sharp and sustained bear market in stocks at some point in the future, historically the impact of these types of incidents on the US equity markets has not been as bad as one might assume.

It is also worth noting that every event listed on the chart introduced a risk that made it sound like a great idea to sell at the time. However, in most of these cases the market recovered in short order, with the longest time to recovery still coming in at under a year. Remember, attempting to time the market is rarely a successful endeavor, and there is always a reason to sell (pandemic, war, etc.). We would encourage investors to maintain a long-term perspective and stay invested in the markets despite the occasional speed bumps. And as it relates to the situation in Ukraine, focus on the things that you can control – your asset allocation, investment discipline, personal savings goals, etc. – and maintain that long-term approach to investing.

Russia/Ukraine Conflict: Some Considerations for Investors

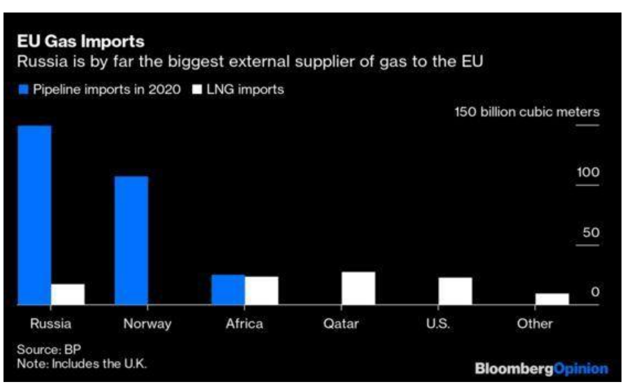
US Has Limited Direct Exposure to Russia/Ukraine

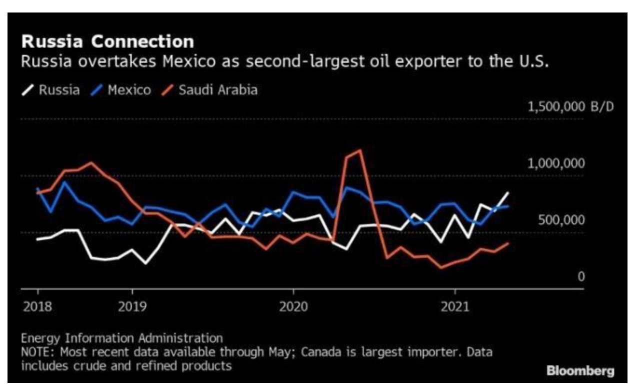
Both Russia and Ukraine are rather small economies, and US businesses do not have material exposure to either outside of a handful of sectors (commodities and energy). Investors in US equities are largely insulated from any direct effects of economic sanctions, and it appears that the market has realized this with the sharp rebound in US stocks we have seen following the initial selloff. Additionally, while the European Union has significantly more trade exposure compared to the US, it is quite small relative to the bloc's GDP.



But Russia Is a Major Producer of Oil and Natural Gas

While Russia's economy is relatively small, it is the third-largest producer of oil and the second-largest producer of natural gas in the world, making it a key player in global energy markets. Any supply disruption in the near-term – for example due to Western sanctions on Russian natural gas or a retaliatory reduction in oil exports by Russia – would likely drive energy prices higher from already elevated levels. The potential for a major energy price shock is one of the bigger risks to global economic growth the Russia/Ukraine conflict poses, and the severity of its impact could vary greatly depending on the magnitude and duration of the price shock.

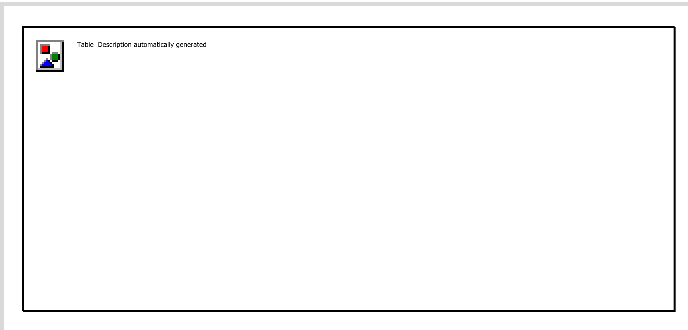


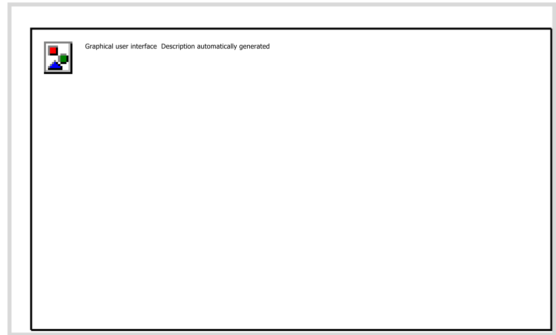


However, following a spike in the immediate aftermath of the Russian invasion, oil price gains moderated into the Friday close as markets appear to be discounting the degree of sanctions that will be implemented. With the EU having become heavily reliant on cheap Russian gas and the US attempting to contain inflation (with prices at the gas pump being of particular focus) it may be that markets doubt the political will to implement an aggressive energy sanctions regime given the potential boomerang effects on Western economies.

Russia, Ukraine, and Belarus = Big Players in the Agriculture Export Markets

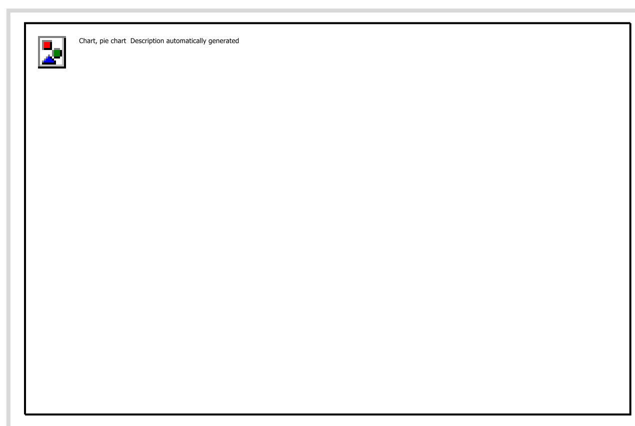
Important agricultural commodities are also exposed to the recent escalation in the Russia/Ukraine conflict. Russia is the world's leading wheat exporter while Ukraine is in the top five; together they account for nearly 30% of the global export market. Russia is also a major producer and exporter of critical agricultural fertilizers such as potash, phosphate, and other key inputs. With respect to potash, Russia and Belarus (which will likely be included in any sanctions as well) combined have a 40% share of the world's potash export market.





Russia Is Also a Key Supplier of Raw Materials/Metals

Russia is a major producer of palladium, nickel, platinum, and aluminum, among other metals. Palladium is a critical component in catalytic converters, and supplying around 40-45% of the world's palladium Russia's importance to the global auto industry is high. Additionally Russia and Ukraine combined account for 90% of global semiconductor-grade neon production (neon gas is used in chip lithography) and about 2/3 of this neon is purified by one company in Odessa. While any reduction in the supply of industrial metals as a result of this conflict would see prices rise further and exacerbate inflationary pressures globally, with respect to palladium and neon gas it would appear that Russia has the ability to up the ante in response to Western sanctions by restricting palladium and neon gas exports which could cripple key supply chains, at minimum.



Key Takeaways RE: Russia/Ukraine Considerations

- The US and other major Western nations do not have significant direct trade exposure to Russia and/or Ukraine given the relatively small size of their respective economies. However, Russia and to a lesser extent Ukraine are major commodity producing countries and thus supply disruptions (whether unintentional or deliberate) would see input prices rise and exacerbate inflation globally.
- These rising prices – particularly for food and energy – would likely pressure consumer spending in the United States and elsewhere which would exert some headwinds on economic growth.
- Markets expect that central banks including the US Federal Reserve take a more cautious approach to tightening monetary policy (i.e. less hawkishness) in the near-term as a result of renewed geopolitical tensions. However the balance of risks the Fed and other central banks have to navigate remains largely unchanged; reducing monetary accommodation to combat inflation without stalling economic growth.

Additional Comments

- Western sanctions appear unlikely to have the desired effect on Russia's behavior; they were fully aware of the potential consequences of an invasion and clearly made a judgement that benefits outweighed costs. However, it is possible that Russia has identified actions they could threaten to take (throttling palladium exports for example) that would hit the West at their weak points and cause them to back off from some of the more aggressive sanctions. This is a potential unknown that could introduce additional risk.
- Vladimir Putin has arguably demonstrated himself to be a wily yet largely rational geopolitical actor over his career, but recent comments from the US intelligence community suggest a belief that he has become increasingly isolated and irrational. There is a non-zero possibility that Russian aggression extends beyond Ukraine and should it involve NATO countries (targeting the Suwalki Gap for example) the situation would become much more serious.
- Reports indicate that the Russian forces may be encountering stiffer resistance from the Ukrainians than anticipated. Should Russian casualties be significant and/or the economic consequences from the invasion severe it is possible that domestic public opinion turns against Putin with the eventual result being his exit from Russia's leadership. This could be an upside or a downside risk depending on his successor.
- Cyberattacks on Western governments, corporations, and infrastructure may be a route of action Russia takes in response to sanctions and support of Ukraine.
- SWIFT is a bank messaging system that helps transmit billions of dollars around the world every day. Ejecting Russia from SWIFT could prove to be a red line that initiates an aggressive escalatory response. Additionally removing Russia from SWIFT reduces their stake in the international system and might spur the development of alternative networks that eventually erodes the US-controlled SWIFT system.

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