

Russia and Ukraine: On the Edge

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Volatility in the equity market remains elevated with the S&P 500 notching its first 10% decline (based on closing prices) in almost two years as uncertainty surrounding Russia/Ukraine intensifies. The long holiday weekend saw a flurry of headlines, from a reported potential Biden/Putin summit to Russia moving 'peacekeeping' troops into Ukraine's Donbas region. While our base case remains that diplomatic pressures will avoid a mass Russian invasion that takes control of the entire country, that is far from a certainty. While Putin's acknowledgement of the independence of the separatist-backed regions and placing of troops in the region escalated tensions, it was not the worst-case scenario of a full country incursion. As a result, the 'modest' sanctions placed on the Donbas region and Russia by the US and Europe still provide a hopeful off-ramp for negotiations. A de-escalation in tensions would avoid unnecessary bloodshed and economic pain. As it is unclear what Putin's next move will be and how this situation will ultimately unfold, we wanted to provide our thoughts on the situation and potential impacts to the market.

Past geopolitical events (e.g., wars, terrorist attacks and other events) have historically led to short-term weakness in the equity market. However, as economic growth and earnings are the longer-term fundamental drivers of the equity market, they have tended to recover their losses and rally over the ensuing six and twelve month periods. The exceptions tend to result when these events adversely affect the fundamental backdrop of the economy.

With this in mind, it is important to put both Russia and Ukraine's economies into perspective. Russia's GDP is ~\$1.5 trillion (making up ~less than 2% of the global economy) and is the eleventh largest in the world, whereas Ukraine's GDP is ~\$550 billion (making up 0.6% of the global economy). More specifically, while Russia is the largest country by land mass, the size of its economy is only that of Texas (and less than California). When looking at Ukraine, it would be the thirty-third largest US state, the size of Nevada! From an equity market perspective, the Russian equity market has a total market cap of just over \$215 billion. That is less than 1% of the S&P 500, and ~30 S&P 500 companies have a market cap larger than the total Russian equity market.

While both sanctions and war will be a significant headwind for the Russian and Ukrainian economies and equity markets, negative economic spillover effects should not

materially influence the positive backdrop for the broader global economy.

However, what is of importance, is that Russia is the world's third largest oil producer - supplying ~10% of global crude. Additionally, it is a major producer of a number of other commodities such as wheat, fertilizers and nickel for example. Higher commodity prices or increased bottlenecks would pose a risk to the global economy. Any additional rise in crude oil prices (WTI oil temporarily hit \$96/barrel today) and other related commodities could have implications:

♦ **Headwind for Consumer Spending:** Over the last year, oil prices have increased from \$59 to \$92, resulting in the average price per gallon of regular gasoline rising by ~\$1 over the last twelve months (\$3.53 vs \$2.58). On an annualized basis, that translates to an almost \$180 billion deduction in discretionary consumer spending. If gasoline prices were to rise to the psychological \$4/gallon, it would likely further pressure consumer spending and place downside risk on our economic forecasts.

♦ **Impact on the Federal Reserve:** Both breakevens and inflation expectations had been suggesting in recent weeks that we were nearing a peak in the year-over-year pace in inflation. However, a surge in oil prices may bring this into question. A further, more sustainable, surge in inflation could pressure the Fed to hike rates more aggressively. However, with inflation remaining elevated, the Federal Reserve (Fed) would have to navigate raising interest rates in a slowing economic environment. It is unlikely that the Fed would turn even more aggressive in the face of both geopolitical and economic uncertainty. The 10-year Treasury yield remaining near 1.95% (and not moving lower in the midst of increased market volatility) suggest that the market may be concerned about the potential prolonged inflationary scenario.

Bottom Line: There remains quite a bit of uncertainty around the path of tensions in Ukraine. Assuming there is no further escalation and potentially de-escalation (our base case) in Ukraine, our economic and financial market forecasts remain unchanged. While our economist recently downgraded our US GDP growth forecast to 3.0% (from 3.5% at the start of the year) primarily due to Omicron related impacts, US economic fundamentals remain solid due to strong consumer spending and robust capex plans. Equity market

volatility is likely to remain elevated because of geopolitical tensions and the uncertainty around the Fed's path to tightening. While the first 10%+ decline for the S&P 500 of this bull market accompanied this uncertainty, we acknowledge that declines of this magnitude are not unusual, occurring typically at least once per year. However, the favorable corporate earnings backdrop (above consensus \$235 in earnings in 2022) keeps us confident in our year-end S&P 500 target of 5,053. As a result, we would use periods of further weakness as buying opportunities. The close economic ties between Europe and Russia, particularly in regard to energy needs, is another reason we favor US equities. The biggest risk factor which we will closely monitor is oil. If a Russian full-scale invasion of Ukraine occurs, sending oil to \$120/barrel, our economic and financial markets forecasts would likely need to be revised lower.

Ed Mills, Managing Director, Washington Policy Analyst, Equity Research

We expect near-term market risk and volatility to materially rise following Russia's recognition and troop deployment into separatist-held Ukrainian territory given the uncertainty of the path forward and sanctions increasing in severity if Russia escalates the situation from here.

We are seeing a relatively targeted initial sanctions response with limited direct market impact, indicating an off-ramp scenario is still in play should Putin see it in Russia's interest to lower the temperature. We continue to see the most likely path forward as a continuously simmering conflict with periods of potentially dangerous escalation and a scaling back of tensions. However, the scope of the current military deployment by Russia significantly raises the risks of a spiraling and expanded confrontation in Eastern Europe that leads to broader sanctions with market impact across Technology, Financials, and commodities.

Longer term, the recent developments will likely be a pivotal moment for US foreign policy. We expect more funding to be devoted by Congress to defense priorities with impact for the defense industry, aimed at bolstering European defenses and alliance coordination. Focus will also be heightened on Asia as the potential next geopolitical hotspot, particularly on China's relationship with Taiwan. Concern will rise that lessons learned from Russia's actions and the response from the US and European allies could invite increased assertiveness by China, leading to expanded confrontation with the US on regional interests. This supports the case for continued investment into domestic manufacturing capability for supply chain security purposes and increased scrutiny of investment exposure to China. However, these trends are subject to political and diplomatic developments that will influence the situation along the way, overall adding to the longer-term uncertainty on the path forward.

J. Michael Gibbs, Managing Director, Equity Portfolio & Technical Strategy and **Joey Madere**, CFA Senior Portfolio Analyst, Equity Portfolio & Technical Strategy

In summary, inflation and the Fed remain the most crucial variables for the equity market. We have written that multiple headwinds appearing at one time often influence more significant and longer-lasting market weakness than would otherwise be seen by one item alone. The Russia/Ukraine situation qualifies as one of the 'other' headwinds. So, the already struggling equity market will likely continue to do so for now. As for the conflict itself, it all depends on to what degree it escalates. The most significant risk is the upside pressure on crude oil and natural gas, especially with the world currently wrestling with inflationary pressures. The higher prices would weigh on consumer spending. The European Union (EU) region is at greater economic risk given its dependence on energy supplies from Russia. However, the US consumer will also feel the hit from the higher prices. If the conflict escalates and the west responds with aggressive sanctions, Russia could counter by limiting supplies of energy to the EU, providing upward pressure on prices. The higher inflation and pressure on the consumer would put the Fed in the awkward position of fighting inflation when an economic headwind appears.

The impact on the equity market: Markets struggle when they are dealing with uncertainty. Inflation and the path of the Fed are the significant uncertainties holding stocks back currently. Still, the Russia/Ukraine conflict has already contributed to the weak market seen in 2022. As (if) the conflict escalates, equities will adjust (downward) accordingly. For now, we have no idea how far the issue will progress. Despite the uncertainty, we have a long list of geopolitical conflicts throughout history to look to. For the most part, although causing prices to decline, such events create a buying opportunity for long-term investors. Although this situation may cause issues (rising energy prices and additional challenges for central bankers) that justifiably hurt equities, this conflict pales in comparison to other geopolitical events seen throughout history. It, therefore, will create a buying opportunity if equities take a severe hit. No two episodes are alike, but the market's reaction often is similar. When considering previous conflicts, the current situation seems much less troubling. For example, consider the advent of war, such as the First Gulf War, which caused equity prices to decline ~20% over a couple of months. However, they returned to a new high within four months of the low. That period also experienced an economic recession due to the Savings & Loan crisis. Another 20+% decline occurred in 1962 as the US and Russia came close to military conflict during the Cuban Missile Crisis. Stocks fell over 20% in three months only to return to a new all-time high over the next year.

The Russia/Ukraine crisis will contribute to a market already struggling with the coming transition to tighter monetary policy. However, we doubt the conflict can grow to the point of triggering an economic contraction, and, therefore whatever degree of decline equities experience is likely short-lived. At best, trying to calculate downside levels when markets are trading on emotion is guesswork. Should the S&P 500 fall below the 4,222 intra-day low reached on January 24, 2022, we are using somewhere in the 4,000-4,100 (just below the 23.6% retracement of the entire gain since March 2020 low) as our back of the envelope downside target. The S&P 500 would become more attractive at 17.7-18.2x next twelve months expected earnings—a discount to the five-year 18.91x average and below the pre-pandemic peak of just over 19x.

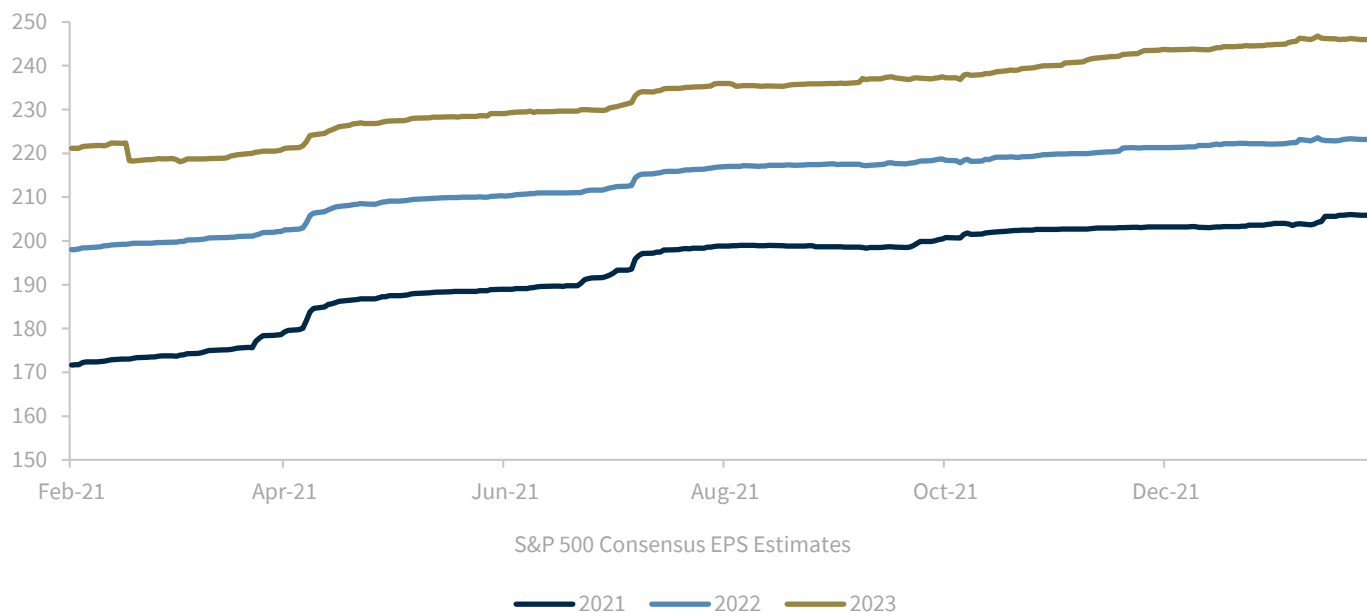
For now, we maintain a year-end base case target for the S&P 500 of 5,053, with earnings growth still expected to reach the low double-digits and the US economy expected to grow above the long-term growth trend. However, we are cognizant of the potential need to moderate our earnings and economic growth projections, and hence our price target, if inflation remains stickier throughout the year. Nevertheless, regardless of the potential fine-tuning to our numbers, we still envision attractive upside gains for investors from the current levels by year end.

Pavel Molchanov, Director, Energy Analyst, Equity Research

The worst-case scenario – an all-out invasion of Ukraine by the Russian military – has not materialized, at least thus far. But the presence of 100,000-plus Russian troops along the border, alongside President Putin’s decision to recognize the independence of eastern Ukraine’s rebel-held regions and send ‘peacekeepers’ there, means that the possibility of further escalation is set to persist for a long time. Why does this matter for the oil market? Because Russia produces approximately 10% of the world’s oil supply – on par with the US and Saudi Arabia – and half of that production is sold into the European market. Russia’s natural gas production – three-quarters of which goes to Europe – would be impacted to an even greater extent. In the event of war, oil and gas pipelines would be at high risk of damage, even if neither side is targeting them deliberately. Long after the war ends, Russia would face broad-based and harsh sanctions, which may include restrictions on energy exports. For example, the German government has made it crystal-clear that, if war breaks out, the Nord Stream 2 gas pipeline – an \$11 billion project – would be permanently banned from operating.

Whether we like it or not, high oil prices are here to stay.

S&P 500 Consensus EPS Estimates



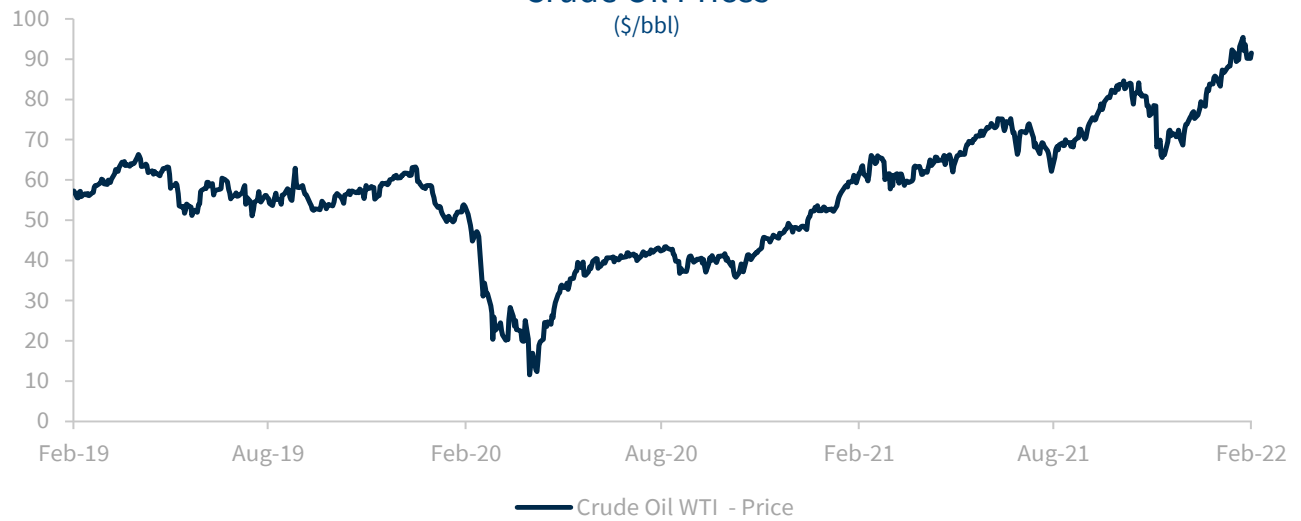
Source: FactSet, as of 2/2/2022

S&P 500 Hits First Correction in Current Bull Market



Source: FactSet, as of 2/2/2022

Crude Oil Prices (\$/bbl)



Source: FactSet, as of 2/2/2022

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Source: FactSet, as of 2/22/2022

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