INVESTMENT STRATEGY GROUP

UKRAINE AND THE MARKET'S RESPONSE

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On Tuesday of this week, the world awoke to learn that Russian President Vladimir Putin had ordered Russian forces to seize the Luhansk and Donetsk regions of Ukraine for what he called peace-keeping purposes. Following this, on Thursday, Russia launched a full-scale invasion of the rest of Ukraine. The U.S. and other nations have imposed economic sanctions on Russia and are prepared to announce further sanctions. Before rushing to arrive at conclusions, it is important to refresh one's memory regarding the road that led to the current situation and to examine what the root cause of the situation might be.

How Did We Get Here?

In 1989, the Berlin Wall fell and the world embraced the end of the cold war and a new era of peace. Two years later in 1991, Mikhail Gorbachev as leader of the Soviet Union, agreed to allow the Soviet Union to disband into independent republics and to allow the members of the Warsaw Pact - those communist countries in eastern Europe that formed a buffer zone between the Soviet Union and the NATO countries of western Europe - to become democracies.

By the end of the 1990s, NATO had embarked on a path that involved expanding eastward by absorbing the former Warsaw Pact countries. As NATO expanded eastward, Russia's then-President Boris Yeltsin repeatedly condemned and called for an end to this expansion. Since Vladimir Putin became Russia's president in 2000, NATO's eastward expansion has continued and Mr. Putin's requests that this expansion cease have been ignored. Since a country's membership in NATO presents the possibility that it might be used by NATO to host nuclear missiles aimed at Russia, NATO's eastward expansion towards Russia during the last twenty-five years has caused growing alarm in the Kremlin. Recall that in 1962, the Cuban missile crisis was triggered by essentially the same thing - the prospect of Russian nuclear weapons located 90 miles from U.S. soil and aimed at American cities. The U.S. response in 1962 was severe but justified, so it should not come as a surprise that Russia has responded with force.

We cannot presume to know what Mr. Putin is thinking but it looks like Russia will not tolerate any further eastward expansion of NATO towards its borders. In response, the U.S. and its allies have imposed and will increase economic sanctions on Russia unless it withdraws its forces. Although there are some who think a NATO military response is warranted, the U.S. and NATO did not come to the aid of Hungary in 1956 and Czechoslovakia in 1968 when the Soviet Union re-occupied those countries to quell uprisings. This, and the fact that Ukraine is not a NATO member, is probably why the U.S. has ruled out a NATO military response. With neither side willing to back down and lose face, Mr. Putin has said he is willing to look at further diplomacy to solve the crisis. This provides a way out for both sides but until then, the post-invasion war of words will continue and the sanctions will remain.

The Market's Response

For investors, the potential for an increase in sanctions and the impact this may have on equities appears to be the main risk presently. Russia is a significant producer of energy and commodities. It is estimated that Russia accounts for 13% of global fertilizer production, 4% of copper, 10% of nickel, 6% of uranium and that Russia and Ukraine together produce 29% of the world's wheat. So, sanctions targeting Russia's output could reduce the availability of oil, natural gas and many commodities that already are in tight supply, exacerbating forces that have pushed inflation to levels not seen in 40 years. It could also affect the timing and size of rate hikes by central banks as they try to control inflation. Conventional thinking suggests that the inflationary effects of sanctions will require more and larger rate hikes but more and larger rate hikes from central banks could push economies into a recession. So central banks will have a tough balancing act ahead, especially in an environment of escalating sanctions.

Will sanctions be effective in forcing Russia to withdraw from Ukraine? For now, this appears uncertain because it is estimated that Russia has approximately US$600 billion of foreign currency reserves, a budget based on an oil price that is half what the price is today and a debt-to-GDP ratio of only 18 percent. So Russia looks well protected against near-term and medium-term pressures.

Tuesday's action by Russia caused equity markets to fall during the next two days but although Thursday's move by Russia to annex all of Ukraine may have been a surprise, the move up in the TSX Composite and the S&P 500 indices on Thursday suggests investors do not expect much negative impact on equities from sanctions, at least for now.

This aggression by Russia comes when the financial markets have been under pressure as we prepare for an end to quantitative easing by the world's central banks, the prospect of rising interest rates and the reality of higher inflation. Perhaps, these factors will be more of a driver of markets over the next several months than is the situation in Ukraine. The table below shows the impact over the last three days in North America on energy prices, energy stocks, gold and the share prices of selected defense contractors.

Index/Security	Last 3 Days	Thursday	Wednesday	Tuesday
S&P TSX Composite Index	-1.2%	0.1%	-0.8%	-0.5%
S&P 500 Index	-1.4%	1.5%	-1.8%	-1.0%
S&P TSX Energy Index	-1.4%	-0.9%	1.0%	-1.5%
S&P 500 Energy Index	-6.7%	-6.9%	0.3%	-0.1%
Gold	1.4%	0.8%	0.2%	0.4%
Crude Oil (WTI)	1.7%	0.8%	-0.3%	1.2%
Natural Gas (NYMEX)	3.1%	-1.2%	2.8%	1.5%
Raytheon Corp.	0.9%	2.2%	1.4%	0.2%
Northrop Grumman	1.1%	2.4%	1.2%	-0.1%
Lockheed	2.4%	1.8%	0.7%	-0.1%
Boeing	-5.1%	1.0%	-1.2%	4.9%
General Dynamic	1.0%	1.0%	-0.3%	0.5%

Source: Bloomberg.

In Europe, amid low natural gas storage levels and a heavy reliance on Russian energy, natural gas prices are at new all-time highs on concerns surrounding gas deliveries to the rest of Europe, fears that Ukraine’s gas pipeline network could be impacted by the invasion and the impact to future supplies of natural gas due to Germany's decision to halt the Nord Stream 2 pipeline. In the U.K., natural gas prices are now above US$40/Mcf and the price in the Netherlands is above US$42.

What Should Investors Do?

First, investors should keep monitoring the situation because it will most likely keep changing. The odds that sanctions will steadily increase is high and creates risk, so a higher cash position may be considered. Second, investors should not lose their focus and should continue to invest in high-quality companies with good cash flows. Finally, investors should see that Russia's aggression does not change the reality that they should consider preparing portfolios for the impact of higher interest rates by seeking out those companies whose businesses benefit from higher rates and also consider those companies that have a track record of growing dividends because this can help to offset the impact of inflation in portfolios.

In the meantime, perhaps NATO and the U.S. will take Mr. Putin up on his offer to negotiate a settlement, one that will address the alarm with which the Kremlin has viewed NATO's eastward expansion. Then we might see Russian forces withdrawn from Ukraine and peace secured in the region.

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