Market Update

The Ukraine-Russia Conflict: A Fundamentally-Rooted Overview

ADVANCED ASSET MANAGEMENT ADVISORS

The major news outlets and financial commentators are keeping us awash with updates on Ukraine and markets have continued to be volatile. But many questions remain—what's going to happen? What does this all mean for the global economy and markets? How will my portfolios be affected?

Advanced Asset Management Advisors is actively monitoring the developments through a fundamental lens. What will the future bring? Forecasting anything is difficult but we will note several items we have collected from our observations and readings. We believe they are all important to note.

1) Is Market Volatility Over?

The recent high for the (mostly high growth, large cap) Nasdaq 100 market index was 16,973 on November 19th last year. Pre-invasion, the index stood at 13,509 – down 18.5%. On Thursday, the index opened 3.3% lower and proceeded to rally 7% from its low by the close. This type of intra-day recovery is often heralded as a "key reversal" day that is often found at the end of major market declines. However, the size of Thursday's reversal has only been rivaled twice before. The dates are 4/27/2000 and 5/4/2001. Measured by the broader-based S&P 500 both of those key reversal dates were followed by further declines of 13.7% and 23.7%. Based on this limited data set, we cannot say that it is over yet.

"Sell the rumor, buy the news" is an old adage that often provides favorable results. However, one must ask which is rumor and which is news. Iraq's invasion of Kuwait was news, but the appropriate news to buy was the start of Desert Storm.

2) What Does Russia Signal With The Invasion?

The common narrative is that Putin is a thug and wants to rebuild the old U.S.S.R. Rebuilding the Soviet Union today seems an unrealistic goal for anyone to entertain, including Russia. We have not read the various communications regarding proposed (and unsuccessful) security agreements that were exchanged between Russia and the U.S./NATO. However, since they were rebuffed, Putin might view the situation similar to how Kennedy viewed the Cuban Missile Crisis…"we do not want your missiles on our borders". If so, the rebuilding of the U.S.S.R narrative is excessive speculation.

3) Who Will Win The War?

The raw measures of military strength favor Russia with roughly 10 times the military assets of Ukraine. However, the independent mindset of Ukraine and the geographical size of the country suggest it may be a drawn out affair.

4) How Will The War Affect Already Rampant Inflation?

Investors can expect increased price inflation in certain commodities, at least over the near term. Oil, natural gas, grains, and certain precious metals have already experienced price spikes. And these are on top of the extreme rising price trends over the last 18 months.

The U.S. now imports 11% of its crude oil from Russia. Redeveloping domestic and "friendly nation" sources will be important for our long-term security. The Bureau of Land Management seems to be supporting domestic production by releasing 80 million acres of development in the Gulf of Mexico and 511 drilling permits during the 4th quarter of 2021. In the 12 months ended 9/30/21 a total of 5,145 permits were issued. Baker Hughes rig count is currently 645 versus 397 a year ago. Development takes time and is expensive but the resources are available.

With inflation, particularly within the energy sector, the strength and resolve of NATO may be in the balance. As of now NATO members are united. However, as energy costs spike and that pain is felt throughout the global economy, we could see variations in the members' alignment.

5) What Happens If Russia Is Successful?

If Russia succeeds, it could signal a seminal change away from the post WWII global trends towards democracy, free markets, and global trade. Lurking aggressors could become emboldened in China (Taiwan), Korea and other areas in the South China Sea.

Given the technology manufacturing facilities in Taiwan and Korea, the global impact from aggression here would make Ukraine pale in comparison.

6) Are The Sanctions Imposed On Russia Effective?

The economic sanctions posed on Russia, to date, are serious. Handicapping their ability to bank and trade globally will greatly impede their economic growth. However, many political figures have lobbied for additional sanctioning—such as cutting Russia out of the SWIFT banking system. This is a tricky line to toe, as a complete cutoff from SWIFT may push Russia into a total reliance on China for trade. The dynamics of global trade and the geopolitical landscape are greatly intertwined and delicate. Further sanctioning may come, but they carry greater levels of risk, effecting much more of the global economy than Russia.

7) How Does This Impact The Federal Reserve's Plans To Raise Rates?

Market volatility and rising economic uncertainty may affect the Federal Reserve's path towards monetary tightening. While we haven't seen indicators that this is on the table, the conflict could give the Fed reason enough to postpone their planned March rate hikes.

The last point brings us back to the realities of the economy, interest rates, inflation, and the markets.

Here are some quotes from **our year end commentary** with pertinent updates (quoted text references content from our commentary).

> "The Federal Reserve seems to be behind the inflation-fighting curve as it continues with its zero interest rate policy and money printing scheme (quantitative easing)."
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> "the 29% increase in home prices over the last two years will increasingly filter into rental costs as leases are renewed. Total shelter costs, including furnishings and utilities, represent a significant 42% of the CPI."
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> "Economists and the Federal Reserve have a rather cavalier attitude towards reducing inflation. Reducing future inflation will never restore lost purchasing power."
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> "In his recent news conference, Chairman Powell said, 'In dealing with balance sheet issues, we've learned that it's best to take a careful, sort of methodical approach to make adjustments. Markets are going to be sensitive to it."

Clearly, the Federal Reserve still faces the same dilemma. Less favorable monetary policy should help reduce inflation, yet the markets are very sensitive to the negative impact such a move could have on a slowing economy.

> "Corporate profits have rebounded from pandemic lows and posted new highs—28% above 2019 (a 13.2% annualized gain). Profits are projected to grow at a 9% pace next year—slower, yet a respectable gain. Stock prices have led profit growth and are currently priced at 25 times trailing earnings and 22 times expected earnings. Both measures remain relatively high (in the 83rd and 78th percentiles, respectively)."

Earnings estimates for 2022 have been stabile since the first of the year and stock prices are down. Consequently, the forward earnings multiple has declined from 22 to 20 and falls in the 71st percentile versus the 78th percentile at year end. Overall valuations have improved but remain above normal.

The trend of relative weakness in more speculative segments of the equity market continue to worsen while quality, large cap companies have held up better.

> "Our equity portfolios are generally focused in large cap companies, making sure that more defensive sectors are represented. The Healthcare sector, in particular, stands out in the over-valued market with a median valuation and above-market earnings growth forecast."

> "Risks to stocks primarily lie in the potential for higher interest rates and slower economic growth. The risk for higher rates is real, especially if the Fed overcomes its atychiphobia. The risk of slower economic growth is also real, absent fiscal stimulus from Washington and the potential for consumers to balk at higher prices."

Where Do We (AAMA) Stand Today?

We view the same risks to the equity market. The difference today is that inflation may be more stubborn and economic risks may be heightened. Both make the Fed's job harder and underscore the prospect for continued equity market volatility on both the downside and upside.

Want to learn more? **Click here to contact us**. We'd love to sit down with you and dive deeper into the fundamentals.

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