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CONTENTS

It Won't Be So Easy Next Time For Russia, But for Now There's No Clue On What's Going To Happen 1

A snapshot of What Happened in the Market This Week 4

Conclusion 5

Disclaimer & Contacts 8

Macro View

By Hubert Marleau

It Won't Be So Easy Next Time For Russia, But for Now There's No Clue On What's Going To Happen

Submitted February 27, 2022

I have a very limited knowledge of power politics and foreign affairs. Over the past two weeks I have read many editorial comments and seasoned opinions –FT, WSJ, NYT, Bloomberg, Foreign Affairs, Project Syndicate, Capital Economics, MacroStrategy Partnership, and GaveKal. What I came up with is below. Take note that editorial pieces tend to be negative - they are rarely optimistic.

Trading stocks in a market that is driven by geopolitical headlines is crazy. Making distinctions between what is noise and what is signal is a difficult task because it's hard to keep emotions in check and quantify the odds. Nevertheless, it is important to try to figure out how much geopolitical risk premium is now priced into risk assets. We know two big things: on the one hand, the West is convinced that Russia is not going to limit its incursion into Ukraine to the breakaway provinces, and that something has to done about it and, on the other hand, the idea of Ukraine ever joining Nato, which has been floated in various ways, is an existential red line for Russia. Given that Russia and Ukraine account for only 3% of the global economy between them, the economic risk lies strictly with energy. How this conflict plays out will determine oil prices.

Has the imposition of Western sanctions on Russia been swift and harsh enough to stop an European land war? That's the question. Aside from Germany pausing certification of the Nord Stream 2 pipeline, not much of a concrete nature has occurred on the energy front. Nonetheless, oil remains near $100 a barrel. It's way above fair value, which is roughly $80, reflecting fears that a prolonged crisis would damage the global supply. In the aggregate, energy bills currently account for 10.3% of W-GDP in nominal terms.

History, however, is clear on this one thing: when the cost of energy passes the 10% threshold in a sustainable and protracted manner, deflationary conditions set in. Bloomberg has a disclaimer on this. "To be sure, the

Macro View cont.

By Hubert Marleau

world economy is no longer the oil guzzler it was during previous decades, especially the 1970s, and alternative energy offers some buffer. Other pandemic-era insulators include swelling household savings and higher wages for the lower income cohort." This is sensible, for we may indeed have less to worry about. We have electric cars and people use ride hailing or work at home. The total impact of oil on R-GDP and individual pocketbooks is definitely lower than it used to be. But food prices are out of control. To make things worse, the Roger's Agricultural Commodities Index presently stands at 1327, twice what it was before the pandemic first hit us.

Although the Russia-Ukraine situation is not a direct blow to earnings, the cost of energy and food could cause fearful exogenous shocks, in the form of an inflation, recession or both.

In a worst-case scenario, oil prices could rise to $125, raising inflation while dampenning growth prospects. In a best-case scenario, oil prices could fall to $80, reducing inflation while raising growth prospects. In other words, are we having a stagflation shock or an inflationary bust? It will have a lot to do with whether the risk of war will intensify or not. Or maybe on how fast Russia can bring Ukraine to its knees.

And that is completely dependent on Putin: considerable downside for stocks in an escalation scenario, and considerable upside on any de-escalation. Thus investors should exercise common sense when evaluating geopolitics.

Much depends on whether the U.S. and other countries will impose sanctions on Russian exports of oil, should the Kremlin continue to pursue aggressively and actively its objective of bringing all of Ukraine under its influence, using the pretext that NATO is plotting an offensive and that the interest of Russia and the security of its citizens is unconditional.

Although Putin knows very well that it is ludicrous to think that NATO is about to mount preemptive strikes against Russia, he also knows that Ukrainian public opinion has shifted decisively against Russia and toward an embrace of NATO and the West. This situation makes diplomacy much harder and increases the chance of a real war. Herein, lies the problem. There is a distinct possibility that the West may have to revert to severe oil sanctions.

Knowing what is in Putin's mind counts as the most important piece of financial, not to mention military and intelligence one could possess. He's the only one with insider information. The signs are in plain view, pointing to either a massive invasion or a very expensive and convincing bluff to capture the separatist breakaways. Using its position as one of the world's biggest and most influential players in the oil market, with more than

Macro View cont.

By Hubert Marleau

$600 billion of foreign reserves, gives Russia a lot of geopolitical leverage. Can it afford a world-wide retaliation? I think so. Right now, Moscow holds all the aces. But for how long?

A consensus on Russia's potential weakness is emerging, however. Overplaying one's hand in the energy markets never ends well. It forces importers to race to develop domestic oilfields and alternative energy sources, which quickly results in drastic declines in oil consumption. Canada, the U.S. and Saudi Arabia are bound to come to the rescue. That may be easier than the stock market thinks. Scattered around a series of peninsulas on the edge of the Atlantic, it's relatively easy for Europe to diversify its sources of supply by tapping the global LNG trade. This is actually happening. Terminals in operation across the E.U. and U.K. are able to accept a total of 196 bcm per year. Imports in 2020 came to 89 bcm, a nice gap that could be filled by oil exporters. Oil imports soared in January, hitting 100% of capacity, according to Rystad Energy. Some 56% of that total came from the U.S., which partially explains why spot prices are considerably higher than futures. Moreover, several LNG liquefaction projects, which could add 1213 bcm to the global markets, are awaiting investment signoff and the E.U. is rapidly switching away from fossil fuels. By contrast, Russia has limited options.

In this connection, I suspected all along that the E.U., U.K., the U.S., and Canada would cut Russian banks from Swift and paralyze the activities of Russia's central bank. Late Saturday evening, it came. The West barred Russia from SWIFT, a critical messaging system at the heart of trillions in transactions globally, disconnecting Russian banks from the international financial system. Additionally, they intend to impose restrictive measures on the Russian central bank that would prevent Russia from using its $600 billion war chest that could have been used to cushion the measures adopted last week. US officials said that the West will use the Iran Model. That is to create a mechanism for western economies to purchase Russian energy. Nonetheless NATO is strangling the Russian economy. This could cause a bank run, collapse the ruble and create a political, economic and social crisis without a life line. The end is near and Putin's campaign will ultimately fail.

Russia needs to act fast, if it wants to reap the geopolitical dividends of its petroleum exports now to capture all of what lies east of the Dnieper. Putin has re-united NATO and unleashed world opinion against him, it won't be so easy for him next time. Yet there are still two big geopolitical risks:

Will this embolden China? This question poses difficulties for China. I don't why China would perpetually support Russia when relations with the E.U. and U.S. are much more important to its economy. China sought

Macro View cont.

By Hubert Marleau

to distance itself from Russia on Friday. China's foreign minister, Wang Yi, said: "it's absolutely imperative for all sides to exercise restraint to stop the conflict from getting out of control."
Will this encourage Russia to target the alliance? I don't think so. Under the Washington Treaty Article 5, absolute security guarantee is provided for NATO allies. An attack on one is regarded as an attack on all.

A snapshot of What Happened in the Market This Week:

On Tuesday, the S&P 500 entered correction territory for the first time since the Covid-19 pandemic began two years ago: a symbolic milestone. In the hope of arresting Putin's ambition to annex Ukraine in the Russian orbit, other countries introduced a plethora of penalties. The U.S. imposed a first layer of sanctions on Russia on two financial institutions: issuance of sovereign debt in the West, restrictions on Russian elites, plus prohibition of new investment, trade and financing in the separatist regions of Ukraine. Britain froze the assets of three billionaires and five banks. The E.U. blacklisted Russian lawmakers and blackballed banks with links to separatist areas. Australia, Canada and Japan joined in with similar efforts. This kind of stuff was already written in the cards, however, and it was not expected that Russia would bend. The market knew that Russia had taken steps to buffer itself against the economic blow of shallow sanctions: Russian oil would still flow west to central Europe. What the market did not like was the harsh tone of Western leaders. Joe Biden said: "Russia has started the invasion of Ukraine." The NATO chief said: "Russia is preparing a full scale attack on Ukraine."

U.S. stocks fell on Wednesday, deepening their losses after concerns over the deployment of soldiers in Ukraine's Donbas region. The losses were broad-based with 10 of the S&P 500's 11 sectors declining for the day.

On Thursday, Russian forces fired missiles at several Ukraine cities and landed troops on its south coast after Putin had authorized what he called a special military operation in the east section of Ukraine. Volodymyr Zelensky, President of Ukraine, emphasized that his country posed no threat to Russia. Yet Russia chose the path of aggression against a sovereign and independent country. Zelensky said: "This is a war of aggression. Ukraine will defend itself and win. The world can and must stop Putin. The time to act is now". In retaliation, Putin warned other countries that interfering with the invasion would bring about "such consequences as you have never before experienced in your history." Does this line amount to a threat to use nuclear weapons? U.S. equities initially sank hard as the price of oil crossed the $100 threshold. Meanwhile the Russian army invaded Ukraine from Belarus, Crimea and Russia, encircling the eastern part of Ukraine; and fired missiles at strategic sites and major cities, hoping to topple the government in Kyiv. The S&P 500 and

Macro View cont.

By Hubert Marleau

Nasdaq sank in the morning but staged a dramatic 4.1% and 6.7% rebound in the afternoon, expressing relief that Biden's second tranche of sanctions against Russia did not include SWIFT, a global payment network, and oil. The sanction package was harsh, but specifically designed to minimize the impact on the world's economy, allowing energy payments to continue. Biden said: "The U.S. is working with other countries on a combined release from strategic reserves."

On Friday, the market turned sour once more as speculators pondered what the long term implication of the war in Ukraine could be. Russia now knows that the West wants its oil. What if the West decides to limit Russia's energy exports, or Russia decides to withhold supply. What happens then? That was the way the day started. Later on, Ukrainian President Zelensky called on Russian President Putin to meet for talks. Officials in Moscow have agreed to hold these, and are willing to send a delegation to Minsk, the Belarusian capital, to do so. Traders saw in this a possible resolution to the conflict. So far, Putin has undercut the offer. Nonetheless he must feel the pressure stemming from protests on the streets of Moscow, the cost of war, isolation from the international community, global condemnation and from Xi, the President of China, to open a dialogue with Zelensky. A quick end to the fighting would probably see energy settle around current levels, with everything turning hunky dory again.

After a 3-day correction, the S&P 500 sprinted into the last two days of the week, ending at 4385, up 36 points or 0.8%. The market has realized that Ukraine was a failed state and that no one was going to lift a finger for it and risk an economic catastrophe. It's up to Ukraine to fight for an acceptable resolution.

Conclusion:

Geopolitical events tend to spike volatility. But heads should stay focused on economic fundamentals. The direct effect on the North American economies is not going to be bad. Data is still pointing to strong growth, and investors should take the geopolitical crisis in stride. Indeed, private data firm IHS Markit reported that its composite Purchasing Managers Index for the U.S. had risen to a two-year high in February, suggesting the economy was gaining strength. The NY Fed's Weekly Economic Index (WEI) was updated on Thursday, and was up firmly to 6.84.

Given the geopolitical situation and the possible recessionary effect of fast rising prices of food and energy, the Fed will be prudent in what they will communicate at their March meeting, but it will remain undeterred in their efforts to raise interest rates. At a dinner with Stephen Poloz, the former governor of the Bank of Canada, made the wise observation that the job of a central bank was to deal with probabilities and smooth

Macro View cont.

By Hubert Marleau

things out the best it could. Thus it is far better for the Fed to reduce monetary support in March than wait and allow rampant inflation to run amok, which could foment financial instability and raise the risk of recession even more.

The real signals, however, are in the bond, foreign exchange and commodity markets. The omens are clear. Common relationships are not holding. Prices of items like oil, natural gas, commodities and wheat have surged, yet the dollar has held well. U.S. real rates have declined, while international interest rate differentials have widened in favour of the U.S., which is bound to put a lid on bond yields. Inflationary expectations have risen significantly over the past 3 weeks, but the bond traders do not believe that they will last. In fact, they are betting that inflation will rise around 5.00% over the next 12-months, but quickly fall in the following 3 years to 3.0% and 2.5% and 2.0% respectively.

Meanwhile, the yield curve has not inverted. The bond market is telling us that the pace of the economy is slowing, but without a recession in sight. Indeed, Oren Klachkin, an economist at Oxford Economics, says the conflict in Ukraine will shave only 0.2% off real 2022 GDP. It's a minimal hit that could be easily offset by the positive growth effect that higher oil prices could have on the oil, gas and agriculture sectors.

In this connection, traders' wagers on the probabilities of a quarter-point or half-point rate increase at the Fed's next meeting on March 15-16 have gyrated all over the place in the last two weeks amid geopolitical turmoil and discordant commentary from central bankers. At this given moment, the CME Group says that there is a 65% chance of a 25 bps hike versus 35% for a 50 bps. A fast and furious series of hikes is therefore less likely. The bond market foresees a compromise and thinks that it will suffice.be As a whole, the Fed wants to avoid an abrupt slowdown but also wants to contain inflation.

At 4200, the S&P 500 is near an important support zone. At the low of 4222, which hit in late January, investors swooped in to buy beaten-down stocks. The stock market hasn't looked this cheap, in terms of the Equity Risk Premium, in two years - as cheap as it was in the early days of the pandemic. As a rule, stocks do well after corrections, when the prospects for productivity are good. We are in a period where technology capex is greater than 50% of total fixed capital formation: a phenomenon that has an enormous multiplier effect on productivity.

Callie Cox, an investment analyst with eToto, argued in a note to investors that since 1990, when fear and uncertainty was as high as today, the S&P 500 had averaged 18% returns in the following 12 months. The recipe for a relief rally is present. Accordingly, for the stock market to experience another downward jolt from here is becoming less and less likely. As a matter of fact, there has been no meaningful change in the

Macro View cont.

By Hubert Marleau

Skew Index, suggesting no tail risk. When Russia annexed Crimea in 2014, the S&P 500 sold off in the first few weeks of the year on worries about a full invasion, but the market bottomed 2 weeks before the country was fully occupied.

I have no wish to minimize the seriousness of the current events, but in the fullness of time they turn out to be blips on charts. Except for the Japanese attack on Pearl Harbour, it's been rare for geopolitical events to change the trajectory of markets and the economy.

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