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Weekly Commentary

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Macro View

By Hubert Marleau

The Conflict May End Up In a Stalemate

Submitted March 6, 2022

The Weekly Snapshot of the Market:

The S&P 500 skidded back into correction on Tuesday, buckling to the economic fears mounting over the Russia-Ukraine War. This reality was reflected with higher energy and food prices, lower interest rates, falling stock prices and a stronger U.S dollar. Until there is a durable ceasefire or a meaningful truce, noisy headlines about the war will erratically determine the movement of hot money, the impact of which will dominate the performance of the stock market.

On Wednesday, the broad benchmark stock market shot up 1.9% as an adjustment bounce. The Fed's chief's comments gave the market some certainty that he would be inclined to support only a 25 bps rate hike, and confirmed Wall Street consensus that the U.S. economic outlook had not dramatically changed. Stocks sold off in the final hours of trading on Thursday, on bold hawkish comments by Cleveland Fed President Loretta Mester, suggesting that the Fed-funds rate might have to go above the neutral one. On Friday, stocks took another bad beating as the Russia-Ukraine conflict intensified with the burning of a large Ukrainian nuclear plant. For the week as a whole, the S&P 500 fell 56 points or 1.3% to close at 4329 - 9.8% off its most recent high, near correction territory, but comfortably above the 4222 support level.

Will the West Checkmate Fortress Russia?

When it comes to geopolitical risk, standard assumptions don't work very well. This sort of risk is uninvestable because it is too complex to incorporate in the investment decision-making process: assurance of success is far too low. Overconfidence on knowing what the future looks like is stupid. Moreover, markets tend to price in bad and ugly international events immediately, without taking time to think. Therefore, the wisest path

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forward is prudency. The Ukraine-Russia headlines are and will continue to be a source of concern, introducing volatility and causing choppy days of trading.

It’s hard to tell how and when it will end. Barring a diplomatic resolution to the conflict, it will end either because the Russian army overthrows the Ukrainian government or a « coup d’état » in Russia. resulting from a bank run, credit crunch, currency free fall and debt default. For now, the Russians seem to be approaching the descending hardship with fatalism—there is no panic on the streets of Moscow, but there are signs that the western sanctions have begun to bite. Therefore, Putin must win over Ukraine quickly, before global condemnation kills the Russian economy. Given that the impact of the war isn’t hurting Western economies as severely as it is devastating the Russian one, as it currently stands, Russia appears to be winning the war at the price of being totally isolated.

On the one hand, Russia has doubled down on its Ukraine assault. Its forces have encircled, captured or laid siege to major cities, destroying residential buildings, schools and hospitals, and killing hundreds of civilians while launching warnings to countries that supply weapons to Ukraine, saying it will press ahead until its goals are met. A Ukrainian victory would ensure Putin’s political defeat, so he won't allow it. He needs a quick win, the longer the conflict lasts, the harder it is to spin a credible narrative. He knows the war is a mismatch and that with brutal tactics, Ukraine won't be able to continue to mount fierce resistance to the Russian onslaught much longer. He is also aware that Ukraine’s allies will opt not to send troops. Ukraine is not vital to their national interests nor worth the risk of starting a world-wide war with nuclear-armed opponents.

On the other hand, admonitions, restrictions and bans of various sorts will continue to pile up, until it wrecks the Russian economy. On the economic front, Western companies are retreating from Russia. Canada and the U.S. have banned Russian flights over their airspace and Turkey won’t allow the Russian fleet to use key straits from the Black Sea to the Mediterranean. The ICC is opening an investigation to see whether war crimes and crimes against humanity have been committed. Moreover, the Kremlin’s actions have accelerated the pace of Europe’s energy shift, the militarization of Germany, broad support for Ukraine’s request for EU membership, a movement to expel Russia from the World Trade Organization and discontent among Russian conscripts. On the financial side, taking away Russia’s central bank’s ability to deploy foreign reserves held abroad and restricting its commercial bank to freely deal abroad is a short-cut to a banking and currency crisis.

The final blow to Putin will come when the West decides to bite the bullet and go for an energy embargo. Calls for energy sanctions are growing louder as Russia shows no sign of acting more diplomatically. In anycase, it looks as if the West is already applying self-sanctions and has effectively turned off the oil tap - a

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partial de facto embargo. Oil prices have rallied above $115 a barrel, suggesting that refiners are baulking at buying Russian oil, and that banks are refusing to finance shipments. Futures are settling at a 20% discount to the spot price. Apparently, Trafigura tried to sell oil from the Urals at a $19 discount and found no buyers. An energy embargo may not be necessary, however, due to SWIFT bans and sanctions on Russia's central bank. The West has already engineered a debt crisis, hyperinflation and a deep recession. Russia can no longer depend on its stock of foreign exchange reserves and its current account surplus to defend the rouble or pay for imports. This could break the Russian economy because there would be no further access to any hard currency. It would then be left with gold, which is not easy to move around and would take quite a scheme to collateralize.

JPMorgan believes that the West has dynamited the Russian economy, and that on a seasonally adjusted basis, it may shrink around 10% in Q1 and as much as 35% in Q2.

The big unanswered question is whether China will provide a financial lifeline. China could buck the Western alliance effort to isolate Moscow. And, it would not be illegal under international law to do so. There are three possible avenues:

1) The People's Bank of China does a multi-billion dollar currency swap with Russia
2) Russia has foreign exchange reserves in yuan assets that it could sell for liquidity.
3) Russian banks join China's payments settlement system.

It's unclear whether support for Russia will be forthcoming. So far China has trodden cautiously. But it did signal willingness to play a role in realizing a ceasefire through diplomacy. The Chinese foreign minister, Wang Yi, said that he respected the territorial integrity of all countries, but insisted that regional security could not be achieved by expanding military blocs. Throwing a lifeline to Moscow is not as easy as it sounds. However, Jude Blanchette and Bonny Lin, officials at the Centre for Strategic and International Studies on Chinese Affairs, made it clear why China has opted for diplomacy: "If Beijing had its way, it would maintain strong ties with Moscow, safeguard its trading relationship with Ukraine, keep the EU in its economic orbit, and avoid the spillover of sanctions on Moscow–all while preventing relations with the U.S. from significantly deteriorating. Securing any one of these objectives may well be possible. Achieving all of them is not." Beijing can ill afford international pushback if it wants to change the global order. Perhaps China was played.

London-listed Russian shares are zero. They are considered outcasts. Alexander Butmanov, founder of a Moscow-based hedge fund, was asked on Russian television whether "stock market strategies are now outdated." He pulled out a glass to what he declared: "the death of the Russian stock market." He added: "Dear stock market, you were close to us, you were interesting, rest in peace dear comrade."

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All this looks like a cold war stalemate. Russia wins the battle but loses the economic war, while Ukraine loses on the battlefield, but creates an Algerian imbroglio for Russia. For all the scary unknowns Russia has brought the world, it has strengthened the will of NATO nations to defend itself, unshackling public finance to fund everything from enhanced military capabilities to alternative energy supplies. It will hasten the process of subdividing the global economy into competing blocs. It will harden economic policies toward global rivals. It will force them - especially - America, to introduce industrial policies to protect their edge or leadership in new technologies, including semiconductors, artificial intelligence, electrical vehicles and 5G wireless.

Conclusion:

So far, the Russian invasion of Ukraine has not radically altered the short-term outlook for growth. The majority of the recent economic prints are surprising the consensus to the upside, and the war might force the Fed to hike interest rates less aggressively than originally expected. Indeed the upward trend in R-GDP growth is expected to continue, albeit at a slower pace. The stronger than expected 687,000 gain in non-farm payrolls in February and upward revisions to previous months gains is another sign that the economy has considerable momentum.

Unfortunately, the rising price for essentials, like food and energy, combined with the decelerating growth in the money supply, presents world-wide recession risk. Energy bills jumped to 12.4% of global GDP this week, the highest on record, other than May through July 2008. Meanwhile, agricultural commodity prices are heading to record levels. These are growing risks. The changing terms of trade resulting from higher food and energy prices are absorbing a big piece of monetary growth, and may eventually force consumers to use their extra savings accumulated during the pandemic to make ends meet. We had oil spikes before, albeit larger than the current one, and all were followed by serious slowdowns in real economic activity.

The Barrons reported on the weekend that Helima Croft, global head of commodity strategy at RBC Capital Markets, had observed that the 2008 oil spike didn't cause demand destruction until prices reached $140. That's the equivalent of around $200 today, adjusted for inflation, which is the price that the investment bank Stifel estimated oil would have to see if Russia were pushed out of the market entirely. In a separate analysis, BofA Securities calculated that $200 oil would slice two percentage points off U.S.economic growth. But there is also the matter of "super-backwardation" - what traders call an unusually sharp drop-off in the oil futures curve. The market expects oil prices to fall to $90 a barrel from $115 over the coming year,

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suggesting that $200 oil won't happen. Jack Hough, a writer for the Barrons, sums it this way: "Here's hoping for peace, new barrels, a future of falling oil dependence, and a management change in Moscow."

Thus, we have decided not to overhaul our long-term strategies, continuing to focus on growth and income objectives with broad diversification. We are constantly re-balancing our portfolios, trimming our positions in the energy and material sectors in favour of gradually accumulating beaten-down tech stocks, taking extra positions in Alberta- and Saskatchewan-based consumer and industrial stocks, while keeping overweight exposure in REITs and Utilities.

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Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca