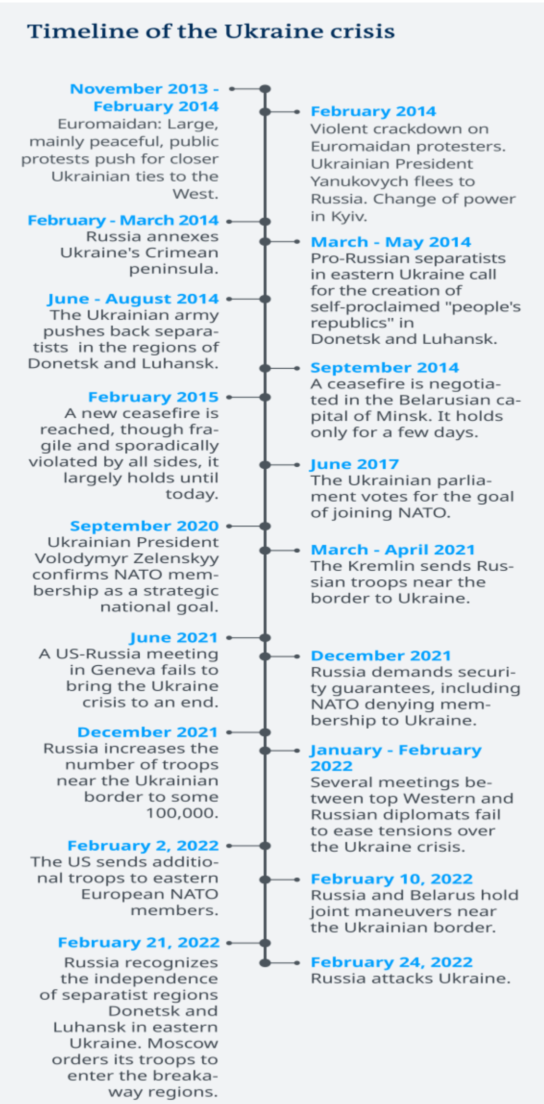
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

Economic and Market Update – FOCUS ON RUSSIA/UKRAINE CONFLICT (02/28/2022)

Latest Developments and Economics



1Credit: Deutsche Welle

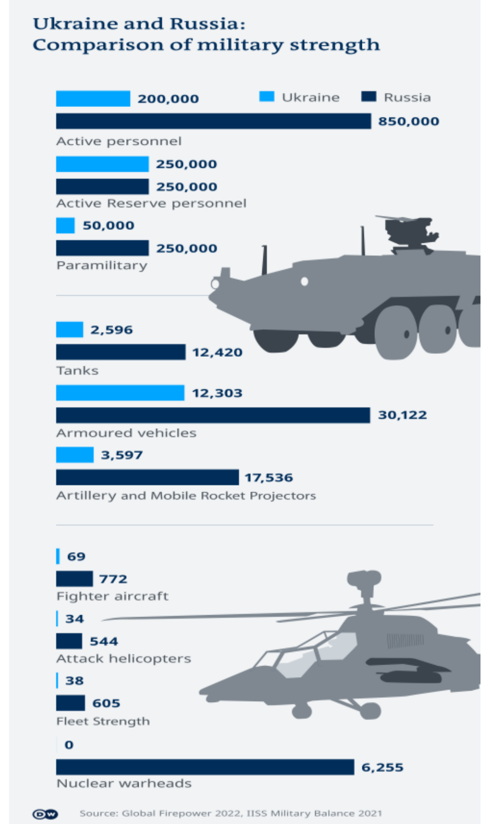
Despite the backdrop of a slowing U.S. economy, continually increasing inflation and a period of rising interest rates the markets have been focused squarely on the headlines coming from the unprovoked Russian invasion of the sovereign nation of Ukraine. The priority of attention first is to the terrible consequences for the country and its people and the world seems unified in support of their cause. While that remains paramount our job is to also pay attention to the economic and market consequences from this action. Global markets have increased in volatility over the last week – in what was already a volatile start to 2022.

To summarize where we are currently, Western nations, particularly the U.S., had first called out the massive troop movement by Russia along the Ukraine border and concern for an imminent invasion, but the scale of the operation was uncertain. The Biden administration also laid out the possible narratives which would give Russia seeming justification for an invasion. Diplomacy was not able to defuse the situation, and after the Olympics, the invasion started with the explanation that the Ukraine government was committing genocide against the Russian culture and people in the Eastern provinces of the Ukraine. A first round of sanctions began with some allies not fully on board. Russian security concerns scaled up the incursion into a full-scale invasion of the country with the intent on installing a government friendly to Moscow. There have been about 14 eastern European countries that have joined NATO since the fall of the Soviet Union in 1990 – many with strong former Soviet ties. There are an additional 3 countries with aspirations of NATO membership currently – including Ukraine. The country is not only important to Russia as a buffer country, but Ukraine is considered the "bread basket" of Europe and is rich in natural resources.

The U.S., its allies and most of the world have responded with strong sanctions and other actions in a coordinated way to isolate Russia. Putin, however, had learned from the 2014 sanctions and have tried to make themselves less vulnerable. Russia's debt-to-GDP is only about 18% (vs. over 100% for the U.S.) making them less reliant on foreign capital. They have also built up the fourth largest foreign exchange reserve at

$630 billion – comprised of gold and foreign currency. While the Nord Stream 2 energy pipeline to Germany has been put on the hold the recent increase in oil prices will help Russia build on their reserves by $65 billion potentially. All of this means that the first round of sanctions would not impact Russia in the short term. The subsequent sanctions including a significant cut-off to the global payment system (SWIFT) and targeting personal assets of Putin and his oligarchs may have a more direct impact.

Despite being massively outmanned and outgunned, the people of the Ukraine have resisted their invaders bravely. Attacks have been increasingly indiscriminate, but the Russians hold little territory in the country and no major city just yet. After four days of attacks there are unconditional talks planned between Ukrainian and Russian delegates along the border. At the same time as this hopeful news Putin escalated tension with the West by claiming that he has ordered Russian nuclear-deterrence forces to be on alert. The primary impact so far has been on the Ukrainian people displaced from their homes. Refugees have been fleeing into the neighboring countries of Poland, Slovakia, Hungary and Romania on Ukraine's western borders. Numbers crossing the borders are expected to be about 1 million in the first days and could grow to up to 4 million. European Union countries have relaxed paperwork requirements for people entering from Ukraine.



2Credit: Deutsche Welle

Geopolitical events are difficult to predict, and the near-term future can take several different courses. We can, however, forecast the economic impact of the invasion and subsequent sanctions. While the action adds to economic uncertainty in general, the direct impact of this action on the U.S. economy is very limited. Russia accounts for only 1.0% of U.S. imports and less than 0.5% of U.S. exports. Europe, on the other hand, will feel the effect much harder as they trade substantially more with Russia – especially energy.

The first economic impact would be to commodities. The sanctions will create a supply shock as Russia produces about 10% of oil consumed around the world making it the third largest global producer. Russia also accounts for about 33% of Europe's natural gas supply. With the world returning to normal after COVID the demand for oil was already increasing. Once the sanctions were announced Brent crude oil surpassed $100/barrel for the first time since 2014 and natural gas prices have risen 6.5%. A deal with Iran for oil supply would help alleviate the energy situation. The attacks in Ukraine could cause a disruption to farming, in a country that is a major grain producer. In addition, Russia and Ukraine are major suppliers of Potash, Uranium, Palladium and Titanium. This increase in commodity costs is likely to worsen the inflation picture globally. Finally, the supply bottlenecks that have been in place since COVID may take longer to recover.

Second, the conflict could result in a further slowing of global growth. If the sanctions linger it could get to the point where the increase and duration of inflation will cause consumers to spend less and cause a drag economic growth. The U.S. is not as vulnerable given the expected continued recovery post-Omicron COVID restrictions though political global unrest does have a negative effect on confidence. There is also still an excess of open jobs to be filled (almost 11 million) in the United States. Europe is far more vulnerable given its reliance on the food and energy supply from Russia and Ukraine. The specter of stagflation may not be out of the question in Europe should the sanctions continue for a long period. Moreover, Europe will also carry most of the burden of initial care of the refugees emanating from Ukraine. At this point there is not an expectation that this conflict widens to include more European countries.

Third, this will cause a reassessment of current plans by central banks. The U.S. Federal Reserve was turning their attention to addressing significant inflation, but this may cause a slightly different path. When the Fed meets in the middle of March an increase in interest rates is expected. There was some thought that is may be as much as 0.50% as a larger move would send a stronger signal about the Fed's seriousness in bringing down inflation. While geopolitical events have caused the Fed to delay rate increases or even ease rates in the past, inflation is more urgent this time. The base case is that the Fed continues plans to increase rates in March but only 0.25%.

Of course, this is developing situation and the hope is that it comes to a peaceful resolution soon rather than escalating into something broader or longer (especially for the people affected in Ukraine).

Financial Markets

The fixed income markets had quickly moved to a 'risk off' situation due to the developments in Ukraine. The 10-year U.S. treasury yield fell back to 1.927% after climbing recently to as high as 2.045% based on Fed rate increase expectations. The significant inflation in Europe has also caused the European Central Bank (ECB) to end their bond buying to keep rates low and begin to address inflation as well but the war much closer to home may cause a rethinking of that policy despite the crisis likely contributing to further inflation.

The S&P 500 had a much wilder ride than fixed income since February 24. After opening the week at a level of 4,332 the index dropped to a low of 4,122 on the morning of invasion but recovering most of it the same day. In fact, the amount of selling for this geopolitical event was orderly on Tuesday when compared to exogenous shocks of the past. Then a very strong Friday left the up for the week at 4,834. The index is still down about

8.00% so far in 2022 reflecting the impact of inflation and a rising rate environment. It is mainly driven by a rerating of multiples since company earnings are still expected to rise by 2% in 2022. The Russia/Ukraine conflict adds more uncertainty to the mix. This is reflected in the elevated VIX (fear gage). The VIX spiked at 36 on Tuesday morning (anything above 20 is generally considered a stressed market) before falling back to 27.59 by Friday 2/25.

CNBC

Geopolitical risks

Fundamentals are more likely to determine medium term equity market returns

S&P500 performance around select geopolitical / military events

Date	Geopolitical / military events	1 month later	3 months later	6 months later	12 months later
December 1941	Pearl Harbour	-3.4%	-12.7%	-9.1%	0.4%
October 1956	Suez Canal crisis	-2.8%	-3.8%	-0.1%	-11.5%
October 1962	Cuban missile crisis	8.7%	17.7%	25.1%	32.0%
October 1973	Arab oil embargo	-7.0%	-13.2%	-14.4%	-36.2%
November 1979	Iranian hostage crisis	4.2%	11.6%	3.8%	24.3%
December 1979	U.S.S.R. in Afghanistan	5.6%	-7.9%	6.9%	25.7%
August 1990	Iraq invades Kuwait	-8.2%	-13.5%	-2.1%	0.1%
January 1991	Gulf War	15.2%	23.5%	20.6%	33.1%
August 1991	Gorbachev coup	0.0%	3.0%	7.0%	8.9%
February 1993	World Trade Center bombing	1.2%	2.5%	4.0%	6.4%
September 2001	9/11	-0.2%	2.5%	6.7%	-18.4%
March 2003	Iraq war	2.2%	15.6%	17.4%	28.4%
	Average	**1.3%**	**2.1%**	**5.5%**	**8.6%**
	% Positive	**50%**	**58%**	**67%**	**75%**

8 Source: Truist IAG, Factset. Light blue rows represent down markets where the economy was in recession at some point during the measurement period.

Cazenove Capital

While the particulars of this geopolitical event have yet to be understood and played out, we can take a cue from past events. Clearbridge Investments noted that going back to World War II the median market sell-off for geopolitical shock was about 5.7% for the S&P 500. It took about three weeks for the market to reach bottom and another 3 weeks for recovery. For selected specific past events you can see that in all but three of the twelve events the market had fully recovered the losses and was up an average of 5.5% in six months and 8.6% after twelve months. History doesn't always repeat but the significant events on the list were much larger in impact.

In the short-term recession risks in the near term seem limited. In addition to the progress on settling the conflict the key macroeconomic variables we will be keeping an eye on include: The price of oil and impact on inflation; Federal Reserve action and comments in mid-March and the behavior of the consumer and spending activity.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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