February 25th, 2022

Market Update

Executive Summary

- Our hearts go out to those that have fallen victim to the needless violence taking place in eastern Europe.
- Considerable uncertainty remains, such as the likelihood/magnitude of additional sanctions, the size/scope of the ongoing conflict, and how cyber weapons may be wielded for 21st century warfare.
- Given Ukraine and Russia's presence in the supply chains for multiple key commodities, war in eastern Europe runs the risk of exacerbating recent inflation trends.
- Investors should avoid the temptation to deviate from longer-term plans by selling equities and consider that negative market sentiment and cheaper valuations may justify measured contrarian purchases instead.

Russia Invades Ukraine

- **War in Eastern Europe.** Russian forces have launched a full-scale invasion of Ukraine, marking the largest attack on European soil since WWII. There have been multiple reports of Russian airstrikes and tanks crossing the Ukrainian border after Russian President Putin announced a "special military operation." The move has drawn strong condemnation from the U.S. and its NATO allies.
- **Military Response.** While pledging additional economic, humanitarian and diplomatic support, President Biden explicitly stated that U.S. troops "are not and will not be engaged in the conflict with Russia in Ukraine." However, the U.S. appears to be taking steps to shore up the defenses of Ukraine's NATO neighbors by shifting troops to the Baltic states and Poland.
- **Sanctions Response.** Biden announced an initial round of sanctions on Tuesday targeting Russian sovereign debt, two Russian banks and the Nord Stream 2 pipeline. On Thursday, Biden announced a second tranche, which included limitations on tech exports to Russia, additional sanctions on Russian banks and measures to hamper Russia's ability to conduct business with U.S. dollars. Many U.S.-allied leaders have announced similar sanctions.

Markets React

- **Heightened Volatility.** News of the Russian invasion prompted a fresh bout of global market volatility, particularly in Europe where equities[1] finished almost 4% lower on Thursday. In the U.S., the S&P 500 now sits firmly in correction territory, down 10.6% from its all-time high. Fears of fresh disruptions in energy markets pushed crude oil above the $100 per barrel mark. 10-year Treasury yields, after touching 2.05% just a week ago, now sit at 2.0% amid the prevailing risk-off market move.
- **Handicapping Geopolitics.** Geopolitical events are, by nature, highly unpredictable. Few (if any) serious investors could truthfully claim an edge in geopolitical predictions. As a result, the market tends to reflect these types of risks probabilistically. In this case, a risk that seemed less likely just a few days ago (i.e., Russian invasion) has come to fruition with 100% certainty. This has likely been the dominant driver of the recent risk-off market behavior.
- **Uncertainty Remains.** Going forward, there is still considerable uncertainty with which the market is likely to wrestle. Investors will likely be recalibrating their expectations according to the likelihood/magnitude of additional sanctions, the size/scope of the ongoing conflict and when the fighting may come to an end. This also includes estimations of the economic flow-through effects of the war, which could prove particularly acute in commodity supply chains.

[1]As represented by the MSCI Europe Index

Economic & Fundamental Impact

- **First Order Effects.** From an economic and market perspective, the direct impact of armed conflict between Russia and Ukraine is likely small. Russia and Ukraine combined represent a mere 2.8% of global GDP and less than 0.5% of global equity market capitalization.
- **History as Guide.** Equity markets have a track record of longer-term resilience in the face of geopolitical flareups. For example, U.S. equities experienced a correction when Iraq invaded Kuwait in 1990, but rebounded relatively quickly in the months thereafter. This does not mean that the economy and markets are immune to the risks of armed conflict over the near-term. For instance, in reaction to support for the Yom Kippur War, the OPEC oil embargo unleashed sizable inflation pressure in the U.S.
- **Grains & Gas.** Open hostilities between Russia and Ukraine can have other, indirect flow-through effects. For example, the European Union relies on Russia for more than a third of its natural gas supply. Also, Russia and Ukraine combined account for a quarter of global wheat exports. Such large presence in these markets could cause more disruptions to already strained supply chains.
- **Semiconductor Sensitivity.** The ongoing shortage in semiconductors has been an oft-cited symptom of supply chain stress, and war between Russia and Ukraine could cause additional disruptions. Russia produces 40% of mined palladium and Ukraine is responsible for more than 90% of the world's supply of semi-grade neon.
- **Banking Issues?** President Biden has so far stopped short of calling for Russia's removal from SWIFT.[2] If at some point, this comes into play for a third round of sanctions, this could introduce lending disruptions for those with exposure to Russian borrowers. France, Italy and Austria are the top three countries with outstanding loans to Russian guarantors, though the scale of this exposure in total appears low.
- **Cyberwar.** Cyberattacks have clearly become a key component of modern warfare. There have been reports that Russia unleashed malware alongside its physical invasion of Ukraine and President Biden has reportedly been presented with options for potential cyber counter-measures. The impact of these newer weapons of war will be difficult to handicap, given the lack of historical precedent of their use at scale.

Investment Playbook

- **Stocks Closer to Fair Value.** With earnings expectations more or less holding their ground through this crisis, the correction in equity markets has been primarily valuations-based. Heading into 2022, Glenmede's Global Expected Returns model estimated that global equities sat at the 83rd percentile of longer-term fair valuations, but now sit closer to the 70th percentile. Likewise, U.S. large cap equities are down to the 81st percentile vs. 93rd to start the year. It appears this recent bout of geopolitical risk has let some of the air out from recently-observed premium valuations.
- **Markets Oversold?** Glenmede's Sentiment Index seeks to identify periods of overbought or oversold market conditions in the U.S. via several technical and survey-based indicators. The Index is currently at the 4th percentile; historically, when the Index has sat between the 1st and 5th percentiles, the S&P 500 has outperformed cash in 92.5% of the 1-yr periods thereafter, to the tune of 25.8% annualized total returns, on average. However, the Index has not yet emitted its highest conviction buy signal that marks the full investor capitulation that is characteristic of major market bottoms.
- **Fed Impact.** In the background sits the Federal Reserve, which has been moving steadily closer to normalizing monetary policy in an effort to cool inflation. Fed funds futures markets are pricing in six rate hikes for 2022, with some even expecting a double rate hike in March to kick things off. Given the added uncertainty presented by war in Europe, the Fed is unlikely to skew more aggressive in their tightening path, reducing the likelihood of a half percent hike in March and/or rate hikes outside of the FOMC's[3] regularly scheduled meeting calendar.

Bottom line: Investors should avoid the temptation to deviate from longer-term plans by selling equities and consider that negative market sentiment and cheaper valuations may justify measured contrarian purchases instead.

[2]Society for Worldwide Interbank Financial Telecommunications (SWIFT)
[3]Federal Open Market Committee (FOMC)