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John's Market Outlook – March 2, 2022

In 1810, the British banker Nathan Rothschild said "*buy on the sound of cannons; sell on the sound of trumpets*", meaning to buy market panic at the start of war then sell market euphoria upon victory (the British victory over Napoleon at Waterloo).

Our December 7, 2021 outlook has been generally playing out. How will Russia's invasion of Ukraine change things?

Russia's "hot war" has led to an "economic war" between Russia and the West (US, Europe, Japan). Key Russian banks are blocked from the SWIFT interbank network, assets of Russian leaders and oligarchs are being frozen, and the Russian Central Bank is cut off from most of its foreign exchange reserves. More sanctions, governmental and private, have followed. The world's largest sovereign wealth fund will divest from Russia. Russian securities are being removed from global indices and funds. BP and Shell will divest their Russian energy interests. Many US technology products will be embargoed. Air travel to Russia is restricted. Visa and Mastercard have blocked sanctioned Russian banks. Many global shipping lines and UPS/FedEX are not serving Russia. Switzerland, normally neutral, is joining Europe's sanctions.

For now, sanctions have been designed to spare Russia's primary exports which are energy (oil, gas) and other commodities (wheat, etc) but that trade will nonetheless be constricted as private companies avoid the risk of transactions with Russian counterparties.

The US economy will see increased commodity price-driven inflation pressure and additional supply chain disruptions. The impact on Europe will be more significant, due to the continent's reliance on Russian natural gas piped through Ukraine. The Russian economy, cut off from foreign currency, transactions, and trade, faces consequences so severe, if sustained long enough, as to approximate a depression.

All eyes are on whether Russia will respond by de-escalating or escalating. However, also watch China. As Russia's last large trade and finance partner, China's leverage is growing. China's official tone has shifted from support for Russia's actions to calls for de-escalation. While Russia-West conflict benefits China, the stature of global powerbroker and peacemaker also has benefits.

Turning to the markets, the key question is if the Federal Reserve's actions will be affected. External risk could cause the Fed to slow tightening while higher inflation could cause the Fed to accelerate tightening. Last week's statements by some Fed governors, and today's comments by Chair Powell, suggested that "geopolitical events" are not likely to significantly slow their inflation-fighting actions.

Since we began moving portfolios to more conservative late year, the markets – both equity and fixed income - have corrected sharply. The S&P 500 looks slightly undervalued here in my judgment, using a rather cautious valuation scenario.

I had previously thought that the US market might bottom out around mid-year, after it digests some months of Federal Reserve rate increases and balance sheet reduction. In my view, the primary factor for the market remains, as outlined in my December 7 outlook, the transition from the *stimulus* response to the pandemic, to the *tightening* response to inflation. For the US economy, the invasion of Ukraine means higher inflation pressure, and may accelerate the tightening. As such, I think the development of a market bottom is more likely to be pulled forward than pushed back by the sound of cannons in Ukraine.

Now a few thoughts on sectors and asset classes.

- Today's oil and gas price spikes should ease, but with Russian production impaired (lower investment, fewer buyers) other energy producers may benefit. Europe will shift more toward renewables, and those stocks have started acting better.
- Defense names have outperformed, and US and European defense budgets will increase.
- The real estate sector looks attractive, after the recent pullback. Real estate generally benefits from inflation.
- Among international markets, Europe has underperformed while Latin America has outperformed; both remain undervalued and look increasingly attractive.
- Technology stocks have continued correcting, but at a slower rate, and present increasingly interesting investment opportunities.
- My other comments from December 7 still apply.

As to fixed income, in times of uncertainty investors reflexively seek safety in US Treasuries. This has pushed bond prices up and rates down. I believe rates will rise again, and thus look forward to better buying opportunities in fixed income during 2022.

The portfolios continue to hold elevated cash levels.

I would be happy to go deeper into this outlook and other investment topics than I've done in this brief summary. Please email johnliu@ laurelhurstasset.com or call 510 847 0070.

Thank you!