Що Далі? (What's Next?)

That is the question everyone is asking. What is next? What is the end game for Russia? What does that mean for markets? This goes hand in hand with questions about inflation and what this means for Fed policy. To get to "what's next?" let's establish a baseline of where we are now!

Where Are We Now?

On Sunday morning, it is blatantly obvious that Russia has escalated its attacks on any and all targets. Civilian casualties are rising and humanitarian efforts in some areas have been abandoned. This is after Thursday's attack on a Ukrainian Nuclear Facility (see General (ret.) Kearney's SITREP). For additional information on the Russian invasion of Ukraine, please also see February's Around the World.

From conversations this week and over the weekend, here is a summary of how Academy's Geopolitical Intelligence Group ("GIG") is looking at the situation:

- The initial attack was flawed in many ways, but ultimately, as General (ret.) Marks has repeated, "**if you attack everywhere, you win nowhere.**" This has slowed Russia's progress and calls into question their ability to control regions that were once part of the former Soviet Union. In addition, the number of troops being used in this invasion force is not enough and there are questions about their effectiveness.
- General (ret.) Marks also pointed out that "**tactics are for amateurs and logistics are for professionals**" which dovetails well with General (ret.) Robeson's comments "**that there is a big difference between trained vs seasoned troops.**" Both those statements go towards explaining the current status of the invasion.
- Universally, **the GIG expressed concern that this will only get worse before it gets better**. The devastating tactics typically used by the Russian army are likely to be employed in Ukraine. Shutting off access to food and energy. Indiscriminate attacks on civilians. Russia will also move to a plan designed to destroy the morale, the ability, and the willingness to fight back. It is disheartening when scenes of devastation appear on the TV or social media streams and you realize that you have to brace for more of the same, or worse.
- **The likelihood of a coup or some internal action within Russia to remove Putin remains low.** While there is hope that something happens within Russia to stop this invasion, the consensus is that remains unlikely at this stage.
  - The civilian population doesn't have the arms that would be required to overthrow or even significantly disrupt the security apparatus in place.
  - It is unclear, whether we like it or not, that any major military figure or oligarch would act against Putin. Many owe him their station in life and quite frankly they are likely afraid of him, as they probably should be.
  - Putin, as a former member of the KGB (and who held other roles in national security) is paranoid, cautious (I believe that he still doesn't use cell phones), and dangerous. That makes him difficult to target.
- **Sanctions are stronger than expected, but potentially slow moving and may yet prove to be ineffective**. We have sanctions in place with Russia, Iran, North Korea, and Venezuela, to name a few, where those leaders are opposed to us yet remain in power. **The biggest surprise, and**

one of the most encouraging aspects, is the willingness of companies to impose their own forms of sanctions! We published Business Leads the Flag on Wednesday and the list of companies involved has grown significantly since then.

- We also wrote about "**Mirroring**" last week, in Mirror Mirror, on the Wall. That is the risk that we attribute our own values, even subconsciously, when trying to analyze our foes and competitors. When Putin says sanctions are an act of war, we should believe that he sees it that way, even if we don't. It may also be why "we" seem so excited when Putin puts "peace talks" on the agenda, only to be disappointed. This morning, news channels are filled with stories that Poland may supply planes to Ukraine (makes and models their pilots are familiar with). That may or may not turn out to be a good strategy, but I would expect Putin to ignore the fine print when evaluating how to respond.
- Additionally, there continues to be a risk that Russia unleashes a **cyber-attack** on U.S./NATO critical infrastructure or even specific companies. Academy GIG member Rear Admiral Barrett recently led a cyber-focused discussion addressing these concerns (see Academy podcast). Academy's monthly ESG report is focused on Cyber this month as well and is highly relevant.
- **Taiwan is NOT in imminent danger.** For a variety of reasons (not the least of which is the defensive strategy the Taiwanese military and first responders have adopted over the past 5 years), the situation between China and Taiwan should remain at the status quo. Academy is completing a SITREP on the subject, but for now, the GIG is sanguine on the threat to Taiwan. I only mention this because quite naturally it comes up in every meeting.

Що Далі? (What's Next?)

Worse before it gets better. Longer rather than shorter.

It would be great to have a pleasant surprise, but that is likely just us fooling ourselves and has been a mistake many have been making since even before the invasion began.

Economic Impact

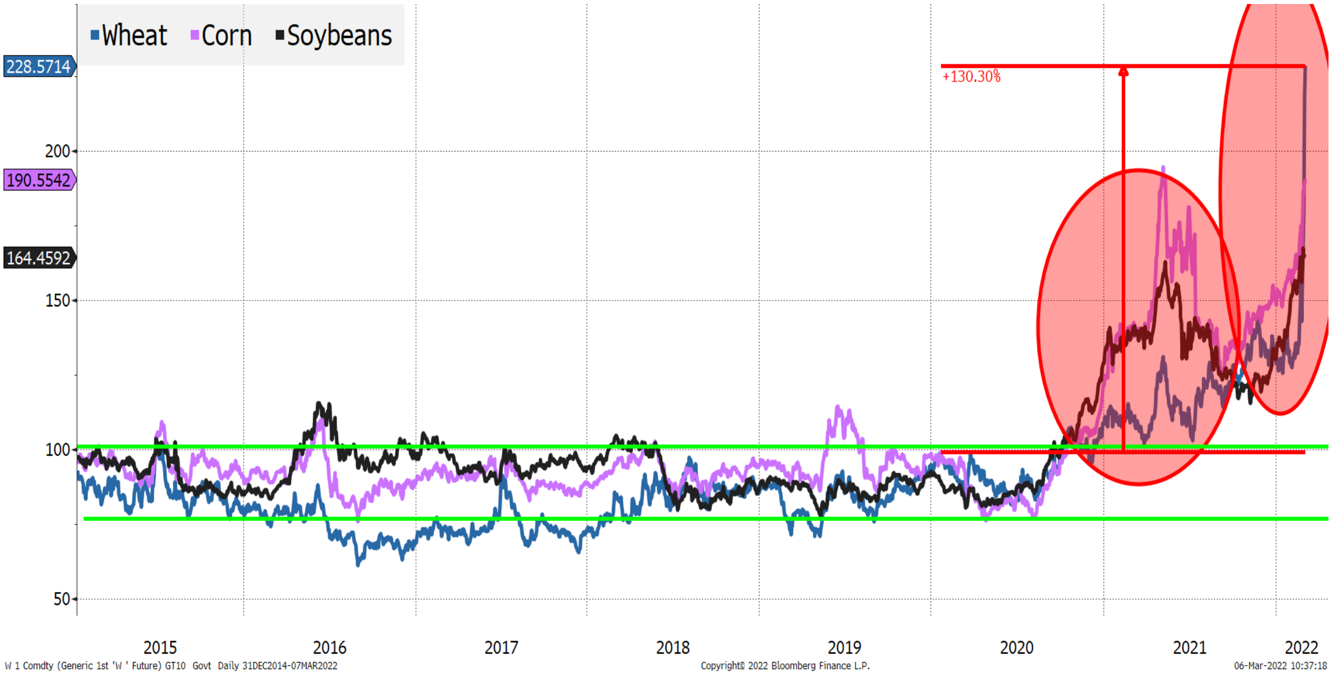
The economic impact could be severe and at this point seems underpriced. **I expect economic problems to be worse and show up faster vs where I see consensus right now.**

- European stocks were down about 10% last week, while the U.S. was down between 1% and 3%, depending on which index you look at. **We were in a high inflation environment with supply chain issues before the invasion started!** That can only be made worse by what is going on, especially as the private sector might do more to slow the flood of commodities and raw resources out of Russia than the governments have done (so far). **Germany and even the industrial region in northern Italy could experience further production problems in the very near future!** While I admit that I don't fully understand the European Carbon Emissions Offset Markets (MO is the commodity ticker), the price dropped from 96 on February 8th to under 65 on Friday. There are supposedly some nuances that impacted both the rise and the fall, but if even a portion of the move represents industrial or energy slowdowns, we need to brace for worse numbers than we've seen already.
- **Energy prices.** I will not spend a lot of time on energy prices and the potential consequences of those rising prices since even my mother knows that Oil (WTI and Brent) is up 25% and UK

natural gas futures are up 130% in just one month! **This is hurting many sectors, but is propelling energy stocks higher!** I continue to strongly believe that in the aftermath of this:

- We will see accelerated timelines for building out sustainable sources of energy.
- We will see dramatic investment in existing energy production, transportation, etc., especially around any energy source that is deemed "safe" or secure! We are paying for the underinvestment in traditional energy sources and their delivery and that will be rectified, even as we increase resources to move to sustainable.
- While the big caps have returned to 2018 levels (XLE), the exploration companies (XOP), the servicers (OIH), and pipelines (AMLP) potentially have a long way to go! This isn't just about supply and demand, it is about energy once again being a national security issue (and if we really think about it, a global security issue). There is a reason that oil and gas from Russia have escaped sanctions, so far.

- **FOOD PRICES!** This issue is only starting to get the attention it deserves. In the end, there are ways many of us can trim our energy usage. Those might not be comfortable (heating your house less, carpooling, etc.), but there are ways to offset some of those rising costs. We cannot live without food and when the price increases are at the "base" of the agricultural pyramid, it will hit everything we eat over time. This really concerns me from a humanitarian aspect, as well as from an inflationary aspect, because there is little that can be done to avoid these costs! There will be opportunities in this sector from an investor standpoint, but this just seems like a risk that the market isn't yet pricing in. There is more chatter recently about this, but I am concerned this problem will make the energy problems seem tame by comparison.
- **Wheat, corn, and soybeans.**



- I see data that shows that **Russia and Ukraine produce somewhere around 25% to 30% of all the wheat exported across the globe**. Russia produces predominantly wheat, while Ukraine has a bit more of a mix of corn and wheat. **Ukrainian production is most at risk** as it is becoming clear that sowing and ultimately harvesting whatever is sown is unlikely to be at anything close to "normal" levels as the country is being ravaged. In theory, Russian production should not be greatly impacted, but if sanctions are imposed or shipping becomes difficult, we could see significant "spoilage" and therefore less effective supply from Russia. I've included soybeans because although neither Russia nor Ukraine are significant growers of soy, farmers across the globe have some ability to farm different crops, and many will adjust their planting to capture the spikes in wheat and corn. So that, over time, will help offset wheat prices, but it will increase the price of soy. Everything is interconnected.

From the end of 2014 until early 2020, these commodities traded in a reasonably narrow band. **They were already rising in 2021!** While weather is one of the vagaries farmers have to deal with, they have also had to deal with increased costs across the board! Fuel and fertilizer are the two costs that are directly correlated to rising energy prices. There are enough stories out there that farmers are also suffering from the inability to procure parts to service their equipment (which seems believable when looking at the market for new and used cars). **But now we are seeing a price shock from already elevated levels.** These supply chain and cost issues apply to every grain farmer across the globe, but they will likely be felt in Ukraine and Russia even more given the situation there.

As corn, wheat, and soybeans are such basic foodstuffs, this is going to ripple through the system (potentially quickly). Basic cereals will have to go up in price (again). Ultimately meat will go up too as livestock needs to eat something as well.

Monetary and Political Policy Impact

Powell told us that we are getting a hike in March. Just 25 bps, but a hike nonetheless. **I continue to believe that the pace of hikes will be in the 1 to 3 range this year**. The market is pricing in more than I am, but I think that as the economy heads in the direction I expect, rate hike expectations will diminish rapidly.

- The global economy could slow rapidly given this war and the impacts listed above.
- **China (with its real estate issues)** has managed to escape the daily headlines, but the impact of a slowing China on global economic growth will continue.
- Hikes do little to **fix supply chain issues** and in fact raising the costs for energy companies, farmers, etc., when they need money to expand may be counterproductive.
- Various measures of **Financial Conditions** show tightening across the board. [The Chicago Fed] shows that financial conditions remain "easy" but have tightened substantially since October of last year. The Fed has to watch financial conditions, which may give them some pause on their path to tightening, as they don't want market conditions to deteriorate too rapidly.

The balance sheet perplexes me. I don't understand why they continued to build it up so long after markets seemed to have normalized. I think this is an area where they could try and take QT off the table, but I keep hearing that they are committed to the path of QT. I find that difficult to believe, but for now I don't think we can take QT discussions off the table.

So, we have all these potential negative economic issues to deal with at a time when the best markets can hope for is a Fed that pulls back from tightening, but is still tightening.

On the political front, I'm hearing that some ideas are being discussed:

- Reinstating the child tax credit payments. That would get money directly into the hands of the people who need it most to combat inflation. Given that we just had that policy in place, this seems like an idea that could get traction as it seems targeted and temporary.
- Suspending national gas taxes or something else to get to the heart of the problem. Gas price increases are effectively a flat tax as everyone pays the same amount. While this would "help the rich" it would also help the less well-off much more as a percentage of disposal income so could be considered in the realm of "fair share" (unless we get to the point of having to show tax returns to determine what price you pay for gasoline, but I digress).

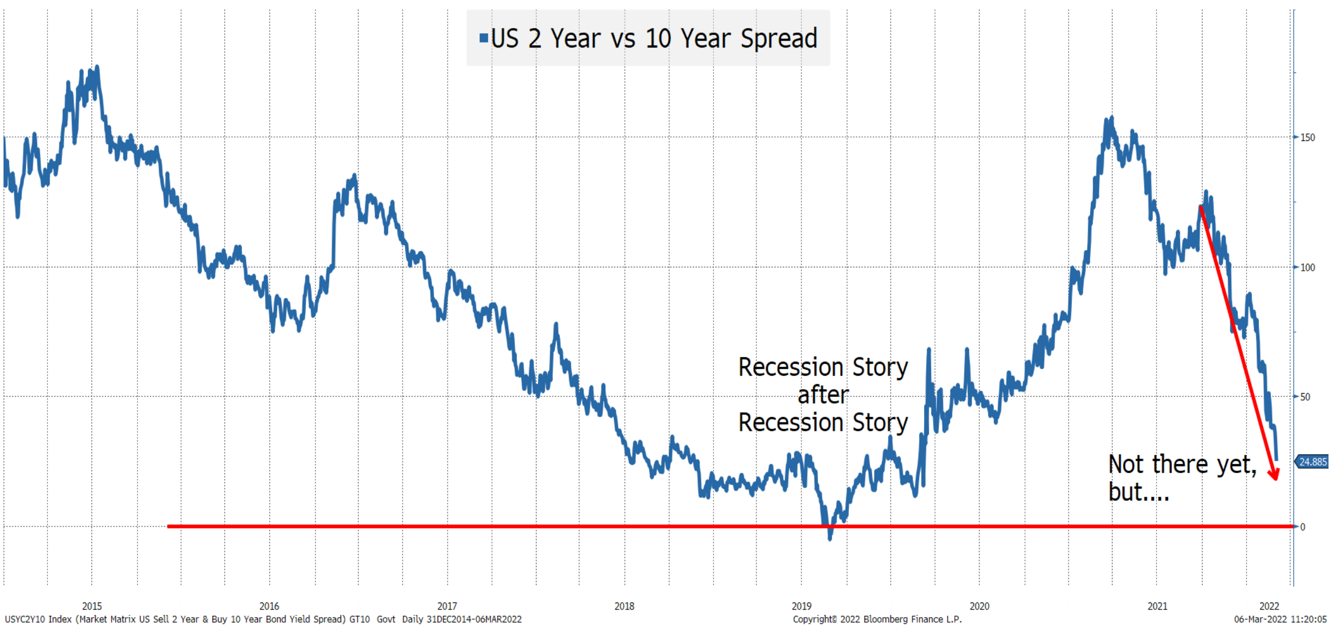
I think that for now the Fed is still an anchor on the market, but less of one at these levels (and given these conditions) than it was at the start of the year when they released their January minutes!

I'm not immediately optimistic that D.C. delivers a policy to help with inflation, but given the widespread support for Ukraine (across all types of media), they might be forced to be tough enough that they feel justified in offering support to help offset the inflationary pressures caused by Russia in a way that is targeted and compelling. Maybe we will see some signs of this in the coming weeks.

Market Impact

Expect a bull flattener in the yield curve.

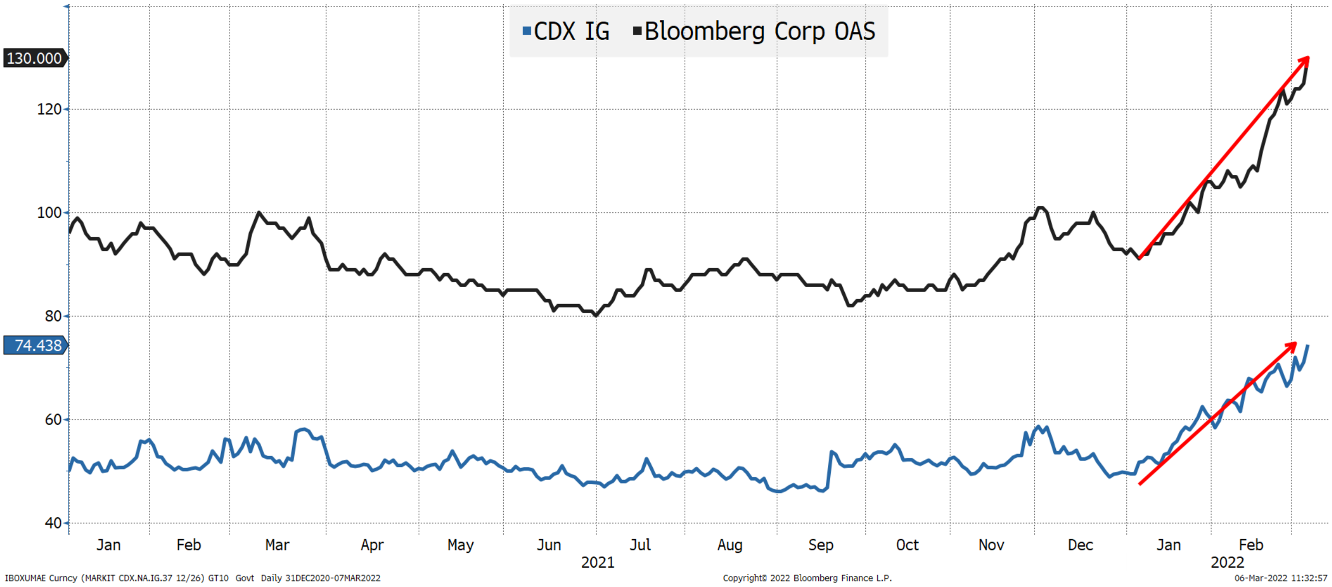
The market will price in fewer rate hikes, but unlike a few months ago where a disregard for inflation caused long-end yields to jump, look for economic doom and gloom to raise its ugly head. I am NOT in the "stagflation" camp, but I wouldn't fight that outlook right now, as it is gaining momentum and will dominate headlines, because who doesn't like a good old-fashioned stagflation scare when it will drive audiences and clicks. It cannot be disregarded, but I just don't think that is how this plays out.



The last thing the Fed wants is for all the recession stories to take over the airwaves again, but we are moving to levels on 2s vs 10s that are going to attract some attention. This is impacting financial conditions.

On equities, away from a few sectors, expect more downside as the harsh reality hits home that the war in Ukraine is going to be longer, more brutal, and more destructive. It will impact the European economy faster than the U.S., but the impacts will be felt here too (and rather quickly) especially with food prices soaring. If the world wasn't already dealing with supply chain issues and the negative impacts of regionalization/deglobalization, we'd be better prepared to deal with the shock of this war. But we are dealing with all of this at once, making our starting point more fragile and susceptible to problems from this war. So, yes, I remain negative on the overall equity market.

Which brings us to credit, which I'd like to think has more priced in than equities. The march to higher yields has been steady, with little respite since the start of the year.



What was once more of a "valuation" story has morphed into a growth (or lack thereof) story. Credit should be more insulated from that, at least in the IG space.

Credit (the corporate bond market) was immediately and directly impacted by the January minutes as it is the market most aligned with the Fed's purchase of Treasuries (QE forced asset managers out the curve, or down in credit quality and IG is next in line after Treasuries and agencies in terms of credit quality).

The only problem is that credit may face issuance, which worked out well in the middle of the week, but felt sluggish by the end of the week.

Given my bearish outlook on equities and that I'm expecting yields to decline, the best I can muster for credit spreads is a "weak" neutral.

Bottom Line

We can all hope for the best, but preparing for the worst (or worse than we've already seen) is the prudent risk strategy right now.

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