## Markets Battling 2 Fronts – Russia & The Fed

Friday saw the market battle with two competing narratives:

- **The morning was dominated by Fed fears.** Yields drifted higher (10-year yield went from a low of 1.98% to a high of 2.06%), pulling down stocks on fears that:
    1. The Fed might hike rates as an emergency measure before the opening bell on Monday.
    2. The Fed, in their 3pm open market announcement, would surprise the markets by stopping their purchases prematurely (they didn't).
    3. The Fed will get to 100 bps by the summer (Bullard's interview).
    4. All the above and more.
- **The afternoon turned to risk off as attention was focused on Russia and the potential for an imminent attack**. The 10-year yield dropped to as low as 1.91%, but this move was coupled with stocks losing ground across the board and finishing near their lows.

While none of the fears have turned into reality (as I type this at 7:30am on Sunday morning), these forces will move markets in the days and weeks to come.

## Russia and Ukraine

Sunday morning begins with this CNN clip with General (ret.) Spider Marks providing an update on his views to a national audience.

Academy's Geopolitical Intelligence Group ("GIG"), headed by Spider and Rachel Washburn, has had an almost endless stream of video conference calls with our clients. Please reach out to your Academy contact if you are interested. We've also published two SITREPS on the evolving situation where **we evaluate the likelihood of various scenarios and their potential market impact**.

Before providing a quick update on where we see these scenarios heading, let's highlight a few **key questions and even some inconsistencies**:

- Putin has been quick, decisive, and aggressive in the past. Both Georgia and Crimea were attacked and the West was caught flat-footed. **For a person so calculated and aggressive, why is he being so transparent in this case?** That is the one question that leads many in the GIG to lean toward the view that Putin is looking for a deal more than land.
- **Why is the reporting from Ukraine, Europe, and the U.S. so different?** The media in the U.S. tends to be more towards "war is imminent" while European media seems to downplay that risk relative to the U.S. Ukraine, in an effort not to antagonize Russia, has the most moderate messaging. **Do Europe and the U.S. have different agendas in the information war** or does one region's media just have better information? On the other hand, with **the U.S. "exposing" Russia's plans to create false flag events**, have we reduced Putin's ability to attack with a "defensible" pretext?
- **Sanctions.** Almost universally, clients and the GIG question **how useful sanctions would be**. Putin and his cronies would not have started this process without knowing sanctions were a likely outcome, so they are prepared. It sounds like we have backed off the idea of turning SWIFT off for Russia (maybe D.C. was listening in on some of our calls), but we will likely see

some form of sanctions, which will be disruptive to the global economy and markets.

Those questions need to be answered as they influence not only the likelihood of various scenarios but also what they will mean for various markets. While some of those questions have become more difficult to answer over time, two things seem to be clearer now compared to when we started our first scenario analysis SITREP:

- **Europe and the U.S. are not 100% on the same page**. Aside from the media coverage, we see differences in what sanctions are wanted and even how meetings and calls with Putin are portrayed. There are clear fault lines being exposed within NATO, though hopefully, the "what doesn't break us, makes us stronger" theory will prevail. So far, it seems like the EU is behaving more or less as one, which is encouraging.
- **China, for expediency to serve current needs (or some other reason) seems to more or less back Russia**. With a 5,000-word joint document released by the two countries, the 30-year energy deal (priced in euros), and other snippets of information, it seems like China has decided, at least for now, to create some closer ties with Russia. **The energy deal makes logical sense** as China is desperate for energy (and will be for decades to come) and Russia is well aware that Europe is trying to eliminate their dependence on fossil fuels. As at least one member of the GIG stated, "**China is Russia's bank**" and that will further reduce the effectiveness of sanctions.
- **COP26 and Climate Change**. I wanted to highlight this for two reasons. First, this winter seems to reinforce the fact that the EU needs a better path to renewable energy independence (hopefully the U.S. learns some lessons as we press for those same goals). That is relatively minor in the grand scheme of things. What I think is more important, and far more discouraging, is that the Russia/China energy deal may well signal far less interest in pursuing climate change goals there. This isn't a "today" issue, but something we probably all need to reassess over time.

## Russia and Ukraine – Scenario Update

As new information comes in, here is how we view the range of possible outcomes (it represents, to the best of our ability, the range expressed by our GIG):

- **Limited Incursion**. This has gone back to being the front-runner, though the margin might not be as high as it seems based on media headlines. **Putin would love to add back land to Russia.** Some on the GIG see that as more important to Putin than any sort of win that a negotiated deal can get him. That pushes this into the lead. On the other hand, his transparency and slowness to act gives others pause that a negotiated settlement is his goal (along with exposing the fault lines within NATO and Europe – which he has been reasonably successful at doing).
    - **The "fig leaf" outcome is far less likely now**. In our original analysis, the most likely outcome in the event of an incursion was that Putin would have a convincing enough pretext and that he would so quickly offer some sort of deal to make Europe feel comfortable that he has no further ambitions (along with a promise of free-flowing natural gas) that things calm down dramatically in a matter of days. As the U.S. has discredited his false flag narratives, it is more difficult to believe that the West can easily accept any pretext. Also, we seem to have dug in our heels on sanctions and even a limited incursion is now likely to take longer to resolve and will be more disruptive to the economy. **There was reason to believe that this was Putin's preferred outcome**.

  - **War posturing, messy negotiations, tough sanctions, and a lack of cohesion between Europe and the U.S. now seem to be the more likely outcome of a limited incursion.** If we get this, markets and the global economy will suffer, though Europe will be hit hardest. This could lead to China acting as a "bank" for Russia which would be very bad for the global economic outlook as the Recentralization and Delinking of China would be more accelerated than even Academy has discussed. **Expect more risk-off days like Friday as we must question the health of the global economy if this occurs, especially if China makes it clear that they will support Russia economically.**

- **Negotiated Settlement Still Likely**. While an incursion has taken the lead, a negotiated settlement is still quite possible, due to many of the points already made. Almost any negotiated settlement is likely to highlight the NATO and/or the EU fault lines. That won't have immediate market implications **as any stand down would be a great relief for markets!**
- **Total invasion still only a remote possibility**. Virtually no one on the GIG sees a full-scale invasion as Putin's primary strategy. On top of everything else, the weather in Ukraine has been very wet, creating muddy conditions that are far from ideal even for modern mechanized weapons. Hopefully, we haven't nudged Putin in this direction by trying to take a limited incursion off the table. **Any sort of war here will have a significant impact on markets, but like every other scenario, China's reaction will be a key driver**. Again, at the moment, this is viewed as a very low probability scenario.

Please see below for a few thoughts from GIG members **General Mastin Robeson** and **General Frank Kearney**:

*"It is certainly plausible that Putin does a limited incursion into East Ukraine. I still believe that he is less prone to attack Kyiv and that he prefers to avoid war with NATO or the U.S. I also believe that he is looking for increased leverage and will continue to increase the threat of incursion in order to stimulate more favorable conditions in the negotiation. I could well be wrong, but I believe that he is less motivated to take Ukraine than to take some sort of deal with Europe, EU, and/or NATO that at least significantly delays further discussion about Ukraine entering NATO."* – **General Mastin Robeson**

*"Good indicator when Department of State says American citizens should leave Ukraine within 48 hours. Suspect activity will commence right after Olympics."* – **General Frank Kearney**

**We will be hosting a webinar (please see link to register) on the current situation in the Ukraine on February 15th at 8am ET. Don't hesitate to reach out with any thoughts or questions on Russia and Ukraine.**

## The Fed

**There is unanimous agreement that the Fed is behind the curve.** I am worried that they missed the curve entirely and that we will start down the path of constraining monetary policy at the exact moment that so much other stimulus is running out, the consumer is showing signs of slowing (still strong, just not as strong), and even some of the post-pandemic gains in the stock market have been eroded (especially true in stocks the Robinhoods of the world liked to trade).

**Thursday's CPI data.** The chatter about being behind the curve really gained momentum with the release of the CPI data. Then the Bullard headlines hit the tape, further creating problems for the bond market. The headlines were actually far worse, and almost out of context with his overall interview, but in this day and age of headline "reading" algos, much of the damage was done. On Friday morning, some semblance of calm returned as a Wall Street Journal reporter, often viewed as an outlet for the Fed, tried to put some context on the Fed. But there is one thing I cannot wrap my head around (it literally gives me a headache trying to reconcile this):

1. **The CPI data was well-telegraphed, and the risk was quite clear at the January FOMC meeting.** According to Bloomberg, the YOY CPI had a median estimate of 7.3% with an average estimate of 7.25%. **The low estimate was 7.0%.** Not one of the almost 50 contributors thought CPI was going to be less than 7%! **So, yes, 7.5% was a miss, but certainly not a miss of epic proportions!** If people were looking for 4%, then 7.5% is bad, but in the context, it seemed more or less in line. **I cannot see why the FOMC, which met on January 25th and 26th, would be horribly surprised by this number!** What data did they have to cause them to look for something much lower? Yes, I understand some of the "internals" were also bad, but even then, it just doesn't seem shocking. **Remember too that this FOMC decided to shrink their bond purchases at the already well-telegraphed rate just 2 weeks ago, when presumably they were aware that this print could be high.** The market, and I, were reasonably prepared for them to cut bond purchases entirely, but they chose not to! As already mentioned, the market was thinking that the Fed would cut their buybacks prematurely, but on Friday, they stuck to the plan they had proscribed just two weeks ago. Powell endured a long and less than friendly press conference at that meeting, where inflation and the Fed's response to it was subject to intense scrutiny.

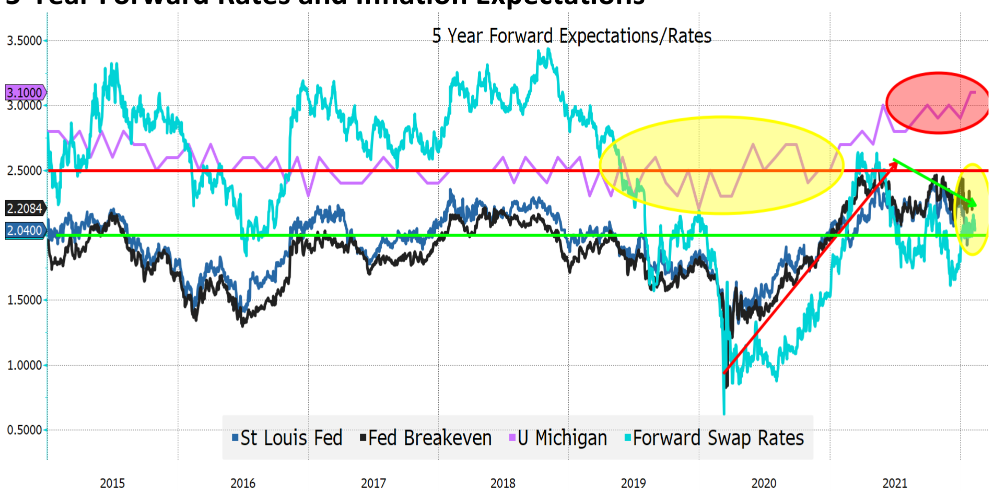
Please see last week's The Fed, Inflation, Rates & Credit Markets for some plausible reasons to expect a slowdown in the inflation numbers in the coming weeks and months.

**The March meeting will certainly have a hike. Whether it will be 25 or 50 remains to be seen, but 50 is a real possibility.**

Maybe the **balance sheet reduction** will be at a very accelerated pace and on an accelerated timeline (which I agree with), but the fact that the Fed is still proceeding to buy bonds might be an indication that they are talking more tough than they intend to act.

The biggest disagreement seems to be whether we get hike, after hike, after hike, or after some initial tightening, they will see how the economy plays out (I'm in the latter camp, and even Bullard's full text seems to be in agreement with that).

**5-Year Forward Rates and Inflation Expectations**



The Michigan survey points to higher inflation expectations, but I have no idea how reliable this is. The market measures are more under control and sitting in the 2.25% area. As the Fed tries to navigate this tightening from somewhere behind where most people think they should have started, they will watch expectations closely.

Russia dominated markets late Friday and will continue to influence markets, **but I think that the bond market fears linked to the Fed are extremely overdone** and will revert to the market pricing in a less aggressive Fed than where we were on Friday morning.

Now to prep for the Super Bowl by watching some great Buffalo Bills victories 😊.

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