Strategist's Corner
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Additional Thoughts on Russia-Ukraine

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Oil prices will drag down growth

In recent days, as the price of energy has soared, market observers have pointed how much less sensitive the US economy is to the price of oil than it was decades ago. Fair point. However, it's hard to ignore $125-a-barrel oil. Just this week I spent $100 for a tank of gas. With these prices, you have to question whether the stash of pent-up savings accumulated during the pandemic will provide the expected macroeconomic tailwind necessary to sustain the US expansion as the economy emerges from two years of COVID disruptions. And we shouldn't forget that the pent-up savings might not last long given the rising costs of nondiscretionary items such as food. When prices rise this high, people change their behavior, and the lower-income cohorts change it most. Looking back, nine of the past 11 US recessions have coincided with elevated oil prices. While the cause of each recession is unique, higher energy prices tend to be tremendously growth depleting. So whatever the probability of a slowdown or recession was headed into the invasion of Ukraine, it has to be higher now.

Rates should rise but more slowly

Everyone keeps using the phrase "multidecade-high inflation." Shouldn't that also mean central bank levers are at multidecade lows? Yes. Slowing growth will likely slow the pace of policy tightening, but it probably won't significantly change where short and long rates settle very much. As we've said all along, rates should be a bit higher than they are. While the speed of the rise may have slowed, its direction is seemingly unchanged.

Markets require trust

The massive moves in nickel this week are a reminder of how fragile markets can be. High levels of leverage and an evaporation of trust among counterparties can cause things to unravel fast. When collateral is weakened or funding dries up, high levels of uncertainty among counterparties can create massive pricing gaps in markets. These can start with margin calls and forced position liquidation and in a worst-case scenario result in participants questioning the viability of clearing houses, or even cause systemic issues. This is another risk that's at least slightly higher now than it was a few weeks ago.

Reassessing ranges of outcomes

We don't spend a minute trying to predict the outcome of the Russia–Ukraine conflict. Instead, we're focused on assessing companies' direct and indirect exposures to Russia, discounting those risks and comparing them to their stocks' valuations. Many Western companies have exited their operations in Russia. For some, that may amount not only to lost revenues but also to stranded assets. In these cases, we assume the worst and add that assumption to the calculus as we assess the ranges of potential outcomes. We try to think of everything that can go wrong (and right). To us, when the analysis is complete, the wider the ranges, the less attractive the investment. In a world with a widening range of outcomes, we're looking for, and finding, attractive opportunities with narrower ones.

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