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Market Update

As all of you are likely aware, last night Russia initiated a military campaign to "demilitarize" the Ukraine. The worst-case scenario that many thought unlikely to occur, occurred. By all accounts, Russia is well on the way to a de-facto takeover of its neighbor. There are far better people than us to turn to for your geopolitical analysis. Instead, we want to share some brief thoughts pertaining to financial markets.

We firmly believe that markets are not on the verge of a Covid-like March 2020 meltdown. What's happening in Ukraine is tragic and threatens the post-Cold War geopolitical balance. But the economy is not on the verge of shutting down and we're not all at risk of catching a virus of unknown lethality for which there are no vaccines or therapeutics. Perspective is helpful. Covid was a once in a century occurrence – a true black swan event. Despite the last three decades of relative global order, wars historically happen with far more frequency.

Prior to the Russian incursion, major indices like the Nasdaq and S&P 500 were already entering correction territory (selloffs in excess of 10%) due to concerns over higher inflation, the sustainability of economic growth, extended valuations and the presumption that the Federal Reserve would embark on an aggressive monetary tightening cycle (with interest rate increases and tapering its balance sheet). The two main impacts on markets from Russia are: 1) do we now have to apply a geopolitical risk discount to asset prices? (to some degree, probably yes) and 2) higher commodity prices, as Russia and Ukraine are key producers of oil, gas, metals and agricultural goods.

Higher commodity prices will make inflation worse, but oil rising from $90 to $110 will not have the same inflationary impact as the prior year's increase from sub-$20 prices to $90. Additionally, to the extent higher commodity prices and increased geopolitical uncertainty create economic headwinds, that will likely make it more difficult for the Federal Reserve to tighten monetary policy as much as markets were anticipating. Unexpectedly, that may actually benefit some of the longer-duration and more speculative growth firms whose share prices have cratered in the last several months.

What should investors do now? For one, don't panic. While events are terrible, this is not going to crater our economy and most companies we invest in have little exposure to Russia. Two: if we see material selloffs in high quality companies whose operating fundamentals are not at risk of deteriorating, we'd be inclined to add on weakness. Three: consider more exposure to geopolitically important industries.

As we have written about in the past year, the world has underinvested in and undervalued stuff we need (like natural resources) relative to stuff we simply want (like technology). The energy shock Europe might experience due to the Ukraine fallout is a reminder that commodities make the world go round. Additionally, defense contractors will likely benefit from European nations increasing their military expenditures from far below 1% of GDP to levels closer to the US (2% of GDP). Other geopolitically important industries include semiconductors, artificial intelligence – particularly cybersecurity firms – and perhaps even life sciences firms.

The conflict in Ukraine is tragic and threatens European geopolitical stability. But it is unlikely to turn into an economic and market contagion event. The key geopolitical risk to now be more attuned to is whether China uses the Russian playbook to invade Taiwan. Unlike Russia, the West is far more economically integrated with China. Hopefully that doesn't happen in the near-term, but with Russia doing the "unthinkable," the odds that China does the same have to be increased. Please reach out with any questions or concerns.

Sincerely,

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