The Russia-Ukraine Conflict: Potential Outcomes and Impact
An American Portfolios Market Commentary

by Chief Investment Officer Clifford T. Walsh, CFA

OUR THOUGHTS AND prayers are with all those impacted by the war in Ukraine. We join with our global, national, business and local communities in bringing hope for a swift and peaceful end to this conflict.

When in crisis, hope is a universal human response that has its place and purpose, giving many—as we've witnessed—the strength to stand strong and carry on. We know that much. As chief investment officer for American Portfolios (AP) and investment manager of Nine Points Investment Management (NPIM), it is my job, when formulating an investment strategy, to predict an event's range of potential outcomes and the impact those outcomes could have on the financial markets and our clients' investments. I share with you an honest outlook of the global markets and economic conditions we face.

The situation that is unfolding in Ukraine is highly volatile with the potential for catastrophic global consequences. Therefore, it is immensely difficult to predict all the potential outcomes, determine the probabilities of each outcome, the most effective investment strategies to protect value and/or how one would capitalize on any resulting long-term opportunities.

Furthermore, the U.S. Federal Reserve (the Fed) appears set to embark on an interest rate hiking cycle in an attempt to slow decades-high inflation. This action was a result of supply shortages due to the COVID-19 pandemic and the current energy policy. What's more, equity and bond valuations are among the highest in history, thus increasing the risk of downside volatility.

It would be irresponsible for our investment team to name one potential outcome, good or bad, and state with confidence that it will happen. The truth is we don't know what will happen, nor does anyone else. If the Russia-Ukraine conflict somehow ends quickly and peacefully, equity prices and other risk assets will rally. However, should the conflict persist and/or worsen, more equity downside is likely.

As of this writing, our investment team forecasts a situation that deteriorates before it improves. But, regardless of whether the conflict does or doesn't end tomorrow and who will be the victor (if any), there are economic consequences that will be felt for quite some time—both at home and abroad. Commodity prices are likely to persist at levels that tax the discretionary impact of the average U.S. consumer and business. Not only will shunning Russian oil keep prices high for those refusing to purchase it, there is no going back to the way things were insofar as a geopolitical premium remains in commodity prices for some time. While the equity markets could turn on a dime and rally at any moment, we do not believe the markets have fully discounted the consequences of what has already happened, let alone any escalation to the conflict that could occur.

Gasoline prices alone impact more than 40% of the economy. Not to mention, other commodities like nickel, silver, gold, wheat and corn have skyrocketed. Russia and Ukraine account for roughly 33% of the global wheat supply, creating potentially greater challenges as we head into the spring planting season. This comes at a time when the consumer and broader economy are already dealing with higher food and consumer goods prices due to inflation. With growth already slowing, it is likely the U.S. economy experiences at least one contractionary quarter (the technical term being "recession"), if not more, and equity prices that decline to reflect the ongoing contraction of earnings expectations.

It is possible the Fed could help soften this blow, depending on what it does with respect to interest rates at its March 16, 2022, meeting and in the following months. Higher interest rates are just one more hurdle the economy and markets will have to overcome. However, the futures market has been rapidly ratcheting down its interest rate expectations for 2022 given all the aforementioned risks. A more dovish Fed would certainly provide some economic support.

Regardless of how dire things may get, the financial markets—along with the people and businesses that make up our economy—are resilient; this has been proven, having navigated through and recovered from severe geopolitical conflict and financial crises time and time again. As always, in situations like we face now, discipline to an investment philosophy, asset diversification and a long-term focus are solid pillars that support investment portfolios.

While the worst may not be behind us, and volatility likely to persist, in the short-term, we will navigate these challenges with prudence and the benefit of lessons learned from the past, hopeful we will persevere as we always have.

For questions or concerns about the current economic and geopolitical landscape, we urge you to reach out to your investment professional for a deeper discussion.

Clifford T. Walsh, CFA
Chief Investment Officer
American Portfolios Financial Services, Inc.
631.439.4600, ext. 277
ctwalsh@americanportfolios.com

Samuel J. Rozzi, CFA
Manager of Due Diligence
American Portfolios Financial Services, Inc.
631.439.4600, ext. 136
sjrozzi@americanportfolios.com

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