COMMENTS ON UKRAINE: "THE FOG OF WAR"

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A full-scale invasion of Ukraine by Russian forces began Wednesday night around 9 pm (U.S. Central Time). Until President Putin's Monday address, where he appeared isolated and increasingly out of touch, we placed a less than 50/50 chance of a full invasion. The Monday address changed that metric and we are seeing the result now.

We are now fully engulfed in the fog of war so there are few concrete answers to how this may play out.

Some key questions:

How long will a military conflict last?
A Russian push to Kyiv and other key strategic targets (it is now clear that Putin plans to pursue regime change and occupation of the whole of Ukraine) could very well be rapid and largely successful. However, there is a chance that a protracted, bloody guerilla war could result, lasting well into the summer and fall, perhaps longer. This will depend largely on what kind of support the remnants of a Ukrainian government and the people of Ukraine, who are overwhelmingly anti-Putin, receive from the US and Europe. It is important to note that we are not geopolitical experts and rely heavily on expert, third party analysis, through professional subscription services. At this time, there are no firm conclusions from these services. This is a highly fluid situation.

What is the likelihood of additional, stiff sanctions on Russia and what are the potential market and economic impacts?
A new raft of stiff sanctions is a near certainty. They are unlikely to deter Russia/Putin, who has spent much of the last few years building up a financial buffer to weather such sanctions.

The financial "nuclear option" is to remove Russia from the SWIFT system (Society for Worldwide Interbank Financial Telecommunication—the back-bone of international payment between countries). At this time, it appears unlikely that Russia would be cut off. If that changes, the likelihood of Russia stopping all flow of energy to Europe increases, potentially throwing the EU into a recession. In other words, it is unlikely the EU will agree to SWIFT sanctions since, while it could cripple Russia, it would also inflict a significant amount of economic pain on Europe as well.

Still, even if Russia does not cut off supply of natural gas and oil from Europe, sanctions will also hamper some economic activity in Europe. Additionally, the already surging cost of energy could have a dampening effect on economic growth globally. A question remains whether U.S. oil and gas companies will ramp up domestic production, something they have been loathed to do thus far, as they have been using higher energy prices to shore up their balance sheets and improve their financial positions following energy routes in 2014, 2018, and 2020.

What is the general market outlook?
As we mentioned in our February Viewpoint (published February 10) and our monthly webcast on February 17, geopolitical events can have a rapid, negative effect on market prices. Historically, this has led to a sharp 5%--15% drop in prices. These declines are usually reversed in relatively short-order and then markets continue on the general trend already in place. For global stock markets the general trend has been higher for the last two years, following the pandemic, and a longer, secular bull market since 2009.

There is also a decent chance that the geopolitical conflict and sanctions could alter the policy path of central banks. Prior to this week, the conclusion of markets was that central banks would begin to pivot policy from ultra-accommodation to beginning to remove excess liquidity and raise rates. It is still likely that the Federal Reserve will end its bond purchases in early March and begin hiking rates at their March meeting. What has changed is that a 50-basis point (0.5%) initial hike is probably firmly off the table. Additionally, we have already seen market implied probabilities of rate hikes in 2022 move from six or seven 25 bps (0.25%) hikes to six or less. We anticipate this estimate—already too high by our estimation—to fall further. The Fed will likely reassess the potential impact of moving too aggressively as energy prices rise, and in light of what could be short-term financial stresses on financial market functions and liquidity. (We are beginning to see repricing of Russian assets and margin calls. Granted, this is a very limited slice of financial markets, but can have ripple effects and bears watching.)

Similar to the geopolitical developments, the outlook for financial markets is also opaque and fluid.

Historical Impact of Geopolitical Events on Markets

Market Shock Events	Event Date	One-Day	Total Drawdown	Market Bottom	Calendar Days to Recovery
Russian Invasion of Ukraine	2/24/2022	-1.12%	?	?	?
Iranian General Killed in Airstrike	1/3/2020	-0.70%	-0.70%	1	5
Saudi Aramco Drone Strike	9/14/2019	-0.30%	-4.00%	19	41
North Korea Missile Crisis	7/28/2017	-0.10%	-1.50%	14	36
Bombing in Syria	4/7/2017	-0.10%	-1.20%	7	18
Boston Marathon Bombing	4/15/2013	-2.30%	-3.00%	4	15
London Subway Bombing	7/5/2005	0.90%	0.00%	1	4
Madrid Bombing	3/11/2004	-1.50%	-2.90%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.90%	-11.60%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.10%	-16.90%	71	189
Reagan Shooting	3/30/1981	-0.30%	-0.30%	1	2
Yom Kippur War	10/6/1973	0.30%	-0.60%	5	6
Munich Olympics	9/5/1972	-0.30%	-4.30%	42	57
Tet Offensive	1/30/1968	-0.50%	-6.00%	36	65
Six-Day War	6/5/1967	-1.50%	-1.50%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.20%	-2.20%	25	41
Kennedy Assassination	11/22/1963	-2.80%	-2.80%	1	1
Cuban Missile Crisis	10/16/1962	-0.30%	-6.60%	8	18
Suez Crisis	10/29/1956	0.30%	-1.50%	3	4
Hungarian Uprising	10/23/1956	-0.20%	-0.80%	3	4
North Korean Invasion of S. Korea	6/25/1950	-5.40%	-12.90%	23	82
Pearl Harbor Attack	12/7/1941	-3.80%	-19.80%	143	307
Average		***-1.18%***	***-4.81%***	***21***	***45***

Source: LPL Research, S&P Dow Jones Indices, CFRA, Bloomberg, Arvest Wealth Management

Most importantly, what should individual investors do?
This is where the rubber meets the road and, candidly, where we have higher conviction.

First, since market reactions to geopolitical events has historically been swift to price in and then reverse, it is extremely difficult for most investors to move rapidly enough to benefit from portfolio moves. The markets have been pricing in the risk of a Russian incursion already, to at least a certain extent. In effect, it is difficult, near impossible, for most investors to be faster than institutional trading firms who are often armed with algorithmic driven software that trades, and reprices markets, almost instantaneously. Or said another way, by the time our clients will read, understand, and act on news, the price movement they are trying to avoid or benefit from has already taken place.

The better alternative is:

1) Behaviorally/emotionally: keep time horizons in mind. Since markets (shorter-term traders) tend to quickly look past geopolitical conflict after the initial repricing, and since our clients tend to have multi-year time horizons, it is often not necessary to do anything at all. When individual investors react to news events, more often than not they end up reducing risk at the wrong time—often closer to market lows—and adding risk near market tops—when all the good news is already priced in. In the context of Ukraine, selling risk assets now could leave the investor sitting on the sidelines when markets reverse and leave them further behind if markets continue to advance.
2) Strategically: have the proper asset allocation target driven by the BluePrint/financial planning process. If or when market repricing occurs, rebalance back to target (sell more stable assets like high quality bonds and buy back to target the more volatile assets like stocks).
3) Review the financial plan to make sure the goals and time-horizons are still valid and, as a result, if the asset allocation needs to be changed. In other words, large asset allocation changes to a portfolio should not be driven by today's news events but driven by the financial plan and the goals of the investor.
4) For retirees or those near retirement, once the allocation is on target, a cash cushion for living expenses can be prudent. The idea is that instead of drawing from investment assets to fund monthly living expenses, having a cash cushion which is equivalent to 3, or 6, or 12 months of expenses keeps them from being subject to market volatility (and selling falling investments for daily expenses) until markets can recover.

Are there other risks investors should be aware of?
The simple answer is "always" but it is also important to be cognizant that every risk does not require action by the individual investor, and negative and positive potential outcomes need to be balanced. It is also important to note that markets tend to discount a risk event once, and only once, and then look past it. Prolonged conflict in Ukraine is unlikely to have a second large draw-down. The caveats would be new NATO entrants into the conflict. For example, if Turkey were to agree to the Ukrainian request to blockade the Bosporus straits to Russian warships, it would be a material escalation. As would Russian use of tactical nuclear weapons if the fighting in Ukraine turns against them. Markets would certainly be susceptible to fresh declines in such events, but they may not occur at all, or not until after markets have already recovered substantially from lows.

The other significant geopolitical risk is if Putin turns his eye towards Latvia, Lithuania, Estonia, or Poland—all NATO members and members of the European Union. If the assessment that Putin may be isolated from advisors and increasingly out of touch is correct, these risks increase, but are likely not imminent while Russian forces are tied up in Ukraine.

Beyond these, the key risks are related to the fundamental issues that are always present in investing—the economic and business cycle, interest rates and credit, company revenues and profits/cash flows, etc. At this time, it appears unlikely that the invasion of Ukraine will have material impact on these fundamental drivers outside of the region (Russia, Ukraine, and perhaps Europe).

Regardless, the individual investor's playbook to international crisis is the same:

1. Moderate emotions by remembering investment horizons.
2. Proper asset allocation and rebalancing.
3. Review financial planning to validate proper allocations and timeframes, and to account for changes in individual financial goals. i.e., news events should not dictate core investment strategy.
4. Raise cash cushions, preferably during times of calm, for short-term financial needs to reduce the chance of selling assets during a market draw-down.

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Clay is responsible for the strategic investment direction of the investment models and portfolios managed by the Investment Management Group and Arvest Bank Trust. He oversees the development of capital market assumptions, the development and management of asset allocations, research on mutual funds, ETFs and outside managers, and communication of investment strategy to Arvest Wealth Management associates and clients. A graduate of Wichita State University, Clay has completed Columbia University's Academy of Certified Portfolio Management and is a member of the Chartered Financial Analyst Institute and Kansas City Society of Chartered Financial Analysts