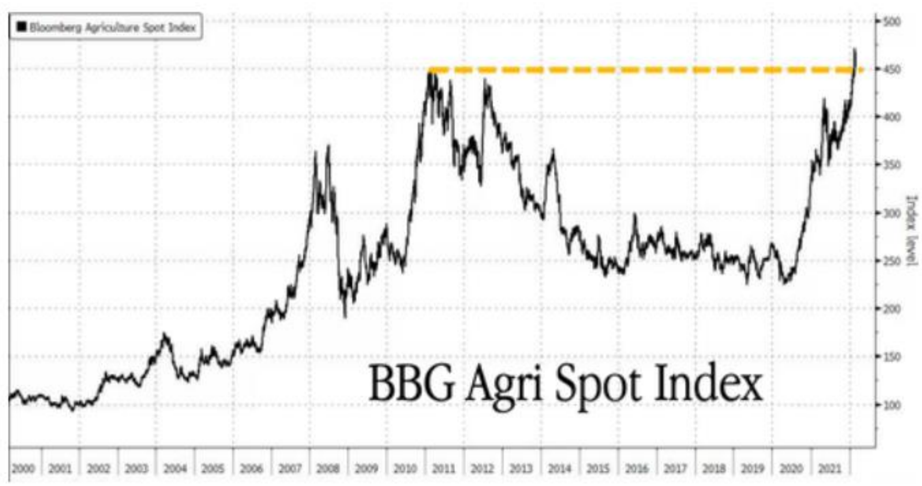
03.03.2022 – A New World

Let's say you have a company which is a buyer of products from Russia. Could be oil, wheat, coal, fertilizer, timber –the basic stuff people need to live a modern life. Your company buys billions of dollars of one of those products. Up until a week ago, it was pretty simple. First you contracted with a Russian supplier and then your company arranged a short term loan (letter of credit) with a large bank that is put in "escrow" to be paid when the product is delivered. Once you get your stuff, the funds are released to the supplier's bank. Simple "trade finance" that has been around forever. This is the way the world works to which few people pay attention as we go about our daily business.

Today, that world has been blown up. Western banks can't provide those letters of credit anymore. So, about 25% of the world's wheat, 20% of its corn^, and a large percentage of fertilizer are not available now. We see the gas pump and shriek, but Ag products have really skyrocketed (see the chart below). Now, many of these sanctions didn't apply to energy, with the idea to not shoot ourselves in the foot. However, for all practical purposes, the sanctions are in force*^ because shippers and bankers are afraid of continuing business as usual due to the potential of sanctions. So, 10% of the world's oil supply* is very uncertain, other than to Chinese and possibly Indian buyers. We all sort of assume these products will come back into the mix, but no one knows when. This has caused prices of commodities to skyrocket. As of March 3rd, oil is up to about $110/bbl (was about $65/bbl in March 2021),** while the Bloomberg Agricultural Index is now at record highs. In other words, the Western banking sanctions meant to drive Russia to its knees, are going to inflict considerable pain on the rest of the world. For "rich" countries it's not nearly as harmful as poor countries that spend large percentages of their daily wages on food and energy. Who knows if 3rd world governments will fall as people protest high prices that can't be subsidized anymore?



This type of "economic warfare" is new to the world.^^ The unintended consequences are anyone's guess and we may not like them. The immediate effect, other than inflating commodity prices, is the decimating of the Russian stock market by over 90% in 10 days and the crushing of the Russian currency, the Ruble, by 75%^*. This could spark a "revolution" by the Russian people or military (which I see as a possibility and maybe the only possibility for getting Putin out and ending the war). China is, no doubt, looking at how things are progressing in terms of their visions of a Taiwan reunification. Their mucky mucks have to be wondering how they would fare under the types of digital guns now being fired at Russia. Perhaps the most important possible future effect could include countries moving away from the US dollar as the world's reserve currency. That would have serious repercussions on the US government's ability to finance our debt and to our economy in the long term (not something to worry about for today). I invite you to read any of the links below to get a more in depth idea of all that's happening.

^https://www.zerohedge.com/commodities/breadbasket-world-choked-russian-invasion-wheat-prices-soar

*https://theconversation.com/can-wealthy-nations-stop-buying-russian-oil-178008

*^https://www.freightwaves.com/news/shipping-isnt-waiting-for-sanctions-its-refusing-to-move-russian-cargo

**https://oilprice.com/oil-price-charts/#WTI-Crude

^^https://www.zerohedge.com/markets/zoltan-pozsar-warns-russian-sanctions-threaten-dollars-reserve-status

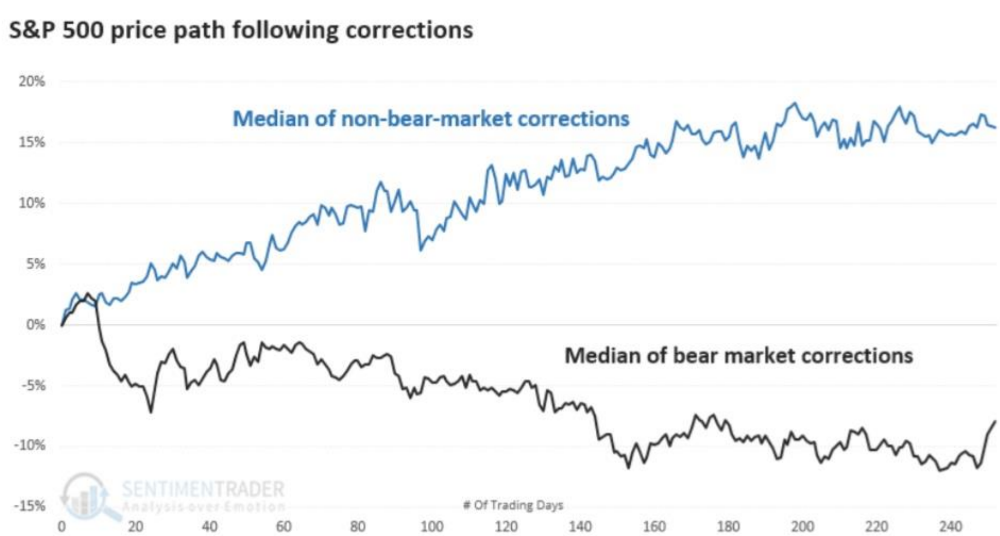
^*https://global-macro-monitor.com/2022/03/03/markets-sometimes-do-the-work-that-armies-cant/

Perf from Invasion Date	Invasion to Trough
- MSCI Europe Small Cap	N/A
- FTSE 250	-21.32%
- Russell 2000	-29.91%
- S&P 500	-19.92%

Source: BP Statistical Review, Bloomberg Finance L.P., FactSet and J.P. Morgan calculations.

Perhaps surprisingly, as I'm typing this note, US stock and bond markets are essentially flat (source: Yahoo Finance) since the invasion. Of course, they were both down considerably prior to the start of conflict so maybe they were already discounting the effects. The US does relatively little business with Russia and Ukraine so direct economic effects are limited and, now that various Covid restrictions are ending around the country, it's possible business activity will pick up. On the other hand, there are so many "butterfly" effects* that are impossible to know, one would think investors might be a bit more cautious. There is a mantra that "war is good for markets," but that's not necessarily true as evidenced by the table showing US and European stock markets during the Iraq war. They were down from about 20% - 30%.

*https://en.wikipedia.org/wiki/Butterfly_effect



For our accounts at Nationwide Advisory, we have been cautious and have reduced "regular" stock allocations considerably while having over-weightings to energy, commodities, and alternatives for several months now. I am looking at stock markets closely over the next few weeks, which may tell us a lot in terms of whether this market is going to start inching back up or whether we are falling into a "bear" market vs just a "correction" (defined as a loss between 10% - 20%). Sentiment Trader did an analysis of stock markets that cycle from recent highs to a correction within 50 days. Their chart shows the median path for markets that recover and those that develop into full blown bear markets (losses of 20% or more). As you can see, based on the median, from where we are now, the two paths start diverging pretty quickly.

As always, thank you for allowing us to be of service. Please let us know if you need anything.

Enjoy,

Thomas B. Paine

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