Citi Global Wealth Investments

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CIO Strategy Bulletin

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UKRAINE

The deaths of innocent civilians and the soldiers defending Ukraine are foremost in our minds as we write this weekend's CIO Bulletin.

"There is no flag large enough to cover the shame of killing innocent people." - H. Zinn

The war that will likely end the independence of Ukraine, the second largest country in Europe, with a population of 44 million, began with Russia's full-scale invasion at 5AM on Thursday, February 24, 2022. Ukraine is a unitary republic with an elected President and legislature, that became independent in 1991. Ukraine's current, elected President is an actor, Volodymyr Zelenskyy, who had starred in a television series called "Servant of the People." Zelenskyy was born to Jewish parents, and his great-grandfather, along with three brothers, were killed in the Holocaust. Freedom House, which grades countries on democracy, gives Ukraine a score of 61 of 100. (By comparison, Russia received a 19, and the US earned a score of 83.) The war now threatens millions, many of whom will be displaced, and is likely to spark a humanitarian crisis in Eastern Europe.

The Ukraine war will likely mark a new security paradigm for Europe and the US. As David Remick and Joshua Yaffa noted in the New Yorker on February 24th (Putin's Bloody Folly in Ukraine), "Putin's confrontation with the West over Ukraine follows a familiar cycle in Russian history of loss and reassertion." The aim of the war is to end what Putin sees as a "prolonged period of Russian weakness and humiliation." Putin considers the expansion of NATO to Eastern Europe and the Baltic states a "direct threat to Russia's security" and the idea of Ukraine drawing closer to NATO "an existential red line." While we will never know Putin's calculus, he perceived Russia's ability to win the war and withstand the likely political and economic ramifications as high enough to proceed with invasion and inevitable bloodshed.

"The fight is here; I need ammunition, not a ride."

Expect a more protracted battle in the Ukraine, with social media providing an unwaveringly clear view of what a ground war in 2022 looks like, fueling protests globally. This is already shifting the views of the German government which has now elected to send weapons and agreed to limit Russian access to the SWIFT interbanking system (Media Monde, France 24, 2/26). Likewise, the US is sending arms and public donations in cryptocurrency are flowing to the Ukrainian resistance. According to a senior US official with direct knowledge of a conversation between President Biden and President Zelenskyy on Saturday, the Ukrainian head of state declined an offer to leave his country. He reportedly said, "The fight is here; I need ammunition, not a ride." (CNN, Sharon Braithwaite, 2/26)

Figure 3: CPI for energy and Brent crude oil price daily

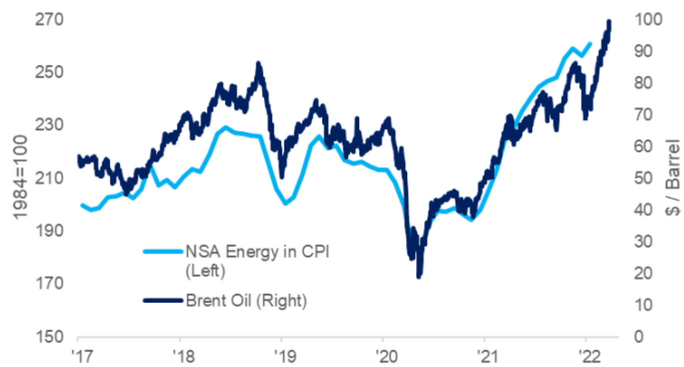
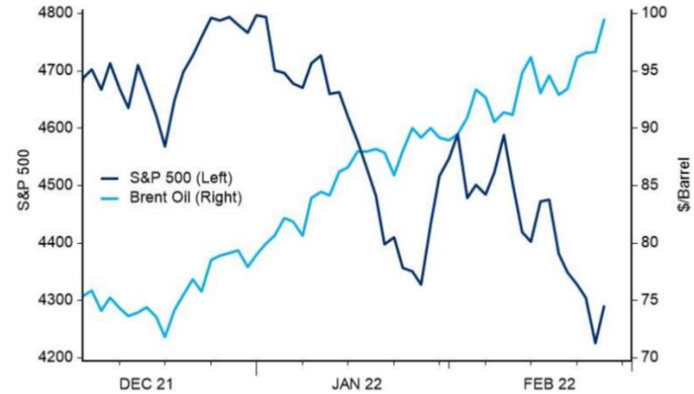


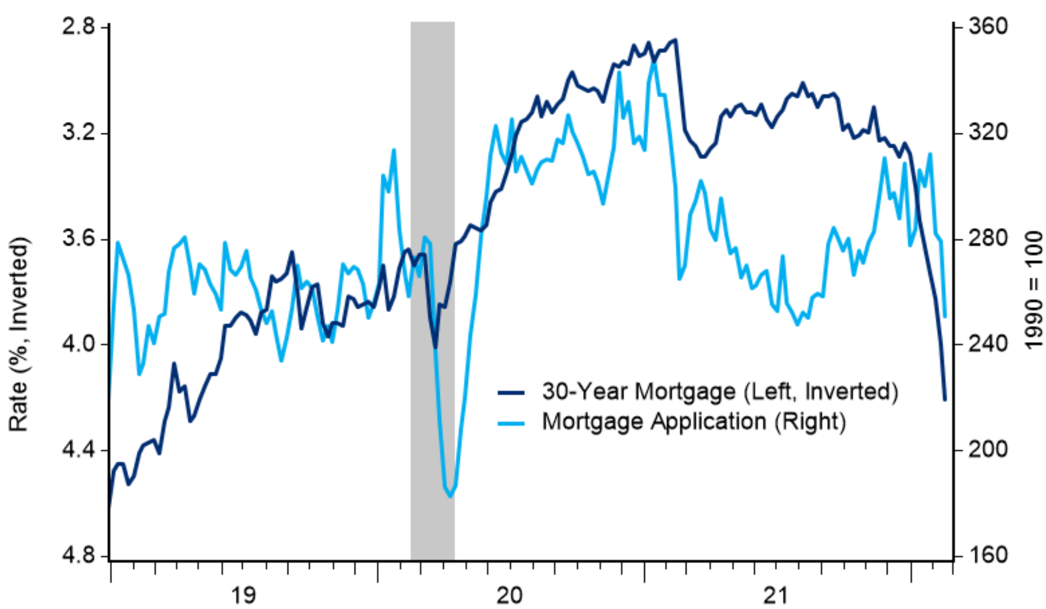
Figure 4: Crude oil price and US equities move to negative correlation on Fed's reactive policy



Source: Haver and Bloomberg as of February 25, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Raising rates too quickly in a slowing economy could be harmful. With the US and global economies already normalizing with a 37% decrease in YoY US federal spending, the war in Ukraine will further depress near-term growth. As trade losses become clearer, we would expect estimates for European GDP growth to be reduced at least by 0.5% due to the war. At the same time, we see that higher US interest rates are already dampening demand for housing, and certainly weighing on household wealth (Figure 5). Thus, the risk that the Fed will overshoot and raise rates too far in 2022 has increased, not decreased, given the negative background issue the war presents.

Figure 5: Mortgage Application Volumes for Home Purchase vs US 30-Year Fixed Mortgage Rates (Inverted Scale)



Source: Haver as of Feb 25, 2022. Note: Shaded region is recession. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

firms that pay growing dividends. In periods such as this one, small, poorly capitalized firms and those within many highly cyclical businesses have seen their equities routinely underperform.

4. If energy prices do not collapse as they did at the start of the last Fed tightening cycle in 2014 – when crude oil fell 66% over two years – we would expect broad emerging equity markets to perform well and offer diversification to global equity portfolios.

Figure 10: Geopolitical shocks have only driven turning points for the world economy twice since WWII

Geopolitical Event	Date	S&P 500 (% since event date)			Crude Oil (% since event date)			MSCI World ex USA (% since event date)			DXY Dollar Index		
		Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days
Pearl Harbor	12/7/1941	-6.87	-2.90	-12.02									
Cuban Missile Crisis	10/19/1962	-3.78	7.61	17.16									
JFK Assasination	11/21/1963	-2.81	3.06	8.28									
US Bombs Cambodia	4/29/1970	-15.30	-6.43	-4.94	0.00	0.00	0.00	-10.45	-17.01	-16.07	-0.20	-0.23	-0.51
Arab Oil Embargo	10/18/1973	-16.26	-5.61	-15.11	67.44	72.09	287.04	-14.68	1.96	-18.53	6.98	4.68	12.31
USSR Invades Afghanistan	12/24/1979	-2.27	5.37	-7.78	8.33	8.33	8.33	3.94	3.94	11.85	-1.06	-0.71	5.91
US Bombs Libya	4/15/1986	2.95	-1.39	0.16	-3.91	8.70	-15.65	0.00	6.19	8.16	-4.15	-4.80	-5.30
US Invades Panama	12/15/1989	-2.06	-3.73	-3.43	2.82	5.08	-6.21	0.00	3.67	-7.04	0.31	-1.69	-0.44
Gulf War	12/24/1990	-4.16	0.09	12.10	17.75	-20.67	-31.32	1.75	1.75	15.96	-0.21	-3.61	4.90
World Trade Center Bombing	2/26/1993	-0.31	1.67	2.04	-0.18	-3.44	-5.81	0.00	8.52	18.62	0.18	-1.15	-4.79
911	9/11/2001	-11.60	0.45	4.34	-4.09	-17.68	-31.98	-8.48	3.24	5.48	-1.08	0.29	1.85
US Invasion of Iraq	3/20/2003	2.49	2.06	15.57	-8.16	-5.86	-6.54	1.53	4.58	22.05	0.84	-1.85	-7.89
Russian Annexation of Crimea	2/26/2014	1.16	0.68	3.62	-3.77	-2.43	-0.92	-2.42	-0.45	3.25	-0.40	-0.31	-0.10
North Korea Related													
Korean War	6/23/1950	-12.80	-8.67	1.20									
Operation Paul Bunyan	8/18/1976	-3.15	1.64	-4.32	0.00	0.00	0.00	0.00	-0.26	-7.60	0.07	-0.57	-0.12
2006 Nuclear test	10/9/2006	0.90	2.60	4.60	-1.46	1.09	-7.43	0.46	4.33	8.09	0.43	-1.32	-2.21
2009 Nuclear test	4/25/2009	-1.28	5.09	13.05	-3.73	19.56	36.56	-2.32	12.28	21.21	0.52	-5.54	-7.04
2013 Nuclear test	2/12/2013	0.02	2.88	7.53	-0.27	-8.18	-12.49	-0.99	1.15	5.73	0.59	3.12	3.96
2016 Nuclear test	9/9/2016	-2.55	-0.81	2.97	-3.38	14.12	16.54	-2.06	-0.81	-0.72	-0.01	1.36	6.05
2017 Escalation	8/7/2017	-0.24	-0.64	4.44	2.19	7.00	21.65	-0.26	-0.49	3.60	0.23	-1.22	1.62
Missle test over Japan	8/28/2017	0.08	2.69	6.43	-0.83	10.37	23.06	-0.25	1.80	5.45	0.05	1.25	0.62

S&P 500	Initial Impact %	30 days %	90 days %
Average all events	-3.7	0.3	2.7
Average ex WW2	-3.5	0.4	3.4
Average ex WW2 and Oil Embargo	-2.9	0.7	4.4

Source: CGWI OCIS and Bloomberg as of Feb 22, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Figure 11: Regional contractions are far more common than global

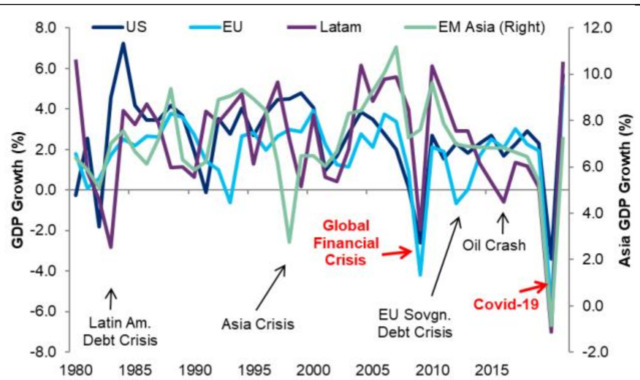


Figure 12: World markets typically sell off together following an initial shock. However, they later distinguish fundamentals

Regional Returns following Russian Invasion of Crimea		
Region	Initial Reaction	1 Year Return
US	0.7%	14.1%
Japan	-5.1%	24.4%
Europe	-3.0%	14.1%
EM	-0.2%	3.6%
Russia	-11.8%	-29.6%

Source: Haver as of February 25, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

THREE AREAS OF CONCERN

1. While the 12% decline in US equities has improved valuation and forward-looking returns since December, the prior three years have already delivered gains of 19.8% per annum for the S&P 500. Future equity gains will be dependent on the delivery of increased corporate earnings in an almost linear fashion. Thus, we believe a future 9% gain in the S&P 500 to be roughly in line with EPS gains in mid- to high single digits, a pace that requires continued economic expansion. The currently high but diminishing pace of upward EPS forecast revisions is a contrarian negative indicator for markets, much the opposite of the investor sentiment data.

2. While self-destructive for Russia's economy, it remains possible that it may withhold oil and gas supplies in an act of retaliation to sanctions. If so, Russia's optimal timing is soon as winter heating demand will soon wane in Europe. European gas inventories were unusually low this winter causing energy services costs to jump at a record pace even before the invasion. Markets may still react to Russian cyber-attacks on western firms and infrastructure despite widespread warnings akin to US warnings over the invasion itself.

3. The history of war is one of unexpected consequence and unexpected spread. For example, the US decision to pull air power from Afghanistan last year may have added to Russia's confidence in its action against Ukraine. While we view the probability of action on the part of China as low, its territorial dispute with Taiwan remains an even larger immediate risk for the world economy given much larger financial and supply chain linkages (please see Outlook 2022).

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