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The human tragedy in Ukraine continues. We would be remiss if we did not mention it first and foremost. Our thoughts are with those in Ukraine, those who are trying to escape, and their loved ones who may be watching from afar. They are living a nightmare right now, and we pray for a resolution to this heartbreaking situation.

We continue to receive a large number of questions from clients about the market and economic ramifications, so we have compiled some of the most common questions and attempted to answer them given the information we have as of March 7.

# The Russia-Ukraine crisis: What investors are asking about oil, recession risks, and more

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## **Oil prices have continued to rise. What does this mean for developed countries' economies, and how bad will inflation get?**

Inflationary pressures have clearly worsened, largely driven by energy prices as well as other commodity prices due to the Russia-Ukraine crisis.

Let's put this in perspective. Using figures from the World Bank, we calculate that global consumer expenditures on oil as a percent of gross domestic product (GDP) would cross the 7% threshold if current oil prices are sustained — and that this figure reached the 7% to 10% threshold twice over the past five decades, since 1970. In both instances, a meaningful decline in demand followed. And so there is an elevated risk that the global economy within a two-year period will have moved from a pandemic scare to an inflation scare to a growth scare.

It is worth noting that some inflationary pressures may be easing, although it is still too early to tell. It looks like labor conditions in the US are returning to normal, with more people returning to the workforce. After months of significant increases in average hourly earnings, they were flat in February.<sup>1</sup> If wage growth were to continue to moderate not just in the United States but in developed economies in general, that would mean at least some inflationary pressures are easing.

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## **What is the 10-2 year US Treasury yield spread telling us about the risk of recession?**

We are seeing a high amount of volatility in Treasury markets as they try to price in changing expectations about Federal Reserve tightening as well as the growing geopolitical risk created by the Russian invasion of Ukraine. While the spread between the 10-year and 2-year yields has compressed, we don't believe this is signaling an impending recession — although clearly the risk of a recession has increased, as we noted above.

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## **What has happened to currencies?**

Hardest hit has been, not surprisingly, the ruble. As expected, the US dollar has strengthened, given its "safe haven" status, while the euro has weakened given that the eurozone is being hit hard by the crisis. "Commodity currencies" have of course benefited from the very substantial price spikes in energy and industrial metals — this includes the Canadian dollar, the Australian dollar and some Latin America emerging markets currencies.

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## **After sanctions against Russia, could the USD lose its status of preferred currency for foreign exchange reserves at central banks?**

It is possible, but is certainly not the base case scenario. Much will depend on how long central bank reserves are frozen and how much some countries want a reserve currency other than the US dollar. It is possible that gold and even cryptocurrencies could gain some further popularity from a reserve perspective.

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## Why has Bitcoin been outperforming other cryptocurrencies during this crisis?

Bitcoin and other cryptos initially fell with other risky assets as events unfolded on Feb. 24, but Bitcoin has risen in the days following. This is most likely due to the ability of Bitcoin to circumvent economic sanctions and allow users to transact across borders regardless of sanctions. While other cryptocurrencies are capable of this as well, we believe Bitcoin has benefited from its relatively more established infrastructure, greater acceptance and higher profile. This has helped fuel demand for Bitcoin. Ukraine is also receiving donations in Bitcoin.

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## What developments should investors be watching?

There are a number of things. Here are a few:

- **From a humanitarian perspective.** It was reported March 7 that Russia has offered conditions for a cease-fire to allow civilians to evacuate four Ukrainian cities. While they are unlikely to be accepted by Ukraine, they represent the clearest set of terms offered to date, providing a glimmer of hope that Russia may be looking for an “off ramp” given that the invasion has been far more difficult than Russia had likely anticipated.
- **From a fiscal spending perspective.** The Russia-Ukraine crisis is creating a short-term increase in fiscal spending in the form of military, medical, and humanitarian aid to Ukraine, and longer term there could be rise in military spending, especially in Europe (which could be worth up to 1% of GDP in Germany, for example<sup>2</sup>). How that will impact economies depends on how it is financed. And, of course, just as spending power is being reduced in energy-consuming countries, it is being boosted in energy-producing nations. The boost to fiscal spending may prove more important to global economies than anything done by central banks.
- **From an energy price perspective.** Rumors continue to swirl that the US is close to a deal with Iran that would enable the US and other countries to purchase its oil. The US is also in talks with Venezuela to once again buy its oil. Iranian and Venezuelan production should certainly help ameliorate rising oil prices — especially if Western allies decide to ban the importation of Russian crude oil.
- **From a central bank perspective.** The calculus around central bank policy moves has evolved dramatically. Last week, Fed Chair Jay Powell made it clear that the Fed is likely to only raise rates by 25 basis points in March, and that it will be measured and thoughtful in its approach to rate hikes. And markets anticipate a more dovish European Central Bank than had been expected. That may alleviate one of the headwinds facing stocks this year.
- **From a growth perspective.** At its annual plenary session, China set a growth target of about 5.5% for 2022.<sup>3</sup> While it is one of the lowest growth targets in three decades, it is higher than Wall Street estimates of approximately 5.0%. We think the more ambitious growth target could be sending a message that policymakers are determined to stabilize and grow the economy in 2022. To achieve its growth target, China will need an even more supportive monetary and fiscal framework for the remainder of the year — which could mean a softer regulatory environment that helps to boost fixed asset investments and the property market.
- **From a global equity perspective.** Some countries have less exposure to the crisis, such as China, and so their markets are more insulated from these pressures. Some countries/markets may benefit from their exposure to commodities, especially some Latin America emerging markets countries, as well as Australian and Canadian stocks and their currencies.

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## What perspective would you give to investors?

Investors are understandably unsure about what, if anything, they should be doing at the moment. We had already anticipated volatility given the Fed's pivot to a more hawkish stance as it prepared to begin tightening monetary policy. However, the situation has become far more complicated in recent weeks. We need to recognize that Russia's invasion of Ukraine came as an enormous surprise to markets, and that is reflected in the stock market sell-off as well as some of the speculative activity in commodity prices.

We do believe there is more downside and more volatility ahead, as markets continue to digest such a dramatic departure from conventional expectations. We need to adjust our expectations: The crisis in Ukraine could persist for some time to come, but we would expect markets to start to recover as the global economy adjusts. As we have said, volatility, even intraday, has materially increased for both equities and bonds this year, but we have not seen panic moves and capitulation. This could be another sign that volatility, linked to the perception of uncertainty, can persist for some time.

We believe this is not a time to abandon stocks if one has a longer-term time horizon. As we have said so many times before, this is a time to be well diversified across and within asset classes, including alternatives such as commodities.

*With contributions from Brian Levitt, Arnab Das, Paul Jackson, Luca Tobagi, David Chao and Ashley Oerth*

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### Notes

<sup>1</sup>US Bureau of Labor Statistics, March 4, 2022

<sup>2</sup>CNBC, "Germany announces major defense policy shift in face of Russia's Ukraine invasion," Feb. 27, 2022

<sup>3</sup>The Wall Street Journal, "China Sets Economic Growth Target of Around 5.5% for the Year," March 4, 2022

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### Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Past performance is not a guarantee of future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

Bitcoins are considered a highly speculative investment due to their lack of guaranteed value and limited track record. Because of their digital nature, they pose risk from hackers, malware, fraud, and operational glitches. Bitcoins are not legal tender and are operated by a decentralized authority, unlike government-issued currencies. Bitcoin exchanges and Bitcoin accounts are not backed or insured by any type of federal or government program or bank.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Quantitative tightening is a monetary policy used by central banks to normalize balance sheets.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

A basis point is one hundredth of a percentage point.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

The opinions referenced above are those of the author as of March 7, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.