THE WAR IN UKRAINE AND THE STOCK MARKET

ATLAS CAPITAL ADVISORS | QUARTER 1 2022

Equities, especially US equities, performed well in the period after the Russian invasion of Ukraine on February 24. The S&P 500 index gained 7.2% from the day before the invasion to March 31. The common narrative we hear is 1) the market has priced in a peace deal and is looking beyond the current turmoil; 2) the Russia/Ukraine conflict, especially the energy shock, is limited to Europe and not likely to derail the strong post-Covid economic recovery in the US.

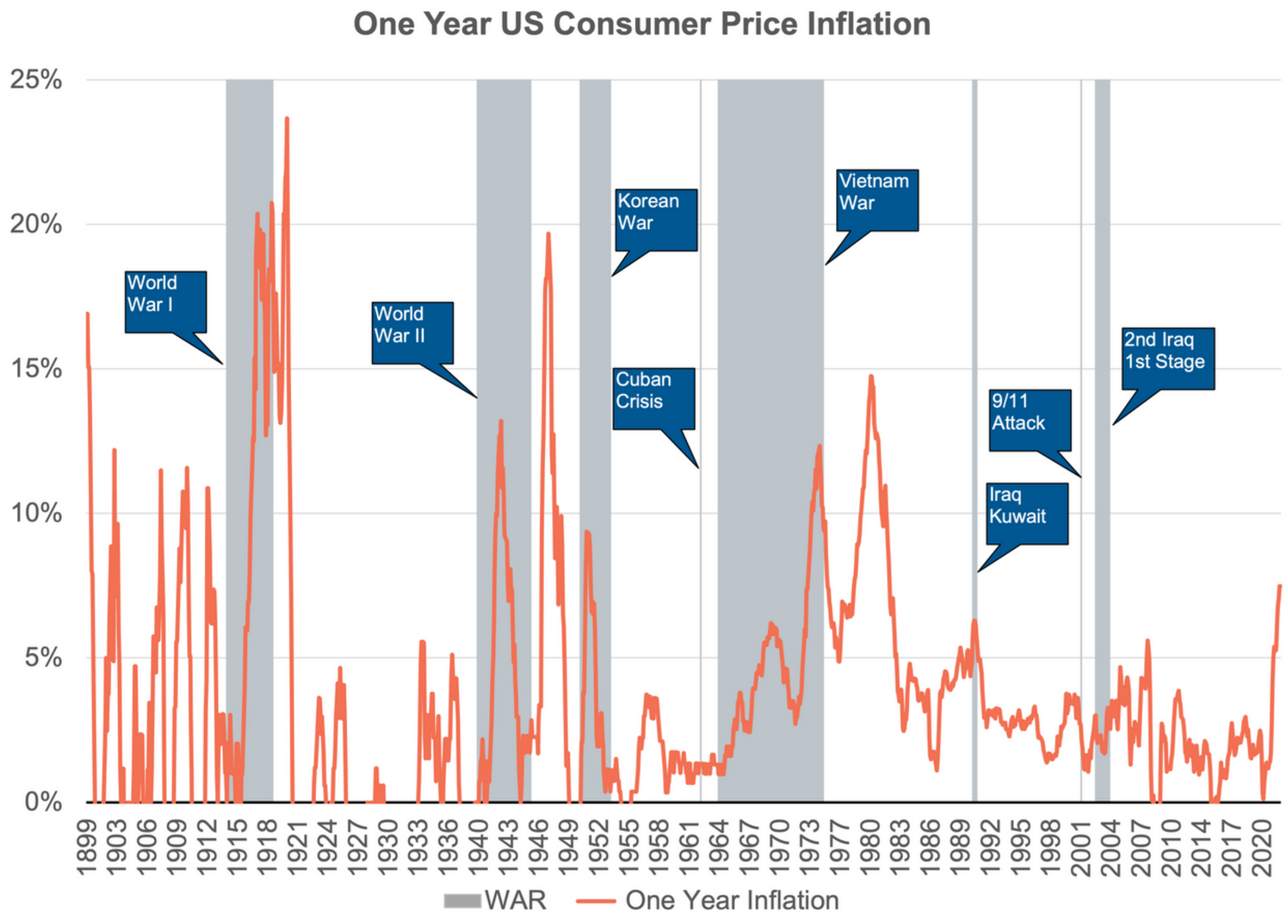
To us, this reaction seems out of sync with the likely economic and market consequences of the war. In this quarterly, we explore the usual economic impacts of wars in general, and the specific impacts we observe and expect from the Russian/Ukraine conflict.

WHAT'S DISCUSSED:

- War and Inflation
- Inflation and Stock Market
- Economic Impacts
- Q2 2022 Client Investment Positioning

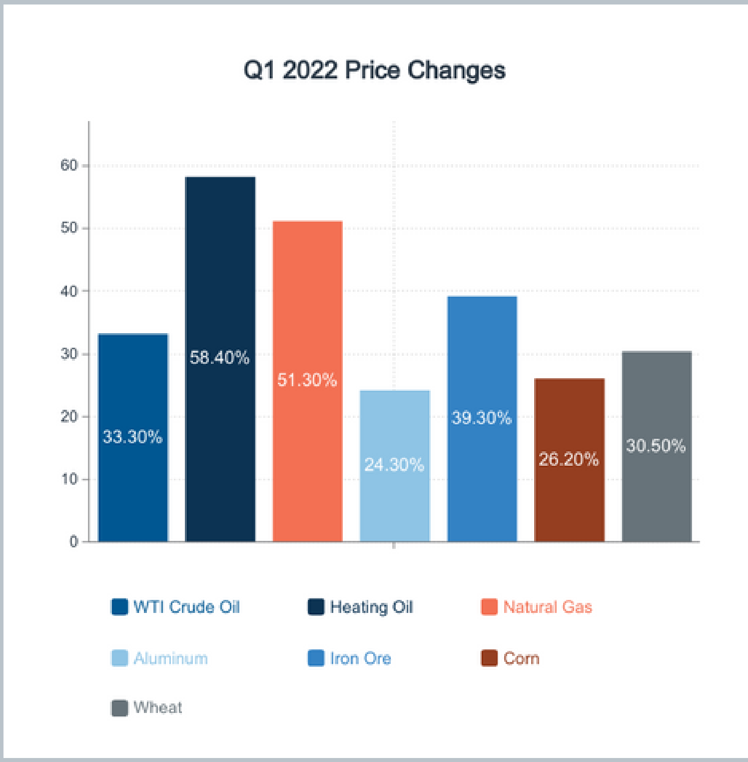
War and Inflation

Wars have often been accompanied by surges in inflation as the chart below demonstrates[1]. US Consumer Price Inflation (the red line on the chart) tended to accelerate during these periods of conflict; on average, US CPI was 5.8% during war periods and only 1.1% otherwise. Note that inflation lingered and even accelerated after the conclusion of most of the major wars.



US inflation was already running at the highest level in forty years at over 7%, prior to the start of the Russia/Ukraine conflict. Commodity prices were a major contributor to this inflation surge, with the S&P Goldman Sachs commodity index up 37% in 2021[2]. The additional inflation impact from the Russia/Ukraine conflict is potentially larger than in other recent wars because both Ukraine and Russia are major commodity producers and exporters. Russian and Ukraine together supply more than 25% of the world's wheat and are also among the largest corn and vegetable oils suppliers. Russia supplies over 10% of the world's oil and over 15% of its natural gas.

As the chart shows, price increases for major commodities in Q1 were significant[3]. Thus, the longer the conflict lasts (and it already has lasted longer than initially predicted), the destruction in Ukraine and the impact of sanctions on Russia will likely have strong ripple effects through the global economy.



Inflation and the Stock Market

Conventional wisdom says that equities are a reasonable hedge during times of inflation.

Indeed, on average, the nominal returns of stocks have been positive during inflationary periods, and the real return is only modestly negative.

This statement is challenging because "on average" can be quite misleading.

As we discussed in a prior quarterly letter[4], the worst real outcomes for equity investors occur when inflation is high and rising as it is now. On average in those periods the S&P 500 return has been 3.3% lower than the rate of inflation. And indeed, during the war periods illustrated in the chart at the start of this note the average return of the S&P 500 was 1.9% below inflation, vs. 3.2% over inflation otherwise.

High and rising inflation is negative for the stock market because investors anticipate a reaction from the central bank. The Federal Reserve is obligated to (eventually) tackle runaway inflation, as they are starting to do this year. Usually, when the central bank intervenes to control high inflation the result is a recession.

That brings us back to the economic fundamentals and the Russia/Ukraine war's impact on the global economy.

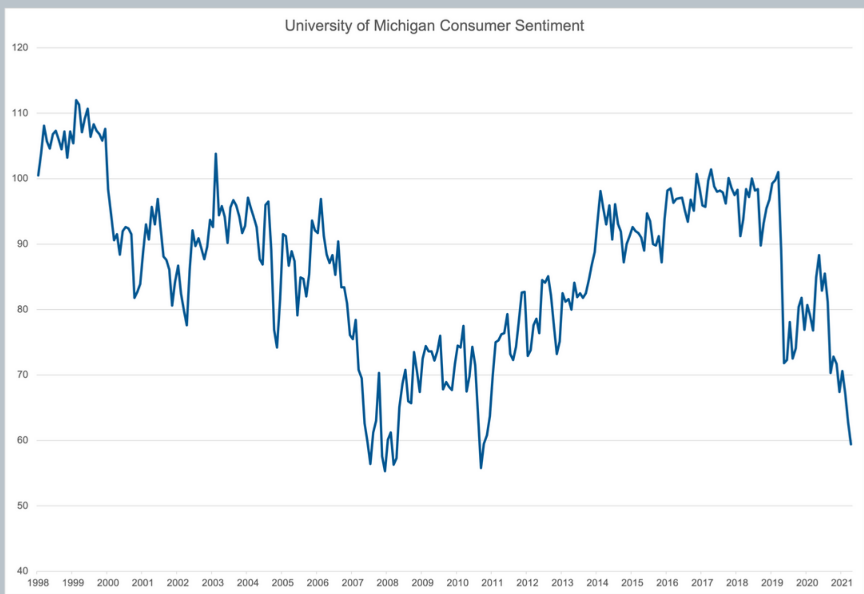
Economic Impacts

Two major components of global GDP are directly impacted by the Russia/Ukraine conflict: energy and food. Energy spending is expected to be 13% of global GDP this year, more than double what it was last year[5]. This acts on the economy as if there were a new universal 7% income tax. Economies heavily dependent on energy imports are at risk, which includes Europe, Japan, and many emerging markets. Regarding food, in China and nearly every other country which has a per capita GDP below $20,000, food represents over 20% of consumer spending.[6] Food spending is at least 10% of GDP in most countries. The surge in food prices is an additional enormous “tax” on consumers.

Because energy and food cost so much more than last year and account for such a large percentage of global GDP, we should expect that the decline in the amount available to spend on other goods and services will impact global economic growth negatively. Discontent regarding food and energy inflation is already starting to impact many countries politically as well.

Another piece of information we consider in evaluating the prospects for consumer spending is consumer confidence, which is often correlated to stock markets. Confidence was already falling and plunged further since the war began, particularly in Europe and the US.

As the chart[7] illustrates, the University of Michigan Consumer Sentiment for the US is now close to the lowest level ever observed for this series.



This is an interesting disconnect that consumer confidence is very low, yet the US stock market has performed remarkably well. This is a contrast to the bear markets associated with the confidence slumps in 2008 and 2011. This is an anomaly that will be resolved over time, most likely to the detriment of US equity investors.

In Summary

Equity market investors seem to have found reasons to buy since the Russian invasion of Ukraine began. However, the war has amplified our two biggest worries about the equity market outlook – rising inflation and slowing economic growth. Due to deteriorating economic conditions, we find the common narrative for the recent market recovery unconvincing, at least not yet, until we can see evidence that the US not only can withstand the inflationary pressure from the war but also lift the rest of the world back to growth. Our equity downside risk dashboard[8] continues to indicate that downside risk is elevated. As a result, we remain cautious and defensive in the equity positioning for Atlas clients.

Q2 2022 Client Investment Positioning

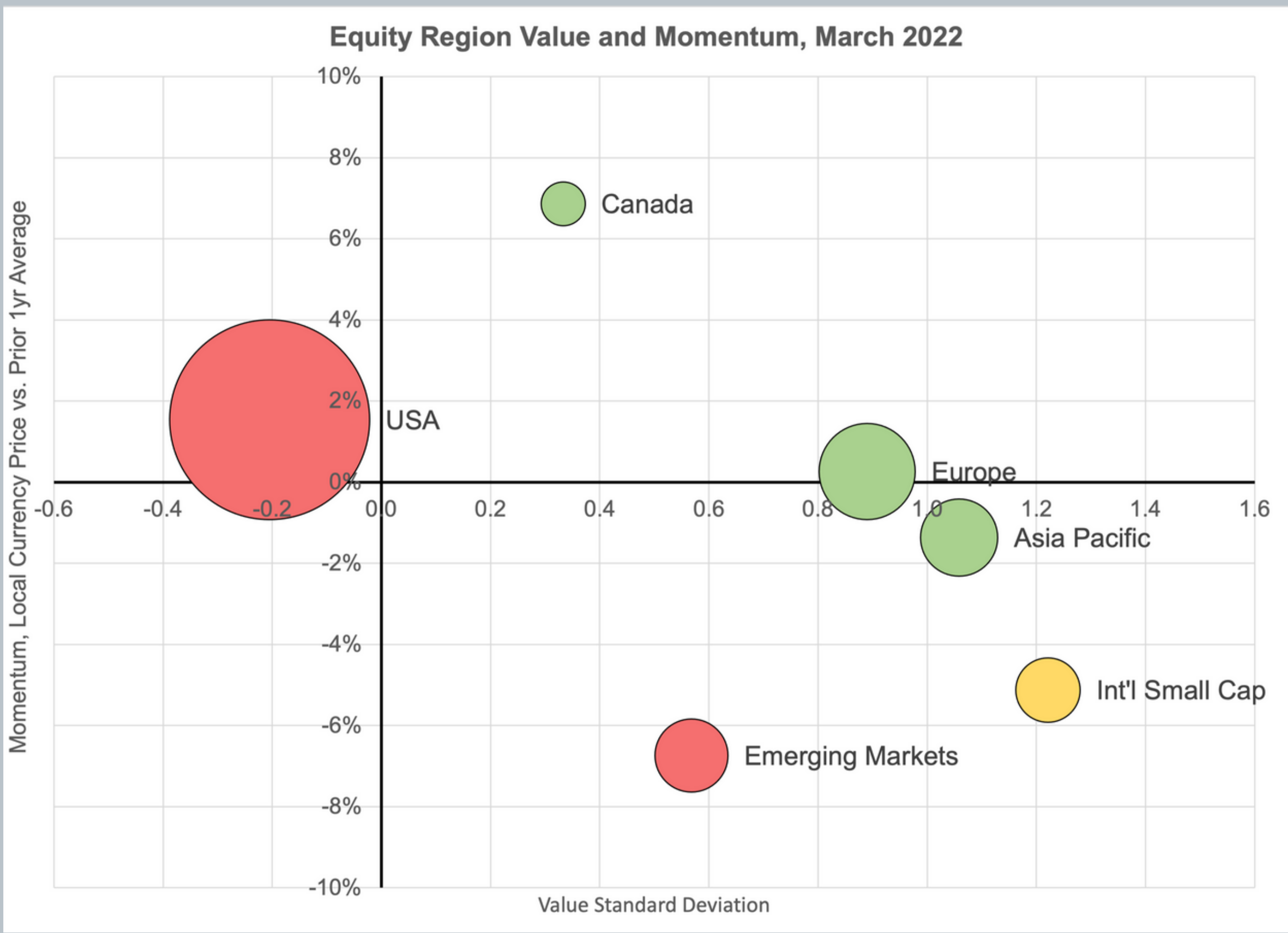
Atlas Capital's systematic process for equity market selection seeks favorable value metrics and positive sentiment (price momentum). The Atlas website[9] provides a set of charts showing our value and momentum assessment for equity regions, sectors, and countries, which we update each month.

The below charts depict Regional and Sector views from March 2022.

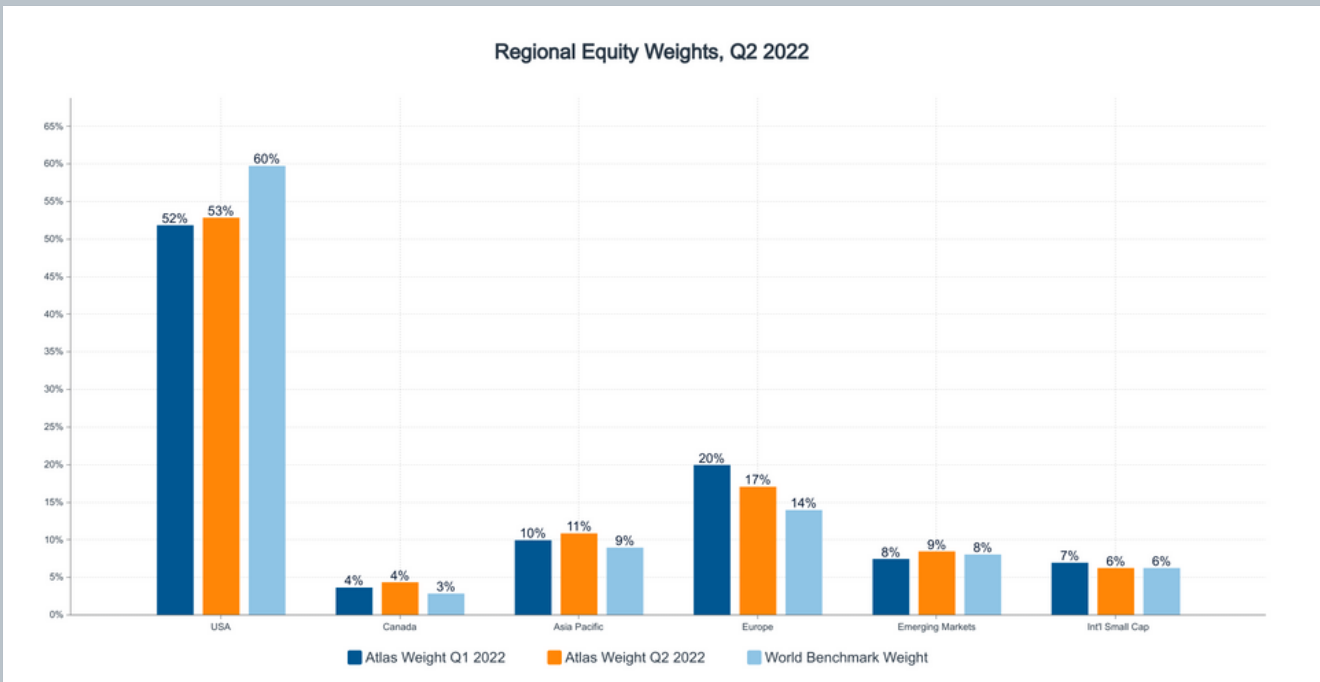
[1] Source: Robert Shiller dataset: http://www.econ.yale.edu/~shiller/
[2] Source: Bloomberg, SPGSCI Index
[3] Source: Bloomberg, Dec 31, 2021 through March 31, 2022
[4] https://www.atlasca.com/us-inflation-to-infinity-and-beyond/
[5] https://oilprice.com/Latest-Energy-News/World-News/Energy-Spending-To-Hit-Record-13-Of-Global-GDP-In-2022.html
[6] Source: https://ourworldindata.org/grapher/share-of-consumer-expenditure-spent-on-food-vs-gdp-per-capita
[7] Source: Bloomberg, University of Michigan Consumer Confidence, CONSSENT Index
[8] https://www.atlasca.com/equity-downside-risk-dashboard/
[9] https://www.atlasca.com/current-market-assessment/#quantitativeassessment

Regional Selection

As the following chart illustrates, at the end of March the regions with the better combination of value and momentum were Canada, Europe and Asia/Pacific. In this chart (and on the website) the size of the bubble indicates the market weight of the equity region. The color of the bubble indicates whether we are over the benchmark weight (green), neutral (yellow) or under the benchmark (red).

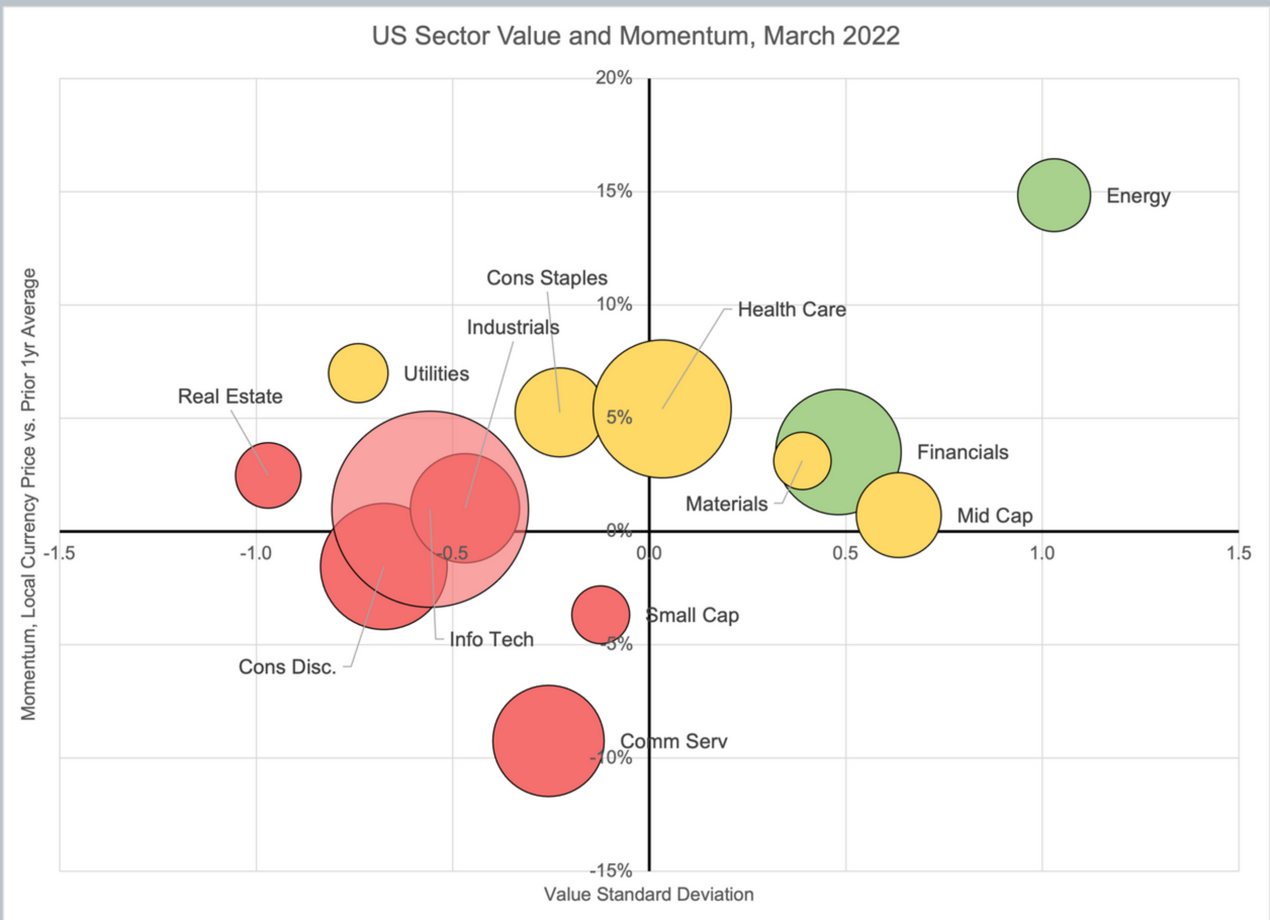


Our regional equity weights are tilted accordingly, as shown in the following chart. Clients are about 7% below the benchmark weight for the US, and above the benchmark in the rest of the world. Compared to our December 2021 positioning, we have reduced the weight to Europe, the region which has been most affected by the war in Ukraine, and made small increases in the other regions.

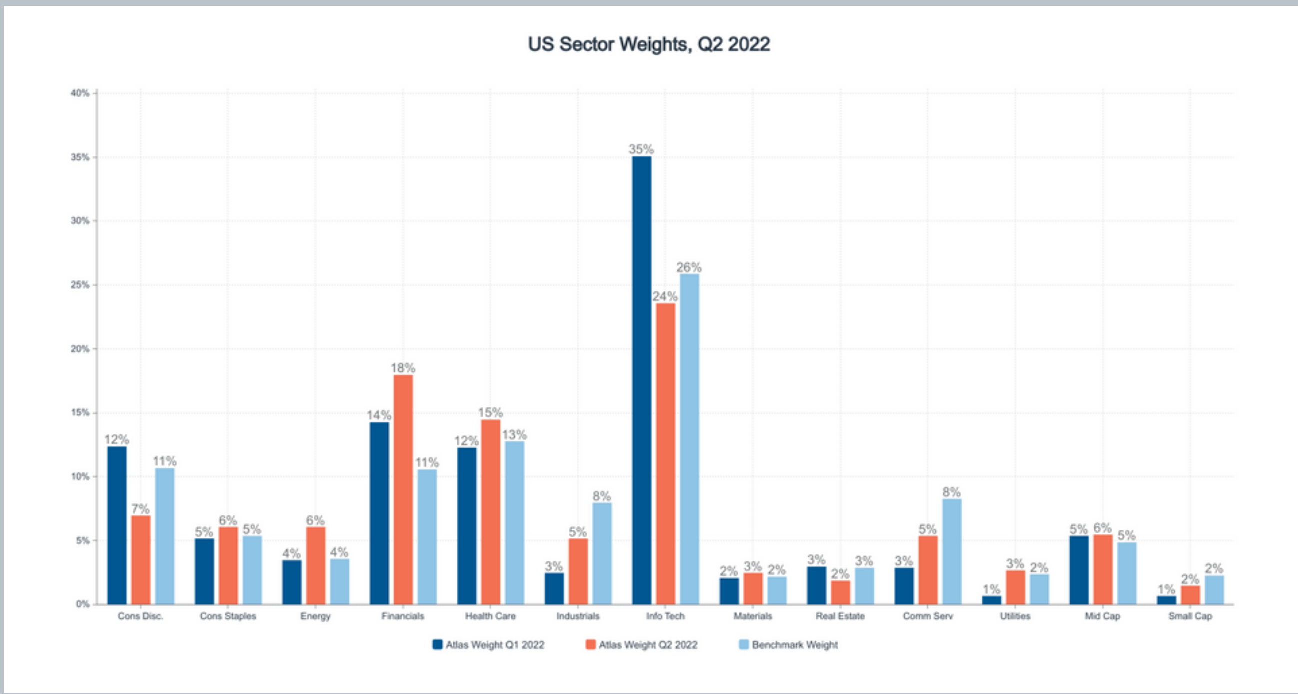


US Sector Selection

The US ranks at the bottom of our assessment of regions, and therefore we are underweight (red) or neutral weight (yellow) in most of the sectors. The two sectors with positive tilts are energy and financials, which combine good value with favorable momentum.



As compared to the December 2021 positioning, we made large reductions in the weight given to InfoTech and Consumer Discretionary, increasing weights to Energy, Financials, Industrials and Communication Services.



Additional Client Investment Choices

Atlas added exposure to MLPs and short-term TIPs in client portfolios in the March rebalance. The investment case for MLPs is supported by the boom in energy prices as well as current dividend yields in excess of 7% per year. We added TIPs to client portfolios for safety and inflation protection. Most clients also maintain a small holding in short-term fixed income as a safety measure, given the downside risks to equities.

Thank you for your interest.

If you have questions or comments, we would be happy to hear from you at info@atlasca.com.

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