



CIO OFFICE MORNING MARKET WRAP – 24th February, 2022. ALSO AVAILABLE ON ALEXA.

US futures and Asian markets are plunging this morning as the Ukrainian crisis deepens. Oil, gold and treasuries are climbing and concerns about rising inflation and a subsequent policy mistake have heightened. President Putin has decided to conduct special operations in the separatist republic of Donbas, saying there is no plan to occupy Ukraine, that suffered cyberattacks to several government and bank websites. Yesterday the S&P 500 closed at -1.8%, and the Nasdaq Composite led losses falling 2.6%.

Although Ukraine-related matters are in the foreground in this note, it should be clear that the Federal Reserve 'war' on inflation is even more relevant for markets than the current real-world conflict.

The Ukrainian crisis is far from over and there is the feeling we might be facing a longer-lasting, different flavor of geopolitical risk than we have so far been accustomed to. Yes, these kind of risks are painful, but usually come and go with relatively little market damage, because in the end the related economic disruption is limited. It may be the case that Russia is facing, from its viewpoint, a security challenge in its

backyard, hence Putin might not be willing to give in so easily. He has repeatedly mentioned his red lines, that the West is unwilling to accept, at least without some sort of loss of face, hence the stalemate. In turn, the US is unwilling to engage in an open conflict, never mind the possibility of an invasion, and the European allies cannot challenge Russia too harshly, depending on its energy. In the end, one side has no interest in giving in, the other cannot exert maximum pressure. As a matter of fact, the Western sanctions are far from constituting a shock and awe approach, they are actually relatively mild as a starting point. And Russia is not isolated, it is openly supported by China, so much so that the joint statement issued during Putin's visit in China in early February said "The parties oppose the further expansion of NATO", not by chance the very kind of existential threat President Putin sees to Russia. Last but not least, basic resource prices from oil to agricultural commodities are heavily affected by what is happening. This does not mean that markets will be indefinitely weighed down by the crisis, but it could mean that the geopolitical risk might not go at all that quickly.

So, if this crisis may be of a peculiar kind, it is worth assessing its possible market impacts, and the most obvious one would be via stagflation, subverting some past norms we may have given for granted. The direct consequence of the crisis is to make commodity prices stickier, with most negative repercussions for commodity importers like the euro area and the UK within DM, but also for Biden's political agenda, as high inflation dents consumer purchasing power making him even more unpopular. The Fed is for now holding to a gradualist approach, but board members have already remarked that they would support a more aggressive one, in case price pressures remained high. In general, commodity-related equities would be holding up much better, and the revenge of the old economy - scarcity - versus the new economy - efficiency - would be exacerbated, especially considering the still large valuation differential against the post-covid winners that seemed to be the forever winners to all the investors liable to extrapolate. Overall, if the growth-inflation tradeoff remains unfavourable, with multiple factors beyond the current crisis at work, the paradigm of the past decade, when growth and inflation were muted in the goldilocks scenario, would be completely subverted, with the whole spectrum of asset classes coming into play. Of course, government bonds would still be the serial losers and the more value-skewed emerging markets in a better position. In the meantime, we all entertain the hope that Biden and Putin will be shaking hands soon, on the basis of some compromise we are not able to envisage right now.

Gold has continued to be stronger than expected in the face of what could be considered a tough Fed tightening cycle, or maybe not yet so tough as against the highest inflation in four decades. This perception of the Fed's being late in tackling inflation, combined with the growing geopolitical risks, has supported gold against many consensus forecasts for lower prices. The yellow metal is headed above \$2,000/oz if tensions don't subside. Ultimately, it is not gold, but the US dollar which has most to fear from inflation. If the Fed doesn't get inflation right, fixed income investors will no longer be happy to purchase depreciating assets, compounding the problems of the United States as an indebted country. But this is more of a longer term issue, rather than one relevant within the time horizon contemplated in this publication.

And continuing on inflation, in the euro area annual CPI growth was at 5.1% in the month of January as per forecasts, a fresh high and to be compared with 0.9% only one year ago. But that is not a surprise, right? We just said that Europe is a commodity importer, and Brent crude is trading close to \$100/bbl, so ... Is this coming to an end soon? There is a power crisis in Europe, the Ukraine challenges, supply bottlenecks are not completely out of the way, so ... However enthusiastically Europe may have embraced the green transition, no embrace must have been more mistimed than this one.

Stay safe.

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