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The Financial Backdrop as Ukraine Waits and Worries

Published on February 22, 2022

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57 articles

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Nor'easters. Each storm is plotted on weather maps days in advance. A low pressure area swoops down from the Rockies, gathers moisture in the Gulf of Mexico, rides up the east coast over the warm waters of the Gulf Stream and then stalls in the Gulf of Maine, churning itself into its full intensity. Every storm has the potential to turn into a blizzard. But whether it does or not depends on two things: First, what is the exact track of the center of the storm and second, how much cold air is in place before the storm arrives?

In the same way, the investment implications of the gathering storm in Ukraine depends both on how far the Russian president is willing to escalate the crisis and the economic and financial backdrop as the situation begins to unfold.

On the first issue, it is useful to consider two broad scenarios.

The first, a partial invasion of Ukraine, is already underway. On Sunday, President Putin signed decrees recognizing two regions in the east of Ukraine, Donetsk and Luhansk, as independent republics and ordered Russian troops into the area to perform what he described as "peace-keeping duties". In response, the White House announced that President Biden would sign an executive order barring Americans from investing in, trading with or lending to these regions. It could be that this annexation will satisfy Mr. Putin for now and, if that is the case, it will have limited global repercussions.

However, given the buildup of Russian forces on the Ukrainian border, a second scenario of full-scale invasion is also very possible, involving tanks and artillery blasting their way into Kyiv. This, with all the horrific civilian casualties that it would entail, would undoubtedly lead to a more strident western response.

political leaders such as President Biden, President Macron of France and Chancellor Scholz of Germany would feel huge pressure to make sanctions very painful for Russia and for Putin's supporters. The U.S. Senate has already compiled a list of sanctions and a bipartisan majority would likely quickly agree to measures to seriously hurt Russian banks, limit trade, and penalize western institutions which continued to deal with Russia.

In addition, European leaders might feel compelled to cut off imports of natural gas and oil from Russia, despite the very serious economic pain which this would entail. Putin could, of course, turn off the energy tap himself in reaction to Western sanctions. However, in either case, the long-term consequences for Russia would be very severe as Europeans would likely, belatedly, resolve to never again make themselves energy dependent on the whims of a Russian leader.

A third scenario of even further escalation is also possible. Putin could launch cyberattacks on European and U.S. targets. This would, however, be both counterproductive and dangerous. It would be counterproductive as the west would likely do the same to Russia. It would also be extremely dangerous, given the obvious and horrific potential end-game of any series of escalating retaliations among the world's biggest nuclear powers. We can only hope that Putin has enough sense to avoid such a path. However, it is troubling to consider that, by invading Ukraine, given its cost both in lives and long-term damage to Russia, Putin would be confirming how much he lacks both basic humanity and strategic foresight.

As U.S. investors consider these scenarios, it is also important to consider the current state of the U.S. economy.

than initially feared. We expect this Thursday's GDP report to show an upwardly-revised 7.5% growth rate for the fourth quarter and this could be followed by between 1% and 2% growth in the first. In addition, as the pandemic continues to fade, we expect real GDP growth of close to 5% in the second quarter with service sector activity rebounding strongly.

The February jobs report, due out next Friday, should also have an optimistic tint, showing strong gains in both labor force participation and employment. However, with the unemployment rate already at 4.0% and close to zero growth in the working age population, the pool of available workers is very limited and this should both constrain job growth and boost wages in the months ahead. The lack of available workers is a primary reason we expect real economic growth to slow to a pace of between 2% and 3% by the end of the year.

Meanwhile, strong wage growth is feeding through to higher inflation. The January report on consumer spending and income, due out this Friday, could show year-over-year gains of 6.0% and 5.1% in the headline and core personal consumption deflators respectively. While we expect both of these numbers to fade as the year goes on, strong wage growth and increases in housing costs should keep underlying inflation well above the Fed's 2% target.

The trajectory of growth, jobs and inflation has led the Federal Reserve to adopt much more hawkish rhetoric in recent months and we currently expect five rate hikes in 2022, in March, May, June, September and December. We also expect a reduction in the Fed's balance sheet, ramping up to $100 billion per month starting in July. However, even before considering Ukraine scenarios, most Fed officials who have spoken recently about monetary policy seemed to be 0.5% rather than 0.25%.

Meanwhile fiscal policy remains on hold with currently little chance of further significant stimulus being passed by Congress. However, with very strong corporate profits, pent-up consumer and business demand and strong wage and job growth, the U.S. economy is currently exhibiting significant momentum and inflationary pressure.

A partial Ukraine invasion, such as we have effectively seen already, would probably allow for a gradual slowdown in growth and cooling of inflation. Fiscal policy would remain restrained and could turn contractionary in 2023 if the mid-term elections return one or both houses of Congress to the Republicans. Supply chain issues would gradually resolve themselves and the current excess demand for labor would diminish as businesses figured out how to get by with less help and higher wages drew more people in from the sidelines. Absent a big shock, the Federal Reserve would gradually tighten monetary policy and the economy could settle into a slower but more extended expansion. In this scenario, distortions in relative valuations could gradually diminish. In particular, bond yields could continue to rise, value stocks could outperform growth, the U.S. dollar could drift down and international equities could outperform their U.S. counterparts.

However, a full-scale Russian invasion of Ukraine could cause serious disruption to world energy markets. While the worst of this would be experienced by Europe, if global oil prices vaulted over $100 per barrel it could have a significantly negative impact on U.S. consumer confidence. In addition, such an invasion could be expected to boost the U.S. dollar and reduce Treasury yields as global investors sought safe haven for their assets.

could result in stronger fiscal policy and less monetary tightening. In a significant faceoff with the Russians, President Biden would likely be in a stronger position to demand Congressional action on some of his stimulus proposals. In addition, while the Fed would recognize the inflationary impacts of higher oil, they would also recognize the greater uncertainty of the situation and likely tighten policy more slowly.

Eventually, the geopolitical situation would find a new equilibrium. For Russia, this could be one in which they had nominally more territory but in which they would be seriously weakened economically by the cost of western sanctions and, likely, fighting an ongoing guerilla war in Ukraine. Global energy markets would settle down as some Russian supplies were diverted to China and U.S. and other producers ramped up production in response to high prices. Renewable energy would also see stronger investment in response to further proof of the unreliability of many producers of fossil fuels. Markets that had been battered by the shock of the Ukrainian war would rebound and the Federal Reserve would resume more aggressive monetary tightening.

Perhaps most importantly for investors, this new equilibrium should still allow for a resumption of a trend back to more normal relative valuations. Despite all that has gone on in the world over the past two years and all that could yet transpire in 2022, the most obvious feature of the financial landscape is that long-term interest rates remain too low. Regardless of the destruction that the Russian leader visits upon on the people of Ukraine or the long-term damage he simultaneously inflicts on his own country, the world economy will heal. Consequently, investors should still be prepared for the more normal relative valuations that this recovery should eventually bring.

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