

Celebrating 34 Years in 2022

War in Ukraine, Energy, Inflation and Volatility

Special Newsletter

March 3, 2022

Our hearts and prayers go out to the people of Ukraine as they attempt to repel an unprovoked attack and take-over attempt by Russia, the world's third most powerful military. The unfolding humanitarian tragedy is sad for free people and democratic countries around the world. Freedom can sometimes be taken for granted by democratic societies as we engage in political debate and internal party posturing, but the people of Ukraine are fighting and dying for freedom in the streets of their own country against a hostile invader. War is hell for the combatants and their families and hell for civilians caught in the crossfire or forced to leave their home as refugees.

War in Ukraine

Not since World War II has Europe experienced an act of aggression as brutal and unprovoked as Vladimir Putin has unleashed on the people of Ukraine⁽²²⁾. Putin has shocked the west by upending European peace and ignoring international law by using military might to conquer a sovereign nation⁽³⁰⁾. However, President Putin is taking a big risk with potential consequences for Russia's economy, global position, and internal stability as he looks to make Ukraine once again part of mother-Russia⁽²⁶⁾.

Ukraine's military and civilian fighters are bravely putting up a defense despite the overwhelming firepower against them⁽²⁹⁾. The predictions that the Russians would take over parts or all of Ukraine very quickly has proven elusive so far after more than one week of fighting. The Russian military has been hindered by supply-chain issues and heavy resistance by the Ukrainians⁽¹⁾. President Volodymyr Zelensky of Ukraine stated in a video call pleading with European leaders for more military hardware that "this might be the last time you see me alive"⁽²⁹⁾. President Zelensky has rallied his nation as well as most of the world to his country's side with his out-front leadership in the resistance effort against the Russian invaders⁽³³⁾. President Zelensky in response to a U.S. offer for his safe passage out of Ukraine to escape the rumored hit squads deployed by Russia for his assassination, stated simply "I need ammunition, not a ride"⁽³³⁾. Despite the tremendous effort put forth by the Ukrainians thus far, their position remains dire as the Russian forces begin to surround and besiege several cities with overwhelming force and indiscriminate bombing⁽³³⁾⁽⁴⁵⁾⁽⁴⁶⁾.

Some speculate a worst-case scenario, where the Russians would advance on, or otherwise provoke NATO countries such as Poland and Lithuania, thereby prompting NATO military involvement⁽¹⁾⁽²²⁾⁽²⁸⁾. Military aid for Ukraine from countries throughout the world and economic sanctions against Russia over the past week have boosted the hope that fighting could end without Russia taking control of Ukraine. However, Vladimir Putin has too much to lose at this point from a military loss which may provide increased incentive for escalating the hostilities⁽¹⁾. President Putin put his nuclear forces on high alert for alleged threatening comments from NATO leaders and seemed to shift to a strategy of bombarding civilian areas to demoralize the Ukrainian population and resistance which has led many in the international community to view him as erratic and extreme⁽³³⁾⁽⁴⁵⁾⁽⁴⁶⁾.

Although no American wants war, our adversaries are watching our response to this attack on Ukraine to gage their next move, namely Russia, China, and Iran⁽²³⁾⁽²⁹⁾⁽³⁴⁾. The botched Afghanistan withdrawal may have bolstered Russia's calculation that we may not engage, and China is certainly observing our reaction as they eye Taiwan⁽²³⁾⁽⁴⁷⁾. This is not to blame America but to reinforce the idea of supporting our allies in NATO by delivering significant military weapons and equipment for the Ukrainian resistance and working with our allies to shut off the Russian economy from global commerce⁽²³⁾⁽²⁸⁾⁽³³⁾⁽⁴⁷⁾. Additionally, the U.S. needs to show energy leadership in not relying on hostile foreign actors for oil and natural gas⁽²³⁾⁽²⁴⁾. During the past week, the U.S. and European allies have levied punishing sanctions against Russia targeting the country's commercial banks, central bank, business, industry, wealthy oligarchs, and political leaders with the list of countries on board including once reluctant Germany, Cyprus, Japan, and the usually neutral Switzerland⁽⁴³⁾⁽⁵⁰⁾⁽⁴²⁾. Major U.S. and European companies have halted or severed business dealings inside the Russian country, including major oil and gas companies⁽⁴⁴⁾. Sanctions most likely will hurt the global economy but the bet of the western allies is that they are resilient enough to absorb the consequences, while Russia most likely will not be able to endure the economic pain⁽⁴¹⁾.

Energy

The rising price of oil, which now tops \$110 per barrel, is expected to slow global economic growth as oil prices tend to feed through to consumer prices very quickly⁽⁷⁾⁽²⁷⁾. Gas prices have increased during the past year, but now are expected to go higher through the summer driving season⁽⁷⁾. Additionally, natural gas prices in Europe, which had been on the rise for the past year, may move even higher with any disruption of Russian gas supplies to the European Union⁽⁷⁾⁽²⁷⁾. Russia supplies 11% of global oil supply and 17% of global natural gas supply⁽¹⁷⁾. One third of Russian exports to Europe go through a pipeline across Ukraine⁽⁴¹⁾. Just 15 years ago, countries in the European Union produced more gas than Russia exported; however, European production has fallen by more than 50% during the last ten years, as protesters against fracking with their movement toward green energy spread across the European nations⁽⁴⁹⁾.

President Joe Biden has stymied U.S. energy production since taking office with increased regulation on the fossil fuel industry and cancelling leases for drilling, extraction, and pipelines, preferring to move the U.S. to green renewable energy sources⁽¹⁾. The green energy push will continue and evolve for carbonless alternative to fossil fuels, but in the meantime, the U.S. can produce enough fossil fuels to be energy independent and with fewer emissions for the environment than almost all foreign suppliers⁽¹⁾. The U.S. was energy independent before the current administration's tenure but now the U.S. buying energy from Russia may not be an energy policy the public will tolerate⁽¹⁾. Europe is even more dependent on Russia for natural gas and oil after years of failing to develop its own fracking potential⁽³¹⁾. However, Germany, despite their reliance on Russian energy, has now committed to becoming less dependent on Russia for oil and gas and increasing military spending in a meaningful way⁽⁴⁰⁾.

Inflation

Equity markets have been hit this year by the dual risk of multiple interest rate hikes and the conflict in Ukraine which will likely result in higher energy prices⁽³⁾⁽²⁷⁾⁽³⁶⁾. Global supply-chains are expected to become more challenging and thus inflationary due to the war especially with cars and semiconductor chips⁽¹⁾⁽²⁷⁾⁽³⁶⁾. There is growing consensus that the Federal Reserve may be more cautious and likely not raise interest rates as fast as previously forecasted due to the economic stress on the economy⁽¹⁾⁽³⁾.

Inflation is at a 38-year high, well above 7%, and is broadening across all parts of the economy and is now present right in front of most Americans when buying gas and groceries which adversely effects most low-income households and fixed-income retirees⁽⁴⁾⁽⁵⁾⁽¹¹⁾⁽¹²⁾⁽³²⁾. Grocery store prices rose an average of 7.4% in 2021 according to the Labor Department, although many staples such as meat, grains, oranges, fish, sugar, pork, and turkey had steeper increases⁽³⁷⁾.

The M2 supply of money which includes cash in circulation, bank accounts, money markets, and time deposits is up more than 40% since the beginning of the pandemic⁽¹⁶⁾. Milton Friedman, the winner of the 1976 Nobel Memorial Prize in Economic Sciences and considered by some as the 20th century's most influential economist, has stated "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output"⁽³⁹⁾. Keep in mind inflation affects money in two ways; over time the true buying power of money diminishes while the price of goods gradually increases⁽¹⁹⁾.

U. S. fiscal policy has poured more than \$6 trillion in stimulus into the economy since the pandemic began and coupled with the monetary policy of the Federal Reserve which has doubled its balance sheet by \$9 trillion, has over-stimulated demand in the economy thereby igniting inflationary pressures and supply chain backlogs⁽³⁸⁾⁽⁴⁾⁽¹²⁾. Some have argued that greedy corporations have increased inflation in their stated attempt to maximize earnings for their shareholders, but businesses have always had this objective and inflation for the last twenty years has averaged 2.1% annually⁽¹²⁾.

In the Federal Open Market Committee meeting in January, Fed Chief Jerome Powell stated a reversal of the easy money policy but has yet to move from a zero-interest rate policy⁽⁴⁾. Further, monetary financing of a bigger government through quantitative easing bond buying has not yet ceased⁽⁴⁾⁽¹⁴⁾. The path to decrease inflationary pressures must include disciplined fiscal as well as monetary policy. Increasing interest rates to combat inflation by the Fed without a corresponding reduction in deficit spending by the government may send the economy into an eventual recession⁽⁵⁾. John Cochrane, a senior fellow at the Hoover Institution at Stanford University, stated "Inflations do not happen to happily growing economies, whose governments run things well and with flush treasuries. Historically, inflations have always come to countries in trouble, primarily fiscal trouble, but fiscal policy trouble caused by bad macroeconomic policies"⁽⁵⁾.

"Successful investing is about managing risk, not avoiding it." — Benjamin Graham

Market Volatility

The Russian invasion of Ukraine has added additional downside risk to the market. This coupled with the Federal Reserve's expected tightening cycle to begin in March has increased volatility thus far this year⁽⁶⁾. The S&P 500 has entered correction territory, down 10% from the January 2022 peak⁽⁸⁾⁽¹⁸⁾. Over the past 50 years we have experienced 19 market corrections that have been relatively short lived playing out over only a few months with the average return 12 months later double digits from where it entered the correction⁽⁸⁾. However, we have had 8 additional market corrections of 10% that went on to become a bear market, down 20% or more, that took longer to recover and preceded recession in some instances⁽⁸⁾. While past performance is no guaranteed of future results, historically speaking, market corrections can be expected just like navigating rough waves from time to time when on a ship at sea⁽⁸⁾. Although market corrections can be disturbing, it is likely to open the door for a healthy recovery in which high quality companies with good businesses can stand out for investors, according to economists at AllianceBernstein⁽¹³⁾.

Vanguard examined the major geopolitical events over the past 60 years and what they discovered was that while equity markets initially reacted negatively, the selloffs were typically short-lived and returns over the following 6- and 12-month periods were largely in-line with long-term average returns⁽²⁾⁽¹⁰⁾. Vanguard's analysis included 22 major geopolitical events since 1956⁽²⁾. Equities have generally shrugged off geopolitical events after the uncertainty of the initial shock as these types of events rarely have a lasting impact on the overall business cycle⁽¹⁰⁾.

The old adage states "it is time in the market, not timing the market" and looking at the past twenty years ending 12/31/2021 reveals that if you missed just the ten best trading days, your return would be cut in half verses the hypothetical investor who stayed invested in the S&P 500 index, and if you missed the 20 best trading days while riding out a turbulent market, the return would have only been a quarter of the investor who stayed invested⁽²⁰⁾. As Paul

Harvey used to say, “the rest of the story” is that 24 of the 25 worst trading days occurred within one month of the best 25 trading days during the prior 20 years ending 12/31/2021 in the S&P 500 index⁽²⁰⁾.

Rational investors can become emotional and inclined to make irrational, impulsive decisions when markets become turbulent. The conviction to maintain a fundamentally based investment plan during turbulent markets often benefits the investor with achieving their long-term investment goals, and conversely those shaken out by emotions many times have difficulty timing the market for advantage⁽⁹⁾.

Conclusion

Despite the uncertainty caused by the Russian hostilities as well as inflationary pressures present in the United States at present, we believe U.S. GDP growth will slow this year but not go into recession and corporate earnings will also be slower than in 2021, but in the high single digits⁽¹¹⁾⁽¹⁵⁾⁽¹⁶⁾. We expect the Federal Reserve to begin interest rate hikes in March to combat inflation, with three to four 0.25% hikes likely as the Federal Reserve becomes more cautious with a slowing economy⁽¹¹⁾⁽¹⁴⁾. Additionally, we believe the Federal Reserve will end quantitative easing (bond buying) and begin quantitative tightening (bond selling) this year to reduce its balance sheet⁽¹²⁾⁽¹⁴⁾. Each of these actions are important monetary policy actions with the aim of quelling inflationary pressures while executing a soft landing and not driving the U.S. economy into recession⁽¹²⁾. Federal Reserve Chairman Jerome Powell will have all eyes on him to gauge if he can accomplish the Fed’s goals this year⁽¹²⁾⁽¹³⁾. We believe President Biden’s Build Back Better proposal to increase social spending and increase tax rates over the next decade is less likely to get passed in the current inflationary environment and with mid-term elections right around the corner⁽¹²⁾⁽¹⁾.

LW GamePlan

Our **Leshnak Wealth Portfolio Models** are not immune to declines in global markets nor do we have a crystal ball, but neither do any of the market analysts and forecasters. Our belief is that our LW Portfolio Model construction has positioned us for potential resilience in most environments and situates the portfolio to possibly take advantage of market mispricing. We see no need to change course or modify the overall asset class allocation due to market corrections, or sudden market shocks unless a fundamental change in the underlying outlook for the domestic or global economy has diminished or brightened verses our expectations. As the ancient Buddhist proverb states “If we are facing in the right direction, all we have to do is keep on walking”. Corrections and pullbacks can be expected to last shorter periods on average compared to the bull markets they take reprieve from, as the greed present turns to fear and shakes out those investors who are not fundamentally based in their convictions.

The **LW Portfolio Models** are globally diversified and strategically constructed with core equity positions in small, medium, and large cap equities, each straddled by momentum-based and value-based investment positions. We believe adding momentum-based investment positions using technical analysis offers the opportunity to allow current market trends to play out while also providing the flexibility to potentially reduce exposure when market trends retreat. We also believe adding value-based positions puts us in the position of the “turtle”, in the proverbial tortoise verses the hare scenario, over the long-term with equities. Value-based investment involves buying securities whose shares appear underpriced by a form of fundamental analysis. Additionally, we believe that by combining value and momentum strategies across diverse markets and asset classes may result in significantly higher risk-adjusted rates of returns based on the academic research conducted. Lastly, we prescribe dividend yield from all our equity investment positions so that no matter what markets are doing day to day, we have dividends continuously coming into the portfolio. Our fixed income blueprint for the portfolio consists of allocations to core domestic, foreign core, strategic investment grade, inflation protected,

and high yield bonds. Overall, we evaluate investment positions in seven asset classes including domestic equities, foreign developed stocks, foreign emerging market equities, domestic bonds, foreign bonds, cash equivalents, and alternative assets such as real estate, commodities, gold, natural resources and infrastructure for inclusion within our overall asset allocations. How much of each asset class, if any, we hold in these asset classes is based on your unique risk tolerance, financial resources and personal goals and objectives.

As your financial fiduciary, the Leshnak Wealth team cares deeply about your financial well-being and will monitor for rebalancing opportunities that may add value to your portfolio, or to be defensive as conditions might warrant. We know that as your advisor, the trust you bestow upon us is built and maintained on three pillars; doing what we say we will do, assisting with planning for and achieving your financial independence, and providing unbiased advice with your best interest at the forefront. As always, please call with questions or if you wish to discuss your specific portfolio in greater detail.

–Bob Leshnak, March 3, 2022

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