The Russia-Ukraine War — Why now, what's next, and how to position your portfolio

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Putin launches an imperial war, while Ukraine pays the price

Vladimir Putin is seeking to reassert Russian power, prestige, and regional geopolitical dominance of eastern Europe by engaging in a multi-stage military assault against Ukraine — an escalation of the war that began in 2014. Putin's intent now is to end Ukraine's existence as a unified and independent sovereign nation-state so that no political, economic, and foreign policy decisions can be made without Moscow's consent. If he can take control of Ukraine — or dismember the country to consolidate full control over the more prosperous, fertile, and pipeline-intensive east and south regions — Putin will have achieved his regime change objective.

If Ukraine's existence as a unified and independent sovereign nation-state comes to an end, no political, economic, and foreign policy decisions will be made again without Moscow's consent.

Therefore, any new government would need to comply with Moscow's insistence that Kyiv, the capital of Ukraine, follow pro-Russian policies that reject any future in NATO, the European Union (EU), or other organization/bloc that Putin considers to be hostile to Russian interests. Putin, therefore, seeks to re-establish Russia as a primary global power, along with the United States and China. With this renewed strength, Moscow would look to build a new security framework for the European continent — with profound consequences for the future of NATO and the European Union, and the global redistribution of geopolitical power.

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So, why now?

The timing of this war on Ukraine is noteworthy for two reasons:

1. Though Ukraine does not have a formal military alliance with the U.S. or NATO, it was expecting the delivery of additional defensive weapons systems to better secure its borders. Before that could occur, Putin deemed this moment to be most favorable for a major military offensive. Additionally, with most European countries being energy-dependent on Russia for oil and natural gas — and the American political environment currently under the strain of inflation and prolonged COVID-19 restrictions — the timing was accommodative for ensuring that Putin's strategic security objectives could be achieved decisively.

2. In October of this year, Putin will be 70 and have been in power since 1999. Two years ago, he enacted constitutional reforms that would enable him to seek re-election as president for two more six-year terms. If Putin succeeds, he could end up leading Russia through 2036 — essentially a life term. He believes this window of opportunity to gain control over Ukraine frees him to rebuild and consolidate popular support among Russia's electorate and establish a historical legacy for an imperial Russia to be resurgent on the global stage.

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Countering global sanctions

President Biden's leadership efforts to impose a trans-Atlantic and international response began with new sanctions against Russian business interests, the national economy, and Putin's allies — though not against Russia's energy exports to Europe (which have increased since the invasion began), and the United States. And these new sanctions were in addition to prior rounds imposed after the 2014 Crimea annexation and in response to a series of human rights abuses. However, over the past eight years, Russia had already successfully absorbed the impact of that first round of sanctions.

More recently, the Biden administration began to target more of Russia's largest banks. However, that may not serve as a sufficiently persuasive deterrent as Beijing is considering having its state-owned banks provide support loans to Moscow. If the West does unite to completely deny Russia access to the international SWIFT financial messaging system, it may matter less than intended. Moscow has already become less dependent on dollar-denominated trade by collaborating with Beijing on separate, yet parallel, financial messaging systems in anticipation that their respective military actions in Ukraine and Taiwan might trigger SWIFT sanctions from the West.

Additionally, sanctions on exports of U.S. semiconductors and other high-tech components to Russia's lucrative industrial and military markets may not carry the full weight expected. Russia can cut off the supply of metals and rare earths it possesses in outsized reserves (e.g., copper, gold, nickel, aluminum, and palladium) — the materials advanced technology-dependent economies need. Also, Ukraine's current control of 90% of the world's neon gas — used in the manufacture of semiconductors for smartphones, computers, industrial machinery, automobiles, and home appliances — could be taken over by Russia. Those neon production and processing facilities would then provide Putin with inordinate influence over the global semiconductor sector, as well as the cloud and data center industry.

Germany's suspension of the certification of Nord Stream 2, may not be an immediate concern to Moscow if Putin believes Berlin will again proceed and complete the pipeline certification after the initial shock of the war has subsided. If Germany were to ultimately cancel the entire pipeline project, energy-hungry Beijing is expected to purchase those Siberian natural gas supplies, and Moscow would suffer no significant loss. To note, Austria and Slovakia are 100% dependent on Russia, Hungary is 80% dependent, and Germany — the economic engine of the EU — relies on Russia for 55% of its natural gas needs. If Russia eventually takes full sovereign control of most or all of Ukraine, it will also control Ukraine's oil and gas transmission system that supplies Europe — which is one of the world's largest pipelines at 24,000 miles.
A takeover such as this would make the Nord Stream 2 pipeline nearly irrelevant.

Also, despite Washington's pleas to Riyadh to increase oil production and reduce global prices and Russian revenues, the five-year old Russia-Saudi oil alliance remains intact. Even as Washington was preparing for a possible showdown with Putin over Ukraine, the U.S. in 2021 was purchasing 595,000 barrels per day (or 7% of its total needs) from Russia — now America's third-largest oil supplier. The U.S. also imports 5.5% of its coal from Russia.

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These are only a few of many examples highlighting the fact that Putin has been preparing for a U.S.-led sanctions regime since the war with Ukraine began in 2014. Russia has also built up $630 billion in foreign exchange reserves and gold over the past decade, and a $160 billion sovereign wealth fund to cushion financial blows from additional sanctions. Where Russia's GDP was 70% dependent upon trade in 2010, Putin has successfully decreased that foreign reliance to only 46% of GDP by 2020. But the potential cutoff of all Russian banks from the SWIFT system, and the run on Russian banks expected to follow, could crush the nation's economy, trigger hyperinflation, and launch domestic civic revolts in multiple cities against Putin's war.

The challenges are intensified by Russia's highly formidable cyberwarfare capabilities — as Americans learned during the Colonial Pipeline shutdown. German Parliamentarians discovered their email accounts were hacked, and supply chain logistics giant Expeditors International had most of its operating systems shut down on February 20, 2022 — impacting the company's ability to arrange freight shipments and manage customs and distribution activities for its customers' shipments worldwide.

Putin has two major cyber options to retaliate against the U.S. and European sanctions: ordering direct cyberattacks targeting infrastructure inside the U.S. and other NATO allies — especially at sectors that can drive up the price of gasoline. The second is deploying cyber weapons inside Ukraine, a global informational technology powerhouse connected to most every major technology company in the West.

The U.S. also retains superior cyber capabilities, and can deploy its own retaliatory attacks, recalling the "mutually assured destruction" doctrine of the U.S.-Soviet nuclear weapons build-up during the Cold War.[1]

New refugee crisis in Europe

When the Russian war with Ukraine began in 2014, hundreds of thousands of Ukrainian citizens fled to Poland. In 2015, about one million refugees from Syria, Iraq, and South Asia upended European societies and political establishments. Ukraine's defense minister estimates that Russia's current invasion could lead to more than three million Ukrainians seeking safe haven in neighboring countries. The Biden administration projects a surge of up to five million Ukrainians exiting into eastern Europe — especially Poland, Romania, and Hungary. The EU does not yet have a coherent policy for another such mass migration flow, and the debates from 2015 still poison the governing halls of Brussels. The cultural differences between the EU and Ukraine are minimal, but the sheer scale of the potential refugee flows could overwhelm the bloc.

Potential future Russian incursions

Just south of Ukraine lies the small former Soviet republic of Moldova, barely larger than Rhode Island. Since the mid-1990s, 1,500 Russian troops have been stationed in the country's breakaway eastern region of Transnistria, ostensibly protecting the minority rights of ethnic Russians, as well as 20,000 tons of Soviet-era munitions, perhaps the largest arms depot in eastern Europe. Putin may decide, if he succeeds in Ukraine, to confer recognition on Transnistria — forcibly splitting this European country to create another diplomatic crisis.

Just as Putin's full-scale assault on Ukraine surprised military strategists expecting a more limited series of operations, so does the possibility of a Russian invasion of Estonia, Latvia, or Lithuania — all NATO members on Russia's border. Putin may decide to attack in the expectation that neither the U.S. nor leading NATO powers are politically willing to risk a major conventional war, with its potential escalation to theater nuclear weapons, to preserve the sovereignty or territorial integrity of any or all three small Baltic countries.

Wide-reaching strategic implications

Several key planning takeaways from this latest geopolitical crisis involve the trade-offs between Western energy policies and national security, the drive to rebuild European defenses, and the enhanced investments that will target eastern and central European economies. Whether Russia takes over all of Ukraine, dismembers it to control the eastern half, or installs a pro-Russian government pledged to permanent neutrality and equal European security for Russia, Putin has demonstrated the strategic leverage that comes with being a nuclear-armed commodity superpower. As a result, he wields inordinate energy power over Europe, especially to cut off oil and natural gas supplies.

The EU's energy scarcity is unnecessary, given the access to all the natural gas, coal, and uranium it needs to produce low-cost, reliable heat and electricity for generations to come. Environmental, social, and governance (ESG) policies that were desirable during a period of relative international tranquility may undergo greater scrutiny in the context of national security impacts in this new era of great power rivalry. In hindsight, the continent's overly ambitious green energy transition has weakened Europe on the geopolitical stage. New policies in Washington and Brussels to adjust their renewables strategy to no longer undercut national security will emerge. Watch for European leaders to aggressively seek out alternate sources of natural gas, especially from the U.S. and other reliable suppliers.

The disparate European responses to Putin's invasion exacerbated ongoing tensions regarding NATO member commitments and capabilities. The Biden administration proposes an $800 billion national defense budget with an eye to a more muscular presence in East Asia and throughout the Indo-Pacific region to address the pacing threat from the Chinese Communist Party. The administration will also issue a new Nuclear Posture Review that calls for up to $2 trillion to build the next generation of nuclear-armed bombers, submarines, and land-based missiles, now that both China and Russia are challenging U.S. international pre-eminence.[2]

Most European nations failed to effectively improve and modernize their forces over the past two decades. They need to rebuild them, make them more interoperable, and address the challenges posed by emerging and disruptive technologies. Even Germany, with its prominent pacifist movement, is reversing planned defense reductions to now increase military spending by $100 billion and deliver weaponry to Ukraine.[3] With NATO member spending on weapons and ammunition, as well as cyber security and electronic warfare, expected to increase, European defense stocks gained during the invasion. If all NATO countries fulfill their 2% GDP pledges, overall defense spending in Europe (including Germany) could increase by more than $180 billion.

Thirty years of post-Cold War "peace dividends" have ended. Increased NATO defense spending will likely be concentrated in those European countries that directly border Russia, Ukraine, and Belarus. We believe that additional U.S. basing and deployment of forces, weaponry, and vehicles, along with larger and more frequent regional rotating task force participation by NATO forces, will also enhance foreign direct investment in needed new infrastructure, transport, and telecommunications systems. In turn, these multiplier sectors will deliver enhanced economic improvements to eastern and central European markets that will become more secure and investment-friendly under a more robust NATO security umbrella.

What it means for investments

The crisis in Ukraine is rapidly evolving — and with it are investor expectations for international relations, commodity prices, inflation, the corporate operating environment, and company margins. As the crisis unfolds, equities could fluctuate if development leads to contained conflict and lighter sanctions — while equities could deteriorate in moments of escalation.

That said, market prices have already responded to the initial surprise of the invasion. In our view, there is little benefit to adjusting a portfolio *after the fact*. Investors should keep in mind that exiting positions during moments of market stress is a common means of destroying long-term wealth. With sentiment depressed and economic growth otherwise overheating, moments of market volatility may instead generate buying opportunities for investors.

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What's more, this geopolitical risk is not unfolding in a vacuum. Russia's invasion of Ukraine is one of the most meaningful geopolitical events in decades, but it is also taking place alongside a global transition from a two-year pandemic — and in a time of unprecedented monetary policy unwind. Both realities are clear drivers of the economy and markets ahead. Investors should consider the broader picture for their portfolio before making any allocation changes. Therefore, we encourage investors to stay calm and keep their long-term financial goals in mind.

Building a more resilient portfolio

Five key actions we believe can keep portfolios on track amid the uncertainty:

1. **Keep the broader investment environment in mind.** Exogenous events tend to reinforce pre-existing trends more than change the tenor of the broader market. Themes related to inflation — bolstered by the threat of higher energy prices, central bank tightening, and the quality segments of cyclical asset classes — remain firm in our mind.

   Allocation considerations: Small-cap and value equities, as well as floating rate, short duration, and high-yield fixed income are our high conviction overweights.

2. **Focus on action, not distraction.** Geopolitical events understandably contribute to investor fear. Keep in mind that there is always a reason to take money off the table, but cash can be a significant drag on a portfolio — especially when inflation is rising.

   Allocation considerations: Stay focused on long-term investment goals. Make allocation changes only when the key market drivers for your time horizon have shifted.

3. **Consider targeted geopolitical hedges.** Geopolitical risk often manifests via currency volatility and commodity price changes.

   Allocation considerations: Investors could consider a 50% currency-hedged strategy or targeted commodities exposure as a means of generating portfolio resiliency.

4. **Maintain a diversified portfolio.** By diversifying across regions, sectors, and asset classes, investors can reduce their exposure to idiosyncratic risks such as that unfolding in Ukraine.

5. **Build resiliency with active managers.** Given geopolitical, monetary, and fiscal policy risks this year, we encourage working with managers who can quickly and flexibly navigate the numerous and sometimes competing impacts on the investment environment.

1. Source: *Encyclopedia Britannica*, 2022. Mutual assured destruction is a doctrine of military strategy and national security policy in which a nuclear attack by one superpower would be met with an overwhelming nuclear counterattack such that both the attacker and the defender would be annihilated.

2. Sources: Arms Control Association, *U.S. Nuclear Modernization Programs,* January 2022.

3. Source: *CNBC*, February 27, 2022.

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