

When Worlds Collide

Despite repeatedly denying he had any designs on his neighbor, Vladimir Putin launched an invasion of Ukraine late last month.

Conditions on the ground are quite fluid, and we won't delve into military strategy.

From a financial perspective, investors had been bracing for a possible invasion for much of February. We saw it in increased market volatility and a drop in the major indexes, though the decline up to the invasion was generally modest.

Since peaking on January 3, the S&P 500 Index's peak-to-trough decline has been 11.9% (through February 23), according to S&P 500 data supplied by the St. Louis Federal Reserve.

It's the first official correction (defined as a decline of at least 10%) since the early days of the pandemic. However, not all of the sell-off can be blamed on the Russia-Ukraine crisis. Investors are also wrestling with higher inflation and talk of higher interest rates from the Federal Reserve. But the crisis at hand has driven sentiment in recent days.

Yet strong Q4 corporate profits, according to Refinitiv, and the growing economy have cushioned the downside. It has been a powerful tailwind for investors, but not enough to overcome stiff headwinds from geopolitical uncertainty and talk of higher interest rates.

Russia makes noise before invading

Massing Russian troops along the border of Ukraine created uncertainty for investors. Analysts often say that markets despise uncertainty. We feel that the term "heightened uncertainty" may be a more accurate description, as there is always some uncertainty attached to investing.

When heightened uncertainty arises, it simply means that the number of potential outcomes for the economy is increasing. In most cases, those possible outcomes are usually negative, even if the odds of occurring are remote.

Therefore, short-term investors recalibrate and attempt to discount possible negative outcomes.

Over time, the new reality gets incorporated into the outlook and the focus returns to the domestic economy. That has been the historical pattern. In other words, historically selloffs tied to geopolitical uncertainty have been limited.

Research compiled the market reaction to 22 geopolitical "market shock events" since WWII. On average, the total drawdown was just 4.6% for the S&P 500 Index.

During the Cuban missile crisis, the S&P 500 lost 6.6% over eight days. At the time, the world appeared to be on the brink of nuclear annihilation.

The biggest decline in the survey occurred after the surprise attack on Pearl Harbor. The index shed nearly 20% in 143 days but managed to erase losses within one year of the attack.

Looking into a murky crystal ball

How the war affects the U.S. and global economy will ultimately have the biggest impact for investors. What will happen to oil prices? How might sanctions play out? Could we see cyberattacks or a wider war that involves NATO? Will the invasion rein in the Fed's apparent impulse to boost interest rates at an aggressive pace?

These are difficult questions to answer.

At the same time, stiff sanctions against Russian banks and Russia's Central Bank did not cause immediate tremors in U.S. markets.

"The U.S. and other Western economies have deployed a set of highly potent financial weapons against Russia with remarkable speed," said [<https://www.nytimes.com/2022/02/28/us/politics/us-sanctions-russia-central-bank.html> Eswar Prasad, a Cornell University economics professor and former International Monetary Fund official].

From a financial perspective--and this is important--Russian oil and natural gas have not been sanctioned.

Stocks were priced for perfection heading into 2022. When stocks are priced for perfection and unexpected events occur, we typically see a reset.

In this case, a more hawkish-sounding Fed and Russia's aggressive posture toward Ukraine provided the perfect pretext for short-term traders to take profits.

While we have been due for a market correction, attempting to time such a pullback is all but impossible. There are those who have been calling for a correction for over a year and found themselves watching the major stock market indexes rise to new heights.

Besides, if you want to time the market, you must be right twice to be successful—near the top and near the bottom. The smartest analysts haven't figured out that equation. They never will.

Longer-term, the biggest influence over stocks is the U.S. economy, the Federal Reserve, and corporate profits, or what we call the economic fundamentals. How the invasion affects consumer psychology will play a big role.

Are people going to avoid dining out, or, for that matter, skip the purchase of an appliance or a planned trip? It seems unlikely.

The direct impact of Russia and Ukraine on the U.S. economy is quite limited. From December 15, 2021 to February 17, 2022, just 4% of the of S&P 500 firms that conducted earnings calls with analysts (earnings calls typically follow the release of an earnings report), cited the word "Ukraine," according to FactSet.

By contrast, 72% of S&P 500 companies cited "inflation" over the same period.

Indirect concerns might spring from oil prices and certain commodities Russia and Ukraine export.

Control what you can control. What is happening overseas is something you and I cannot control.

Your financial plan helps manage emotions. It is the roadmap to your goals. It incorporates the unexpected potholes you will hit along the way toward your goals.

Just as it helps prevent you from taking on too much risk when stocks are rising at a quick pace, it also helps prevent emotional decisions that are rarely profitable when stocks are declining.

War can take ugly turns, and we are bracing for more volatility. Disappointments could send stocks lower, while positive surprises could boost equities.

We won't pinpoint a market bottom but in the 32 times the S&P 500 Index has shed at least 10% since 1980 (excluding the current correction), one year after hitting a bottom, the index was up 24.8% on average. It was higher 90.3% of the time.

In the 13 times the S&P 500 has dropped between 10% and 15% since 1980 (excluding the current correction), the average gain from the low after one year was 21.9%. The index rose in all but one of those instances after one year.

We realize that market volatility can be frustrating. But through diversification and various measures, we take steps to help manage risk. When corrections end, the historical trends are encouraging.

We understand that news from Ukraine is very unsettling. In the face of overwhelming odds, many of us have been heartened by incredible acts of patriotism, bravery, and defiance from ordinary Ukrainian citizens. Their heroics have inspired us all.

Let's wrap this up with a broad historical perspective from UBS analyst Art Cashin. When Art began in the business over 60 years ago, a veteran trader told him, "The world only ends once. Don't bet on the end of the world. The odds are way against you."

As always, we want to emphasize that we are here to assist you. If you have concerns or questions, please remember that we are only a phone call away.

Table 1: Key Index Returns

	MTD %	YTD %
Dow Jones Industrial Average	-3.5	-6.7
NASDAQ Composite	-3.4	-12.1
S&P 500 Index	-3.1	-8.2
Russell 2000 Index	1.0	-8.8
MSCI World ex-USA*	-1.7	-6.1
MSCI Emerging Markets*	-3.1	-4.9
Bloomberg US Agg Bond TR USD	-1.1	-3.3

Source: Wall Street Journal, MSCI.com, MarketWatch, Morningstar

MTD returns: Jan 31, 2022—Feb 28, 2022

YTD returns: Dec 31, 2021—Feb 28, 2022

*In US dollars

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