CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

February 25, 2022

# The Russian Invasion of Ukraine

**Tom Galvin**
Chief Investment Officer

### HIGHLIGHTS

> No changes to our investment portfolios at this stage of the conflict, but remain cautious near term.

> Expect volatility to remain elevated until uncertainty subsides.

> Limited impact on US economy and corporate profits, Europe is significantly more exposed supporting CNR underweight.

> Impact is mainly on inflation, which will stay modestly higher for some part of the year.

> Historically, market reactions during these events prove to be worthwhile long-term investment opportunities.

## Overview

To reflect the invasion of Ukraine by Russian military forces on Feb 24, we are updating our framework and expanding the range of potential outcomes to include an extreme scenario under which we would anticipate making potential changes to our asset allocation positioning. However, given our current assessment of developments, our conclusion is that US macroeconomic impacts will be limited and manageable, and we are not at present taking any additional portfolio actions. Direct exposure to Ukraine and Russia in our flagship strategies is nominal, amounting to less than 2% of total assets. While uncertainty and volatility should continue to be high until the crisis is over, history shows us that markets tend to be resilient over time to geopolitical risk, as long as economic and corporate fundamentals are strong.

Indeed, the intermediate to longer-term outlook continues to be favorable, and we are maintaining our overweight risk assets with expectations that the US economy will grow strongly this year and that corporate earnings will reach record levels. In equities, our focus remains on high-quality US companies with durable and sustainable revenues, and superior competitive positioning, while we also continue to significantly underweight European equities, which are expected to meaningfully underperform going forward. In fixed income, we remain overweight high-yield corporate and muni bonds. As stewards of capital, we are attentive to risks but also need to balance our vigilance against the opportunity ahead for higher returns in client portfolios. In the unlikely extreme outcome described below, we would change course quickly to diligently manage capital at risk.

## Revised Risk Framework and Economic Implications

Our risk frame now includes 3 scenarios: hopeful, most likely and extreme. Our "Most Likely" outcome has gone from 60-75% probability to 85% and is now assuming that Russian aggression will be met with severe Western sanctions, though the most onerous financial ones, as well as those covering food and energy commodities, are likely to be avoided for the moment. Risk assets and global equities will remain volatile in this scenario, but we expect the US to outperform Europe.

After 75 years of peace, this invasion will likely impact Europe much more so than US through higher commodity and energy prices, further supply chain disruptions and sanctions on European companies that have been doing business with or lending to Russian entities. The direct impact on the US economy is significantly lower, as Russia and Ukraine represent less than 1% of sales and earnings for the S&P 500, and trade flows with both nations amount to less than 1% of US GDP. Although slower economic growth from Europe could have some impact on large US companies, underlying US fundamentals are strong and our proprietary 4Ps framework* continues to indicate the US has not only structural advantages but a superior economic and earnings growth profile over the next few years.

In the US, the main source of risk for broader economic repercussions come from inflation, as the rise in global commodity prices and supply chain disruptions from the Ukrainian invasion will likely keep price pressures elevated domestically in the near term and may delay improvements we anticipate in the second half of 2022. Given this environment, we do not believe the Fed will deviate meaningfully from its current policy direction. Also, we expect that "flight to safety" in financial markets will be moderate in this scenario, with the value of the US dollar moving modestly higher and the yield on treasuries modestly lower.

Our other two scenarios have significantly lower probabilities. Perhaps we're being too hopeful, but there is a 10% chance that the Zelensky administration can find a means to work with Putin. At the other end of the spectrum is the extreme scenario, which we assign a 5% probability. In this outcome, not only does Russia complete its hostile takeover of the Ukraine, but it extends its aggression to other nations in the region. Such an action would likely lead to the most severe sanctions being implemented to cripple the Russian financial system and economy. If we were to sense such an outcome would occur, we would be more likely to focus on risk mitigation of capital, depending on the facts on the ground.

**UKRAINE RISK MATRIX**

| SCENARIOS | Hopeful | Likely | Extreme |
|---|---|---|---|
| ACTION | Annexes East/ Land bridge to Crimea | Russian takeover of Ukraine | Ukraine takeover and weaponization of commodities |
| | Aggressive military and cyber attacks | Aggressive cyber response | Aggressive cyber response against Western institutions |
| | Compromises reached with Ukraine | Disruptions to commodity supplies | Threats to Baltic states |
| REACTION | Additional arms supplies | Aggressive sanctions on key firms and individuals | Sanctions designed to cripple Russian financial system |
| | Moderate level of sanctions | Restrictions placed on export and imports | Military conflict with NATO |
| | Nord Stream 2 stopped | Increase troop deployment to NATO countries | |
| **Probability** | **10%** | **85%** | **5%** |
| **US Recession Risk** | No change | Remains low | Likely |
| **Inflation Impact** | Modestly higher | Higher | Solidly higher |
| **Oil Prices** | Modestly higher | Higher | Steeply higher |
| **Policy Response** | No change in Fed policy | No change in Fed policy | Fed hikes off the table, increased military spending |
| **Dollar $** | Stable | Modestly higher | Solidly higher |
| **10-Year Yield** | Stable | Modestly lower | Solidly lower |
| **SPX** | Stable | Modestly lower | Solidly lower |
| **Risk Exposure** | Maintain/Uptick depending on market levels | Maintain/Uptick depending on market levels | Lower risk levels, raise cash levels |

Source: CNR Research.

* The 4P analysis is a proprietary framework for global equity allocation. Country rankings are derived from a subjective metrics system that combines the economic data for such countries with other factors including fiscal policies, demographics, innovative growth and corporate growth. These rankings are subjective and may be derived from data that contain inherent limitations.

## INDEX DEFINITION

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

The 4P analysis is a proprietary framework for global equity allocation. Country rankings are derived from a subjective metrics system that combines the economic data for such countries with other factors including fiscal policies, demographics, innovative growth and corporate growth. These rankings are subjective and may be derived from data that contain inherent limitations.

### Important Disclosures