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AN UPDATE FROM PAUL DIETRICH

RUSSIA-UKRAINE WAR & THE U.S. ECONOMY

This past month, stock markets have been highly volatile as investors assess risks to the U.S. economy fueled by "Vlad The Invader" Putin's war in Ukraine.

Just as the U.S. was beginning to recover from the Omicron Covid variant last month, the war in Ukraine completely disrupted world stock markets. The S&P 500 Index, as of the market close on Wednesday, March 2nd, is down -9.6% year-to-date, the Dow Jones Industrial Average is down -8.3% year-to-date, and the NASDAQ is down nearly -13.5% year-to-date.

The NASDAQ is formally in a stock market correction. The S&P 500 Index has given up almost five months' of performance gains since October 14, 2021.

S&P 500 Index (one-year chart)

Dow Jones Industrial Average (one-year chart)

NASDAQ Index (one-year chart)

The Stock Market Is Now Closer To A Normal "Fair Market Value"

At the end of 2021, the stock market was overvalued. According to *FactSet*, at the end of last year, the S&P 500 Index had a forward Price/Earning Ratio of 21.3. The long-term 10-year P/E Ratio average was 16.7. As of today, the forward P/E has dropped to 18.8. While the stock market is still overvalued, this correction has allowed the stock market to get somewhat closer to an average fair market value.

The stock market can't remain "*out of whack*" (that's a technical, economic term) with its long-term trends without eventually reverting to its average fair market value. In the end, that is a good thing! The Russia–Ukraine war has provided that much-needed market correction.

The Stock Market & The Economy Are Two Different Things

The economy grew a robust +7% in the fourth quarter of 2021. That is the fastest GDP growth since 1984.

Corporate earnings remain stellar, and *FactSet* reports that CEOs are still delivering optimistic earnings projections despite the Ukraine war, sanctions, high oil

prices, inflation, supply chain disruptions, staffing shortages, and Covid-related issues. Analysts are currently projecting 8.5% overall earnings growth in 2022 for S&P 500 companies.

A New War In Europe – After 83 Years Of Peace

As Russia invades Ukraine, most military analysts believe Putin's overwhelming military advantage will eventually win and conquer Ukraine. But the world has been stunned by the courage and heroism of the Ukrainian people standing up to Putin's invasion.

My father was a World War II veteran. As a little boy, he always told me that "throughout history, every generation has to fight the barbarians of their age." It looks like the Ukrainians are on the front-line of that battle against the barbarians of our age. God bless them!

Please make no mistake about it, there will be many lives lost, and the human toll in death and suffering will be terrible. I don't want to minimize the tragic nature of this war caused by one autocratic dictator.

Putin's war will not only affect the people of Ukraine, but it will affect the stock markets, economies, and energy supplies of many other countries.

Over the past few weeks, I have received hundreds of emails, texts, and telephone calls asking about this war.

In this Market Commentary, I answer several of the most frequently asked questions. Following is my analysis of the potential impact of this war on the U.S. economy.

Will Russia Stop At Ukraine Or Consider Invading Other NATO Countries Next?

According to Admiral James Stavridis, the former NATO Supreme Allied Commander of Europe, Putin will never invade a NATO country.

That would be suicide since NATO has three nuclear-armed countries—the U.S., Great Britain, and France.

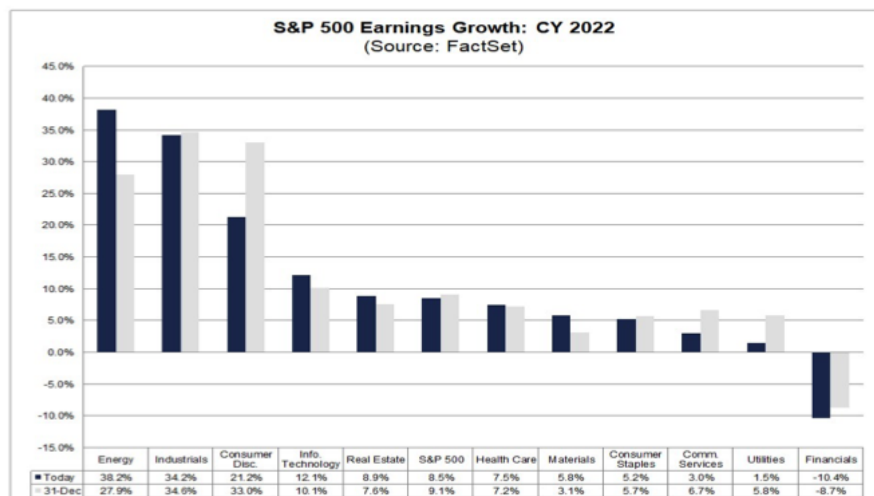
NATO is well prepared in that many NATO countries already border Russia. NATO has plans to protect each country as part of Article 5, which states that an attack against one NATO member is an attack against all.

Stavridis says that NATO outspends Russia on military spending every year by 10 to 1, has a 3 to 1 advantage in troops, and has far more aircraft and ships than Russia.

How Will The Russia–Ukraine War Affect The U.S. Economy?

The U.S. economy will feel some short-term effects from the Russia–Ukraine war (the War) until it ends. Americans will also feel some short-term impact from higher food and gasoline prices to higher inflation.

Current 2022 S&P 500 Projected Sector Earnings Growth



	Energy	Industrials	Consumer Disc.	Info. Technology	Real Estate	S&P 500	Health Care	Materials	Consumer Staples	Comm. Services	Utilities	Financials
Today	38.2%	34.2%	21.2%	12.1%	8.9%	8.5%	7.5%	5.8%	5.2%	3.0%	1.5%	-10.4%
31-Dec	27.9%	34.6%	33.0%	10.1%	7.6%	9.1%	7.2%	3.1%	5.7%	6.7%	5.8%	-8.7%

Source: FactSet Research Systems, Inc.

But, other than higher energy costs, this War will have minimal impact on the U.S. economy.

Ukraine's GDP is 0.2% of the world's GDP, and the country's investable stock market comprises just two companies. Ukraine is simply not big enough to cause a ripple in the global economy.

It is also important to remember that Russia is not a superpower, at least not when it comes to the global economy. Russia's economy is 25% smaller than Italy and 20% smaller than Canada—two countries with a fraction of its population.

Russia's economy only makes up 2% of global GDP, but it is the world's third-largest oil producer (the U.S. is number one and Saudi Arabia is number two). It is the world's largest exporter of natural gas. When energy markets are experiencing tight supplies and strong demand, disruptions to Russian output could drive up world prices, especially for Europeans.

Russia and Ukraine combined make up far less than 1% of total U.S. imports and exports. Also, Russia's status as a major natural gas exporter does not affect the U.S., given that we are a net exporter of natural gas.

Higher Energy Costs

On Wednesday, March 2, 2022, oil prices rose to $116 per barrel for the first time since 2014. The average price of a gallon of regular gasoline rose to $3.65.

As the War continues, many oil analysts believe oil could go as high as $130 per barrel by some estimates and possibly as high as $150 per barrel. For every $10 increase in the price of oil, gas prices usually rise by $0.20. Consumers could see average gas prices go from $3.65 today to somewhere between $3.95 (at $130/barrel) to $4.35 (at $150/barrel).

The European Union is more exposed to this War because Russia supplies 40% of Europe's gas, and the EU relies heavily on Russia for other food and commodity exports.

According to a Goldman Sachs report, a $10 per barrel increase in oil prices would boost U.S. inflation by 0.2% while lowering GDP growth by just 0.1%. They also point out that oil prices remained above $100 a barrel from the beginning of 2011 through the summer of 2014, during which time the U.S. economy grew, and the stock market went up by over 50%.

Investors need to understand that higher oil prices do not necessarily equate to economic recession or weak stock markets.

Investors need to weigh all of these factors. Technically, a recession requires trillions of dollars worth of damage to the global economy, which Russia and Ukraine are simply not capable of delivering. It helps to remember that S&P 500 companies have only a fraction of 1% of their revenue and profit exposure to *Russia and Ukraine combined.*

Higher Food Costs

Wheat prices recently hit their highest since mid-2008. According to Reuters, the knock-on effect of higher agricultural commodity costs on consumer prices tends to be relatively weak; it could still add 0.2% to 0.4% to the inflation rate in developed economies.

Increased food prices will affect Europeans more than Americans. Russia and Ukraine export more than a quarter of the world's wheat, and Ukraine is a major corn exporter.

Bottom Line

Investors need to remember that Russia invading Ukraine will have little impact on the overall U.S. economy.

The U.S. doesn't buy much of anything from Ukraine, and because of sanctions, we buy and sell very little to and from Russia. We import only about $1.1 billion a year from Ukraine. We import only about $6.4 billion a year from Russia out of $2.8 trillion from the rest of the world. We import over $151 billion from China.

Depending on how long the war lasts, the invasion will have only a tiny, short-term impact on the stock market.

How Will Sanctions Affect The U.S. Economy?

Here are the significant sanctions imposed on Russia:

- Excluded major Russian banks (but not all) from the SWIFT financial messaging system that allows international banking payments and transfers. This sanction will also affect Russian credit cardholders.
- Froze Russian Central Bank assets.
- Banned transactions by the Russian Central Bank, the Russian National Wealth Fund, and the Russian Ministry of Finance.
- Personally sanctioned and targeted Vladimir Putin, Foreign Minister Sergey Lavrov, and other Russian Oligarchs.
- Restricted exports of specific technologies to Russia (i.e., semiconductors, computers).
- Prohibited Russian commercial and private aircraft from the U.S. and European airspace.

These sanctions are already having a significant impact on the Russian stock market and the Russian economy. The ruble is now worth less than one U.S. cent.

These sanctions will cause real pain for the Russian economy and average Russians.

However, these sanctions were designed **NOT to hurt the European economy.**

Oil, gas, and food exports from Russia and Ukraine are **exempted and will be allowed to continue**.

After this War, Russia will need more oil and natural gas revenue than ever. Some people have suggested that Putin could weaponize energy by stopping exports to Europe. Most analysts believe that would be the end of Russia as we know it. They don't think Russia will stop exports since limiting oil shipments would ultimately endanger Russia's energy-dependent economy. Oil and natural gas made up about 43%, on average, of the Russian government's annual revenue between 2011 and 2020.

Bottom Line: This means that once the fighting is over, 80% of Russian exports will still be allowed, so there will be minimal impact to the U.S. and European economies, and in the end, minimal impact to Russian export revenue—its primary source of national income.

Where Does The Stock Market Go From Here?

Historically, the stock market almost always rebounds quickly from geopolitical events that have minimal impact on the U.S. economy. The stock market snapbacks from these corrections have tended to be very sharp.

One year after the 1941 bombing of Pearl Harbor, the S&P 500 index gained 15%. A year after the U.S. invasion of Iraq in 2003, it was up 35%. History shows that just one year after most stock-market-shattering crises, the S&P 500 Index has risen.

Currently, the consensus price growth estimate of the **S&P 500 Index over the next 12 months** (by over 10,800 Wall Street analysts) is a **24% price increase** from where the stock market is now, according to *FactSet*.

Could The U.S. Be Headed For A Recession?

Because of the war in Ukraine, high inflation, rising interest rates, and stock market volatility, some investors are worried about the possibility of a recession.

The good news is the U.S. has never had a recession when the economy was growing and expanding, and we essentially had full employment, as we do now.

The economy has notched blockbuster growth over the past six months. GDP grew by a stunning 7% in the fourth quarter of 2021. The national unemployment rate is at a low 4%, and most Americans have considerably more money in their bank accounts than they did before the pandemic.

It is always possible that the Federal Reserve can slow the economy by raising rates to such an extent that we enter a recession. The Federal Reserve has done that before, but most Federal Reserve members are aware of this and have vowed not to repeat that history.

Barring some unexpected disaster, I don't see a recession in either 2022 or 2023.

In my mid-February Market Update commenting on the market volatility, I said investors needed to myopically focus on the two primary drivers of U.S. economic growth in 2022.

1) **We currently have "full employment" in the U.S. for anyone who wants to work.** In November 2021, there were almost 11 million jobs available. There were only about 6.3 million unemployed. That means we have approximately 4.7 million more jobs available than workers to fill those jobs. That is a problem because our economy will not fully function until we find those 4.7 million more workers. However, looking at it another way, too many jobs and too few workers is a problem every other country in the world would love to have.

2) **The U.S. government will start pumping $1.2 trillion in infrastructure spending into the economy**. I also believe there is a high probability that President Biden and Senator Joe Manchin (D-WV) will create a new social spending bill of about $1.5 trillion that will only include programs that Manchin likes, including funding for universal pre-kindergarten, an expansion of the Affordable Care Act, and hundreds of billions of dollars for climate-related spending that he approves. Manchin's proposed bill also supports raising taxes on billionaires.

Full employment and the almost $3 trillion in government spending programs over the next ten years will be the two main drivers of the U.S. economy and stock market expansion over the next few years.

We as a country may pay the price for all this government spending in the future—but for the next few years, this spending will be driving the economy and the stock market on an upward trajectory.

You can do only two things with new money flowing into the economy. We can spend it, and that drives corporate earnings up. Or, we can save and invest that money, which will cause the stock market to go up.

Closing Thoughts:

I reiterate my previous guidance that investors should stay fully invested in the stock market during any corrections. There will be more pullbacks and corrections this year. Still, investors need to be focused on the underlying fundamentals of the U.S. economy, which will ultimately drive the stock market up over 2022.

If something impacts the stock market and does not substantially affect the underlying U.S. economy—IT IS NOISE—TUNE IT OUT!

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as a frequent on-air commentator and regularly contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*

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