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COMMENTARY

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Sanctions and the Financial Markets

- Western sanctions are pressuring the global economy.
- Stagflation is a distinct possibility for the domestic economy.
- Diversification remains an important strategy in times like these.

Nearly two weeks ago, Russia invaded Ukraine. We continue to believe Western governments are unlikely to escalate this war by directly engaging Russian military forces. Instead, their primary tool has been economic sanctions. While there is clear evidence that the sanctions have impacted the Russian economy, they have also exacerbated global economic headwinds. With the U.S. and the United Kingdom just announcing a ban on Russian oil imports, price pressures will continue longer, and overall inflation will become more entrenched in the global economy, potentially slowing overall growth. Though risks are increasing, now is not the time to alter your portfolio risk above or below your long-term investment objective.

Western sanctions on Russia have affected its economy with the value of the ruble plummeting to a record low and the Russian Central Bank forced to double its key interest rate to 20%. However, with sanctions limiting the purchases of Russian exports and because Russia is a significant exporter of commodities such as metals, agricultural products, and chemicals, global prices have spiked for these commodities. While Russian energy was not officially targeted until the U.S. and the United Kingdom announced the official ban today, financial sanctions had made it difficult to buy Russian energy exports. The result has been significant price surges in commodities usually supplied by Russia into the global economy including wheat, nickel, oil and natural gas. For example, here in the U.S., oil has doubled since its December low and gasoline prices have reached a new record high of $4.17/gallon.

These sanctions, especially the new Russian energy ban, will continue to drive inflation pressures higher. While the possibility exists that more fossil fuels can be acquired from Saudi Arabia, Venezuela and Iran or that the U.S. can increase domestic oil production (we are still producing about 1.5 million barrels of oil less per day than before the pandemic), this will take some time to reach the economy. Since energy is about 7% of the consumer price index, expect inflation to be elevated much longer than anticipated prior to the Russian invasion. Furthermore, given the impact of higher prices on a domestic economy that was already flashing slowing economic growth signals such as a flattening yield curve, falling consumer confidence, and declining real wages, stagflation is a distinct possibility. Stagflation occurs when an economy is experiencing a simultaneous increase in inflation and slower economic output. Optimistically, we do not expect a recession now. Despite the jump in prices, the consumer is in great shape financially, spending data continues to show strength, and the labor market is very robust.

Despite our optimistic tone, the rise in prices due to the Russian invasion and ensuing sanctions raise uncertainty around our economy and domestic monetary policy. The Federal Reserve (Fed) is in a tough predicament. If they raise rates too quickly to combat inflation, they risk slowing the economy too much. If they raise rates too slowly, they risk rising inflation materially affecting consumer spending. As these risks and the fallout from the Russian invasion continue to evolve, we expect the Fed to err on the side of caution and take a more measured approach than the markets anticipate. Three weeks ago, there was a 95% chance the Fed would raise interest rates by 0.50% at its meeting next week. Today, it is widely expected (96% chance) that they raise rates by 0.25%.

With market uncertainty rising every day, we continue to anticipate more volatility for the foreseeable future. Each day brings breaking news around the Russian invasion of Ukraine and the global economic fallout. While risks ebb and flow as events evolve, expect financial markets to react accordingly. Today's events have not been similarly experienced in 80 years so there is much uncertainty. However, one certainty remains – maintaining a long-term perspective with an investment portfolio that is consistent to your goals is vital. Now is not the time to dramatically increase or decrease risk. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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