MONTHLY
MARKET REVIEW

02 2022

Strategic Investment Group®

Global Market Review

The fog of war fell on markets in February. Although heavily foreshadowed by U.S. intelligence reports, the February 24th invasion of Ukraine by Russia sent shockwaves through global markets. However, with the exception of markets directly affected by the crisis, most equity and credit markets rebounded following a sharp decline in reaction to the invasion.

How long the Russian invasion will persist, how wide the conflict may spread by accident or design, and its ultimate cost in terms of lives and treasure are unknowable. History provides some comfort that the market impact of major geopolitical events has proven surprisingly benign and short lived (Appendix Exhibit 1). For example, among major geopolitical crises, the Pearl Harbor attacks triggered the largest total U.S. equity market drawdown (-19.8%) and most prolonged recovery period from the trough (309 days). The terrorist attacks of September 11, 2001, in contrast, precipitated a drawdown of 11.6% that was recouped in 31 days.

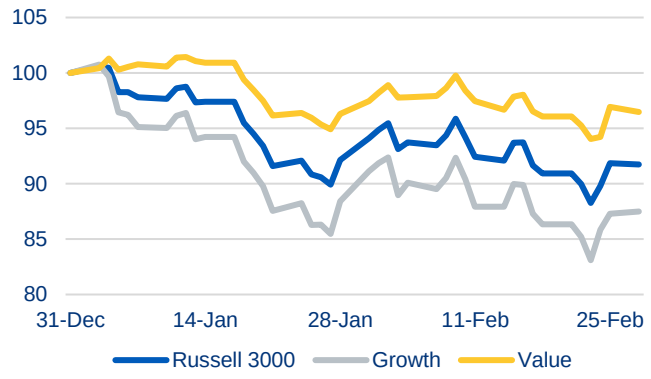
The early market reaction to the invasion has so far also been muted, albeit with significant intra-day volatility. The biggest declines in asset prices have been felt by Russian assets, Eastern European equities, and emerging market sovereign bonds. Given Russia's importance as an exporter of oil and natural gas, and the Ukraine's importance as a major exporter of wheat and corn, commodity prices have soared.

Exposure to Russian equities in our clients' portfolios is limited, reflecting the small weight of Russian assets in global capital markets. Prior to the Russian invasion, Russia represented about 3.4% of the MSCI Emerging Markets index, and about 0.3% of global equities included in the MSCI All Country World IMI index. We estimate that as of March 1 the actual exposure to Russian equities across the portfolios that we manage was no higher than 25 basis points and, in many cases, lower. We are actively engaging with our underlying managers and monitoring their limited equity positions in Russia. Client portfolios are performing in line with expectations. We are closely monitoring developments for the risk of spillovers and the threat to global growth and inflation posed by rapidly rising energy prices.

U.S. Equity Markets Shrug Off Invasion News

U.S. equities declined sharply on the news of the invasion, but soon recovered those losses (Exhibit 1). Despite this rebound, U.S. equities fell 2.5% in February extending January's steep losses and bringing the decline so far in 2022 to 8.3%. Disappointing earnings, especially in the tech sector, the prospect of policy tightening to dampen persistent inflationary pressure, as well as the heightened uncertainty created by the invasion undercut equity prices.

Exhibit 1. U.S. Equity Markets Extend Decline
Source: Bloomberg. Index January 1, 2022 = 100.



1001 Nineteenth Street North
17th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com

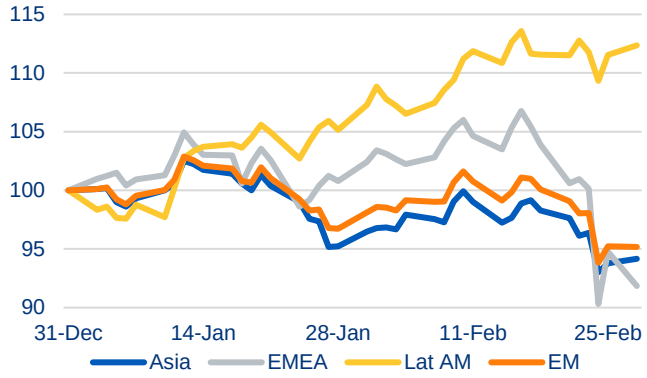
The U.S. equity market's decline so far in 2022 has been broad based. Small cap and large cap stocks are down 8.7% and 8.2%, respectively. Value stocks have outperformed growth by a wide margin, although both have fallen, with growth stocks dropping 12.5% versus value's less jarring 3.5% tumble. Across sectors, tech stocks have led the decline, losing 11.8% this year. Only energy sector stocks are up in 2022 (26.5%) fueled by a surge in oil prices.

Eastern European Equities Post Largest Declines

The MSCI World ex-U.S. index of advanced non-U.S. equity is down 5.9% through February. Even prior to the invasion of Ukraine, European equity markets had been suffering from the effects of high inflation, driven largely by energy prices and supply constraints. Despite their heavy reliance on Russia as a source of natural gas, developed European equity markets fell only 2.8% in February and are down 7.3% so far in 2022. Emerging equity markets also declined in February, led by the 10.3% fall of markets in the EMEA region. So far in 2022, emerging equity markets as a group are down 4.8%, notwithstanding the strong performance of bourses in Latin America (Exhibit 2).

Exhibit 2. Eastern European Equities Shaken by War

Source: Bloomberg. Index January 1, 2022 = 100.

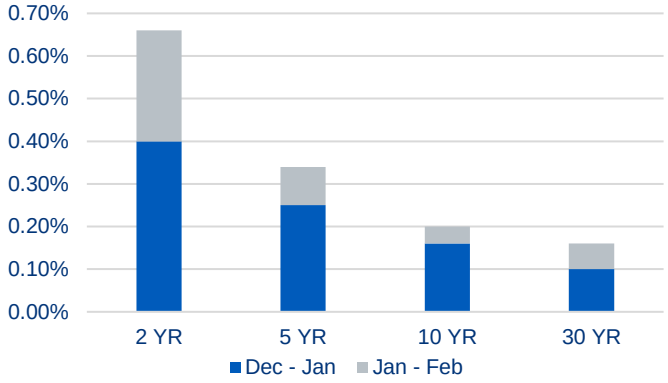


Inflation Fears Dominate Safe Haven Flows

U.S. Treasury yields have fallen since the invasion and markets have priced in expectations that the Fed will raise rates at a slower pace than envisaged prior to February 24. The post-invasion decline in real yields was particularly pronounced, suggesting that economic growth may be an indirect casualty of the war in Eastern Europe. Despite this spurt in safe haven flows in the aftermath of the invasion, yields across advanced economy sovereign bonds are up this year. February extended the recent trend of rising U.S. Treasury yields across the maturity spectrum and a flattening yield curve (Exhibit 3). So far in 2022, U.S. Treasury prices have declined 2.6% with losses on Treasuries with maturities of 10 or more years totaling 5.8%. U.S. credit markets are also down. Long maturity investment grade bonds have suffered the steepest declines so far in 2022 (7.6%), while the shorter duration of high yield bonds has tempered their losses to 3.6%.

Exhibit 3. U.S. Treasury Yields Rise Further in February

Source: FRED. Yields in percent.



The sovereign bonds of other advanced economies have also lost ground so far in 2022, with the WGBI ex-U.S. index falling 3.5%. Emerging market bonds fell 5.5% in February alone and the JP Morgan EMBI Global index is down 8.2% in 2022.

Russian Assets Plummet; Commodities Soar

International sanctions have crippled Russian financial markets. Russian banks are severely restricted in their ability to make international transfers. The Russian central bank's ability to intervene to support the ruble is severely impaired, and there are reports of widespread withdrawals from Russian banks. Trading on the Moscow equity exchange is suspended, and international trading of Russian equities has all but dried up. The impact of these sanctions is most evident in the sharp depreciation of the ruble, which has lost over 40% against the U.S. dollar, despite the doubling of short-term rates by the Russian central bank to 20%. Russian bonds have also been hard hit and are priced at 30 cents to the dollar, although trading has essentially ceased. Safe haven assets like gold, in contrast, are up so far in 2022 as is the broad U.S. dollar index. The prices of oil, corn, and wheat have risen sharply given the fear of supply disruptions due to the conflict.
We provide further analysis of the impact of the war on major markets in the appendix that follows.

Performance of Major Market Indices through 02-28-2022

Sources: MSCI, FTSE, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, S&P GSCI, HFR, Bloomberg.

	1-Month	QTD	YTD	1-Year	3-Year	5-Year
S&P500	-3.0%	-8.0%	-8.0%	16.4%	18.2%	15.2%
Russell 2000	1.1%	-8.7%	-8.7%	-6.0%	10.5%	9.5%
MSCI World Ex-US (USD)	-1.6%	-5.9%	-5.9%	4.5%	8.3%	7.4%
MSCI Emerging Mkts (USD)	-3.0%	-4.8%	-4.8%	-10.7%	6.0%	7.0%
Citigroup US Treasuries	-0.7%	-2.6%	-2.6%	-1.7%	3.1%	2.4%
Citigroup Credit	-2.3%	-5.3%	-5.3%	-3.5%	4.7%	3.8%
Merrill High Yield	-0.8%	-3.6%	-3.6%	0.9%	5.1%	4.7%
JPM EMBI Global (USD)	-5.5%	-8.2%	-8.2%	-6.1%	1.4%	2.0%
Citigroup WGBI Ex-US (LC)	-1.5%	-2.7%	-2.7%	-2.7%	0.9%	1.1%
Citigroup Credit AAA/AA 10+	-2.7%	-7.6%	-7.6%	-2.7%	7.1%	5.7%
Barclays US Aggregate	-1.1%	-3.2%	-3.2%	-2.6%	3.3%	2.7%
GSCI Total Return	8.8%	21.4%	21.4%	46.9%	10.6%	7.1%
HFRX Eq. Wtd. Strategies	-0.3%	-1.5%	-1.5%	-0.3%	3.6%	2.0%

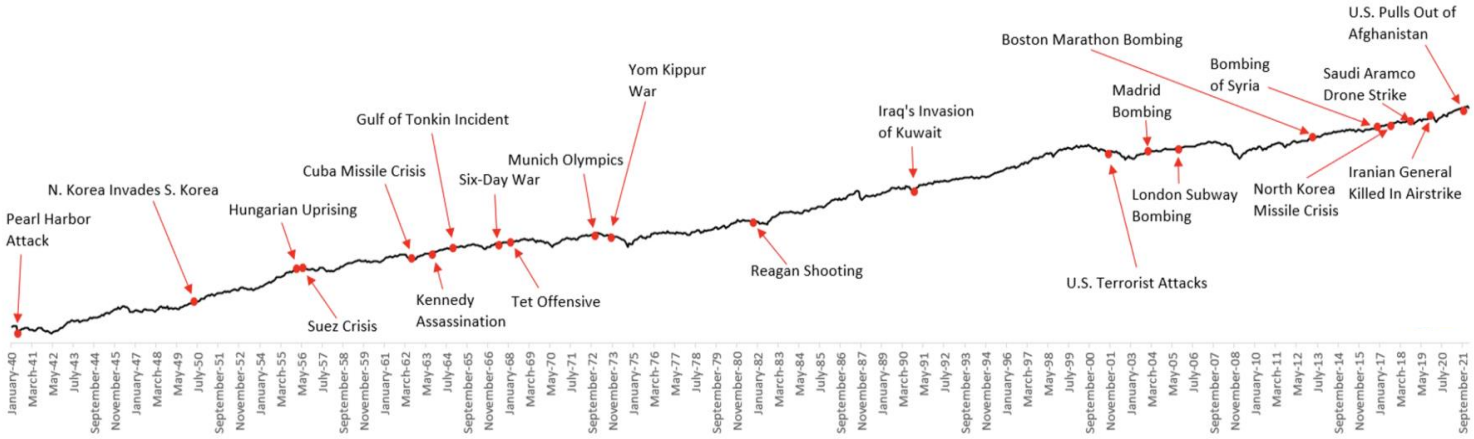
Appendix – Impact of Ukraine Crisis on Markets

Geopolitical Events Since World War II

Although a major source of uncertainty, the historical record suggests that geopolitical shocks usually have had a limited impact on global markets (Exhibit 1). So far, the market impact of the Russian invasion of Ukraine has been focused on Russian assets, Eastern European equities and bonds, and commodity prices.

Exhibit 1. Geopolitical Shocks Are Usually Limited and Short-Lived

Source: Ritholtz Wealth Management.



Financial crises typically have a bigger impact on markets than geopolitical crises.

Volatility Increases with War Induced Uncertainty

Although expected volatility increased across equity and bond markets, the heightened uncertainty created by the invasion was most notably manifested in the implied volatility of options on U.S. Treasury securities, reflecting the uncertain path of central bank tightening (Exhibits 2 and 3).

Exhibit 2. U.S. Equity Market Implied Volatility

Source: Bloomberg. Data from 12/31/20-2/28/22.

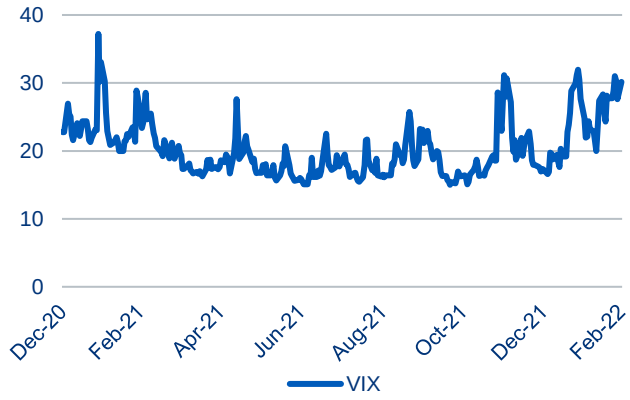
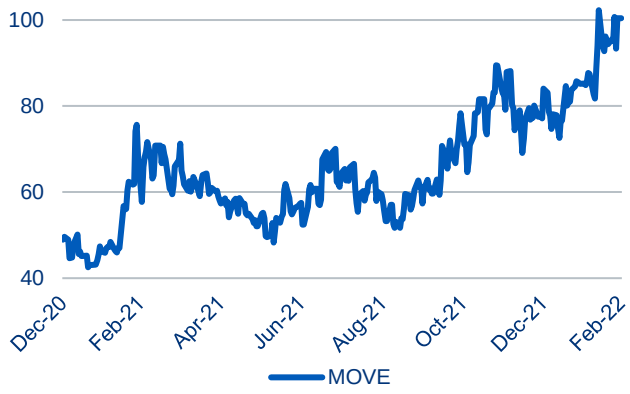


Exhibit 3. U.S. Treasury Market Implied Volatility

Source: Bloomberg. Data from 12/31/20-2/28/22.



Equities Continue Downward Trend Established Since November

Advanced economy equity markets have declined so far in 2022. The downward trend was in place prior to the invasion and the losses in February were less than those suffered in January (Exhibits 4 and 7). The U.K. equity market managed to buck the downward trend to post a modest 1% gain (Exhibit 5). Russian equities in contrast have plummeted and trading has ceased as sanctions have had a devastating effect on its financial markets (Exhibit 6).

Exhibit 4. U.S. Equity Markets Fell Further in February

Source: Bloomberg. Data from 12/31/20-2/28/22.

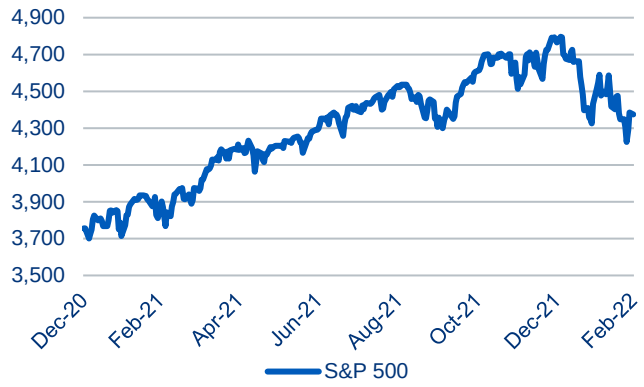


Exhibit 5. U.K. Equities Manage Modest Gains

Source: Bloomberg. Data from 12/31/20-2/28/22.

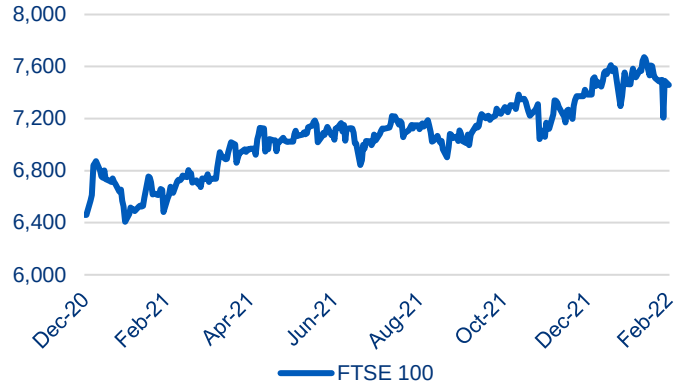


Exhibit 6. Sanctions Decimate Russian Equities

Source: Bloomberg. Data from 12/31/20-2/28/22.

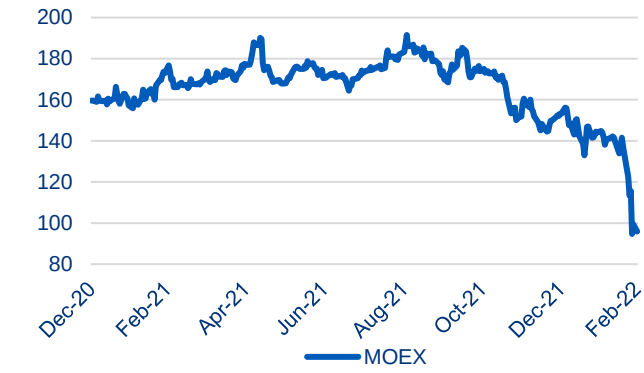
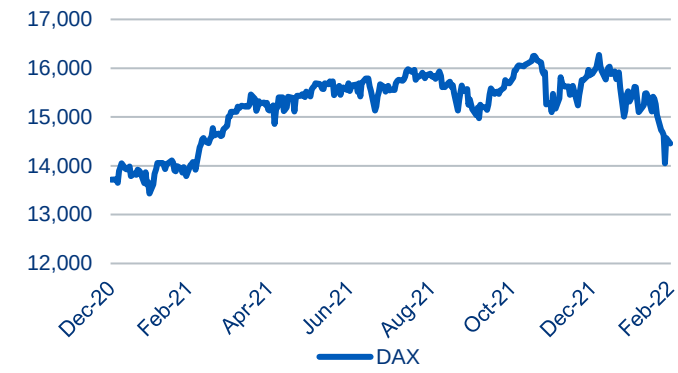


Exhibit 7. German Equities Decline

Source: Bloomberg. Data from 12/31/20-2/28/22.



U.S. Bond Yields Rise and Yield Curve Flattens

Concerns over persistent inflationary pressure have sent U.S. Treasury yields higher (Exhibit 8). Reflecting expectations for Fed tightening, yields at the short end of the curve are up most and the yield curve has flattened (Exhibit 9). Since the invasion, markets have priced in a slower pace of Fed rate hikes. U.S. real yields have declined substantially in the wake of the invasion, possibly signaling concerns that global growth may be a casualty of the war (Exhibit 10). Yields on European sovereigns are also up through February (Exhibit 11). The Bank of England was the first G-7 central bank to raise rates and has now done so twice.

Exhibit 8. U.S. Treasury 10 Year Yields

Source: FRED. Data from 12/31/20-2/28/22. Yields in percent.

Exhibit 9. U.S. Treasury 2 Year Yields

Source: FRED. Data from 12/31/20-2/28/22. Yields in percent.

Exhibit 10. Real Yields on 5-Year TIPS Decline

Source: Bloomberg. Data from 12/31/20-2/28/22. Yields in percent.

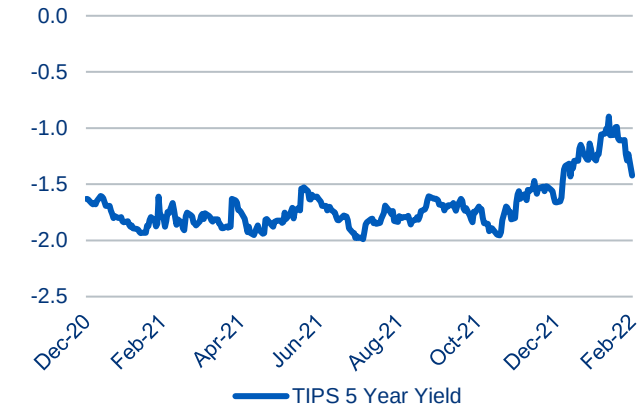
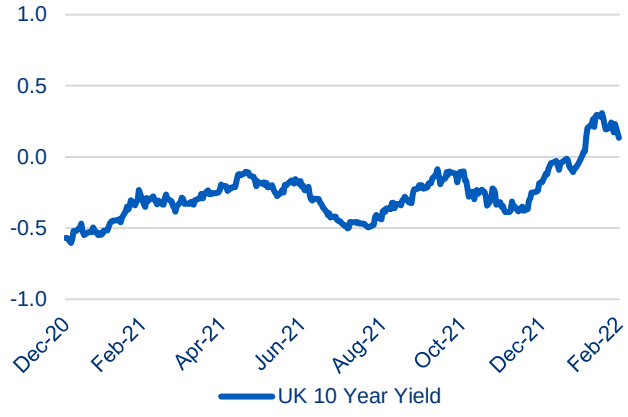


Exhibit 11. United Kingdom 10 Year Yields

Source: Bloomberg. Data from 12/31/20-2/28/22. Yields in percent.



Sanctions Stymie Russian Bond and Currency Trading

Trading in Russian sovereign bonds has virtually ceased as a result of sanctions and prices have plummeted to cents on the dollar suggesting a high probability of default. The price of Russian credit default swaps has spiked, and the Russian component of the EM bond index has lost most of its value (Exhibits 12 and 13). Sanctions on Russian banks have raised the prospect of a run on the banking system and a full-blown financial crisis. Sanctions on the Central Bank of Russia have prevented its ability to intervene to support the ruble which has plummeted despite a doubling of short-term interest rates to 20% (Exhibit 14). The U.S. dollar, in contrast, is up against a broad index of currencies (Exhibit 15).

Exhibit 12. Russia 5-Year CDS Price in Default Risk

Source: Bloomberg. Data from 12/31/20-2/28/22.

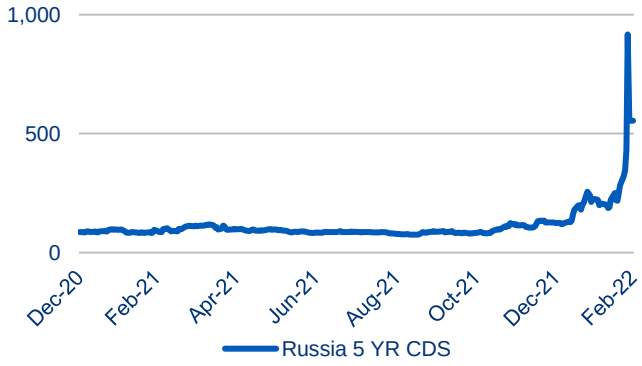


Exhibit 13. Russian Component of EM Bond Index Plummets

Source: Bloomberg. Data from 12/31/20-2/28/22.

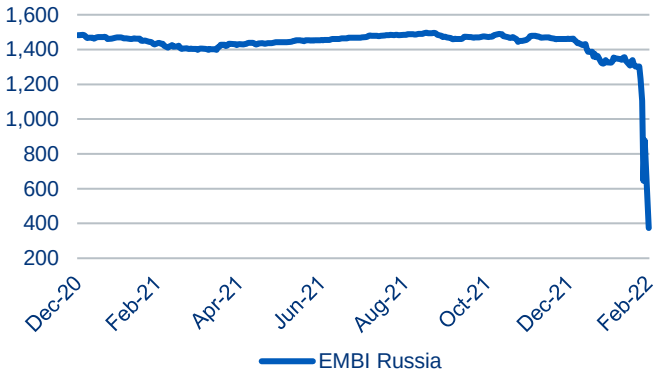


Exhibit 14. Ruble Falls Against the U.S. Dollar

Source: Bloomberg. Data from 12/31/20-2/28/22.

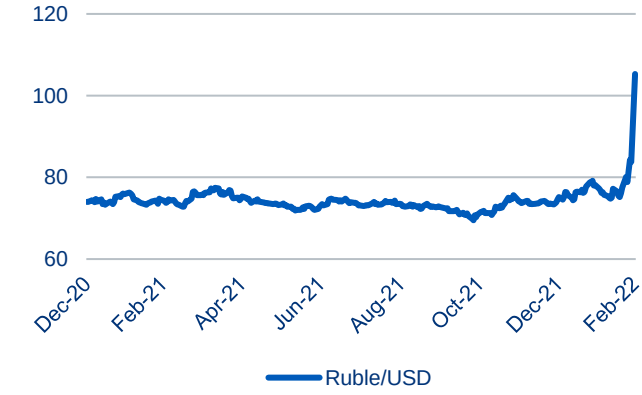
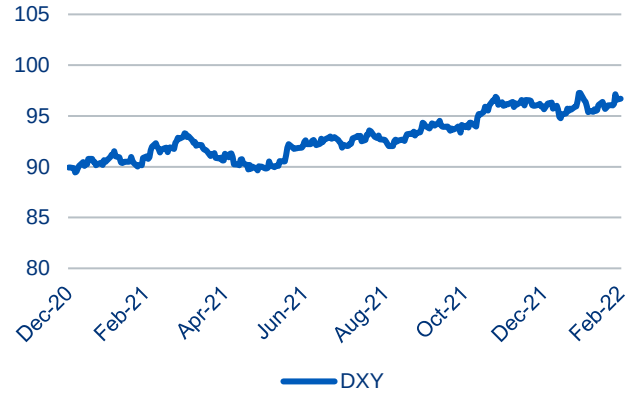


Exhibit 15. U.S. Dollar Index Benefits from Safe Haven Flows

Source: Bloomberg. Data from 12/31/20-2/28/22.



Commodity Prices Soar as Supply Concerns Mount

Russia is the third largest producer of petroleum products after the U.S. and Saudi Arabia and a major exporter of oil and natural gas. Oil prices had been rising rapidly throughout 2021. The Russian invasion has accelerated this trend (Exhibit 16). Europe is especially dependent on Russian natural gas. A main driver of inflation in Europe even before the invasion was concern over the reliability of Russian natural gas supplies. With tensions between Russia and Ukraine flaring into war, natural gas prices have spiked (Exhibit 17).

Exhibit 16. War Propels Oil Prices Higher

Source: Bloomberg. Data from 12/31/20-2/28/22.

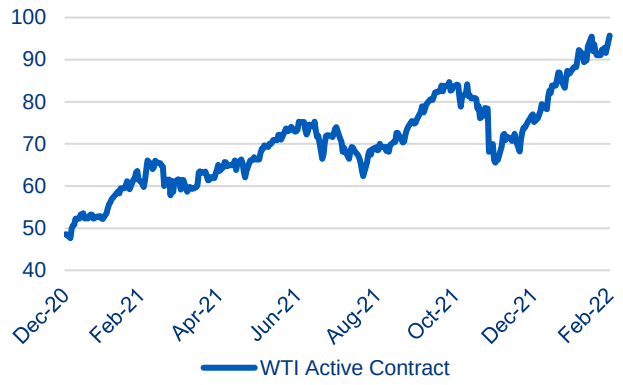
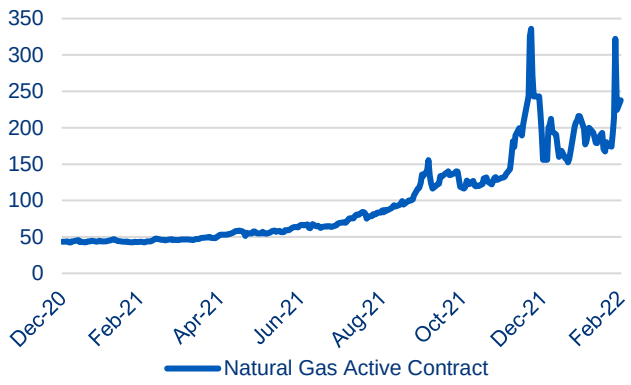


Exhibit 17. Jump in Natural Gas Prices Reflects Supply Concerns

Source: Bloomberg. Data from 12/31/20-2/28/22.



Russia and the Ukraine are major exporters of wheat. Ukraine is also a major exporter of corn. The prices of both of these foodstuffs have risen sharply with the outbreak of hostilities (Exhibits 18 and 19).

Exhibit 18. Wheat Prices Soar on Supply Concerns

Source: Bloomberg. Data from 12/31/20-2/28/22.

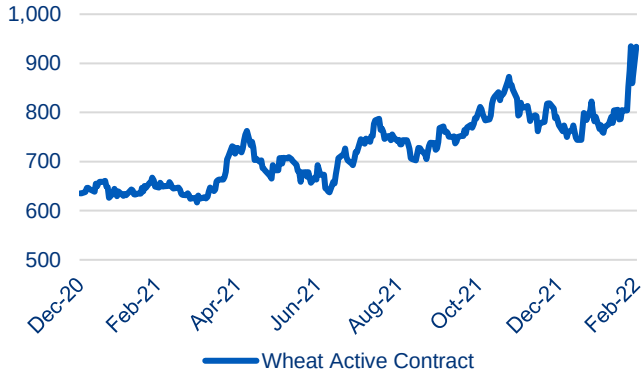


Exhibit 19. Corn Prices Also Reflect Heightened Uncertainty

Source: Bloomberg. Data from 12/31/20-2/28/22.