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There is no agnostic way to discuss the financial market consequences of a human tragedy. Despite the professional necessity to analyze the economic, geopolitical, and liquidity scenarios of how Russia's invasion of Ukraine could play out, I struggle to do so through clear eyes. To draw conclusions that are optimistic to global asset prices from current levels feels almost inappropriate. The Ukrainian people face an unfathomable hardship, and whatever the outcome, Russian citizens, the vast majority who are innocent in all this, will feel the consequences of an unstable banking system and sanctions for years to come. Russia's leadership and the oligarchs who have underwritten Putin's power and enormous personal wealth will be inconvenienced. Sergei Lavrov may not make it to Canne this summer, and Chelsea Football Club may have a new owner, but like all the tragedies the world has faced in the past thirty years, those with the lowest exposure to financial assets face the greatest risk.

Most investors have not witnessed an event of this magnitude, and therefore, the array of potential outcomes and consequences is unclear. There is no way to model such scenarios, no precedence to take the lead from. This is not the EU's 9/11 moment or a repeat of Bosnia. It is not an echo of Crimea or Russia's follies in Afghanistan. There is no playbook on how Brussels or Washington will respond or how central banks react. We have no field of reference when the Western response involves limiting access to the SWFIT system, arms support, and cyber attacks.

Up until now, I have encouraged you all to take as little risk as possible because you have no edge. While we have only a little more clarity than we did a week ago, we do not have the luxury of continuing to sit on our hands. A portfolio adjustment is needed if a global political and financial response is coming.

I am not implying that central banks are about to turn on the taps. However, the one common characteristic from major global upheavals we have faced this century has been an outsized policy response that swamped the prevailing problem and benefitted financial assets to a much greater extent than the bottom 80% of income earners. We have just lived through the liquidity and fiscal response to COVID. Few would argue that the liquidity/support was not excessive in hindsight and lasted for much longer than necessary. The liquidity response to the Global Financial Crisis and the EU debt crisis underwrote assets for years to come. 9/11 was different as the markets were still coming to grips with the bursting of the tech bubble, but certainly, since 2008, governments have erred on the side of caution and done more rather than less.

The response will not be monetary this time around, even though we could see a slightly more dovish response than the consensus.

The policy frameworks will be coordinated to mitigate commodity inflation if Russian oil and gas supplies are taken offline.

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It will involve global efforts from OPEC and Gas suppliers to ensure spiking prices are temporary. The Saudis will need to be at the center of these efforts, and the election chances of Emmanuel Macron and the Democrats in the November mid-term elections could well depend on ensuring stable oil and gas supplies.

If a coordinated response can ensure that energy prices do not spike and oil remains below $100 per barrel, the medium-term consequence for the global economy and financial assets could be straightforward:

1. Declining oil prices would confirm consensus thinking that global inflation has peaked.
2. While central banks across the globe, led by the Federal Reserve, will tighten policy throughout 2022, the prospect of a significant interest rate shock where the Fed hikes rates by more than 175bps is greatly reduced.
3. Any prospect of ECB tightening should be discounted.
4. If oil prices do not rise above $100 per barrel, peak inflation fears and peak interest rate hawkishness will mean that global equities have limited downside. While the NASDAQ and SPX could well retest the lows of last Thursday, I suspect that could be the limit of the selling pressures if this framework plays out.
5. The catalyst for the growth to value rotation reverses in favor of growth equity if oil prices head lower in the event of a coordinated response. While energy equities remain compelling due to longer-term factors such as valuation and uncertainty over the energy transition, a sizable correction away from $100 per barrel will prompt rotation out of energy and back into high-quality growth equity. This is supportive of US equity indices.
6. Lower oil prices will mean that the prospect of spiking US long-duration yields is low. In a coordinated oil supply response, risk parity is compelling.

We face enormous volatility between now and the Fed meeting, and it is naïve to believe that the actions of Mr. Putin cannot derail this scenario. Prudence is required, and this framework is just that. An escalation driven by Russian cyberattacks on the United States cannot be discounted, leading to further de-risking of portfolios. That is why owning fixed income makes so much sense both as a safe haven tool and a beneficiary of lower energy prices. From an execution standpoint, own bonds now and add to growth equity into what appears to be the inevitable weakness that will occur this week.

The Western response has been timid

In my opinion, the response by Western governments to Russian aggression is appalling. While I completely appreciate the complexity of direct military engagement, the West continues to buy Russian commodities, and as such, the current list of sanctions, while wide-ranging are, relatively toothless. Gasprom cant access western capital markets, but it can still sell gas at elevated levels. Rosneft can still sell oil on the open market. While limiting certain Russian banks from SWIFT is unprecedented, the only way to truly hurt Mr. Putin's ambitions is to cut off his commodity revenue. While the Chinese will continue to be a ready buyer of anything the Russians are selling, there is little doubt that this will hurt the Russian economy in ways that other sanctions will not. The only way to impose a meaningful penalty on the Kremlin is to structurally shrink the Russian trade surplus. Current measures will not do that.

This shows the timid nature of the Western response and shows that the EU and the United States are not prepared to deal with any potential fallout dealing with Russia's aggression. This falls squarely on President Biden, who knows the political consequences of spiking energy prices heading towards a mid-term election he looks destined to lose. Triple-digit oil prices create a political nightmare for President Biden, as do skyrocketing gas prices from French President Macron, who faces re-election in a matter of weeks. Inflation will be the most pressing issue in every election across the globe this year, and the removal of Russian oil and gas from the market would only add to this problem for incumbent leaders. This is the sad reality facing the Ukrainian people amid their existential crisis.

The West is willing to help up until the point that higher energy prices become politically inconvenient.

Eventually, to stop Mr. Putin, you have to hurt him economically, and partial SWIFT bans do not do this because Russian oil and gas are still flowing. To ease the suffering of the Ukrainian people, the West needs to do more, but it risks a further inflation shock that is unpalatable to Western consumers and voters.

The 1998 Russian Default and Contagion

We have seen the global consequences of a Russian crisis before. The Asian Crisis was brewing for 18 months before the impact was felt directly by US asset markets in Q3 1998. Countries from Thailand to South Korea were heading towards insolvency, yet US markets, the economy, and the Fed were unaffected. It took a devaluation of the Ruble and the Russian USD bond default in August 1998 for this crisis to spread to the United States. However, it was not the Russian default or Asia's effective bankruptcy (ex-China) that prompted the Fed. The demise of the highly levered hedge fund Long Term Capital Management and its consequences for the financial stability of their Prime Brokers at Lehman Brothers and Bear Sterns prompted a 75bps cut in the Fed Funds rate. It is a valuable lesson for all US-Centric investors.

Unless a crisis directly affects US financial stability, the Federal Reserve will not respond.

This is vitally important when assessing whether or not contagion from a deterioration in the Russian Financial System is likely. Russian sanctions over the past decade due to Donbas and Crimea have greatly reduced the exposure of Russian assets to US investors. The prospect of a single leveraged investor having exposure that could systemically harm the balance sheet of a leading investment bank is low. European banks will certainly have more exposure, but it is difficult to think it is comparable to 1998. I can only assume that every leading investment bank is currently stress-testing their balance sheets for Russia risk and the Fed and the ECB are keen to witness the findings.

I am assuming that US investment banks have no systemic exposure to Russia, so, therefore, there will be no Fed response required to manage this risk.

Two significant risks to the global economy:

To hurt Russia economically is to risk global consequences. There are two potential financial risks facing the global economy. I feel both are low probability events, and hence, I do not see a systemic issue or a significant near-term pivot in global monetary policy. There will be tweaks. I have always been skeptical whether the ECB would raise rates in 2022, and I believe this geopolitical crisis will end that debate for the next several quarters. While equity market weakness and credit widening may have taken 50bps off the table for the March Fed meeting, the path towards higher USD cash rates in the months ahead looks assured. That said, the two Russian risks to the global economy in the months ahead are:

1. A banking crisis in Russia
2. Spiking energy and commodity prices due to lost Russian supply

What makes this geopolitical crisis different is the resilience of emerging markets and the absence of contagion. One of the great challenges I have faced when trading emerging markets in the last decade is that I learned this craft during the Asian crisis when a stress point in one emerging market quickly spread elsewhere. Despite the lack of interest in the asset class for the past fifteen years, it is undeniable that healthier balance sheets, improved governance, and the structural tailwind for commodities due to decarbonization efforts have made most emerging economies much more stable. Despite the ongoing trauma in Turkey and Argentina, developing economies have been able to ring-fence themselves from troubles elsewhere. Today's emerging market asset class is simply more resilient and idiosyncratic than it was back in 1998. The strength of LATAM carry and equity despite the pending Fed tightening cycle is a testament to the idea that it is different this time.

That said, the preconditions we are witnessing have never been seen before. The market mechanism has limited access to USD funding for certain economies in the past. Funding markets have frozen because investors and counterparties didn't want to take the risk. However, outside of North Korea, Iran, Cuba, and Venezuela, we have never witnessed an orchestrated campaign to formally restrict an economy the size of Russia from USD funding channels. The removal of some banks from the SWIFT system creates a level of imposed risk on the Russian banking system, which is without precedence. This may not be a catalyst for a bank run, but it cannot be completely discounted.

At a minimum, the Russian banking system will face enormous stress in the months ahead. However, with a sizable trade surplus and $630bn in FX reserves, it should meet most challenges. That said, it is all depended on how long this crisis lasts. Russian companies will face USD refunding issues in the months ahead, and even with sizable reserves, it will be troubling for Russian corporates. Ruble weakness and further equity selling look assured.

The one structural negative is, unlike other emerging economies that have faced a crisis in the past 30 years, Russia doesn't have a white knight in the event of an economic upheaval. Putting any potential Chinese assistance to one side, The International Monetary Fund is off the agenda in the event of a full-blown economic crisis. To be clear, this is an incredibly low probability event, but given we are looking into the scenarios; you need to keep this in mind.

The Saudis to the rescue

The relationship between President Biden and the Saudis has been contentious. That said, the Saudis are well aware of the potential demand destruction that comes with triple-digit oil. Global energy markets have been orderly over the last 18 months, driven by the supply discipline of the Russian Saudi accord. While no conversation has been had publicly about a formal disintegration of this agreement, Mr. Putin's atrocities in Ukraine put this supply collaboration in doubt. As I have alluded to throughout this article, I believe that the only way to hurt the Kremlin economically is to reduce the Russian trade surplus by limiting commodity sales. To take such a measure would require that OPEC replace that lost Russian output immediately. While it is natural to be skeptical about the ability of Saudi to produce these lost barrels of oil, the perception will be that they can achieve this goal, and price movements will be based on this perception, not any anticipated reality.

The economic consequences of lower energy prices are relatively straightforward. Any move back towards $80 a barrel should end the debate on whether inflation is peaking for the cycle. The market scenarios I outlined above, such as a rotation back into growth equity and risk parity, should play out.

The link between oil and inflation is clear. A 20% reduction in the price of oil changes the rate dynamic

Conclusion

When assessing the unprecedented, there are limits to how convicted you can be. The scenario I have outlined relies on the Saudis embracing the notion that spiking oil prices are detrimental to the global economy over the medium term. This has been their mindset in the past, but even the world's largest producer of hydrocarbons does not have complete control over the price of oil. We cannot discount an unruly spike in oil prices due to a Russian cyberattack on the United States or any deterioration in the ugliest geopolitical situation the world has witnessed since

9/11. A complete ban of all Russian institutions from the SWIFT system would see oil prices spike as oil and gas settlements would be limited to countries like China who prefer to operate outside of USD settlement norms.

I have been reluctant to take risk before we had clarity over Mr. Putin's actions. We do have much more than we did a week ago, and while the worst fears of many have come to fruition, we now have a starting point on managing risk in the weeks and months ahead. We still face extraordinary uncertainty, but we can develop a framework.

As with prior financial crises, the response by governments and central banks has been decisive in efforts to prevent economic shocks globally. While central banks adjust policy marginally as the path towards the removal of COVID accommodations is entrenched, efforts to ensure smooth oil and gas supplies will receive the most urgent attention. While Europe's gas supplies could see disruption, it will be efforts in global oil markets that will warrant the most attention. I believe that the Saudis and other OPEC members will support EU and US efforts to ensure that the global economy isn't derailed because of a Russian oil shock. The result will be lower oil prices in the weeks and months ahead once we receive confirmation that OPEC is onboard.

Lower oil prices will lead to lower bond yields. Owning duration into a peak inflation environment and geopolitical concerns is a must in an environment where investors remain very short duration.

Upon the release of this report, the tactical model portfolio will take a $200,000 per bp position long US 10 Years.

As for equities, I intend to add to exposure in NASDAQ, Brazil Equities down 5%, 7.5%, and 10% from Friday's close. I will cover the short EEM hedge initiated last week -5% from Friday's close. I expect these could be filled this week.

Also, look to short a tiny position in oil above $100 WTI

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