EQUITY STRATEGY INSIGHTS

Investment Implications of War in Ukraine

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EXECUTIVE SUMMARY

- High oil prices from increasing demand and tight supply help support energy stocks in the near term, but there is a lot of uncertainty beyond the very short term.

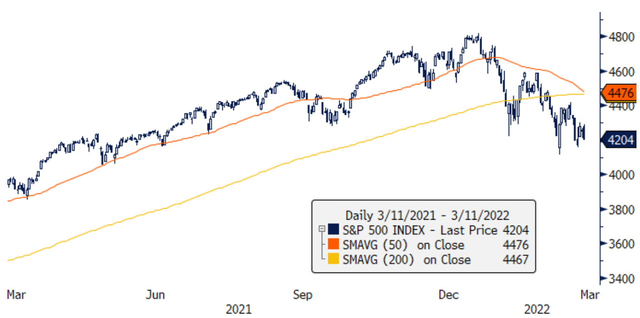
- Selective exposure within the materials sector could benefit from rising prices in agricultural products and metals.

- We currently favor a tilt towards U.S. stocks over international and emerging market equities.

Stocks were already off to a bumpy start to 2022, with the S&P 500 Index down 10% year-to-date on the day Russia invaded Ukraine (2/24/22). While some of the weakness before the invasion reflected anticipation of Russian aggression, as troops moved toward the Ukraine border and drove oil prices higher, stocks had already taken cues from the expected increase in inflation and implications for the Federal Reserve (Fed).

Since then, the broad index is little changed, suggesting that military conflict and higher inflation may have already been priced in—and that markets generally do not expect direct NATO involvement (other than supplying weapons and not jets). The year-to-date decline for the index, now about 12% as shown in [Figure 1], certainly could have been worse if not for the market's pulling back of Fed rate hike expectations for 2022.

1 S&P 500 Index Has Entered Correction Territory



Source: LPL Research, Bloomberg, data as of 03/11/2022
All indexes are unmanaged and cannot be invested in directly.
Past performance does is no guarantee of future results.

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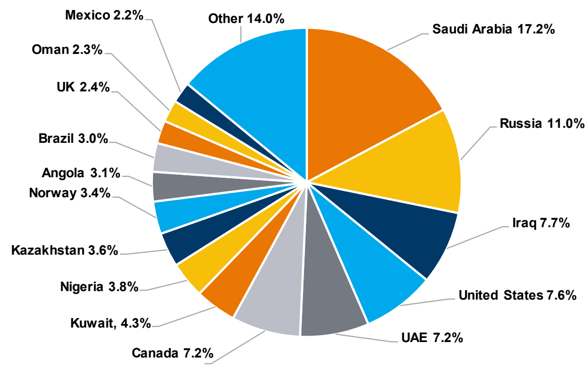
Assessing where stocks may go from here and what areas of the market might be best positioned requires some speculation as to potential outcomes of the devastating developments in Europe. Here we try—still with so much uncertainty—to highlight some investment implications as a result of the Russia-Ukraine war. We pray for Ukraine and its resilient people.

Energy is an Obvious Place to Start

The obvious place to start when thinking about investment implications of the war in Ukraine is with oil and gas. Roughly one-third of European natural gas consumption and more than one-quarter of its crude exports are derived from Russia. Also, Russian oil production accounts for 12-13% of the global oil trade and is consistently in the top five producers globally, making this a potential disruption that can't be ignored. [Figure 2].

The odds that Europe cuts off Russian oil imports may be remote, but the mere possibility makes the energy sector an interesting hedge against the intensifying geopolitical threat.

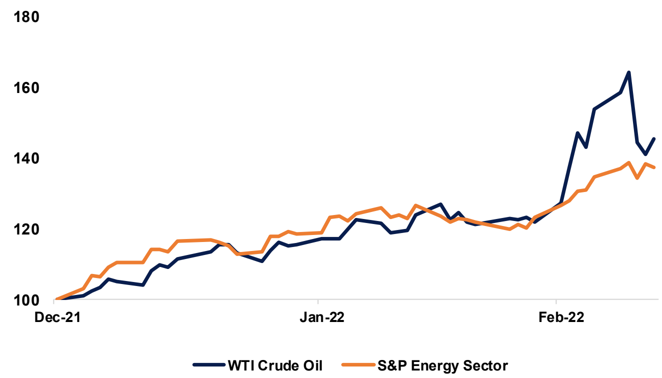
2 Global Crude Oil Exports By Country



Source: LPL Research, theworldstopexports.com 3/08/22
2020 data.

Oil prices spiked 33% from the Russian invasion through March 8, before pulling back about 12% to end last week at $109 [Figure 3]. Despite the pullback, the energy sector is still enjoying a very strong year on the back of those higher oil prices—the sector has returned over 38% year to date. The latest catalyst for gains came after the U.S. and United Kingdom moved to cut off Russian oil imports, while the risk that Europe sharply curtails its purchases of Russian oil has likely provided support for prices as well.

3 Surging Oil Prices Have Boosted Energy Stocks



Source: LPL Research, Bloomberg data as of 03/11/2022
future results.

The odds that Europe cuts off Russian oil imports may be remote, but the mere possibility makes the energy sector an interesting hedge against the intensifying geopolitical threat. The European Union's announcement on March 8 that it plans to cut its Russian natural gas imports by two-thirds, if executed, would be a strong step by Europe to starve Russia of energy money, even as Putin threatened to cut off natural gas supplies to Europe—likely an empty threat.

In terms of our latest thinking on the sector, prior to the Russian invasion we had maintained a positive bias toward energy as its stocks and underlying commodities broke out from a technical analysis perspective. With inflation spiking to 40-year highs, the economic reopening progressing, and rising interest rates, the environment had appeared ripe for a cyclical value rotation.

High oil prices from solid reopening-driven demand and tight supply, along with producers' improved capital discipline should help support energy stocks in the near term. But there is a lot of uncertainty beyond the very short term. We don't know how much Russian energy will be taken off the market and for how long. We don't know how much of the gap the U.S. and OPEC can fill and how quickly. These are big questions for an overbought oil commodity from a technical perspective with very optimistic sentiment based on the lack of short interest in crude oil futures and the oil futures crowd sentiment polling by Ned Davis Research. And that doesn't even consider the push towards greener energy sources and electric vehicles in the U.S. and Europe, which is getting stronger and expected to slow fossil fuel demand in coming years.

Bottom line, there is still a big geopolitical risk premium built into the price of crude right now (probably more than $20) that could come out quickly. And from a technical perspective the sector looks significantly stretched and poised for a pullback. However, as a short-term hedge against further escalation in the conflict, a slight overweight allocation seems reasonable—the sector makes up only about 4% of the S&P 500.

Materials Make Sense but be Selective

The materials sector seems like an obvious beneficiary of the war, with significant metals and grain exports coming out of Russia and Ukraine. But the impact on the sector is more of a mixed bag which is generally why performance has been nowhere near as strong as it has been for the energy sector [Figure 4]. Materials stocks have significantly lagged the Bloomberg Commodity Index, even excluding energy.

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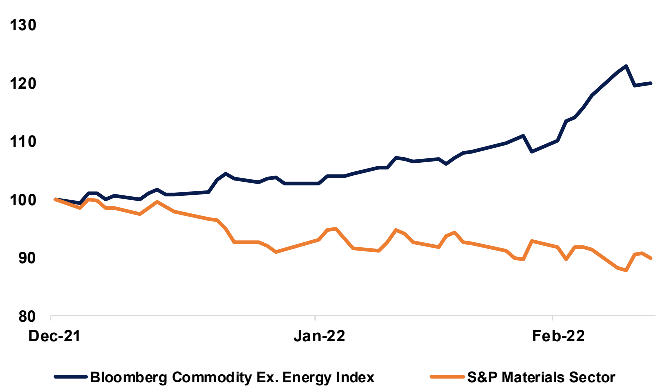
4 Materials Stocks Have Not Kept Up With Commodities Prices



Source: LPL Research, Bloomberg 03/11/2022
Data indexed to 100 as of 12/31/2021. Indexes are unmanaged and cannot be invested in directly.

Higher prices for metals such as copper and agriculture, particularly grains, do tend to buoy the materials sector. Increased demand from the U.S. and China as both economies reopen (at varying speeds), in addition to investments in infrastructure by both countries, should provide some attractive intermediate to long-term tailwinds for the sector. In the short-term, given Russia and Ukraine are leading grain exporters (both for wheat, Ukraine for corn), materials should get a boost from fertilizer stocks tied to agriculture prices (as should agricultural equipment stocks, part of the industrials sector).

Conversely though, what helps energy can be a headwind for materials because the largest sub-industry within materials is chemicals, composing about 64% of the S&P 500 Materials sector benchmark. While the chemicals industry would have been expected to benefit from stronger demand amid the reopening, profit margins will likely be squeezed by higher natural gas prices, a primary input into chemicals manufacturing.

Also, a stronger dollar presents a headwind for materials (much are purchased globally and sold in U.S. dollars). The dollar has remained stubbornly strong due to war-driven safe haven flows coming over from international markets in addition to prospects for further increases in interest rates. So we would favor pure-play metals and mining exposure, or pure agriculture/agriculture equipment exposure, rather than broad U.S. materials sector exposure that is dominated by chemicals. The technical analysis picture for the gold commodity looks particularly promising. The domestic sector has minimal gold exposure, and most of the best metals resources are outside the U.S., so global commodities strategies are preferred to domestic.

Strengthening Regional Preference for United States

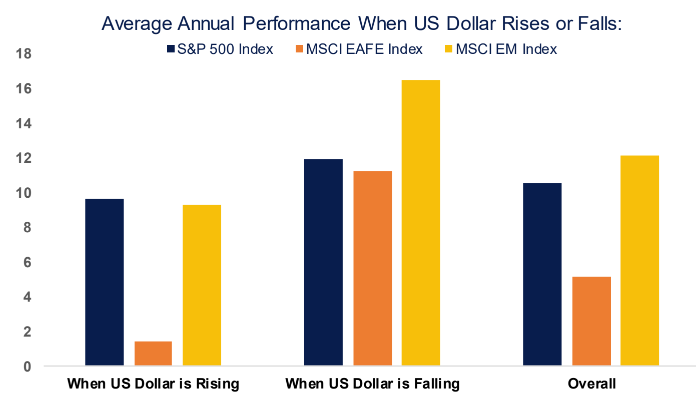
Given the current market environment, it seems prudent to be cautious with developed international equity markets and emphasize the United States even more.

From a pure economic perspective Russia is the biggest loser in the conflict as the West's devastating sanctions are likely driving the Russian economy into a depression. Western Europe is the next biggest loser economically, with its heavy reliance on Russian oil and gas. As a result, it seems prudent to be cautious with developed international equity markets presently, as we communicated in our recently-released *Global Portfolio Strategy* report, and emphasize the United States even more. Germany appears particularly vulnerable, as Russia is the source of 30% of crude oil supplies and more than 50% of its natural gas, and appears to be on the cusp of recession. The strong U.S. dollar adds a particularly big headwind for international equities, greatly reducing the chances they are able to keep up with U.S. stocks. The historical underperformance of international stocks in strong dollar environments is striking [Figure 5].

Don't Run From Emerging Markets but Recognize Additional Risk

We had been warming up to EM as China began to inject monetary stimulus into its economy and contemplated relaxing COVID-19 restrictions, but then Russia invaded Ukraine and the calculus changed some. The commodity exporters like Brazil and South Africa are getting a lift, but tightening global financial conditions related to the war and impending Fed rate hikes create a tricky environment for EM equities. Additionally, MSCI is removing Russia from its emerging markets (EM) indexes, though the market already did most of the work, making emerging markets a bit more Ukraine resistant.

5 International Stocks Facing Significant US Dollar Headwind



Source: LPL Research, Strategas 03/11/2022
US Dollar represented by DXY Index.
Equity indexes represent US (S&P 500), Developed International (MSCI EAFE), and Emerging Markets (MSCI EM)
All indexes are unmanaged and cannot be invested in directly. Past performance does is no guarantee of future results.

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The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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