SPECIAL REPORT

COLLATERAL DAMAGE

by **Robert F. DeLucia, CFA**
Consulting Economist

Financial markets have entered a decisive risk-off phase, which will persist until the war winds down and energy markets begin to stabilize. Government bonds, energy assets, commodities, real estate, high-quality large-capitalization growth stocks, and the US dollar will continue to attract investment flows. Asset classes at greatest risk include speculative-grade bonds, economically sensitive stocks, small-capitalization stocks, European equities, the euro, and emerging market stocks and bonds.

The Russian invasion of Ukraine is a game-changer for world financial markets. It is becoming increasingly apparent that the world economy and world financial markets have become collateral damage as the war intensifies. The decision by President Biden to place an embargo on Russian oil exports — a positive long-term strategic initiative — could greatly increase economic risks in the short term.

A state of strategic gridlock is emerging as a result of Russia's determination to prevail in Ukraine and the determination of the Ukrainian people to resist and maintain their sovereignty. *The implication is that this stalemate will persist for longer than previously expected, thereby inflicting pain on world financial markets and the global economy, each of which have taken a back seat to US long-term strategic objectives*.

- Investors should expect a protracted military conflict that will not end until Russia achieves its goal of establishing political control over Ukraine. Vladimir Putin is determined to pull Ukraine away from NATO and the West and to establish a buffer between Russia and NATO forces.

- At the same time, Ukraine is unlikely to surrender anytime soon. Increased shipments of weapons from NATO members to Ukraine will bolster Ukrainian defense efforts but will also prolong the war, with negative implications for energy and commodity prices and consumer inflation.

- The combination of fierce resistance by Ukraine and an uncoordinated Russian military effort point to the likelihood of an extended conflict. The Russian military has performed ineffectively, in sharp contrast with the valiant efforts of the Ukrainian military and emboldened citizens.

- However, with additional more troops and more intense air strikes on major cities, the Russian onslaught is likely to ultimately prevail. Although its control over eastern Ukraine will be fragile and indecisive, it seems likely that Russia will eventually install a puppet government in Kyiv.

- An end to the military conflict does not mean the end of hostilities. It is highly unlikely that the Russian army can gain control of all of Ukraine, a country of 44 million people. The Russian military will continue to terrorize Ukraine, but its citizens will continue to demonstrate brave resistance.

- Relations between Russia and the West will continue to deteriorate, which means that a renewal of the Cold War is inevitable. Neither Russia nor the West will have an incentive to disturb the fragile status quo that will emerge from the end of the formal military confrontation, thereby implying continued geopolitical instability.

- The economic consequences of the conflict depend upon the duration of the war and the direction of energy prices. The impact will also vary by geographic region. Because of their close commercial ties with Russia and heavy dependence upon Russian oil and natural gas, European economies could weaken significantly, and an outright recession is a probable.

- World economic growth will be slower than previously expected, and world trade will weaken. Whatever path its leaders decide to follow with respect to future relations with Russia, China will be a big economic loser in the long term. The lasting damage to globalization and world trade that appears inevitable will exact a massive economic toll on China.

- *The outlook for financial markets depends upon the likelihood of a US recession within the next 12 months*. An increasing number of economists and market strategists are warning that the probability of an outright recession is uncomfortably high and rising.

- The issue of recession is crucial with respect to financial markets. There have been 33 stock market declines since 1950 that exceeded 10%, and only seven occurred during recessions with an average stock price decline of **35%**. For the 26 market drawdowns that did not precede recessions, the average decline was only **16%** and in only one case (1987) did stocks fall by more than 20%.

- Analysts point to five classic indicators that have successfully predicted recessions in the past: (1) Surging world oil prices; (2) A flat or inverted yield curve; (3) Rising credit spreads in the corporate bond market; (4) Plunging consumer confidence; and (5) A sustained spike in the US dollar.

- The US economy will be adversely impacted by the crisis, but to a much lesser extent compared with other major economies. There are several factors that could protect the US economy from a recession:

1. The US is a closed economy with a low level of exports and a heavy dependence upon domestic demand.

2. The US is primarily a service economy, which should benefit from improving public health conditions and a resurgence in mobility and commercial activity as the COVID-19 pandemic winds down.

3. Far greater than any other country, the US has benefitted from massive fiscal and monetary stimulus over the past two years.

4. The US is the world's largest producer of crude oil and natural gas. The domestic economy will be negatively affected by surging energy prices but is not at risk to supply disruptions.

5. The US economy has the lowest ratio of energy consumption to GDP among the major economies of Europe and Asia. The US economy requires only 25% of energy input when compared to the energy crises of the 1970s.

6. The US financial sector is the healthiest in the world.

7. The US dollar is near an all-time high, which means that the domestic economy will continue to benefit from massive capital inflows worldwide.

8. The advanced state of digitization within the US will provide efficiencies and growth opportunities to a much greater extent than other countries.

<u>The bottom line is that despite rising economic challenges, an outright recession is unlikely any time soon</u>.

- Nonetheless, the outlook for the US economy has deteriorated since the Russian invasion. Growth in output and spending in 2022 will be slower than previously expected, and inflation will be higher. Company earnings will remain in an uptrend but narrowing profit margins could lead to negative earnings surprises.

- The US embargo on Russian oil means that world oil prices could remain elevated, culminating in higher consumer inflation, higher business input costs, and some reduction in aggregate spending. Higher prices for agricultural and industrial commodities will also have adverse economic effects. However, supplies of all commodities will eventually improve, leading to lower inflation during the second half of this year and during all of 2023.

- The outlook for financial markets is fraught with uncertainty. Markets have entered a decisive risk-off phase, which will persist until the war winds down and energy markets begin to stabilize. Government bonds, energy assets, commodities, real estate, high-quality large-capitalization growth stocks, and the US dollar will continue to attract investment flows.

- Risk assets will remain vulnerable in coming weeks to unanticipated news from Ukraine and from volatile world energy markets. Asset classes at greatest risk include speculative-grade corporate bonds, economically sensitive stocks, small-capitalization stocks, European equities, the euro, and emerging market stocks and bonds.

- Long-term investors should be patient and await periodic opportunities to purchase shares of high-quality companies at depressed market prices. US equity market valuations are the most attractive in several years, but further market weakness appears likely in coming weeks. Equity markets will remain volatile for much of this year but could form a cyclical bottom within the next several months. I continue to expect positive total returns from domestic equities for all of 2022, led by economically sensitive stock groups.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

This material is intended to provide information only. This material is not intended as advice or recommendation about investing or managing your retirement savings. By sharing this information, Prudential Retirement® is not acting as your fiduciary as defined by the Department of Labor or otherwise. If you need investment advice, please consult with a qualified professional.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Certain information contained herein may constitute "forward-looking statements," (including observations about markets and industry and regulatory trends as of the original date of this document). Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making any decisions. No representation or warranty is made as to future performance or such forward-looking statements.

The financial indices referenced herein are provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

Bloomberg US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

NYSE FANG+ Index: is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded stocks of technology and tech-enabled companies.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

The Value Line Geometric Composite Index: is the original index released, and launched on June 30, 1961. It is an equally weighted index using a geometric average. Because it is based on a geometric average the daily change is closest to the median stock price change.

These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. Past performance is not a guarantee or reliable indicator of future results.

The information provided is not intended to provide investment advice and should not be construed as an investment recommendation by Prudential Financial or any of its subsidiaries.