



SPECIAL REPORT

FIVE MILITARY SCENARIOS AND WORLD FINANCIAL MARKETS

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The Russian invasion of Ukraine is a seismic event that marks the end of an age and the triumph of politics and geopolitics over economics. In this new world, common stocks would significantly outperform bonds, although equity returns would likely be modest because of increased uncertainty surrounding both company profit margins and valuations. A combination of heightened geopolitical risk and higher interest rates and inflation would exert downward pressure on price-to-earnings (P/E) ratios in the indefinite future.

The deplorable atrocities within Ukraine continue without respite, bringing unmitigated tragedy and horror for the people of Ukraine. Despite widespread Russian brutality, Ukrainians continue to exhibit incredible bravery, valor, and resilience. Unfolding military and diplomatic developments will continue to undermine confidence and will determine the direction of global financial markets in the short term. This *Special Report* explores five military and diplomatic scenarios pertaining to the conflict and analyzes potential investment implications.

- Because the impact on the US economy is likely to be modest and temporary, financial markets will be primarily affected by psychology. Stated differently, Wall Street earnings estimates for companies in the S&P 500 have not changed; the 13% decline in equity prices since early January can be explained by a deterioration in valuations.
- The price-to-earnings (P/E) ratio for the S&P 500 has declined from 22 to 19, and further shrinkage in valuations is probable. The principal link between the Russian invasion and the economy is through energy and commodity prices and the potential for higher inflation. However, these effects are likely to be temporary, and are unlikely to inflict **permanent** damage on the US economy.

Five Potential Scenarios: There are numerous potential scenarios regarding the endgame, but there are five that appear to be the most plausible. Two of these five scenarios are moderately bullish for risk assets, one is wildly bullish for common stocks, and one is extremely negative for financial markets.

1. **Partial Russian Victory:** The most likely scenario would be a partial Russian victory in Ukraine whereby the country is partitioned into two halves, with Russia gaining political control over the eastern half of country. Putin would achieve his primary objective of establishing a buffer zone between Russia and Poland and installation of a pro-Moscow ruler in Kyiv.

Russian forces would also gain control of the southern city of Odessa, the largest port on the Black Sea. This scenario envisions the Ukrainian government retreating to the west and establishing a rump state in Lviv, close to the border with Poland. A Ukrainian insurgency in the eastern region of the country would persist, as would Western sanctions on Russia.

- Despite the negative long-term geopolitical consequences, this scenario would be favorable for financial markets. The decline in equity markets would end, and stocks would rally into yearend. With the Federal Reserve in a sustained tightening mode, long-term interest rates would resume their cyclical uptrend, resulting in further declines in bond prices.
 - Energy and commodity prices and the US dollar would peak and drift lower into yearend. Economically sensitive stocks and small-company stocks would outperform large-cap growth stocks. The probability of this scenario is 35%.
2. **Comprehensive Russian Victory:** This is the second most likely scenario, whereby Russia achieves military and political control of all of Ukraine and replaces President Zelensky with a pro-Moscow puppet government in Kyiv. This development would be accompanied by a NATO-backed Ukrainian government in exile outside the country and a prolonged insurgency inside Ukraine. Although the Ukrainian resistance has been impressive, the Russians have an overwhelming military advantage, and Putin is determined to achieve his goal of establishing a buffer zone between Russia in the east and NATO countries in the west.
- This scenario is similar to but less likely than scenario number one because of the practical and logistical challenges facing Russia in gaining control over Ukraine.* According to military experts, Russia would need to deploy several hundred thousand troops to gain full control of Ukraine, a country of more than 40 million people with a geographic area 75% larger than Germany. An end to the “hot” war means that a new Cold War would return that could persist indefinitely.
- The investment implications associated with this outcome are similar to those of the first scenario. In each case, an end to the military conflict and return of a new political status quo should alleviate business and investor anxiety and trigger a rally in stock prices. Interest rates would increase at a more rapid pace, causing bond prices to fall, while energy and commodity markets would also weaken. The probability of this scenario is 25%.
3. **Escalation of War:** The most damaging scenario for financial markets would be an escalation in the war, in various respects. An expansion of the war beyond the borders of Ukraine would be a shock to financial markets. Also alarming would be Russian use of chemical or nuclear weapons as a pretext for ending the stalemate and bringing the war to a close. It is impossible to predict the exact response of the US and NATO, but it seems plausible to assume that hostilities would intensify to a much greater magnitude.

Unlike all other scenarios, an escalation of the war beyond the borders of Ukraine could have a more severe and sustained impact on the US and global economies. US economic growth would slow markedly, Europe would fall into recession, and the Russian economy would suffer an even more crippling recession or outright depression.

- An escalation of the war would trigger an immediate and decisive sell-off in risk assets and a massive flight into safe-haven assets. The equity market correction would almost certainly accelerate to the downside, led by small-cap and economically sensitive stocks. Government bonds would rally, causing market interest rates to decline and energy and commodity prices to rise. The probability of this scenario is 20%.
4. **Negotiated Settlement:** A negotiated settlement would result from perceptions on both sides that the war was evolving into a stalemate, with mounting losses suffered by both Russia and Ukraine. This condition could prompt Russia to cut its losses and agree to a cease-fire. In reality, the more likely outcome would be resistance to a cease-fire until Putin has achieved his objectives of a puppet ruler in Kyiv and Russian control of eastern and southern territory in Ukraine.
- Although unlikely, a negotiated settlement would be favorable for risk assets. Global equities would perform best, while government bonds would suffer severe losses. European, small-cap, and economically sensitive stocks would become equity market leaders, while energy and commodity prices could fall precipitously. The probability of this scenario is only 10%.
5. **Putin Overthrown:** The most favorable scenario for financial markets would be an overthrow of the Putin government. This outcome could result from a military stalemate similar to scenario four, but in this case President Putin is toppled, either by Kremlin elites, the Russian military, by officials in the Federal Security Service (FSB) — the successor to the KGB — or by the Russian people.
- Also unlikely, this scenario would trigger a massive rally in risk assets, led by global equities. European, small-cap, and economically sensitive stocks would perform best, while government bonds could suffer huge losses. Energy and commodity prices could fall precipitously, depending upon the nature of the new government structure in Russia. The probability of this scenario is only 10%.

Long-Term Implications: The Russian invasion of Ukraine is a seismic event that marks the end of an age. According to Fareed Zakaria, it marks the triumph of politics and geopolitics over economics. National security — along with security and resiliency of supply chains — will become more important than efficiency and productivity. Defense spending and energy security will also become a high priority. Inflation and higher interest rates will likely become permanent fixtures in the global economy.

In this new world, common stocks would significantly outperform bonds, although equity returns would likely be modest because of increased uncertainty surrounding both company profit margins and valuations. A combination of heightened geopolitical risk and higher interest rates and inflation would exert downward pressure on equity P/E ratios in the indefinite future. Industries and product markets would likely continue to consolidate, suggesting that equity portfolio holdings should be focused in the shares of companies that dominate their industries and generate free cash flow.



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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.

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