NORTHERN TRUST
ASSET MANAGEMENT

INVESTMENT STRATEGY COMMENTARY

GEOPOLITICS
IS RUSSIA-UKRAINE ANY DIFFERENT?

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Geopolitical events often follow a standard blueprint. The event consumes the headlines. Investors show some panic, causing a period of market volatility. And, finally — so long as fundamentals are not broadly impacted — financial markets go back to what they were focusing on prior to the fire alarm. Currently, that's inflation and the central bank reaction function. Our monthly *Perspective* Newsletter details broader asset allocation (no changes were made this month); while this short note provides specific thoughts on Russia-Ukraine.

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Exhibit 1 shows a number of geopolitical events over the years and how financial markets responded — both in terms of the length and size of the drawdown as well as the period of time it took to regain previous levels. On average the markets lose around 4% and make up those losses in just over a month. The current geopolitical event is occuring at the time of another pressing question for the markets — the timing and scope of Federal Reserve tightening. As such, it's a bit difficult to disentangle the two — but, overall (driven by both), we've seen global (U.S.) equity markets fall by 8.6% (10.5%) at their lowest (January 27) only to rebound by 5.7% (6.6%) — and are currently down 5.2% (7.6%) year-to-date. We view this market weakness as an opportunity — with the global growth story supporting an overweight to risk, specifically in developed equities, high yield and natural resources — even in the face of current uncertainty (though, the markets are never "certain").

EXHIBIT 1: GEOPOLITICAL EVENTS

Historically, geopolitics do not impact financial markets for long unless the market outlook fundamentally changes.

The Events	Year	During the initial market reaction it declined for	And lost	Market returned to pre-crisis level in
Hunt Brothers Silver Crisis	1980	43 days	-16%	152 days
Asian Currency Crisis	1997	6 days	-11%	45 days
President Eisenhower - heart attack	1955	18 days	-10%	76 days
Sputnik I	1957	19 days	-10%	215 days
Iraq invades Iran - war	1980	7 days	-5%	52 days
Chernobyl -- Nuclear Accident	1986	4 days	-4%	29 days
Japan earthquake and tsunami	2011	5 days	-4%	12 days
Bay of Pigs	1961	7 days	-4%	29 days
Grenada Invasion	1983	13 days	-3%	20 days
John F. Kennedy assassinated	1963	1 day	-3%	5 days
Iran Hostage Crisis	1979	5 days	-3%	10 days
Watergate	1972	8 days	-3%	44 days
Iraq attacks USS STARK	1987	5 days	-3%	11 days
President Reagan -- shot	1981	6 days	-2%	19 days
U.S. embassies in Africa -- bombed	1998	7 days	-2%	11 days
U.S. invades Panama	1989	5 days	-2%	14 days
The Cuban Missile Crisis	1962	1 days	-2%	2 days
Three Mile Island -- Nuclear Accident	1979	6 days	-2%	9 days
Suez Canal -- Crisis	1956	2 days	-2%	3 days
Saigon Falls	1975	4 days	-1%	5 days
World Trade Center -- bombed	1993	3 days	-1%	4 days
Average (of 21 post 1940 bull market crises)		8 days	-4%	37 days

Source: Northern Trust Asset Management, Crandall, Pierce & Co.

WHAT COULD HAPPEN WITH RUSSIA-UKRAINE? THREE POTENTIAL SCENARIOS

Outlining scenarios and assigning probabilities is always a useful tool with uncertain events such as geopolitical tensions and risks. Below we outline the three most likely scenarios, our best guess at each scenario's likelihood and the impacts on the fundamental inputs of growth and inflation.

Full Invasion: *Russia invades with the intention to take full control of Ukraine (10% probability).*

- Growth Impact: Negative for emerging and developed Europe. Trade would be negatively impacted and, depending on the sanctions regime that gets implemented, European financial institutions run the risk of capital impairments on Russian and Ukrainian assets. Higher energy prices would also hurt economic growth, and uncertainty over energy supplies would be a headwind, too (double whammy).
- Inflation Impact: Energy prices move higher and second-round effects likely kick in.

Partial Invasion: *Russia consolidates its de-facto control of the Donbass region and perhaps some other parts but does not attempt to take full control of the country. In doing so, it sends a signal to the Western World how seriously it takes its security (40% probability).*

- Growth Impact: Negative but muted, and not a game changer for developed Europe depending on the sanctions regime.
- Inflation Impact: Short-term negative but could fade relatively quickly if the situation stabilizes and energy markets remain functioning.

No Invasion: *Russia retreats a large part of its troops (although it is likely Russia will also maintain a very meaningful presence for longer) but gets enough diplomatic concessions that it refrains from invasion (50% probability).*

- Growth Impact: Positive but muted and mostly due to lower energy prices.
- Inflation Impact: Positive through lower energy prices, which will shorten the time for headline inflation to return to target.

CONCLUSION: A PORTFOLIO DESIGNED TO ADDRESS RISKS

Investment portfolios are subject to market risks (short or longer-lived) all the time. And, as such, the first conclusion is an oft-repeated one: the portfolio's risk aversion should mirror that of its owner. This means having an allocation to risk-control assets (cash, investment grade fixed income and inflation-linked bonds) commensurate with the amount of protection the owner wishes to have against broad downturns in equity markets (and related risk assets such as high yield, real assets and alternatives). At their best, risk-control assets gain value during risk asset downturns; at their worst (at least in the century of data we have) risk-control assets at least provide downside protection. Having the right mix of risk-control and risk assets is always the first — and most important — decision to make. Beyond that, certain asset classes (even within risk assets) are in the portfolio to provide an answer for more acute risks that arise from time to time. We believe a strategic position (and tactical overweight where appropriate) to natural resources can help navigate the current environment given the likely impact a Russian invasion would have on oil and natural gas supplies, specifically into Europe.