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The Economic Impact of Ukraine War

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War is the most disruptive geo-political event. It interrupts economic activity, destroys the ability to return to productive activity, and most of all kills thousands or in some instances millions of people. The war in Ukraine is particularly ugly as the Russian military has proven itself to be much less capable than its reputation and consequently, they have resorted to targeting civilians and non-military targets. NATO (North Atlantic Treaty Organization) and its most powerful member the USA are limited in their ability to respond as Russia has an estimated 6,000 nuclear warheads. Therefore, the duration and the direction of this war has been quite difficult to determine.

There are three primary aspects of the economic impact that we will examine. The first is the impact on inflation and how it is being increased by the war. Second, is the inevitable worldwide increase in defense spending. Third, is the decline of globalization, which has both positive and negative aspects.

Prior to Russia's attack on Ukraine, the United States was already experiencing a severe inflationary effect from the Covid lockdowns, and the government spending intended to be a remedy. From December 2020 to December 2021, inflation was running at a seven percent rate which, as Bloomberg says:

"The consumer price index climbed 7% in 2021, the largest 12 month gain since June 1982, according to Labor Department data". Clearly the Ukraine war is not the cause of US inflation, but it certainly has exacerbated the prob-

lem. "US inflation will likely hit double digits this summer as the ripple effects of the Russian invasion of Ukraine lead to further financial pain for American households, according to famed economist Mohamed El-Erian."

The inflationary impact of the war is largely due to two factors: the sanctions placed on Russia by many countries around the world and the loss of exports and imports from Russia and Ukraine arising from warfare activities. Russia's oil and gas exports have been cut back because of other nations refusing to buy from them. Also, other minerals like nickel are major Russian exports that have been curtailed.

Additionally, wheat is another major item exported by both Russia and Ukraine, with each ex-



porting approximately 30 million and 20 million tons annually, respectively. Poorer countries may experience food shortages as a result of this war-caused grain cut-back. When considering the shortages of minerals, oil and gas and wheat on the world markets, the inevitable affect is rapidly rising prices, which is considered inflationary.

This war is a sobering wake-up call for many nations as to their needs to build up their national defense. As this Reuters report says:

BERLIN (Reuters, Maria Sheahan & Sarah Marsh) -Chancellor Olaf Scholz said on Sunday Germany would sharply increase its spending on defense to more than 2% of its economic output in one of a series of policy shifts prompted by Russia's invasion of Ukraine.

Germany and much of Europe will be increasing their defense spending. Also, I believe that many Asian nations like Taiwan and Japan will be doing the same thing because of their concerns about an aggressive China. In the US, the Administration may also be forced to increase defense outlays because of the weapons we have given to Ukraine will need to be replaced. Overall, worldwide defense spending will be increasing.

Globalization (the interdependence of companies having manufacturing done wherever it can be done at the lowest cost) will likely suffer a setback as a result of the war. From Forbes:

"Russia's invasion of Ukraine is an invasion of the global supply chain," according

to Jennifer Bisceglie, founder and CEO of Interos, a supply chain risk management company. "Continued pressure on global supply chains will exacerbate imbalances between supply and demand, causing increased inflation and potentially stagflation," she warned.

Globalization is positive because it can lead to the greatest efficiency and lowest cost. However, it also has a significantly negative aspect: such as Germany's dependence on Russian gas when trying to sanction Putin, the United State's dependence on China for various medications and masks when Covid erupted, or the growing need for rare earth minerals for electric vehicles – China controls 80% of the world's rare earth minerals resources. The decline of globalization is a mixed blessing, but its decline is essential for self-sufficiency and for national defense.

Clearly, this war is having profound effects on each of the three above-mentioned areas: inflation, global defense spending, and globalization. And because it is ongoing, we do not yet know how it will turn out.

OUTLOOK

Looking back at the first quarter of 2022, we experienced our first real correction since March of 2020. The market dropped over ten percent but rallied back in the second half of March to trim its losses. The tech heavy Nasdaq was hit harder, and the value-type stocks and funds fared better. The reason for this divergence is that generally growth-type stocks have a tougher time when interest rates are rising.

Looking forward is always challenging, but now it is particularly difficult because there are two major factors that have the ability to drastically change the outcome. The first, is the war and the factors that we have already discussed. Second, is the Fed and specifically how skillfully Powell and the other Fed governors are able to engineer what is called a "soft landing." If they raise rates too aggressively then they could put us into a recession, and if they are too timid then they could cause stagflation – defined as a period of considerable inflation with little or no economic growth and usually accompanied by relatively high unemployment. Hopefully, they can hit the "sweet spot" and give us a soft landing.

Since we do not have the proverbial "crystal ball," we are intending to pursue three different low-key strategies. First, we plan to continue our gradual investing into the inflation hedges. Second, we have established a small investment into an ETF that invests in defense sector stocks, which we may increase over time, because of the anticipated global military buildup. And third, we are considering another incremental shift from growth funds (growth funds are those that invest in companies that are growing rapidly and do not pay high dividends, like Amazon or Google) to value funds (these funds invest in companies that are steady performers and generally pay out good dividends like, Proctor & Gamble and Verizon). This decision is still pending. As always, if conditions change, then our approaches follow suit.

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