Вторжение (Invasion)

BMO Nesbitt Burns | February 2022

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U.S. Military Intelligence – sometimes seen as something of an oxymoron – had it right this time. The invasion of Ukraine by Russia is underway with missile strikes on “military targets.” First and foremost, our thoughts are with the Ukrainian people and the many Canadians of Ukrainian descent, as this great country enters another terrible ordeal. As always, our goal with this missive is to try to weigh the market implications of this action rather than make geopolitical predictions. For context, Russia produces about 10 million barrels of oil per day and supplies 40% of Europe’s natural gas needs (with much of that gas going through Ukraine currently). The ultimate impact on energy prices will depend greatly on the extent of further sanctions that will be imposed on Russia by Europe and the U.S.[1] Given North America’s low bilateral trade exposure with Russia and the Ukraine, we believe it is primarily through this prism that investors should consider the market ramifications of this military action.

Historically, exogenous shocks tend not to have a long lasting impact on the market, and the economic cycle is by far the most important driver of financial asset returns. We believe it is no different this time. The table below shows the market impact of different military conflicts, and the results are clear: a negative initial reaction with a subsequent recovery in the vast majority of cases. Going back to 1940, the median downdraft was 2%, followed by a gain of 8% in the next six months, and over 20% in the subsequent year. The Russian invasion of Georgia in 2008 is an exception (with very negative performance across that timeframe), but that was also in the context of the financial crisis.

Figure 1: Market Impact of Major Military Conflicts (Number of Days Listed are Market Days)

Event	Reaction Dates	Reaction Date %Gain/Loss	DJIA Percentage Gain Days after Reaction Dates			
			22	63	126	253
Germany invades France	05/09/1940 - 06/22/1940	-17.10	-0.50	8.40	7.00	-5.20
Pearl Harbor	12/06/1941 - 12/10/1941	-6.50	3.80	-2.90	-9.60	5.40
Korean War	06/23/1950 - 07/13/1950	-12.00	9.10	15.30	19.20	26.30
Cuban Missile Crisis	10/19/1962 - 10/27/1962	1.10	12.10	17.10	24.20	30.40
U.S.S.R. Invades Afghanistan	12/24/1979 - 01/03/1980	-2.20	6.70	-4.00	6.80	21.00
Falkland Islands War	04/01/1982 - 05/07/1982	4.30	-8.50	-9.80	20.80	41.80
U.S. Invades Grenada	10/24/1983 - 11/07/1983	-2.70	3.90	-2.80	-3.20	2.40
U.S. Bombs Libya	04/14/1986 - 04/21/1986	2.80	-4.30	-4.10	-1.00	25.90
Invasion of Panama	12/15/1989 - 12/20/1989	-1.90	-2.70	0.30	8.00	-2.20
Iraq Invades Kuwait	08/02/1990 - 08/23/1990	-13.30	0.10	2.30	16.30	22.40
Gulf War	01/16/1991 - 01/17/1991	4.60	11.80	14.30	15.00	24.50
War in Afghanistan	10/05/2001 - 10/09/2001	-0.70	5.90	11.50	12.40	-16.80
Iraq War	03/19/2003 - 05/01/2003	2.30	5.50	9.20	15.60	22.00
Russia Invades Georgia	08/08/2008 - 08/16/2008	-2.20	-4.00	-26.00	-34.20	-19.20
Israel Invades Gaza	12/27/2008 - 01/21/2009	-3.00	-13.50	-4.20	7.90	23.60
Russia/Crimea Conflict	02/20/2014 - 03/26/2014	1.03	0.95	2.59	4.49	11.86
	Mean	**-2.8**	**1.6**	**1.7**	**6.9**	**13.4**
	Median	**-2.1**	**2.4**	**1.3**	**8.0**	**21.5**
Notes						
The 22, 63, 126 and 253 day rate-of-change is calculated from the last day in the reaction dates column.						
The first date in the reaction dates column indicates the start of the market reaction or the trading day prior to the event.						

[1] Germany and the U.S. have already announced they would halt certification/impose sanctions on the Nord Stream 2 pipeline which is designed to double the gas flow capacity from Russia to Germany.

In other words, the bigger worries right now are the risk of more persistent inflation and the slowdown in economic momentum. The current macro circumstances only reinforce our view that the Canadian stock market – by virtue of its very high exposure to energy and basic materials – should continue to perform well in 2022. In fact, our work has shown that the S&P/TSX has historically been a solid inflation hedge for portfolios.

On that point, BMO Chief Economist Doug Porter recently wrote that an added wrinkle to the Canadian inflation outlook is that the loonie is staggeringly stable, even in the face of resurgent oil prices. The prior air-tight relationship between crude and the Canadian dollar used to act as an important safety cushion for consumers. Not this time. The loonie is now essentially unchanged since the start of the year, even as oil prices have vaulted almost $20/bbl. As a result, crude prices in C$ terms are now the highest on record, aside from the short-lived spike in mid-2008. While this is great news for Canadian energy-producing companies and provinces, Canadian consumers will feel the full weight of rising gas prices, further exacerbating the current inflationary impact. To whit, even excluding high-profile pump prices, Canadian inflation sprinted at a 30-year high of 4.3% in January – reinforcing the broad nature of this advance.

High inflation, combined with lower economic momentum may complicate central bankers' expected tightening exercise, but our economists are still expecting the Bank of Canada and the U.S. Federal Reserve to begin raising rates in March. The silver lining of the current political uncertainty is that it lowers the odds of a 50 basis point increase. In other words, financial conditions will remain relatively accomodative for the foreseeable future which limits the downside risk for housing and financial markets.

As discussed, markets tend to recover pretty quickly from these shock events. Encouragingly, we seem to have moved well past the Omicron peak, as both Canada and the U.S. move rapidly towards reopening and normalization. In this context, continued market volatility – driven by geopolitics – should present solid investment opportunities for long-term investors.

As always, we strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well diversified portfolio including cash, bonds and high-quality stocks. Please contact your BMO financial professonal if you would like to discuss your invesment portfolio.

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