INVESTMENT INSIGHTS

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RUSSIA–UKRAINE CONFLICT AND YOUR INVESTMENTS

The markets have turned volatile as investors digest the escalating Russia-Ukraine tensions. As uncertainty looms, there is no clear consensus on what is likely to follow. Winston Churchill once described Russia as "a riddle wrapped in a mystery inside an enigma." We remain humble about the unknown future as geopolitical tensions are inherently unpredictable. Instead, this issue of Investment Insights focuses on the potential impact these current tensions may have on your investments.

KEY POINTS

- The Russian-Ukraine tensions have a long history, and possible resolutions to the current crises remain uncertain.
- Over the long term, earnings are the primary driver of stock market returns.
- The fundamentals of U.S. corporations are strong, and the direct revenue exposure to U.S. companies from Russia and Ukraine is limited.

BACKGROUND

The Russian-Ukraine conflict has a long history and traces back to the dissolution of the Soviet Union between 1988 to 1991. Following the Cold War, 14 regions in Western Russia became independent countries. In a 2005 speech, Russian President Vladimir Putin called the fall of the Soviet Union the "greatest geopolitical catastrophe."[1] Among the 14 post-Soviet states, Ukraine is the most populated and is considered Russia's lost crown jewel.[2] Since gaining independence, Ukraine has experienced political turmoil. In the 2004 Ukrainian presidential election, Russian-supported candidate Viktor Yanukovych initially won the election. A series of protests against election fraud, known as the Orange Revolution, forced a recount. As a result, reformist candidate Viktor Yushchenko became the President instead. In 2010 Yanukovych made a comeback and won the election against reformist Yulia Tymoshenko.

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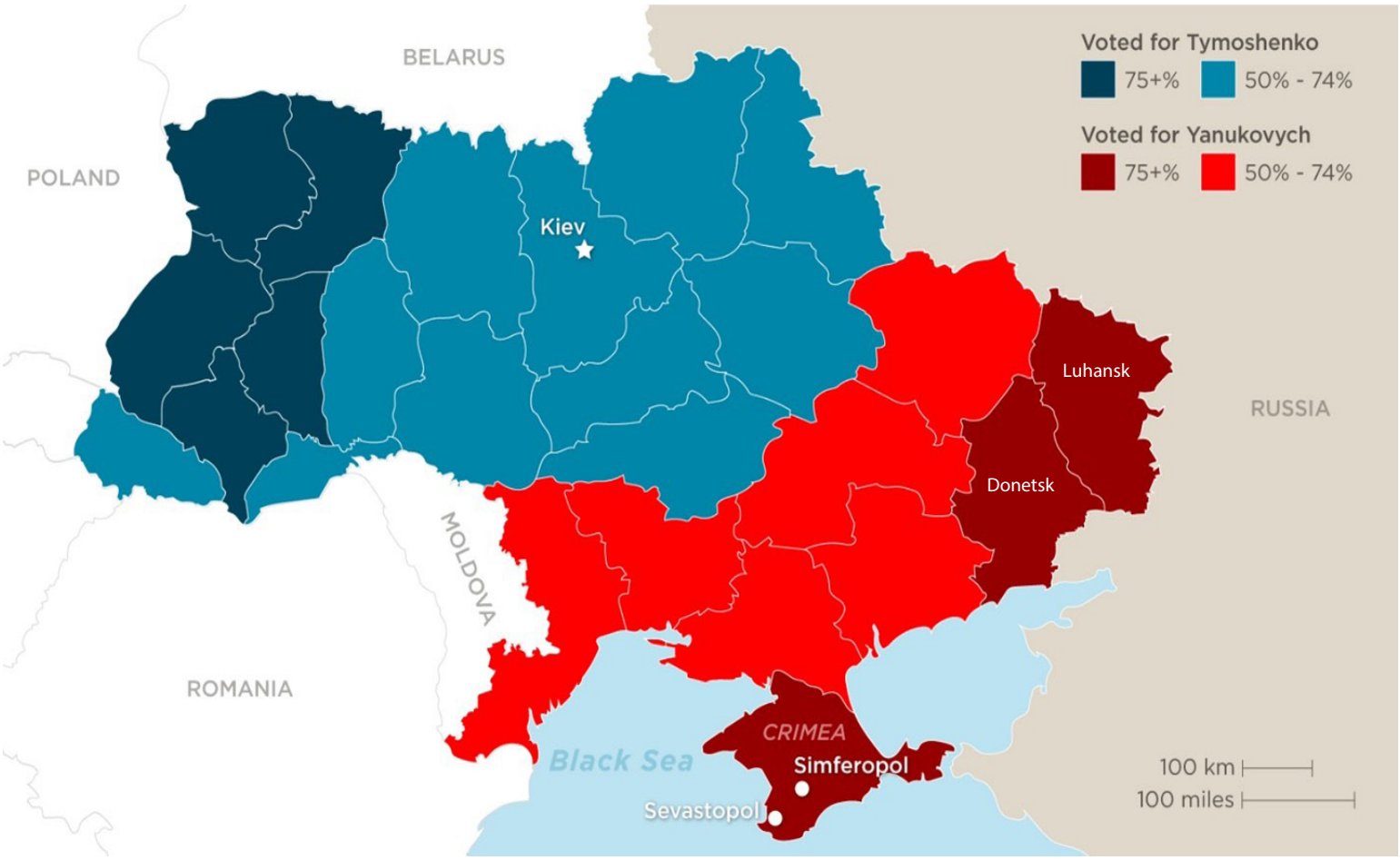
1 "Putin, before Vote, Says He'd Reverse Soviet Collapse If He Could: Agencies." Reuters, Thomson Reuters, 2 Mar. 2018.
2 "'The Crown Jewel That Was Lost': This Is Why Putin Wants Ukraine - CNN Video." CNN, Cable News Network, 18 Feb. 2022.

UKRAINE'S 2010 PRESIDENTIAL ELECTIONS



Source: "A Divided Ukraine." CNN.

In 2014 a series of violent protests known as the Revolution of Dignity occurred as a result of Yanukovych's refusal to sign a partnership with the European Union (E.U.). Ukraine's parliament relieved Yanukovych of duty, and an interim government was placed into power. Yanukovych fled the capital to Crimea and asked Russia for assistance. Putin convened a meeting to discuss the extraction of Yanukovych and decided that "we must start working on returning Crimea to Russia."[3] The Russian army subsequently annexed Crimea, and the Donetsk and Luhansk regions were determined autonomous by their citizens.

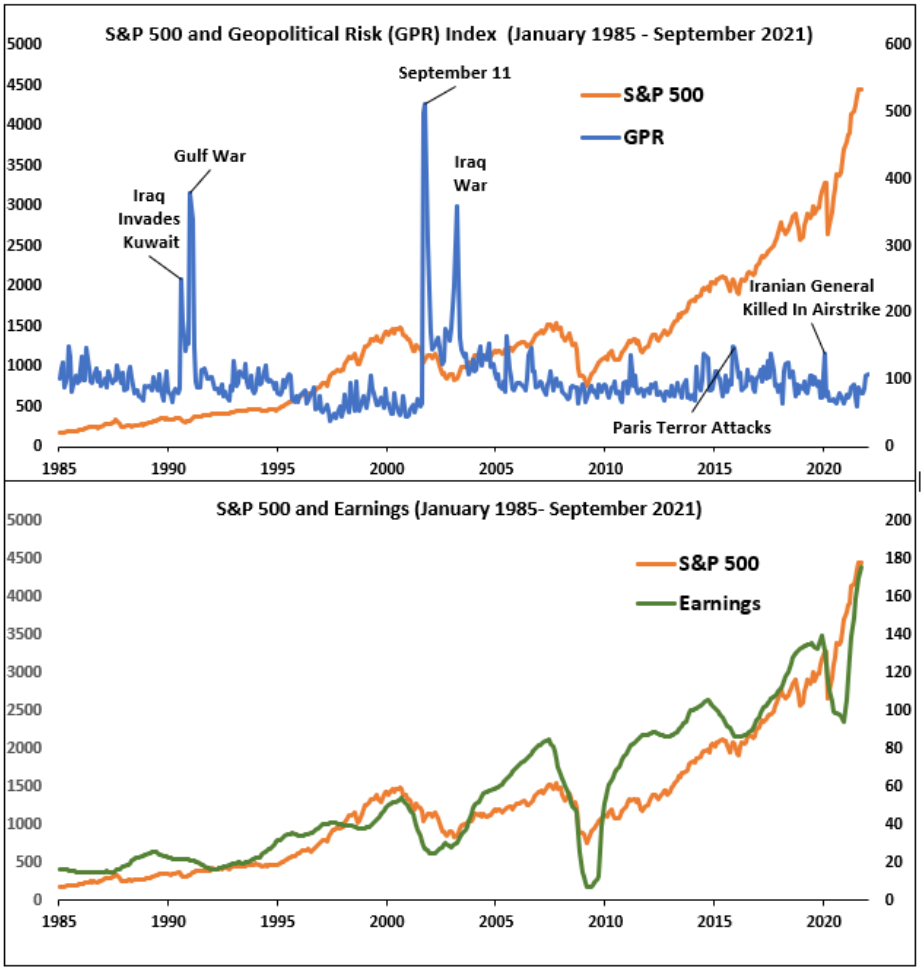
In November 2021, reports surfaced with satellite images showing the build-up of Russian troops on the Ukrainian border.[4] In December 2021, the Russian government demanded that NATO never accept Ukraine and other former Soviet republics.[5] The U.S. and NATO replied by reinforcing NATO's "open door" policy but suggested a "principled and pragmatic evaluation" for diplomacy in the future.[6] On February 21, Russia recognized the independence of the Donetsk and Luhansk regions, and Putin ordered the military into those regions for a "peacekeeping" mission.[7] Three days later, Russia launched a large-scale attack on Ukraine.[8] As of February 25, the situation in Ukraine continues to evolve, and the future of this crisis remains uncertain. Russia's goals may be to pressure Ukraine to seek peace, partition the country, or enact a pro-Russian government.

3 "Putin Describes Secret Operation to Seize Crimea." Yahoo! News, Yahoo!.
4 Brown, Jon. "Satellite Imagery Indicates Russian Military Activity on Ukraine Border." Fox News, FOX News Network, 6 Dec. 2021.
5 Martínez, A, and Charles Maynes. "Russia Demands Ukraine and Other Ex-Soviet Republics Be Barred from Joining Nato." NPR, NPR, 17 Dec. 2021.
6 Antonov, Dmitry, and Humeyra Pamuk. "U.S. Responds to Russia Security Demands as Ukraine Tensions Mount." Reuters, Thomson Reuters, 27 Jan. 2022.
7 "Putin Orders Troops into Eastern Ukraine on 'Peacekeeping Duties'." The Guardian, Guardian News and Media, 21 Feb. 2022.
8 Dave Clark and Thibaut Marchand for AFP. "Russia Invades Ukraine, Dozens Killed." The Moscow Times, 25 Feb. 2022.

GEOPOLITICS AND STOCK MARKET

The markets continue to experience volatility as they digest the developments in Ukraine. Markets are likely to remain volatile over the short term. Over the long term, the current crisis can significantly impact the Russian diplomatic relationship with Europe and the U.S.; however, not necessarily the markets broadly. While geopolitical tensions have impacted stock market returns in the past, they are not the main driver of returns.

Historically, corporate earnings have served as the key driver of the U.S. stock market. To illustrate this, take a look at historical data comparing S&P 500 vs. S&P 500 earnings and the Geopolitical Risk (GPR) Index below. GPR is a monthly index calculated by counting words related to geopolitical tensions in leading international newspapers. The graphs below show that fundamentals (earnings) primarily drive stock market returns.



Sources: Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, by Robert J. Shiller; and, Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, December 2019.

EARNINGS FORECAST

The current crisis has become a major geopolitical event and will likely cause more human suffering before it ends. While geopolitical tensions have some impact, the stock market is primarily driven by corporate earnings. Thus, let's closely examine the earning trends of U.S. companies.

The U.S. economy continues to grow along with corporate earnings. In the last quarter of 2021, the earnings per share (EPS) of the S&P 500 grew 30.9%; and 77% of companies beat their earnings estimates.[9] The top line also experienced strong growth of approximately 15.5%, with 78% of companies beating their revenue estimates.[10]

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Over the next three years, U.S. corporate earnings are expected to grow. Over the next 12 months, earnings are expected to grow by more than 20% and approximately 10% for the two years after.[11] The financial conditions of these companies are also expected to improve. Additionally, net debt per share is expected to reduce over the next three years.[12]

Measure	Actual	F12 Est	Growth	Y+1 Est	Growth	Y+2 Est	Growth
Earnings Per Share	183.19	221.32	20.82%	242.37	9.51%	267.7	10.45%

Source: Bloomberg

The direct impact on the revenue of the S&P 500 from the current crisis in Ukraine will likely be limited. In fact, according to FactSet, the combined revenue exposure of the S&P 500 to Russia and Ukraine is about 1%.[13] The indirect impact through supply chains and trade, however, remains uncertain. This is a possible reason why the markets have been volatile. The robust economic backdrop, however, suggests that as long as the conflict doesn't spill into other regions, the crisis' impact on markets will likely be limited in the long run.

STOCK MARKET RETURNS AFTER CORRECTION

As well as strong expected growth in earnings of U.S. companies, another reason to be optimistic is the historical returns following a market correction. As of the market close on February 22, the stock market had declined by approximately 10% from its all-time high. Over the past 42 years, the stock market returns following a 10% to 15% market decline were positive all but once in the following year.

Stocks Tend To Do Well After Corrections

S&P 500 Index Corrections Between 10% - 15% (1980 - Current)

Start Date	End Date	Correction Return	1 -Year Return After Lows
5/7/1982	8/12/1982	-14.3%	57.7%
10/10/1983	7/24/1984	-14.4%	30.3%
10/21/1987	10/26/1987	-11.9%	24.0%
11/2/1987	12/4/1987	-12.5%	21.4%
10/9/1989	1/30/1990	-10.2%	3.7%
10/7/1997	10/27/1997	-10.8%	21.5%
9/23/1998	10/8/1998	-10.0%	39.2%
7/16/1999	10/15/1999	-12.1%	10.2%
3/24/2000	4/14/2000	-11.2%	-12.1%
11/27/2002	3/11/2003	-14.7%	40.4%
5/21/2015	8/25/2015	-12.4%	16.5%
11/3/2015	2/11/2016	-13.3%	26.6%
1/26/2018	2/8/2018	-10.2%	5.0%
1/3/2022	2/22/2022*	-10.3%	TBD
	Average	-12.1%	21.9%
	Median	-12.1%	21.5%
	% **Higher**		92.3%

Data from "Stocks Move into a Correction." by LPL Financial Research. Source: LPL Research, Ned Davis Research, FactSet 02/22/2022. * The current correction may not be over yet. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

In addition to the stock market's history of being higher 92.3% of the time following a 10–15% market sell-off, the subsequent returns over the next year have also been strong. Of course, the future may not look anything like the past. It is also possible that the current market decline becomes larger than 15% down. Nevertheless, the historical perspective can be helpful, especially when no news seems positive.

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