Kalos Market Commentary

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Ukrainian Conflict Shouldn't Derail Markets

Russia's antics in the Ukraine continue to dominate headlines, which is no surprise given the potential geopolitical importance of ongoing conflicts. Still, the economic impact of tensions remain very uncertain. The annexation of Crimea and the potential civil war in the south and eastern Ukraine so far have had very little impact on the global economy. Economic sanctions to date, even recent ones, are more symbolic than biting. The bigger issue will likely center on Russia's reaction. Do they start playing nice – or at least nicer – or will they continue to escalate the crisis? Either way, global stocks could easily continue to perform well although a sharp increase in the conflict would likely rattle markets. Recent geopolitical events such as the Arab Spring and the civil war in Syria provide similar examples of national unrest that hardly impacted global stock markets.

Probably the largest global economic risk, especially for Europe, is the disruption of energy flowing from Russia. The region is just coming out of its debt crisis and recession, and the economy remains fragile. According to Energy Information Administration (EIA), Russia supplied 30% of Europe's natural gas in 2013 with 16% of the total passing through Ukraine's pipeline network.

While it's obvious that Russia could decide to halt or restrict gas flows, this seems highly unlikely without a sharp rise in the confrontation. Europe needs energy, but Russia is probably even more dependent on cash from energy exports. European consumers add about US$100 million a day to Russian coffers, accounting for about 3% of the country's gross economic output. A significant decrease in energy shipments would throw Russia into a recession almost overnight.

Two other factors appear to favor Europe in the short term. First, the mild European winter has allowed countries to build sizable reserves that could last months. Second, Europe can turn to other countries for natural gas such as Algeria and Norway. Europe could even use other pipelines from Russia that flow north of the Ukraine and the trouble zone. Looking at many factors, the probability of Russia halting gas exports to Europe remains low. It's a lose-lose situation. Of course, because of these expectations, a dramatically more disruptive escalation of the conflict could hit markets more sharply.

Returning to U.S. shores, strengthening U.S. growth this year and next should help the world economy withstand the turmoil in the Ukraine and weaker recoveries in emerging markets. The U.S. recovery remains the strongest among developed economies, and the economy's momentum and size should enable it to pull the rest of the world along. The IMF predicted global growth of 3.6% this year, accelerating to 3.9% in 2015.

In the U.S., growing oil and gas output continue to propel the economy forward. As the boom matures, rising efficiencies are contributing more to growth as drillers keep finding ways to extract more fuel per well. In the Marcellus Shale region of Pennsylvania, natural gas output is up while rig counts hold steady. The story is the same in North Dakota's Bakken basin, and Texas' Eagle Ford Shale. Drilling is also faster, slowing the demand for more workers.

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The growth in output is spurring expansion and even new industries. Crude not served by pipelines is moving via rail and increasingly, shippers. Kirby Corp., a major barge shipper, has 60 oil barges, up from just a handful several years ago. And, they expect to buy more as demand rises.

New technologies are also developing to better use cheaper electricity resulting from plentiful gas. Magnetic pads in the road at bus stops wirelessly allow buses to recharge while riders board. Delivery and trucking companies are continuing to change over parts of their fleets to natural gas.

The positive trends in energy will help offset some short-term challenges resulting from federal air-quality rules taking effect. Dozens of coal-fired power plants will close by 2016. Almost none, if any, of the plants will be replaced due to environmental restrictions. While utilities are building natural gas plants, it takes time. Electricity rates will rise in the short-term, in some cases even faster than inflation, as utilities shell out billions for new infrastructure.

U.S. corporations continue to generate record profits, and are still sitting on nearly $2 trillion in cash. Industry capacity in use has risen to 78.8% from 70% in 2009, and increased investment will be necessary to satisfy future growth. Excess cash and a calmer playing field with no expected government shutdowns or major regulatory changes has likely factored into recent mergers and acquisitions. Major deal announcements by pharmaceutical companies and investors have helped drive the stock market to new highs.

Small business also seems to be turning a corner. Sales and profits are enjoying their strongest growth since 2007. For many, double-digit gains are in sight, helping bolster the economy as a whole. Companies with fewer than 100 workers make up 98% of all firms and employ more than a third of American workers. In aggregate, they also create the majority of new jobs. Optimism is up, uncertainties around the fiscal cycle are down, balance sheets are stronger, credit is more plentiful, and higher home values are allowing easier borrowing against higher equity values.

Solid job growth of 192,000 in March and an upward revision to February's gains bodes well for the rest of the year. Overtime hours are also up in manufacturing, which hints at future hiring. Monthly gains of 200,000 for the year are likely. But, while the respectable gains will more than cover new entrants to the workforce resulting from population growth, they will only put a small dent in the millions of long-term jobless and part-timers looking for full-time work. As a result, wages should increase by less than 2.5% this year after a 2% rise in 2013. Still, after two years of declines in real wages (in 2011 and 2012), even the modest increase (0.5% growth in real wage increase) should boost consumer spending. It has already helped push consumer confidence to its highest peak in months, near a six-year high.

The rough winter weather in much of the U.S. likely slowed U.S. expansion to only 1%, from 2.6% in fourth quarter. But a brighter outlook in multiple areas including consumer spending, should help propel growth up with expectations to hit around 2.5% in second quarter and 2.7% for the year. While the conflict in the Ukraine is potentially unnerving, it seems likely that a growing swell of positive news will continue to overwhelm concerns over the conflict, which should help the U.S. and many global markets continue to lurch forward, albeit in a very choppy fashion.

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