# Portfolio Perspectives

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## War in Ukraine

At this point, it is well-established that a major foreign conflict has developed between Russia and Ukraine. On February 24, after weeks of amassing forces on the border and warnings of imminent invasion from the West, Russian military units entered Ukraine in a breach of that country's sovereignty. Since that time, battles have been waged across Ukraine between the two forces, and many commentators believe that this could be a long and terrible conflict between the two countries. To date, military involvement by the rest of the world has been limited. However, a stunningly organized and coordinated response has been mounted, particularly by NATO countries, to impose sanctions on the Russian government and economy. This is a fluid situation, but it appears that lines have been drawn, with much of the developed world sympathetic to the Ukrainian position.

As would be expected, financial markets have responded to this conflict in the form of increased volatility. Furthermore, the war has introduced a commodity/inflation shock on the heels of a pandemic shock that is still playing out. In essence, we are experiencing back-to-back shocks for the global economy that stand to exacerbate an inflationary impulse brought on by pandemic-induced supply chain disruptions and extraordinary fiscal stimulus.

Our team has received a number of questions from clients regarding the impact of this war on the economy and their portfolios. While we do not claim to have the answers to how this entire situation resolves, we do wish to share some of the actions we have taken with our clients' portfolios and observations regarding the short- and long-term effects as we see them.

### Our Approach

Our definition of risk at Davidson Investment Advisors can be summarized as "more things can happen than will happen." With this in mind, our team does not believe it is possible to forecast future outcomes with absolute certainly. That said, we do find utility in planning for possible scenarios. As such, we undertake a process annually through which we identify a range of issues that we believe could affect markets in the coming year. Through this process, we rank each issue identified by the uncertainty it presents and its impact to markets. In our most recent exercise (which was conducted prior to the war in Ukraine), our investment team identified global growth and inflation as the most uncertain and highest impact issues facing markets. Since undertaking this planning process, we have worked to broaden our awareness of what a variety of outcomes might present to markets as it relates to the interplay between these issues, should they break in any particular direction.

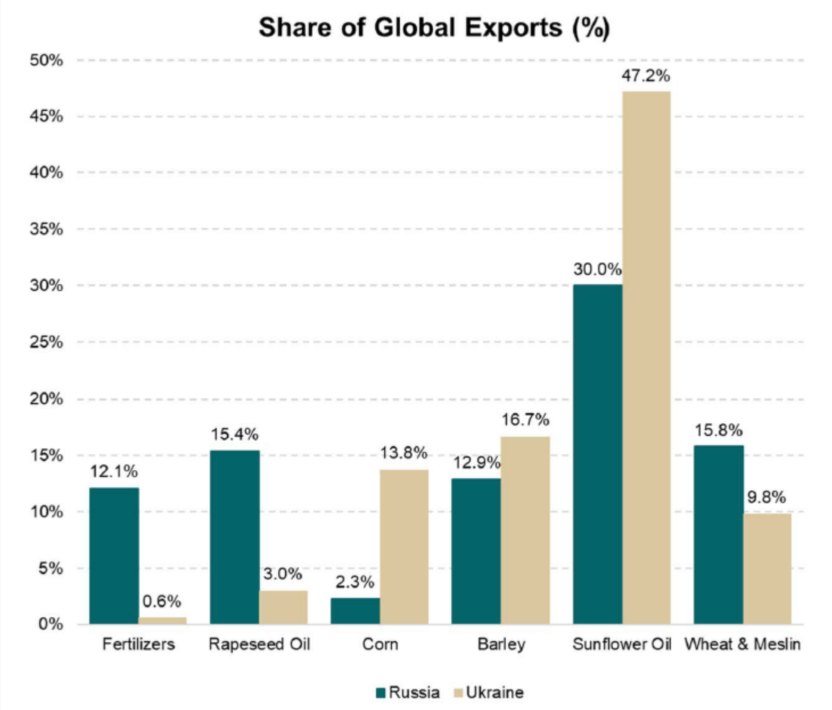
In our mind, the war has solidly established that inflation is likely to remain elevated above pre-pandemic levels, and that global growth will be led by the United States.

In light of this, we have evaluated our portfolios for exposures to companies and markets that will benefit from such an outcome. For example, we continue to favor companies with strong pricing power in an inflationary environment, and we are keeping close watch of companies that may be hurt by rising energy costs. We have also identified companies with direct (revenues, offices, and manufacturing plants) and indirect (currency exposure, vendors, and supply chain) exposures to the Russian and Ukrainian regions specifically, which will allow us to better understand potential winners and losers in a U.S.-led economic recovery post-COVID. Much could still change and develop from here, but we believe that knowing what you own is extremely important in this type of market environment.

**Short-Term Impacts**

There are many heady topics on investors' minds today: the Federal Reserve's intent to raise interest rates, high inflation, a market valuation correction, and now this war (to name a few). Because of this, it is difficult to attribute market responses to the war specifically, but we believe there are a few areas of focus that are more impacted than others.

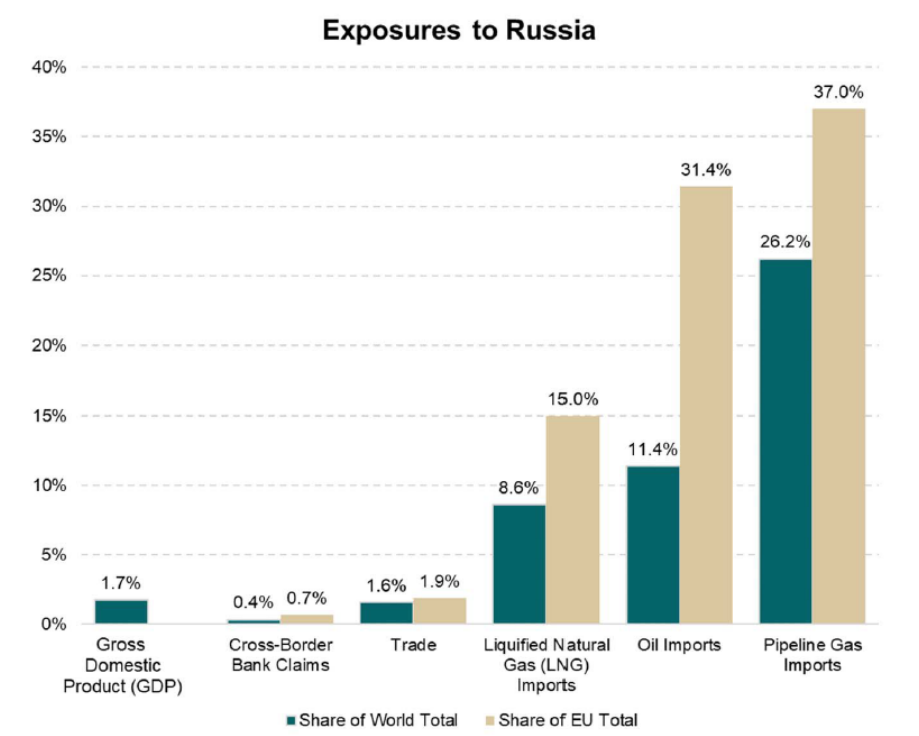
First, the war is likely to create (or exacerbate) a commodity shock globally. The COVID pandemic had already impacted many of these markets due to labor shortages, gummed-up supply chains, and restrictions on foreign travel. However, as the chart below shows, both Russia and Ukraine are major producers of many important commodities on the global markets- particularly agricultural commodities. As long as this war wages on and exports are affected, we expect inflation in these key areas to remain elevated.




Data is from most current reports available as of 3/30/22. Crop Data published 3/9/2022. Source: U.S. Department of Agriculture. Fertilizer Data published 12/31/2020; Source: United Nations Statistical Division

Second, we expect inflation to remain heightened, and for its peak to be delayed. Prior to the war, it was beginning to look as though inflation would peak in Q1 of 2022; since then we have seen energy and food prices, in particular, rise substantially as a result of the importance of these two countries to the markets for these goods. Though the Fed has begun raising short interest rates to combat inflation, we expect it will likely persist for longer than it would have prior to this development.

Finally, we do expect that the European and developed international market economies will be disproportionately impacted by this conflict. As the chart below shows, the European Union is much more reliant on Russia for key economic inputs than other parts of the world. Untangling these engagements is likely to take some time, and will likely result in some disruption in the short term.




Data is from most current reports available as of 3/30/22. GDP Data published 12/31/2020. Source: WorldBank. Cross-Border Bank Claims Data published 9/31/2021; Source: Bank for International Settlements (BIS). Trade Data published 12/31/2020. Source: Eurostat. LNG & Pipeline Gas Data published 12/31/2021. Source: International Energy Agency. Oil Import Data published 12/31/2021. Source: U.S. Department of Energy.

It is important to note that though both Ukraine and Russia are important players in the global economy in some respects (particularly around their production of oil, liquid natural gas, and grains), their collective share of global Gross Domestic Product amounts to less than four percent. In other words, while important in some key ways, we do not believe the global economy is likely to be crippled by this conflict as long as it stays contained to these two nations.

**Long-term Impacts**

A lot remains to be determined with regard to the outcomes of this war, and everything could change very rapidly if the situation escalates beyond the borders of Ukraine. Despite this, we observe some key shifts in the ways governments and individual companies seem to be operating as a result of the conflict. Many of these were already in motion prior to the war, but we believe they will be expedited and amplified in light of the new environment.

First, we believe this situation could result in a further reversal of globalization. Many nations and companies have realized that the more they control the key inputs to their economies and businesses, the less disrupted they are by potential global events like these. As such, there is a growing sense that extricating key functions from nations and other players may allow for more resilience in light of shocks such as COVID and this war. This also may manifest in the form of greater defense spending in Europe and the United States.

Second, we expect to see further development of alternate and redundant supply chains on the part of corporations. Our team has talked since the beginning of COVID about a trend we call "China +1", whereby companies who rely on China for major inputs to their product development have strategically diversified their supply chains to include at least one other major partner. As global shipping lanes, commodity markets, and other key inputs to the goods and services companies produce come under pressure, we believe it makes strategic sense for companies to create more redundancy in these areas- even if it comes at a slightly higher cost.

Finally, we believe the situation in Ukraine will put more pressure on the United States to continue pursuing energy independence, and for the rest of the world to ween its dependence on Russia as a supplier of energy. While we recognize the growing push for less reliance on oil and other fossil fuels in our economy, we also believe it will take considerable time and resource to shift the economy to a point where they do not play a key role. So long as this remains, we expect that from both an economic and national security perspective, the United States will prefer to reduce reliance on imports of these resources and instead opt to increasingly extract and produce them itself.

While the market today presents a high degree of uncertainty, we also think it presents a good opportunity for bottom-up, active investment managers like us to add value to client portfolios. That said, in times of heightened volatility and fear, we remind ourselves that the greatest value we can add is providing the confidence to our clients to remain invested and to keep long-term outcomes in mind above short-term concerns. On that basis, we continue to trust our process and continue to believe that long-term investors do not need to make material changes to their investment approach at this time.

## DISCLOSURES

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