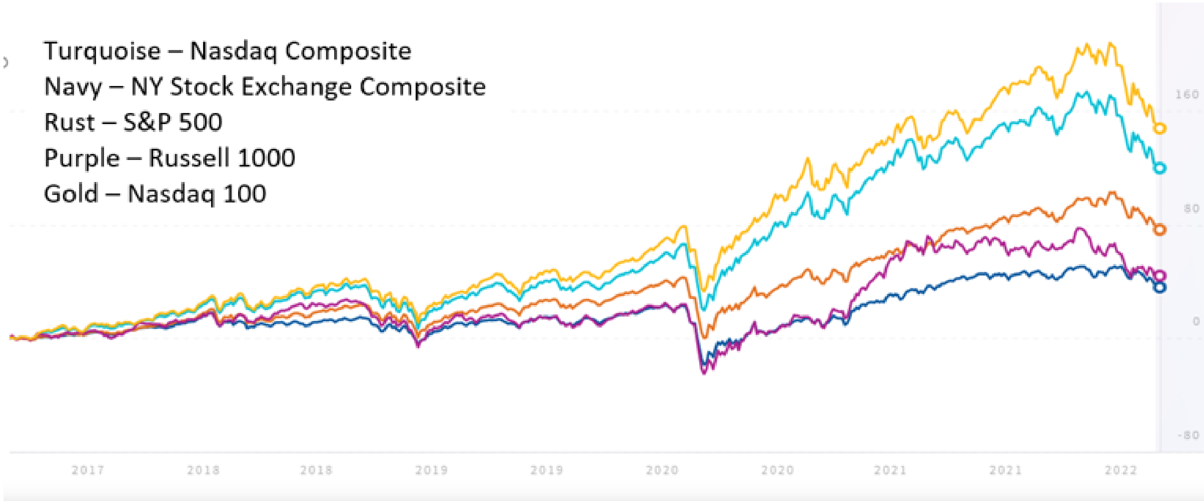
ROYDS REPORT

Late March 2022

The Russian War, the Stock Market and Corporate Sanction Impacts

Do you remember the George Clooney movie, "The Perfect Storm", where 3 storms all intersected at one point to create massive turbulence in the ocean? March 2022 is a little like that perfect storm. Things were looking pretty sunny last fall, with economies recovery from Covid, good corporate earnings and strong returns on stock markets. Fast forward to March 2022. World economies are still grappling with labour and supply shortages due to Covid. Central Banks are belatedly tackling the problem of too low interest rates for the last several years by raising interest rates, even though many citizens may have overextended themselves so much, that they may not be able to handle higher interest rates. Inflation, largely caused by supply shortages and huge demand surges, is surging further due to war-induced supply shortages and inflation is hurting people's buying power and pressuring Central Banks to raise interest rates even faster to curb the inflation, creating a vicious circle. And now a country with nuclear capabilities is at war with world geopolitical tensions at heights not seen for years. All of this is causing choppiness in the stock and bond markets, but we have seen choppiness like this many times before.

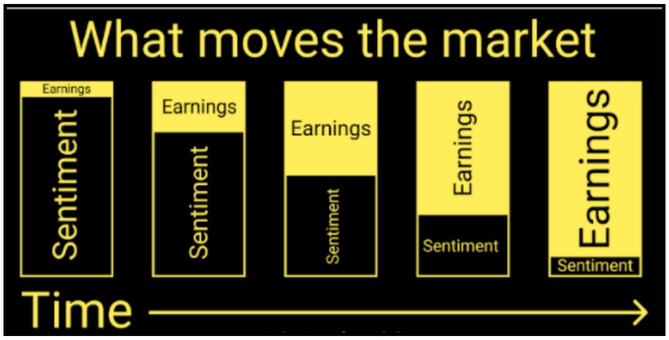
The NASDAQ (the major US stock exchange with the strongest high tech concentration) officially entered "bear market" territory, falling more than 20%, down from 16,212 in mid November 2021 to a low (at time of writing) of 12,588 in Mar 2022. [1] The S&P 500 index for the U.S. is not down as much and the Canadian TSX is doing pretty well, thanks to the energy sector. Since Elaine began her second career, as a financial advisor 25 years ago, there have been the bear markets of 1998, 2001, 2007-9, 2015/16, 2018, 2020 and now 2022. That's a lot of terrible periods in the market, especially 2007-2009 which was the second worst in history. And every time, the markets recovered and went on to achieve new highs. Our best advice has always been not to panic, to hold on to your investments in quality businesses, and to stick with your long-term investment plan. If you get out of the market now, the chances of your getting back in in time to not miss the recovery aren't good. Either fear will hold you back, or recovery will come before you expect it. Remember the old saying that "the market climbs a wall of worry". Don't let the market climb that wall without you! If it makes you feel better, just don't open your statements for a while. Maybe it will help to think about the fact that markets went up so much last year, that even with this recent drop, markets are still nicely up from 2 years ago. And the holdings which have fallen the most, like stocks traded on the Nasdaq stock exchange, shown in the turquoise line on the chart below, are also the ones that rose the most since Covid started, and their gains are still way above the less volatile stocks of the S&P 500 index shown in rust below or the NY stock exchange index shown in navy below. [2] The price of the extra returns is the extra volatility you endure.



The chart above reminds us that markets don't go up in a straight line, and that volatility and drops like we are experiencing now are pretty commonplace. Over the long term history of stock exchanges, markets have had many dips and drastic drops, but they have always risen to new heights afterwards. Please note, we don't want to imply that investing in high volatility stocks always leads to higher returns. "Big Tech – the global behemoths that generate head-spinning profits [Apple, Facebook etc] -actually conceal a far more severe downturn among flimsier companies with shorter track records…. 43 per cent of the stocks in the Nasdaq composite have fallen more than 50 per cent during the current downturn."[3] So the less established, growthier companies on the Nasdaq took a beating, but those are not the kind of companies our managers liked or held. Many of our managers did hold the behemoth tech companies though, which are down a fair bit, just not a disastrous amount. Between their prices dropping and their profits rising, some of these mega high tech stocks may be looking as much like value stocks as they are like growth ones. Meta Platforms, formerly Facebook for example, is trading at 14 times earnings this year, compared to 24 times earnings last year.[3]

If you are worried about your portfolio or accounts, give us a call and let's talk about what's in your portfolio and look at the differences in choppiness and performance between any investments we have for use in the long-term (what we call bucket 3), versus investments in lower volatility funds for the near to mid-term (buckets 1 and 2). Most of the investments we put short to mid-term money into are down 0-3%. They did their job to protect against a 20% market drop, and if you take money out of those investments for your income stream, you shouldn't be crystallizing any loss that you can't recover from.

Whether it was Pearl Harbor, the Korean War, the Iranian war or any of the other conflicts of the last 75 years, markets have always recovered and recovered in a shorter period of time than one might expect. Initially there is a huge reaction and then the reaction fades and logic based on the fundamentals of a business (stock) take precedence again, as illustrated in this chart from AGF.



Further to the chart in our newsletter from last week on market returns, here is a slightly different one from IA Clarington this time to remind you of just how quickly markets have recovered from wars in the past.[4]

S&P 500 performance around select geopolitical/military event

Date	Select geopolitical / military events	1-month later	3-months later	6-months later	12-months later
12-07-1941	Pearl Harbor	-3.4%	-12.7%	-9.1%	0.4%
10-20-1962	Cuban Missile crisis	8.7%	17.7%	25.1%	32.0%
11-03-1979	Iranian hostage crisis	4.2%	11.6%	3.8%	24.3%
12-25-1979	U.S.S.R. in Afghanistan	5.6%	-7.9%	6.9%	25.7%
08-03-1990	Iraq invades Kuwait	-8.2%	-13.5%	-2.1%	10.1%
01-17-1991	Gulf War	15.2%	23.5%	20.6%	33.1%
08-17-1991	Gorbachev coup	0.0%	3.0%	7.0%	8.9%
02-26-1993	World trade center bombing	1.2%	2.5%	4.0%	6.4%
03-20-2003	Iraq war	2.2%	15.6%	17.4%	28.4%
	Average	**1.3%**	**2.1%**	**5.5%**	**8.6%**
	% Positive	**50%**	**58%**	**67%**	**75%**

Source : Truist IAG, iA Economy

There is no reason to think it won't be the same this time. After all, as life goes on, companies will make and sell things or provide services and make money. There are some specific impacts that this war will have on the world economy though. Russia and Ukraine account for ¼ of world trade in grains (notably wheat and corn)[5], and if Russia isn't allowed to export that food due to sanctions, and Ukraine can't find a way to ship their grains out of the country, we can expect food shortages for many in the world and higher prices for all– inflation. The fact that Russia is a significant supplier of oil and gas, especially to Europe[6], means it can have a big impact on productivity in Europe and can impact/has impacted inflation on fuel worldwide, which was not the case in most previous military conflicts. .

Russian bonds, whether issued by the government or Russian businesses, are now in the junk bond category[7]. Russia's ability to pay bond interest has been impaired by international sanctions against Russia and Russia's willingness to service their debt has fallen.[7] For Russia the situation is worsened by how much its currency has fallen versus the Euro and the US dollar.[7] Russian stocks may be virtually illiquid (they can't be sold), because the Russian stock market shut down for the last 4 consecutive trading days[7], when Russian stocks went into freefall as investors tried to exit them. Some emerging market funds will have held Russian stocks, but none of our favourites seem to have held a large percentage, if any. Many fund managers have reported negligible exposure to Russian assets, but that doesn't mean there's no impact on the stocks their funds hold, because of the degree of globalization in the world. Some direct impact examples would be Linde, and industrial gas company that gathers neon gas. Ukraine is the source of about 50% of the neon in the world. Since Linde can't get neon gas in Ukraine now (and who knows for how much longer?), that part of its business will suffer, and companies dependent on neon, like semi-conductor chip manufacturers will also be impacted.[8] Airplane leasing companies have little hope of getting back their estimated 536 airplanes on the ground in Russia now. That will be a huge economic loss for some of them.[9]

You've heard how countries around the world have placed sanctions on Russia, prohibiting some imports and exports, incapacitating the banking system, prohibiting Russian planes crossing their airspace or passing ships through their straits, seizing the assets of Russian oligarchs etc. This makes it harder for Russia to finance the war and may cause enough discontent (and unfortunately hardship) for Russian citizens, that it could lead to some insurrection (sooner that later, please, or is this just wishful thinking that Russia's disinformation campaigns will fail to keep Russian civilians in the dark – W5 had a super interesting program on this on Sat Mar 12 22). But have you heard about all the self-imposed "sanctions" that more than 300 Western companies have implemented which will further disrupt life and commerce in Russia? Many companies have either ceased operations in Russia, or cut off all business they could. Pizza Hut and KFC, for example, could shut down corporate owned restaurants, but couldn't shut down ones owned by franchisees. Pepsi stopped beverage and snack sales, but didn't stop baby food sales, for humanitarian reasons. Visa and Mastercard however ceased all business, even though it could lose outstanding balances. The loss of that spending option at the same time as ATM machines in the country were incapacitate is pretty impactful. Here is a list of just some of the more recognizable companies ceasing business with Russia, according to a team from Yale University[10]:

Ford	Philip Morris	Shell	Kimberly-Clark
Hyundai	Proctor & Gamble	GE	Kraft Heinz
Toyota	Disney	Ikea	Lego
Volkswagen	Hyatt	Under Armour	Levi Strauss
Michelin Tire	Hilton	PayPal	Adidas
Airbus	Netflix	Samsung	FIFA
Boeing	Nintendo	Panasonic	Formula One
Ernst & Young	Whirlpool	Nvidia	BP
KPMG	BBC	IBM	Maersk
Danone	Goldman Sachs	HP	UPS
Diageo	ING	Spotify	FedEx
Estee Lauder	3M	Twitter	Clorox
H&M	Deere	TikTok	Kellogg
Heineken	Caterpillar	Intel	Honeywell
Imperial Brands	Hitachi	Logitech	Facebook

Here's is a list that a spokesperson for one of our favourite Growth At a Reasonable Price (GAPR) funds, BMO Concentrated Global Equity, put out on Mar 8 22 about actions it's top holdings have taken in light of the war with more insight into the implications of those actions:

- **L'Oreal** has just announced it will be temporarily closing stores in Russia and suspending investments in the country. It has a production plant in Russia, which L'Oreal says accounts for a low, single-digit percentage of annual sales.
- **CME Group** - has suspended all six Russian precious metal refineries from its approved list, meaning newly-minted gold and silver bars produced at these Russian refineries are no longer acceptable for delivery to satisfy contracts.
- **Alphabet** - has suspended all advertising in Russia including search ads and YouTube, but services such as Search, Maps, and YouTube continue to operate although at limited functionality. Google has extended free "Project Shield" services to Ukrainian sites (to date more than 150 have signed on) to help protect them against DDos attacks.
- **Booking's** - stock declined around 15% because of the closure of airspace to Russian airlines and Russia's closure of its own airspace, but the Booking CEO commented that Russia represented a "very low single digit percentage" the company's gross bookings.
- **Novo Nordisk** - has not suspended sales into Russia given the life-saving nature of its products. It has donated two-months' supply of medications for treatment of diabetes and haemophilia in its Ukrainian inventory to the Ukrainian Ministry of Health
- **Mastercard** - suspended network services in Russia – this goes further than the steps legally required by Western sanctions.
- **Nike -** has closed down online sales in Russia. The company has over 100 stores in the country – EMEA accounted for 27% of sales in 2021.
- **MarketAxess** - pulled Russian sovereign and corporate bonds from trading.
- **Nestle** - had six factories in Russia as of 2020, including plants making confectionary and drinks, according to its website. Its 2020 sales from Russia were worth about CHF1.7 billion out of total sales of CHF84.3 billion.
- **Microsoft** - has halted sales of its products and services in Russia. It is also supporting Ukraine with cyber-security support to help defend against cyber attacks on government , IT and financial institutions.

Here are some additional notable companies doing their part. AirBnB is offering temporary free accommodation to 100,000 Ukrainians. "Companies have also responded in other ways, including cracking down on misinformation and reducing the online presence of Russian state-owned media outlets like RT News and Sputnik News. Google and Twitter have suspended advertising in Russia." "Amazon: The online giant suspended shipments of all retail products to customers in Russia and Belarus, and suspended access to Prime Video for users in Russia.
Apple: The tech giant stopped selling its products in Russia and is halting online transactions, including limiting Apple Pay in the country. Additionally, it has disabled some Apple Maps features in Ukraine to protect civilians."[11] And that is literally the tip of the iceberg, not even half of the companies beginning with the letter A that are doing their part.

"About 6.5% of Russia's workforce is employed by organizations that are foreign-owned or have joint Russian and foreign ownership, according to statistics agency Rosstat. Foreign companies employing at least 150,000 in the country have announced a suspension of operations, store closures, a moratorium on investment or other measures since the attack, according to Bloomberg calculations. The actual number affected may be far higher, given that not every company has disclosed such steps or employment numbers."[12]

680 News reported on Mar 12 2022 that most of these companies say that the percentage of business they do in Russia is in the "low single digits", so less than 5%. Still, the loss of this business will have some impact on their profits, and therefore on the stocks' worth and investors' returns. This is expected to be a one-time loss that won't affect future growth rates. Virtually all our portfolios will be affected a bit, since almost everyone had some exposure to Visa or Mastercard and Microsoft and many other world leading businesses. The impact won't be huge, and morally we probably all support the actions of these companies and appreciate their contribution to the pressure on the Russian economy and the Russian populace, which may be key in ending the conflict. We just thought you should be aware that it's not just your donations to the Red Cross and other relief efforts, or the actions of our government applying sanctions, or your tax dollars that are funding supplies for the Ukrainian resistance, but also the actions of the companies you are part owners of which are adding pressure to Russia and trying to aid

Ukraine. Any one company or sanction may not have much impact, but collectively they can have impact.

Here are a few other tidbits we thought you might be interested in from the many webinars, emails and news reports we've looked at in the last week:

For more than 20 years, people who wanted socially responsible funds, now called Environmental, Social and Governance (ESG) focused funds, wanted funds free of tobacco and alcohol companies, heavy polluters or weapons producers.   Now there is talk, for example in a Mar 11 2022 webinar (by a long-time manager at Loomis in the US, David Rolley, who manages a fund for IA Clarington in Canada), that weapons/defence companies, like Locheed Martin, Boeing and Ratheon, are ESG candidates! How did this happen? Ukraine, and perhaps recognition of the truth in an oft quoted saying from a 4th century Roman historian Publius Flavius Vegetius Renatus that goes like this: "*Si vis pacem, para bellum* – if you want peace, prepare for war."[13] In other words, to prevent another nation from being aggressive and swallowing you up, you need to have effective deterrents. You may also need for your neighbour to be rationale and sane, but that's out of your control.

For years the threat of China invading Taiwan to re-join it to China has been a concern and a threat to world peace. A strategic analyst at AGF who has important contacts in Washington writes, "Beijing obviously wants to expand its reach in Southeast Asia in general and Taiwan in particular. The latter has a well-educated population and a thriving economy; Taiwan is the world's leading producer of semiconductor chips. Despite sabre-rattling from Beijing, the likelihood of an invasion has slipped dramatically. The astonishing casualties inflicted on Russian troops sends a signal that invading Taiwan also could inflict huge losses; just as Russian tanks have become easy targets, an amphibious landing on Taiwan could be very costly. And as Russia has been hit with enormous global sanctions, China also would suffer a huge economic setback from inevitable sanctions if it attacked Taiwan."[14]   Let's hope China will indeed be deterred from aggressive action toward Taiwan.

On Mar 14 2022, Fidelity's Director of Global Macro in Boston, Jurien Timmer, shared the following:

- Even though interest rates have gone up over the last year, inflation has gone up so much that "real" interest rates (nominal interest rates minus inflation) on long-term bonds have remained around -.3%. That means that even with the interest you earn on the bonds, there isn't enough growth to maintain your buying power with a bond investment. So he is not surprised that the bond markets are still pricing in a 1.75% increase in interest rates this calendar year in 7 or less increments, some of .25% and possibly some increases of .5%.
- Even though bonds have been losing buying power for years now, they still had a place in people's portfolios as a stabilizer. Historically if you wanted returns above GIC rates, you might invest in a traditional balanced fund with 60% in stocks or equities and 40% in bonds. The bonds would drag down returns, but when a market shock occurred, the bonds wouldn't drop as much as the stocks and the value of the balanced fund would be more stable and less traumatic for investors. This year with the market shock of the Russian invasion of Ukraine bonds didn't do much good. At the point in March when he made up his chart, the US market as represented by the S&P 500 was down 12%. A balanced fund, that had 40% bonds to cushion the drop, was down 9%. So giving up returns on 40% of your investment did not provide you with too much cushion this time. Only cash or gold helped you avoid much loss, but then cash is constantly losing buying power with inflation and, over the long-term, gold is like other commodities. It basically keeps up with inflation. [We have been using tactical and non-traditional balanced

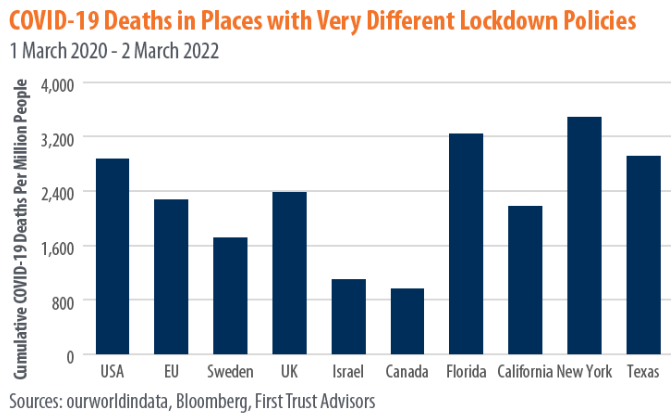
funds for the last few years and some of ours only fell 2-3%, a far cry from –9%. A couple of our other long-term, usually lower volatility favourites did drop 6-8%, which is still better than -9%.]

- Lastly, Jurien showed the history of commodity price shocks since 1784. Most of the shortage and price hikes have been for wheat, sugar and corn, but there various instances of oil and metals spiking up in price. Most of the price hikes look like the blip on a heart monitor (like you see on TV medical shows) every time the heart beats. It's a quick blip up and then returns to the resting position. Some of the blips are a little more like  where the start of the rise is gradual and then spikes and precipitously collapses again. We may have seen this in oil prices over the last month, as shown in the chart below.[15]

Jurien's advice was to take some profits, if you were lucky enough to have been in oil when the Ukrainian shock hit, and not to "overstay your welcome in commodities", because, while they do occasionally have splendid returns, over the long term of 10 years plus, they usually revert to about 3% returns or something near the level of inflation.

It was for that very reason that we had minimal if any exposure to oil before the Ukrainian invasion, and we aren't adding old exposure in our portfolios now. This rapid increase in oil prices has been good for the Canadian stock market and in the last 4 months or so, Canada was a great place to be invested. But for many decades, Canada hasn't kept pace with US markets. Since we can't predict where temporary bright spots will be in the market, we don't even try to chase them. You have to be right about when to invest in them and right a second time about when to get out of them. We're not clever enough, risk-taking enough or market-timing enough for that. Sometimes our fund managers are clever enough to take advantage of a short term anomaly like this, but most think only long-term and don't take risks for these short-term potential gains.

To end on a positive note and to reflect on the 2 year anniversary of Covid restrictions, we'll share this chart. Let's be grateful for the guidance of our Chief Medical Officers and politicians and the compliance of our fellow Canadians. However imperfect the guidance and compliance were, Canada did an excellent job of combatting Covid, relative to so much of the world. Source: First Trust Advisors



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Footnotes

[1] https://www.google.com/search?q=nasdaq+index+chart&rlz=1C1CHBF_enCA983CA983&oq=nasdaq&aqs=chrome.3.69i59j46i67i199i433i465j69i59j35i39j69i60l3j69i61.6690j0j7&sourceid=chrome&ie=UTF-8
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