CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

March 18, 2014

Russia and Crimea

Geopolitics once again presents obstacles for financial markets, markets that for a long spell have looked only at macro-economic issues. While the questions remain about sources of growth in developed economies, in China and in other emerging markets, into the mix come the brazen acts of Vladimir Putin. It is amazing to contemplate a possible military encounter with Russia more than fifty years after the Cuban missile crisis. The rather mild market response to matters in Ukraine suggests the belief that the United States will not confront Russia militarily. Of course, the Russian occupation of Crimea presents far less risk to the United States than the early 1960s installation of Russian nuclear-armed missiles in Cuba. However, Putin's startling invasion of Crimea warns us that he might be willing to undertake further incursions into Ukraine and perhaps into other former Soviet republics. Further steps could certainly offer to the United States a much more serious challenge than is presented now in Crimea. How does one calculate and assess such risks?

As an economic matter, Crimea and Ukraine are utterly insignificant to the United States. Russia is only slightly more important to the US economy. By contrast, the financial sanctions and visa restrictions that the US and Europe might impose upon Russia and the circle of individuals around Putin might be quite hurtful to Russia and those individuals. During the Soviet era, the Soviet Union did not participate in the banking and financials systems of the West. Since that time, however, the very rich Russians and the Russian state are deeply embedded within the global financial system and enormous amounts of assets, including real estate and financial assets, are owned by Russia and its 'oligarchs.' An indication of the scale of these assets was provided late last week in the weekly report the Federal Reserve makes of its holdings. More than $100 billion of 'foreign-owned funds' on deposit in the New York Federal Reserve Bank were withdrawn. Typically there are large weekly inflows of foreign assets to be held by the Fed. It is quite likely that these assets were Russian and removed against the risk that the US would freeze such Russian assets.

In contrast to the willingness of the United States to sanction Russia for its actions, Europeans are far less keen. Germany's trade with Russia is substantial. Moreover, Germany and other Western European countries depend upon deliveries of Russian natural gas that flows through pipelines crossing Ukraine. Russia has long demonstrated a willingness to turn off the taps to threaten and to enforce discipline. The dependence of Germany and others on Russian gas may speed some changes in the United States, which, since the oil embargoes of the 1970s, has had laws strictly constraining US exports of petroleum products. Within the last few years, the US has become a huge and very low-cost producer of natural gas and an ever larger producer of oil. There is now an ex-

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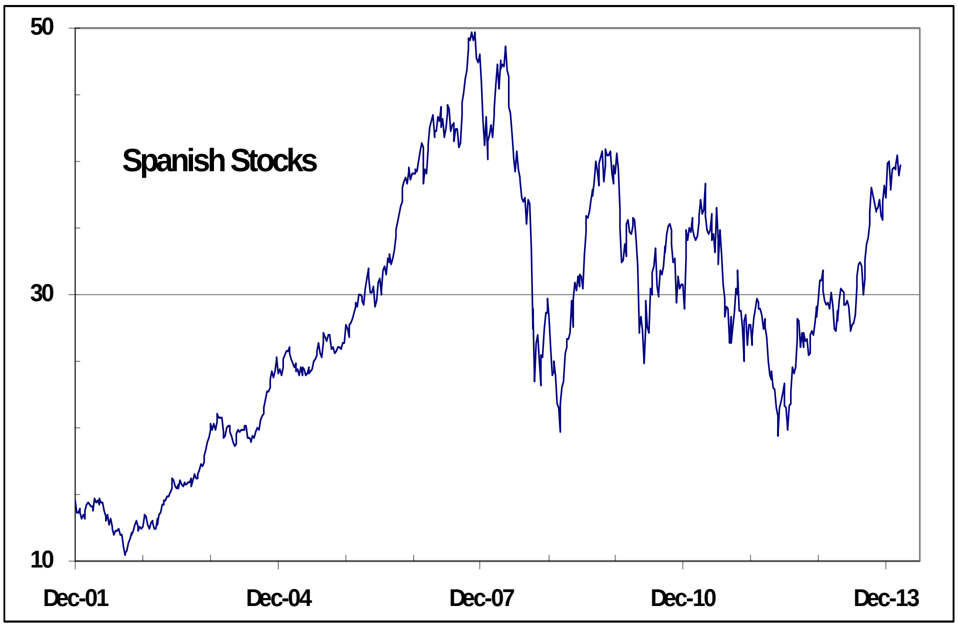
cellent geopolitical reason to amend that law and lessen Russia's sway over Europeans. One hopes that the United States and the European Union will be firm and patient with Russia and supportive of the new government in Kiev.

Spain flourished in the early years of the last decade after joining the Euro, with strong immigration from Latin America and a housing boom of startling magnitude. Came the crisis in 2008-09 and its housing market collapsed, its high level of private debt weighed on its people, and a deep recession engulfed it.

Economic growth appears to have continued at a modest pace in the US this year, although the exceptionally severe winter weather in the Midwest and the eastern part of the country has rendered economic reports a little a bit less meaningful. It is quite likely that the cold and the storms restrained some activity and caused greater spending in other sectors, like home heating and electrical power generation. We will have a clearer picture of the state of the economy after winter finally loosens its grip. Meanwhile, after a bit of selling in January, stocks recovered smartly until the Crimean wobbles.



Europe is more vulnerable to the problems flowing from Russia, as discussed above, and selling connected with this hits Germany harder. External shocks to Europe's economies are less easily absorbed than in the United States. Economic fragility, high unemployment, recession followed by very slow growth and the peril of deflation flow from the handling of the Euro-zone crisis. That crisis and the solution preferred by Germany and the other northern creditor nations--namely cutting wages and government spending in the 'peripheral' countries--puts pressure on prices and wages and tips the weak toward a self-reinforcing spiral of contracting economies, lower prices, high unemployment and low wages. The cushion protecting these countries against a shock from Russia or from China's slowing growth is thin indeed.

The crisis in the euro hit very hard; unemployment soared to 25%. Spain was nearly strangled by fiscal austerity. Unemployment remains very high and growth is very slow, but the ECB promise kept it from collapse. Now its market recovers.

The acute phase of the Euro-zone crisis caused recession throughout Europe and significant selling in European stocks. As discussed previously, European Central Bank President Mario Draghi made his famous declaration in the middle of 2012 that the ECB would do 'whatever it takes' to keep the Euro intact. His promise was sufficient and he was not required to take action. From that time, the fear of Europe's collapse ended. Slowly economies began to stabilize, then slowly to grow. But much more rapidly, the deeply depressed European stock markets began to recover. Over the last two years, Core has been building a fairly large position in European stocks and earlier this year, when markets were selling off, we took a position in Spanish companies. Spain is one of the countries hit hardest by the crisis with the Euro. Its economy has begun to recover, as has its stock market.

There is, as always, plenty to worry about in investing and Russia's nastiness is an unwelcome and distasteful intrusion. The Europeans and Americans are cool headed and unlikely to press Russia to something truly drastic. Hence, for now, we are investing in the expectation of continued slow growth and favorable monetary policy from the major central banks.

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