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

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A New Cold War

Vladimir Putin's actions in Ukraine, provocative missions with spy planes, and Russia's cyber attacks on US firms creates a level of tension not seen since the Cold War.

Despite the economic damage caused by US and European sanctions, the collapse in oil prices, the depreciation of the ruble, one can fear that Mr. Putin may rile things further, instead of seeking a way to calm matters.

By

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In the last *Core Comments*, we noted the increased volatility in stock prices after a long period of rather placid moves. We are in the midst of a remarkably volatile patch as we write. On September 19, the S&P 500 made a new high of 2019.26, whereupon it fell by 10 percent in less than a month to 1820.66. From that point it changed direction once again and rallied by 12 percent to 2038.70 on Monday. Although economic and political events were unfolding during this seven-week period, it is rather hard to write a convincing explanation for the sharp decline and the sharp rally, which caused a net change in the stock market's value of less than 1 percent. We must simply be aware that we are in a period in which stock prices change very rapidly and we should maintain a modicum of dignity through it all.

Russia, the sanctions, oil prices, and the ruble. At last week's ceremonies marking the 25th anniversary of the fall of the Berlin Wall, Mikhail Gorbachev warned that we are at the brink of a new Cold War. An apt comment, in my view. Putin's adventures in Ukraine triggered rounds of ever-more stringent economic and financial sanctions by the US and Europe on Russian banks, companies, and a number of key individuals. It seemed likely to me that the US and Europe had the power, should they choose to apply it, to cause economic pain to Russia in an attempt to address the Russia's revanchism.

I suspect that no one imagined that concurrently with the imposition of the sanctions would come a near 30 percent decline in Brent Crude, the global oil price benchmark, from mid June to this week. Most other commodity prices have fallen during this period, as well. The Russian economy depends very heavily on sales of resources, especially oil. Thus, the sharp fall in the price of oil cuts Russia's export earnings deeply. Moreover, the financial and banking sanctions have real bite. This combination has caused the value of Russia's currency, the ruble, to tumble from about 35 rubles to the dollar in June to 48 last Friday, a decline against the dollar of 37 percent.

A little history. In 1997 and 1998, South East Asian countries were roiled by sharply declining currencies. Despite the damage to local economies, which was <u>very</u> considerable, the impact on US stocks was insignificant. However, matters worsened through the summer of 1998 and in late August Russia defaulted on Soviet-era debt. The bland stock market response then turned to panic and stocks fell by more than 25 percent all of a sudden. A very large US hedge fund, Long Term Capital Management, nearly collapsed. The Federal Reserve and the Treasury (anticipating actions they would take a decade later at the time of the collapse of Lehman Brothers) stepped into the breach and quickly brought the crisis under control.

History does not repeat itself. This time around, one can imagine how a worsening currency crisis in Russia, itself just an emblem of Russia's bigger problems, may trigger a very disturbing outcome. Vladimir Putin's actions have been exceptionally provocative and, as we are told, under his control, Russia's media have spread a story of a beleaguered Russia under attack by the West. His domestic political standing is very high. Apart from the seizure of Crimea and the Russian-supported war in Eastern Ukraine--now apparently underway again after the recent ceasefire broke down--Russia's air force and spy planes have been making flight after flight over the Baltic Sea and into Nato areas. Russia appears to have abducted an Estonian security agent and a Russian submarine was likely in Swedish waters last month. A Russian spy plane nearly collided with an SAS commercial flight from Copenhagen recently. The spy plane had turned off its transponders and was only seen by the SAS pilots through their window just in time to turn away. A series of highly sophisticated cyber attacks, most recently on the US Postal Service, have Russia's finger prints. To the extent that the sanctions and falling oil prices cause sharp rises in inflation in Russia, a process well underway, Putin's domestic political support may melt away. In this case, he may gamble on even more aggressive and provocative actions, perhaps including expanded war in the Ukraine and similar actions in the Baltic states, Latvia, Lithuania, and Estonia, to 'protect' the Russian-speaking people there.

The risk from Russia is not economic, although the sanctions and currency collapse have hurt Europe's exports into Russia. If diplomacy and common sense can prevail, the impact on the Europe and America will be very modest. One hopes that Angela Merkel and Barack Obama are making careful and constructive approaches to Putin and offering him a way out of the corner into which has painted himself and Russia. Of course, the simple part of this is the offer from the US and Europe; the tricky part is getting Mr. Putin to agree.

The central banks. We have written often of the role of the central banks in the investment markets. Since the financial crisis began late in 2007, the Federal Reserve has expanded its balance sheet more than five-fold; it now holds more than $4 trillion in assets. The enormous infusions of dollars into the world's economy has been a significant part of the ongoing rallies in bonds and stocks, in the US and elsewhere. The Fed's latest and largest asset buying spree has just come to an end and now Japan steps forward. Two days after the Fed's announcement that its bond buying ended in October, the Bank of Japan (the BoJ), made an entirely unexpected announcement that it was increasing the rate of its asset purchase program, including stocks as well as bonds. The result was a big decline in the value of the yen and a large boost to Japanese stocks. (Our investment in Japanese stocks, in which the yen's value is hedged away, rose by 10 percent in the three days around the BoJ announcement.) The goal of the plan is much larger as a percent of the Japan's economy than has been the Fed's huge quantitative easing programs. The European Central Bank has not yet acted in a significant way on the undertakings ECB president Mario Draghi has made since August, facing as it does the complex political problem of dealing with Germany's antipathy to its mooted programs. However, it is reasonable to expect the ECB to act dramatically, sooner or later.

The US economy has continued to grow moderately but persistently and job creation here has reduced the level of unemployment to 5.8%, from more than 10% in the aftermath of the crisis. This economic growth will continue, but so will this new level of extreme price fluctuation in stocks and bonds. Buckle up.

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