Portfolio Update

February 28, 2022

A little more than a month ago, we took steps to reduce our exposure to equity risk as the capital markets digested their nearly unprecedented run-up since the pandemic nadir in March of 2020. Our feeling has been that signals of transient inflation are becoming more systemic and, combined with a regime change from the Federal Reserve from stimulating to tightening, the short-term prospects for equities are less attractive. Since that time markets took a brief respite and even rallied a bit before continuing to grind and sometimes lurch lower. We have now taken a further incremental step away from equities in both US and foreign markets as we look for the catalyst that will define the bottom of this downward trajectory. Within our ETF models, we made the shift primarily in US large cap growth and in Developed Europe equities, and in our ESG models through core and growth-biased large cap equities and broad international equities. All proceeeds were committed to cash and cash equivalents for the moment.

Note we did not open by saying "because Russia invaded Ukraine, we chose to reduce equities". Geopolitically this violation of a sovereign nation is tremendously significant. In economic terms, less so. As we have discussed in our periodic blogs, Russia's economy is the 11th largest in the world as measured by nominal GDP, which seems significant until we realize it is smaller than Canada's and 1/10 the size of China's. Ukraine is 55th. Where Russia is most consequential in terms of their economy on the world stage is energy – petroleum and natural gas. Europe is a net importer of natural gas, a significant portion but not all of which comes from Russia. They have been increasing LNG imports from the US and Qatar, but that is mostly offset by a steady decline in domestic production.

Natural gas is not the only major piece of the European energy portfolio, but it is material. Prices have already been high, and the decision to delay certifying Nord Stream 2 in response to Russian aggression means little relief is on the way. Globally, "OPEC+" has been falling short of targets to increase production post-COVID wind-down and the Ukraine conflict will not help climbing prices for oil either. The West put the framework for a new sanctions regime in place but that is determining who takes what share of the economic pain to box out Russia.

Rising oil prices have similar effects on the economy as rising interest rates, so we are interested to see how the Fed digests the changing macroeconomic environment and the need to be aggressive on policy rates later in the year. Looking longer term, assuming the priority does not become preventing total war as Putin tries to reassert the borders of the former Soviet Union, we see this moment as a tipping point for Europe to accelerate their transition to a low-carbon future because it is an undeniable security imperative for the EU member states.

After further buffering our portfolios from the volatility whipping the markets, we are looking for more of a "sideways" trajectory with episodic declines. A more normal return environment over the last few years would have put markets a meaningful amount below where we currently are at this moment in time. We could potentially see a sharp retreat down to those levels, 10% or more below where we currently are, or we could see markets repeat periods of the past where there are very short-term jags up and down, but the net is directionless volatility that goes nowhere until the value of the market catches up to the price of the market. As mentioned above, we are seeking catalysts that would change the narrative and put us on track for a more sedate and historically normal return environment, which would be our cue to re-engage. With global central banks tightening, Congress done with stimulus, armed conflict on the European frontier, inflation on the march and global supply chains still out of sorts even as COVID recedes, a catalyst, if even present, is obscured.

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