



## Quarterly Point of View *Unfortunate Reality*

April 1, 2022

It is an unfortunate reality we need to address Europe's largest war between two sovereign states since World War II. On February 24<sup>th</sup>, Russia, led by Vladimir Putin, invaded neighboring Ukraine triggering heavy fighting and a massive humanitarian crisis. Even without knowing the fate of this conflict, there are enormous implications for Europe, the rest of the world and its leadership, as well as the global economy.

Russia's atrocities against Ukraine, once a member of the Soviet Union, but not a part of the European Union or NATO, has heightened fears over the security of other former Soviet republics, including those that are members of NATO.

Aggressive airstrikes against military and government buildings in Ukraine marked much of the beginning of the conflict, but Russia has shifted tactics, targeting highly populated areas and critical civilian infrastructure, including hospitals, schools, bridges, and railway stations. According to a report by the New York Times, through March 22<sup>nd</sup>, the devastation had included 23 hospitals, 330 schools, 98 commercial buildings, 27 cultural buildings and 900 houses and apartment buildings. An estimated 10 million Ukrainians (roughly a quarter of the population) are now displaced in the country or among the 3.7 million refugees, including 2.2 million that have crossed the border into Poland alone.<sup>1</sup>

Outside of the human toll, assessing outcomes is extremely challenging, though in our view one of few scenarios seem most plausible. The first would be that some sort of peace/ceasefire is negotiated. Talks have taken place often since the war's onset, but with only intermittent indications of progress. This would clearly be the best of all remaining options as it would end the loss of life and destruction of the country (for now), in exchange for a Ukrainian pledge of "neutrality." Given Russia's campaign of targeting civilians and annihilating the country's infrastructure, however, Ukrainians may be pushed farther from a "surrender" of this sort - as we've seen in other historical instances.

The second outcome as we see it would be a scenario where Russia "occupies" Ukraine in a similar fashion to what the Soviets attempted in Afghanistan in the 1980's. Given Russia's military advantages, it originally appeared as if their forces may be able to enter Kyiv and depose of Ukrainian President Volodymyr Zelenskyy, installing puppet leadership beholden to Moscow. This portion of an "occupation" seems less likely now due to the relentless resistance of the Ukrainian forces, assisted in part by weapons being provided by the U.S. and other Western Nations. In any case, a long and grueling conflict - marked by Ukrainian insurgency - seems a likely result. The impact of a drawn-out and bloody occupation can already be envisioned given

evidence of Russian casualties to date. NATO has placed an estimate of between 7,000 and 15,000 Russian soldiers killed through the third week of March.<sup>2</sup> Even using the lower end of that NATO estimate would place the number of Russian troop deaths above that of all American casualties during two full decades of military intervention in Afghanistan and Iraq. This kind of occupation and insurgency would leave Ukraine decimated, and Russia, already a pariah on the global stage, a severely weakened nation.

There are additional “worst case” scenarios that we can only hope are much less likely, including an escalation utilizing chemical or biological weapons, potentially drawing direct NATO involvement. More terrifying even, a nuclear conflict. These are concepts difficult to imagine, let alone to consider the probabilities.

Assessing potential outcomes is difficult at this point, but assessing the impact seems to be straightforward in a few major ways.

### **Supply Chain Control**

Over the past half century there has been continued economic interdependence globally, with the rise of globalization allowing for production to be executed where costs were the lowest, resulting in an ever-increasing reliance on distant sources of supply. This ever-increasing economic reliance has created side-effect risks, that we are now seeing clearly as a result of Russia’s aggression.

Over half of Russia’s exports are energy products, including crude petroleum, natural gas, and coal, with much of it going to supply Europe’s energy needs. Europe allowed its dependence on energy commodities from Russia to increase so dramatically over the past decade that it put itself at risk. In Michael Shellenberger’s piece, “The West’s Green Delusions Empowered Putin” he explained:

*How is it possible that European countries, Germany especially, allowed themselves to become so dependent on an authoritarian country over the 30 years since the end of the Cold War?... The former KGB agent (Putin) knows Russia produces 11 million barrels of oil per day but only uses 3.4 million. He knows Russia now produces over 700 billion cubic meters of gas a year but only uses around 400 billion. Russia mines 800 million tons of coal each year but uses 300. That’s how Russia ends up supplying about 20 percent of Europe’s oil, 40 percent of its gas, and 20 percent of its coal.... While Putin expanded Russia’s oil production, expanded natural gas production, and then doubled nuclear energy production to allow more exports of its precious gas, Europe, led by Germany, shut down its nuclear power plants, closed gas fields, and refused to develop more through advanced methods like fracking... The numbers tell the story best. In 2016, 30 percent of the natural gas consumed by the European Union came from Russia. In 2018, that figure jumped to 40 percent. By 2020, it was nearly 44 percent, and by early 2021, it was nearly 47 percent... The reason Europe didn’t have a muscular deterrent threat to prevent Russian aggression—and in fact prevented the U.S. from getting allies to do more—is that it needs Putin’s oil and gas.<sup>3</sup>*

Whether Europe was simply seeking the lowest cost supply or attempting to be as eco-friendly as possible in its own neighborhood - or a combination of the two - it inadvertently, or unwisely, put itself at risk. Putin knew he had economic leverage because of these factors, which have now prevented the West from using its most powerful “sanctions weapon,” shutting off Russia’s energy exports.

Given how gravely this has illustrated Europe’s security flaws it will begin to greatly impact how nations view all facets of supply chains. Instead of fully economic concerns, national security will play a much greater role in these decisions and the shortening of supply lines to make them more dependable will result in a wide array of goods, services - and commodities where possible - to be produced “at home.”

This will further impact another developing concern, inflation.

## Inflation

As those who've read this letter for an extended period of time are aware, we believe the Federal Reserve long ago started straying from its dual mandate - that of stable prices and maximum employment - and have catered to an elevation of asset prices in order to sustain the "wealth effect" impact. The consequences of this stray from stable prices have become very evident of late.

The consumer price index jumped 7.9% in February from a year earlier, hitting a new 40-year high even before any implications of Russia's invasion of Ukraine could be measured. Even backing out food and energy prices, as many economists do, core consumer prices still rose 6.4%, more than three times the Federal Reserve Bank's target meant to represent stable prices. Food prices alone rose at the fastest pace in 40 years, alarming when considering that the lowest-income quintile of American households spends more than 25% of their income on food.<sup>4</sup>

For a time recently, the Fed believed much of this inflation data was "transitory" and would be alleviated over the next year. Now, based on recent statements after the Federal Open Market Committee met and raised rates by 25 basis points on March 16<sup>th</sup>, the Fed seems to have changed their tune, likely coming to grips with the fact this data is not transitory and will be further exacerbated by the effect of war. To that point, in a speech to the National Association for Business Economics, Fed Chairman Jerome Powell said:

*In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well.*

The Fed is behind the curve, and after failing to normalize interest rates for such an extended period of time, getting inflation under control now without triggering a recession, will be extremely difficult.

Before Russia's aggression we were already entering a new environment as it relates to inflation, interest rates, and a form of "anti-globalization." Judging the ultimate outcome of Russia's war is challenging, but what isn't challenging is concluding the coming decades won't look much at all like the recent past on those fronts.

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Respectfully,



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1. Russia Refocuses on Ukraine's East After Month of Heavy Losses. Wall Street Journal, 3/25/2022.
2. Russia Could Have Lost as many as 15,000 Troops in Ukraine War. Washington Post, 3/24/2022.
3. The West's Green Delusions Empowered Putin. Michael Shellenberger, 3/1/2022.
4. Here's Why it's Time to Focus on the Inflation Economists Ignore. Wall Street Journal, 3/14/2022.

Statistical and analytical data provided by Factset.

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