MV CAPITAL MANAGEMENT

# Weekly Market Flash

## Sanctions, Shorts and Fat Tails

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To be perfectly honest, we do not like writing about geopolitical events within the confines of this weekly investment commentary. What happened yesterday in Ukraine was, and will continue to be, a humanitarian catastrophe and in many ways represents a decisive break from the post-Cold War world order with which we have lived, more or less, for the past thirty years. If this were a weekly commentary about world politics, or European history or sociology then we would be talking more about the humanitarian crisis and less about whether Russia's invasion of Ukraine might change the Fed's thinking on interest rate hikes in March. But here we are. So, from a market perspective, what on earth actually happened yesterday?

### SWIFT Reversal

We all woke up to the news that Russian president Putin had launched a war in Ukraine. By the time markets were ready to open at 9:30 am Eastern time it looked like the grimmest of days for the major indexes. But after plunging at the opening bell, stocks basically marked time, as if patiently waiting for definitive word from the Western allies about just how harsh the response against Russia would be. That news came early in the afternoon when President Biden announced a second round of sanctions – essentially everything that the US and its European NATO allies were able to agree upon. Biden's delivery was firm and his message to Russia stern – yet it was immediately clear to anyone watching that the sanctions stopped a bit short of the "mother of all sanctions" rhetoric that has been circulating around policymaking circles for the past several weeks.

The two most conspicuous areas where the sanctions pulled back from the brink were in not agreeing to kick Russia off the SWIFT international payments system, and in carving out an exception for energy trade in the restrictions on Russian exports. To be clear, Russia's economy is an energy economy – there is almost nothing else that matters to the country's GDP. Not including this sector in the sanctions is tantamount to saying "we're going to come down like a ton of bricks on your economy, except for the one thing that basically makes up your economy."

The stock market rally that followed the sanctions announcement was largely driven by short sellers covering their positions by buying up the individual shares and ETFs they had shorted. The thinking seemed to be that the measured sanctions approach – and visible reluctance especially by European NATO allies to expose their economies to greater financial and energy-related risks – meant that at least from a market perspective the geopolitical implications of the Ukraine invasion were not as severe as they might have been. By the end of the trading day the usual momentum followers had jumped on board, and a three percent decline on the Nasdaq Composite swung to a three percent gain.

### Fat Tail Risks

As always, the wild swings in the market on a volatile day like 2/24 say very little about the longer-term picture. The Ukrainian invasion will no doubt move off the front page as the news cycle continues to churn ahead on the many other topics that consume readers' attention from the substantive to the inane. But there are risks aplenty in this new world order, however it eventually shapes out to be. In analyzing risk we use the term "tail risk" to denote events that, while relatively unlikely to happen, nonetheless exist as

possible outcomes with a probability greater than zero. The “tails” of which we speak are those endpoints of a bell curve distribution where the center of the bell represents the mean, and incremental moves to the left or the right are the deviations from the mean. When the probability of those outlying events at the tail ends of the distribution increases, we say that the tail is “fatter.” The invasion of Ukraine, and the likely inability of the West to halt it, makes the tail fatter in an asymmetric way – the higher risks are skewed to the downside.

We are likely to see evidence of this fat tail risk in more day-to-day volatility, even if the directional impact of the volatility is more sideways – lots of ups and downs – than a decisive downward trend. Sideways volatility was a theme of ours earlier this year given the number of factors at play, even before Ukraine got onto the front pages, and it continues to in our opinion be more probable than a sustained move into bear market country in the absence of an outright economic downturn, which is not on the horizon. Interest rates of course are front and center. In the run-up to the March FOMC meeting expect the news cycles to be more about Powell, less about Putin. But there are also plenty of geopolitical situations beyond Ukraine. Moldova and Georgia both have breakaway Russian separatist regions. The Baltics are where NATO’s Article 5 (one for all and all for one) may be tested. Taiwan is never far from the center of the conversation. And if the West has trouble standing firm against Russia…well, Russia is nothing compared to the global heft of China.

All of which are conversations for a different day. For today our minds are focused on portfolio discipline amid volatility. Our hearts, though, are fully with those in harm’s way in this terrible humanitarian crisis.

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