Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Perhaps nothing says as emphatically that market valuations are divorced from reality as the fact that equity and bond markets are essentially ignoring the increasing risk that Russia invades Ukraine. Investors have grown used to shrugging off geopolitical risks – see just the brief chills after Russia's previous invasions of Crimea and Georgia as cases in point. But this time is different because this time Ukraine is a critical link in Europe's energy supply, macroeconomic stress in Europe will have immediate global repercussions, and Vladimir Putin is making it more than clear that this time he's not just playing around with minor nations he thinks of as vassal states. This time, he will go to the economic map if he believes the Western response to his invasion might pose too much risk to Russia's economy and his popularity and there's no reason to doubt him. As a result, I hope Treasury and the Fed are keeping a careful eye on the Treasury market and global payment system, not to mention on the cyber-security on which core market infrastructure rests. The threat is all too real.

Treasury has long known that the "nuclear option" when it comes to economic sanctions is denying Russia access to any financial institution with any kind of domicile in the U.S. or any point of access to the U.S. payment system topped off by SWIFT sanctions blocking Russian access to the global payment system. If Treasury fires these high-powered missiles – and it's likely to have little choice given the President’s political challenges alongside acute geopolitical threat – then it seems likely that Russia will respond to the greatest extent of its formidable cyber-invasion capacity to disrupt global financial markets.

This wouldn't be pretty on its own, but it could be downright ugly if Western sanctions followed by Russian retaliation come in concert with the usual flight to the safety represented by Treasury obligations. A sudden surge of demand, even if only short-lived, could drop at least some Treasury yields below nominal zero. This would force money-market funds to make urgent decisions between reverse distributions and some sort of fast-acting floating NAV along lines proposed by the SEC.

However, few, if any, MMFs have the operational capacity to switch to floating NAVs and most would almost surely go to reverse distributions. This would send shock waves across financial markets, possibly resulting in redemption runs that pose at least as much systemic risk as those in March of 2020.

Risk is also sure to ricochet across commodities markets given the already short supplies of natural gas in the EU and rising gas prices around the world. These are rarely systemic-scale events, although they're darn painful to those without the patience or capital to weather them.

What's a lot more worrisome in the long run even if none of these risks proves unmanageable is that higher energy prices mean still more inflation and still more inflation puts still greater stress on hard-pressed families. This will surely dampen growth and very possibly trigger a recession. What's the Fed then to do?

Its toolbox is as empty as ever – raising rates to stifle inflation accelerates downward macroeconomic pressures even as it increases whatever financial-market risk Russia hasn't managed to trigger. U.S. economic inequality would also take a turn for the still worse, exacerbating family hardship and accelerating political discontent.

Only Vladimir Putin could like any of these possibilities. Let's hope they just stay that way – possibilities, not probabilities or realities.