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March 8, 2022

War and Peace

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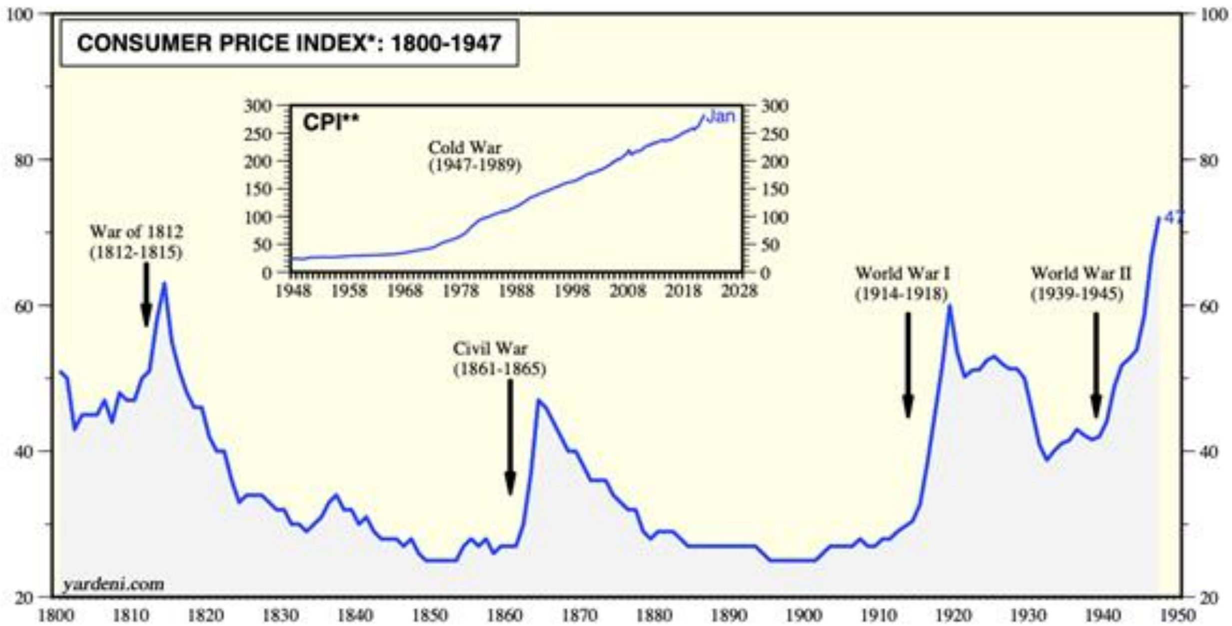
War and Peace is widely considered one of the greatest novels ever written. Although we agree with this general consensus, we'd also argue it's unnecessarily long. In fairness, novels of that era tended to be much longer than novels written for the current generation. We suppose brevity became a more desirable writing style as entertainment options expanded. Leo Tolstoy didn't compete for our attention span against Netflix. Perhaps ironically, Tolstoy was a Russian author writing historical fiction about the unjust invasion of his sovereign homeland during the Napoleonic Wars.

During the pandemic, we oftentimes proclaimed the obvious, we are not virologists. Therefore, we had no competitive advantage in trying to outguess the expert consensus. Rather, our competitive advantage is that we are trained in econometrics, a fancy word simply meaning we use economic variables and not storylines to forecast markets and the economy. As investment managers, our job is to remain unemotional and not let human tragedy impact our decision-making. It is extremely difficult to do so during times such as these. We will start by acknowledging we are also not war strategists or foreign policy experts. We are simply econometricians.

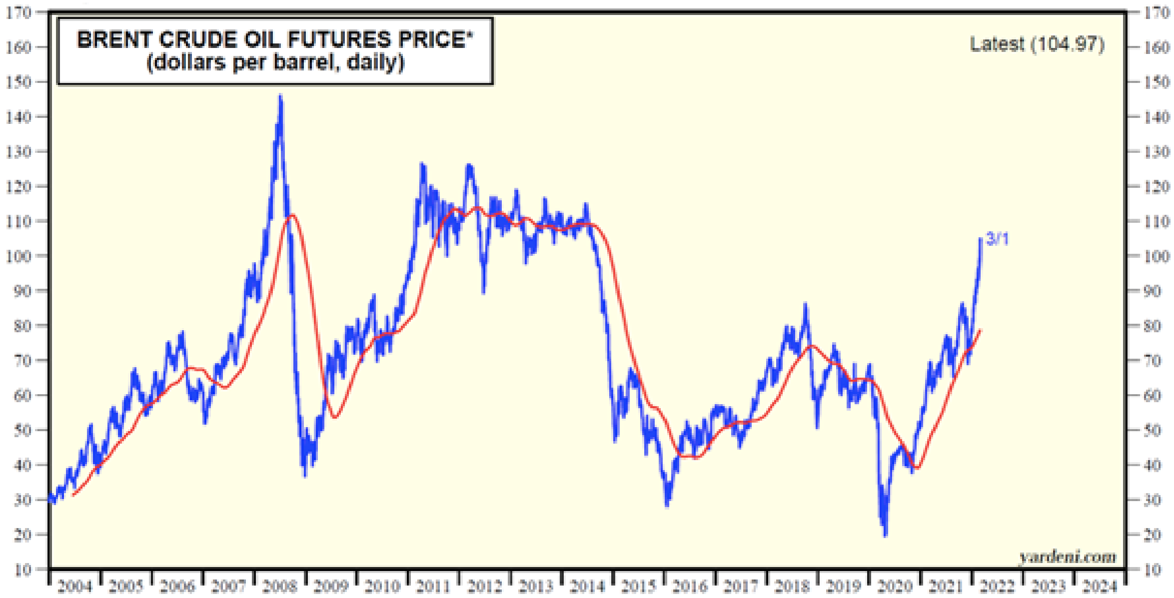
Historically, major wars (Civil War, WWI, WWII, Cold War) have been extremely detrimental to our domestic economy and financial markets. Most other events, regional wars, terror attacks, assassinations, etc. have little impact beyond the initial volatility they create. This is because these lesser events have little to no long-term impact on economic factors, and therefore the valuation, of financial markets. With the notable exception of energy prices, currently, the War on Ukraine appears to be more consistent with the latter. However, it also has characteristics that are consistent with the Cold War.

(We suppose we should also caveat that we are accepting the consensus view that this regional war will not turn into WWIII or go nuclear. If that assumption turns out to be wrong, well, let's just hope it doesn't.)

We included the Cold War as a major war even though it did not involve traditional warfare. The Cold War displayed many of the same characteristics as the other great wars. it was an extended confrontation that greatly impacted global trade and shifted economic production from the peacetime objectives of consumer goods and services (private sector production) to wartime objectives of military production (public sector production). The decrease in global trade and the shift from private to public production are extremely inflationary forces. Inflation spiked during these periods and financial markets suffered.

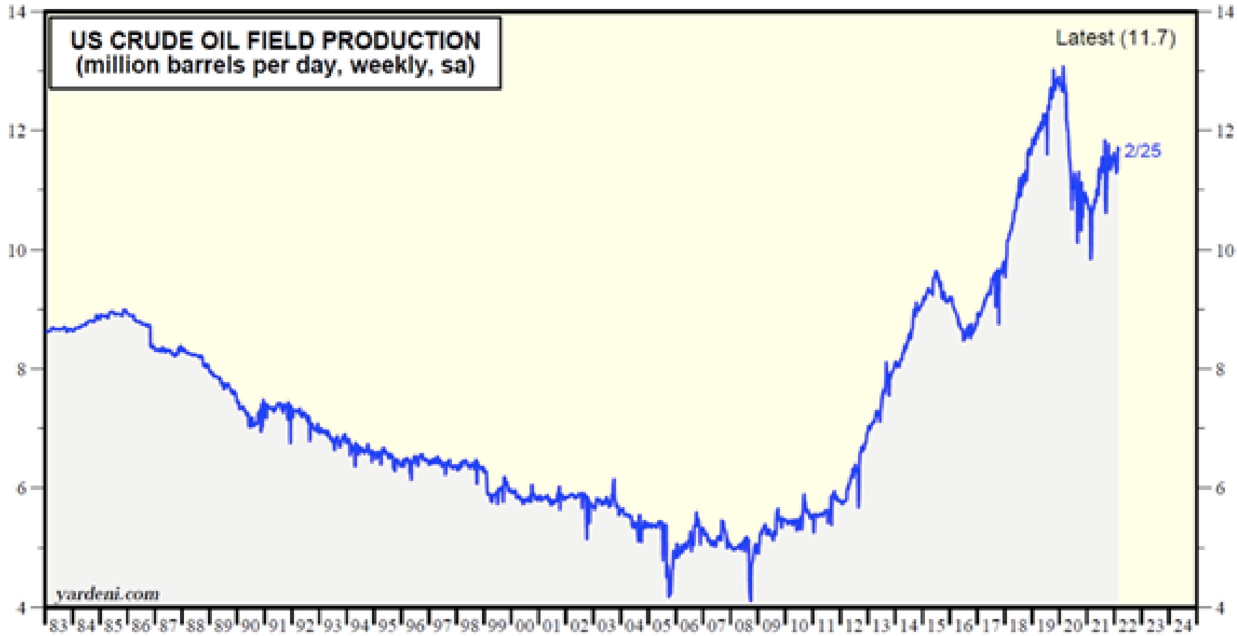


This war is causing an environment that was already inflationary to worsen. Energy prices are soaring. Higher energy prices have an immediate negative impact on consumer discretionary spending, cost of production, and corporate profits.



We are not yet ready to panic over higher energy prices. There's an expression in the commodity pits; "the cure for high commodity prices is.... high commodity prices". It's an important observation. Currently, headlines are correctly observing that oil prices have doubled over the last year. Headlines neglect to mention that energy prices remain well below levels they were at 10 and 15 years ago. Anyone who invested in oil a decade ago still needs oil to appreciate just to break even. We expect energy prices, in particular oil, to eventually ease. Here's why;

Unlike the 1070s, the supply of oil is not controlled by a single supplier (OPEC). The United States is currently producing about 1 million fewer barrels of oil today than it was a couple of years ago, and 2-3 million barrels below its estimated potential. While much of the blame for the decrease in production is being placed on clean energy advocates and environmental regulations, it would be naive not to also recognize that some of the blame should also be placed on low oil prices due to the pandemic. Oil companies are for-profit companies, when prices are low there is an incentive to produce less oil. This decreases supply, increases prices, and increases profit margin. We are not judging, just observing that the cure for low commodity prices seems to be.... low commodity prices. Regardless of who deserves what percentage of the blame for high oil prices, we think it is very likely production will increase and prices will moderate. Increased production will not be immediate, historically it has taken about 6 months to fully ramp up production.



As of this writing, we are still importing oil from Russia. The pressure to stop doing so is enormous and we expect Russian oil imports will stop very soon, which will likely cause a further increase in oil prices. Increases in domestic production and/or increased oil imports from other countries will eventually offset the decrease in imported Russian oil, but the impact of another spike in energy prices will have an immediate impact on our domestic economy. Once again, we want to reiterate that we don't see the 1970s as a comparable period to now. Our domestic economy is nowhere near as reliant on foreign energy as we were in the 70's.

As we stated earlier, we are not war strategists. The consensus view is that this war will likely be an ongoing war that will remain regional. This war is greatly impacting the European economy and its financial markets. It is having a significant albeit less so impact on our domestic economy and financial markets. Global trade is declining (inflationary) while global economic growth is slowing. Stagflation is becoming a very real threat in Europe and is also creeping into our domestic economy. The Euro has weakened considerably vs. all the major currencies.

Please allow us a moment of therapy. It is difficult for us to look through the human tragedy we are all witnessing and plain-speak on its financial impact. Nevertheless, it is our fiduciary duty to do so.

Immediate outlook and actions - We plan to communicate more frequently than usual until we once again reach some sort of normalcy in this world. Over the last several years, we have been decidedly more bullish on stocks and dismissive of inflation than most market strategists. **Today marks a turning point, at least temporarily, in our outlook. We expect the European economy will stagflate (higher inflation and lower growth) and the US economy will battle the forces of stagflation until the energy supply expands and energy prices moderate.** We aren't forecasting a recession, but the odds of a recession are materially higher than they were at the beginning of the year. The Federal Reserve's ultra-easy monetary policy has put them in an extremely difficult situation. Global inflationary forces have been inserted into an economy that was already inflationary and running hot. The Fed now has 2 options; aggressively combat inflation through tighter monetary policy, or let inflation run wild. Both options greatly harm economic growth.

Stock valuations remain reasonable and we think it is likely domestic stocks will be higher at year-end than they are now. As energy production increases and energy prices ease, corporate earnings should recover. We find it unlikely that this spike in energy prices is structural. That said, the immediate future for stocks is uncertain and volatile. As evidenced by yesterday's market movements, the negative correlation between stocks and bonds is likely over given increased inflation rates and the likelihood of tighter monetary policy. We will continue to underweight duration for the foreseeable future. We continue to hold a 100% domestic portfolio tilted towards Value stocks. This has helped to limit losses and we don't expect to change this positioning anytime soon. In summary, the next several months will be a challenging period for investors but our expectations are for a gradual recovery in stock prices.

The Mommaerts Mahaney Team

<u>**Jon C Mommaerts, CFP®**</u>**:** Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

<u>**J. Matthew Tuccini, CFP®**</u>**:** Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

<u>**Robert Kea, CFA**</u>**:** Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

<u>**Jason Rolling, Financial Advisor**</u>**:** Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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