



Market Commentary  
September 2022

English Version

# Of Saints & Monsters

Get guidance on investments, and the major structural factors behind your clients' portfolios.

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“ There are no monsters in the world, and no saints. Only infinite shades woven into the same tapestry, light and dark.

**Katherine Arden**  
*The Winter of the Witch*



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### Executive Summary

Putin erroneously believed that he could blitzkrieg his way to Kyiv and that Russian troops would be welcomed as liberators.

The West now too mistakenly believes that they can outlast Russia’s determination on a core security issue in its near abroad.

All nations have interests, capabilities, and constraints.

Balancing these interests, capabilities, and con-

straints, it is possible to deduce four possible scenarios for the war’s end:

Russia conquers Ukraine militarily, or at the very least, forces regime change with a pro-Russian (preferable) or neutral government.

Regime change within Russia, probably via a coup d’état on Putin, and a new government arises with a different ideology.

Sufficient western support is given to Ukraine that it can end the war on its terms and not Russia’s.

A negotiated settlement at the current stalemate regions whereby Russia maintains control of its current holdings which entail approximately a fifth of Ukraine’s territory.

Of these four possible outcomes, two of them – Putin’s removal and the status quo – would be the only ones that may be deemed market friendly.

The others – Ukraine’s fall and Russia’s imminent defeat – would likely entail heightened volatility for markets because both would require an escalation of hostilities.

Investors should maintain elevated levels of cash, energy and other commodities, and gold given these risks.

In terms of European assets, it is still too early to overweight equities despite how inexpensive they are compared to their US counterparts.

However, an opportunity to do so may be closer than many anticipate.

Russia is a complicated place, and its story is no less intricate and misunderstood. The same with Ukraine, places shaped by their geography and history to an extent unrivaled elsewhere and underappreciated by many. In the current polarized world of political commentary, where sides barely speak to one another, rather they talk past each other, it is comforting to label a thing “good” and another “bad.” But it is not helpful and, perilously, it only serves to echo our already preconceived ideas, offering scant solutions along the way. Indeed, there is now considerable evidence that Vladimir Putin’s dearth of opinions around him, choosing instead to surround himself with sycophants, led to Russia’s quagmire in Ukraine. The Russian President overestimated his military capabilities and underappreciated Ukrainian resistance and Western resolve. He erroneously believed that he could blitzkrieg his way to Kyiv and that Russian troops would be welcomed as liberators. The West, mainly through NATO, now too mistakenly believes that they can outlast Russia’s determination on a core security issue in its near abroad. Unless the adversaries (the West/Ukraine and Russia/China) can acknowledge the interests and constraints adherent to the conflict, the world risks either a prolonged, inflationary war, or the increased risk of un/intentional escalation of the struggle. In either scenario, the lasting effects will reverberate through markets and economies for years to come.

First, it is prudent to begin with the basics. All nations have interests, capabilities, and constraints. These are inescapable. They may be softened or hardened by political actors, but their lasting veracity must be acknowledged. Understanding these is crucial to geopolitical modeling and analysis. So, what are they in the current conflict? **This war did not begin this year; it began in 2014 when Ukrainian rapprochement with NATO and flirtation with the West became serious.** Similar to Russia, Ukraine has historically straddled the boundary between the European Continent and the center of the Eurasian landmass. But this is not

merely a geographical question, it is one of culture and civic society as well. After all, post-World War II Japan is a Western country in the free market, democratic and civic sense even though it lies on the eastern side of Eurasia. **The simple fact is that an increasingly anti-Western power, like Russia under Vladimir Putin, could not stand for an increasingly anti-Russian/pro-European Ukraine capable of hosting NATO troops and weaponry at its underbelly.** Think of the American response when the Soviets tried to place nuclear missiles in Cuba in 1962. It could not stand, and the world edged closer to global, nuclear conflict than it ever had before or since. Russia’s interests here are the same as they were back in 2014. **Ukraine, on the other hand, now has interest in preserving**

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**its territorial integrity and access to the Black Sea where its export-driven economy sails through.** And what about the grand patrons of this conflict, the US and China? As far as I can tell, the US has numerous interests in the outcome. Most notably, they are to reinforce the Western or rules-based international order against a multipolar assault, enhance the nation’s global leadership role after many recent setbacks, and strengthen military deterrence globally. China’s interests, on the other hand, as a rising regional hegemon with global aspirations is to upend the democratic (but not free market) interna-

tional order, guarantee its access to the commodities it vitally needs for its economy over Eurasian land routes and away from the reach of the American blue water navy, and deter foreign interference on its most pressing issue – the Mainland’s reabsorption of Taiwan.

In terms of capabilities, the lines are more nebulous. NATO weaponry, training, and intelligence has lifted Ukrainian capabilities into conventional parity with Russia. The latter, however, retains nuclear superiority with the former and parity with the US. Although China remains distant from the tactical battlefield in this instance, its assistance in absorbing Russian exports and providing financial flexibility to Russia is just as crucial. As far as constraints go, from the US perspective there are a few as well. For one, public

ductors manufactured in Taiwan to access to global markets for its exports. Moreover, China’s ability to project hard power beyond its littoral region is untested, and it is not yet a peer competitor with the US military in the global commons. As mentioned previously, every country faces constraints that reign in their ambitions and shape their interests in a delicate balancing act.

Balancing these interests, capabilities, and constraints, it is possible to deduce four possible scenarios for the war’s end. First, Russia conquers Ukraine militarily, or at the very least, forces regime change with a pro-Russian (preferable) or neutral government. The second possible outcome is that there is regime change within Russia, probably via a coup d’état on Putin, and a new government arises with a different ideology. The third scenario is one where enough

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opinion is very much set against another military engagement given the country’s two-decade long war in the Middle East. Also, Russia’s and China’s nuclear capabilities argue for restraint. From Russia’s perspective, its conventional capabilities are dwarfed and outclassed by NATO. And although the suite of sanctions placed on the country will not hinder its current capacity to wage war, their economic and technological impact will impede the country’s future growth prospects and ability to acquire and maintain high-end weaponry. For China, though it wishes to upend the democratic emphasis of the international order (along with its criticism of its increasingly autocratic regime), it still is very much dependent on the economic tenets of said order, from its reliance on high-end semicon-

western support is given to Ukraine that it can end the war on its terms and not Russia’s. Lastly, a negotiated settlement at the current stalemate regions whereby Russia maintains control of its current holdings which entail approximately a fifth of Ukraine’s territory along the eastern axis stretching all the way down to Crimea and Kherson that gets absorbed formally or informally into the Russian Federation. Of these four possible outcomes, two of them – Putin’s removal and the status quo – would be the only ones that may be deemed market friendly (i.e., reduces the geopolitical risk premium on assets). The others – Ukraine’s fall and Russia’s imminent defeat – would likely entail heightened volatility for markets because both would require an escalation of hostilities that could trigger

a risk-off moment for asset prices. **At this stage, NATO could not allow Ukraine to fall since it would materially undermine their global deterrence capabilities.** They would need to intervene more directly either by providing troops and/or increasing the lethality and quantity of weapons supplied to Ukrainian resistance. This, of course, would bring NATO into direct conflict with Russia, multiplying the probability of a global conflict. Both the US and China need a distraction for their domestic troubles. Nothing would rally support at home more effectively than a crusade against the other. With respect to the other option, Russia's imminent defeat, Moscow would likely treat this as an existential threat for the current government. Putin knows Russia's history very well. **Things do not end well for Russian leaders with failed military adventures abroad. They usually turn up dead.** Indeed, Russia would likely escalate the war substantially, perhaps with tactical nuclear weapons, if its conventional forces were facing expulsion from Ukraine. The problem with these two nefarious outcomes is that they are the most knowingly probable ones because of their importance in that hierarchy of interests discussed earlier. For us and other market participants, the probability of Putin's ouster is unknowable because we do not have much information on the rumblings within the Kremlin. The status quo outcome is the least proba-

ble of the knowable ones given how little it satisfies any of the participants' interests.

**Consequently, it is still too early for investors to ignore the risks stemming from the war, unlike the mainstream media and pundits who have already moved on.** Investors should maintain elevated levels of cash, energy and other commodities, and gold given these risks. In terms of European assets, it is still too early to overweight European equities despite how inexpensive they are compared to their US counterparts. However, an opportunity to do so may be closer than many anticipate. Currently, European natural gas prices are higher than estimated after a complete cutoff of Russian natural gas flows. With countries rapidly approaching their storage targets for the winter months ahead of schedule, the pain from higher prices may have already been absorbed. **In early February, we downgraded European assets to underweight on the eve of the war once a Russian invasion became probable in our estimation. The time to upgrade them back to neutral, within a global equity portfolio, might present itself once winter actually begins.** A more aggressive stance to overweight, however, would likely require a benign outcome to the war and/or a material change in Europe's corporate profitability.

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# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
US Equities <sup>1</sup>	NEUTRAL	UNDERWEIGHT
European Equities	UNDERWEIGHT	NEUTRAL
Japanese Equities	NEUTRAL	NEUTRAL
Emerging Market Equities	NEUTRAL	NEUTRAL
Chinese Equities	UNDERWEIGHT	NEUTRAL
US Treasuries <sup>2</sup>	NEUTRAL	UNDERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	NEUTRAL
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	NEUTRAL	UNDERWEIGHT
Energy <sup>3</sup>	NEUTRAL	OVERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT
Cash	OVERWEIGHT	OVERWEIGHT

<sup>1</sup> Relative to global equities in USD

<sup>2</sup> Relative to aggregate fixed income markets in USD

<sup>3</sup> Relative to an overall commodity allocation



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