WINTHROP Capital Management

*Yesterday Crimea voted to secede from the Ukraine and to join Russia. If you've followed the news over the past several months, Ukraine has been effectively dating two suitors and wrestling with joining either the European Monetary Union or Russia. Leading up to the winter Olympics, the Ukraine population had protested President Viktor Yanukovich's refusal to sign a long term integration pact last November with the European Union and instead accepting a $15 billion handout from Russia. The United States and European Union have condemned the referendum as illegal accusing Vladimir Putin of forcing the vote under duress of Russian military intervention. Ukraine is in need of financial aid. This report discusses the events leading up to the Russian invasion and what it means for investors.*

## A Quick History Lesson

A quick history lesson may help to put Russia's claims to Crimea into context. Russian claims to Crimea go way back to the Crimean War in 1853. However, during the Russian Civil War, Crimea changed hands. In 1921, Crimea was formerly created as part of the Russian Soviet Federative Socialist Republic. During World War II, the Ukraine was heavily damaged and suffered severe famine. After Stalin died in 1953, Nikita Khrushchev became the new leader of the USSR. In 1954, as part of the 300th anniversary of Ukraine becoming part of the Russian empire, Khrushchev transferred the Crimean Oblast to Ukraine. This transfer was considered largely symbolic by Russia; however, after the collapse of the Soviet Union in 1990, the Crimean parliament made this permanent in May of 1992. Crimea exists within Ukraine as an autonomous republic with its own parliament.

Under the Budapest Agreement in 1994, the Ukraine agreed to give up its nuclear missile cache for certain assurances, trade and international aid. As part of the agreement, the United States, Russia, and the United Kingdom agreed to recognize the Ukraine's borders and not invade the country. Now, in a chapter out of 1956 cold war diplomacy, Russia invaded Crimea two weeks ago and scheduled these elections immediately.

Like many of the new democracies around the Baltic Sea, Crimea has struggled to get its economy on track. A culture deeply rooted in communism and a central state that will tell its citizens what they need and provides its people with their basic needs runs against the grain of capitalism and entrepreneurship. Crimea has had twenty years to get its act together and has squandered most of it. Regardless of Russia's right to Crimea and the real desire for the Crimean citizens to join Russia, the Unites States and Europe are indignant at the way in which Russia moved it's military into Crimea and effectively took control.

## What does this mean for investors?

While this has several implications for investors, we expect the near term impact on the U.S. economy will be negligible. First, the foundation of any investment is rooted in both democracy and capitalism. The post-communism, new democracies, which include Ukraine, Romania, Hungary and Poland have been a challenge for developing free market economies. The previous culture of communism needs to be replaced with capitalism and that is very hard to do over a short period of time. Not to mention, the country needs to establish a strong banking system and develop the means to both lend and borrow credit.

Once the agreement is accepted by Putin, the United States will likely impose sanctions on Russia in protest to this act of aggression. These sanctions will likely include the freezing of assets and the restriction of trade and credit flows. Russia will likely retaliate with their own sanctions. At the end of the day, we expect the Russian economy to contract and the impact on the U.S. economy to be negligible. Russia is not a major trading partner and its banking system is not deeply integrated into the global banking system.

Second, we expect interest rates to decline temporarily over the near term. Interest rate declines are the result of a near term flight-to-quality rally in US Treasury securities and do not reflect the underlying fundamentals of the economy. This is a typical response to a global uncertainty including the invasion of Kuwait, September 11, 2001, the War in Iraq, and the downgrade of the credit rating of the US government from AAA in August of 2011. Eventually, interest rates will normalize as investor focus shifts to economic fundamentals. The yield on the 10 year US Treasury declined from 2.8% to 2.6% since the beginning of March.

*Source: Federal Reserve*

Third, we do not expect this to be a major issue for U.S. corporations and second quarter earnings. At the margin, the defense sector may feel a boost as demand for weapons and supplies increase in the region given the heightened conflict. This may serve as a catalyst for improved earnings in European companies as demand increases for goods and services in preparation for conflict. After all, Russia had to have all new uniforms made that didn't include any of their country's markings when they came over the border to help.

## Is this a Buying Opportunity in Emerging Markets?

Probably not. In designing portfolios and investment strategies, we differentiate the emerging economies from the developed economies; and, within the emerging economies, we breakout the four largest including Brazil, Russia, India and China (the BRIC countries) from the rest of the emerging economies. In our view, any investment in the emerging market countries is a function of the health of international credit flows. Prior to the financial crisis, the European banks were heavy lenders into the emerging markets. However, as European banks rebuild their capital base, this flow of credit has been curtailed. With the more restricted flow of credit, there has been a decline in economic activity in the emerging economies reflected in only modest stock price movement. While we expect a lot of saber rattling, we do not expect this to escalate to war. However, the risks to the investor are to the downside. The Federal Reserve meetings are scheduled for this week and we expect the Fed's tapering of its bond buying program to continue.