

Positioning Recommendations, March 18th, 2022

Send In The Drones

Is this just a bear market rally? Or is the stock market poised for a further rebound? In my view, the correct answer is contingent on the ceasefire talks between Ukraine and Russia.

While acknowledging the usual fog of war, and what does to informational reliability, it's nearly inarguable that V. Putin's invasion has not gone according to his or his senior military advisors' plans. On the latter score, it must be a bit shocking to them that about 20% of his generals involved in this unprovoked attack on a sister country have been killed.

It's also highly likely that the sophisticated weaponry the Ukrainian Army has employed — some of it, ironically, from Russia itself — has been highly effective. Javelin anti-tank missile systems, Stinger anti-aircraft missiles, and relatively inexpensive Turkish drones have helped level the warring field in this David vs. Goliath confrontation, the biggest and bloodiest on European soil since WWII.

You may have seen that part of the military assistance package for Ukraine President Biden announced this week was 100 Slingshot drones. These are significantly more costly — and, presumably, materially more lethal — than Turkey's version. Nonetheless, the latter have apparently performed admirably.

Admittedly, I'm not in the remotest a military hardware, or strategy, expert. However, my partner and bestie, Louis Gave, is at least a decent amateur version thereof. He alerted me in late 2020 to the likelihood that drones have changed the nature of warfare forever. The underdog victory that autumn by Azerbaijan over their long-time enemy, Armenia, was as surprising as Ukraine's success against Putin's 200,000-strong invasion force is today. Previously, Armenia had repeatedly triumphed in their prior conflicts. Azerbaijan's surprise victory allowed it to absorb a critical and long-disputed border area between the two countries (one predominantly Christian, the other largely Muslim).

It was the starring role played by drones in this conflict that alerted the world to the game-changing nature of these weapons. Armenian aircraft, artillery, and tanks suffered huge losses due to being attacked by swarms of Turkey-supplied drones. Shortly thereafter, Armenia sued for peace and was forced to accept humiliating terms.

This led me to begin suspecting that drones might be the modern-day equivalent of aircraft carriers in WWII, which rendered traditional naval warships, if not obsolete, at least highly vulnerable. Two early Pacific battles reflected the new reality. The Battle of the Coral Sea, largely believed to be a draw, was the first naval engagement ever fought where the opposing fleets never made visual contact with each other. Carrier-based aircraft basically drove the hostilities. The far more consequential Battle of Midway, a month later, proved the essential nature of carriers. The Japanese Imperial Navy was ambushed northwest of Hawaii and lost most of its aircraft carriers (four total) almost instantly. It would be on the defensive for the rest of WWII.

When Putin attacked Ukraine, it was my hope that drones would help balance the scales. But, early on, it was obvious Ukraine didn't have an adequate supply. Yet with 100 Slingshots arriving, presumably soon, Mr. Putin's forces could be in even more trouble than they are now.

Of course, there is also a flood of other high-tech weaponry streaming into Ukraine. Some of the famous U.S.-made Patriot Missile Systems have been moved to the Polish side of the Ukraine border where their extraordinary reconnaissance capabilities are aiding the Ukrainian defense effort.

It's also interesting how Russian hacking has ebbed considerably. When the war first broke out, there were widespread fears that Russian cyberattacks might shut down the Western internet. Instead, it seems that its hacking has fallen off in a major way. Earlier this week, I listened to a podcast in which my great friend Grant Williams interviewed geopolitical expert Peter Zeihan. When Grant brought up the drop-off in pro-Russian "bot" messages he's been receiving since the war started, the latter pointed out that it's because Russia has essentially been blocked from the global internet.

Mr. Zeihan also made the point that the Russian economy is in deep trouble. He noted that many of its oil wells will need to be shut-in because the crude can't get to market. Apparently, oil storage is nearly fully maxed out. He believes 4 million barrels per day (bpd) will be removed from a global supply base of roughly 100 million bpd. Global oil stocks were already alarmingly low; thus, this is an extremely worrisome development for the world at large.

The overarching question is how long Russia can maintain a costly and bloody war with an economy in free-fall. Louis Gave has always said words to this effect: "Never underestimate the Russian people's ability to withstand extreme hardship... or of its leaders to inflict it upon them!" There's little doubt those words are true, but it does seem to me that Putin is realizing the enormity of his miscalculation. There is also growing unrest in Russia which is likely to become even more pronounced given the escalating economic dislocations.

Accordingly, there is a decent chance of a ceasefire before long. Both sides appear to be softening their position, such as Ukraine being willing to forgo future NATO membership. This is a most encouraging development.

If peace does breakout soon, stock markets around the world are likely to rip higher. If so, the challenge then becomes to determine if that is sustainable. Frankly, for most stocks, I doubt it; this war has altered a long list of conditions — and not in a good way. Sadly, I don't see that changing anytime soon. For example, multinational corporations are likely to be a lot less "multi" than they have been in the past. They will want to bring their supply chains much closer to their end markets. This will tend to raise the cost of doing business.

Obviously, when it comes to energy it's a whole new ballgame. Prices are almost guaranteed to stay much higher than they would have been pre-invasion due to what will be an ongoing distrust of relying on Russian energy by most countries. Food prices are also nearly certain to remain agonizingly high, creating the risk of starvation in certain regions, especially North Africa and the Middle East.

As I've written before, certain American industries are exceptionally well-positioned to benefit from this new world order. Energy and farm products producers are two shoo-ins in that regard. Additionally, America looks to be in the midst of a massive capital spending cycle. Consequently, companies that benefit from that trend, such as robotics manufacturers, should have a powerful tailwind.

On the other hand, it's hard to make a case, at least longer term, for U.S. treasury bonds even as their yields continue to break to new highs (meaning their prices are under continuing

downward pressure). The key 10-year T-note has risen well over 2% and mortgage rates have jumped to 4%, the highest since 2019. However, considering all the inflationary pressures out there, it's hard to get excited over a 10-year maturity bond paying 2.2%. As a result, for now, any bond rallies are to be sold, in my opinion.

Another consequence of the war, and particularly the seizure of Russia foreign-held reserves, is that many overseas central banks may want to hold their own reserves in gold, situated within their own borders, as opposed to U.S. Treasuries, including even in Swiss banks. This is another reason to have a healthy commitment to the yellow metal, which has represented real money for about 6000 years. (Grant Williams has actually termed it "[Man's 6000 year obsession](#)") Based on all that's going on, the affinity for it is most probably going to become yet more intense.

Positioning Recommendations

LIKE

To build on my recommendation from last week regarding capital-spending beneficiaries – assuming there is a surge of cap-ex looming which I believe is a high-probability bet — Japan's leading robotics company should prosper. For all you *Downton Abbey* fans out there, its name rhymes with "Pamuk".

- Large-cap growth names at a reasonable price.
- Certain international developed markets, especially Japan
- Publicly traded pipeline partnerships, i.e., MLPs and other mid-stream energy securities.
- Gold-mining stocks
- Gold
- Silver
- Select international blue chip oil stocks
- Oil field services companies, particularly those well exposed to the Permian Basin
- Short-term investment grade corporate bonds
- Emerging market (EM) bonds in local currency (focusing on stronger countries, particularly in Asia)
- Large-cap value
- High-dividend equities with *safe* distributions
- Most cyclical resource-based stocks
- BB-rated corporate bonds
- Canadian REITs
- South Korean Equities
- Certain "Virus Victim" equities such as refiners, homebuilders, and select retail stocks
- Investment-grade floating rate corporate bonds
- The higher quality mortgage REITs
- Floating rate bank loans
- Copper producers
- Healthcare stocks
- **Capital spending-related companies, mainly focused on the U.S.**

NEUTRAL

There has been a significant sell-off in developing country fixed-income. Thus, once again, I'm creating a new category. While it might not be time to go all-in, doing a modest amount of buying at these prices and yields should be rewarding in the long run. One leading fund in this realm sells at a double-digit discount from underlying net asset value and yields 11%. There's a good chance this asset class will be upgraded to Likes soon.

- Uranium and uranium producers
- Renewable yield cos
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Mid-cap value
- Emerging stock markets; however, a number of Asian developing
- **Emerging market bonds**
- Markets look undervalued
- U.S.-based Real Estate Investment Trusts (REITs)
- Cash
- Canadian dollar-denominated short-term bonds
- One- to two-year Treasury notes
- Traditionally "safe" sectors such as Staples and Utilities
- Virus Victors
- Small-cap value
- European banks

DISLIKE

Due to the usual flight-to-safety reaction to the invasion of Ukraine, the dollar has rallied. As I've written multiple times, I strongly believe its long-term prospects are not promising.

Consequently, it's a good time to express dollar bearishness either by adding precious metals exposure or accumulating the ultimate hard currency, the Swiss franc.

- The Indian stock market
- A wide range of high-income securities, including preferred stocks
- Intermediate-term Treasury bonds
- Small-cap growth
- Long-term treasury bonds
- Long-term investment grade corporate bonds
- Most municipal bonds
- **U.S. dollar**
- Many semiconductor tech stocks
- Mid-cap growth
- Lower-rated junk bonds
- Green energy stocks
- SPACs
- Most new issues
- Despite a disastrous February 2021, most of the popular Reddit/WallStreetBets meme stocks still have material downside.

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