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Ukraine and the fog of war

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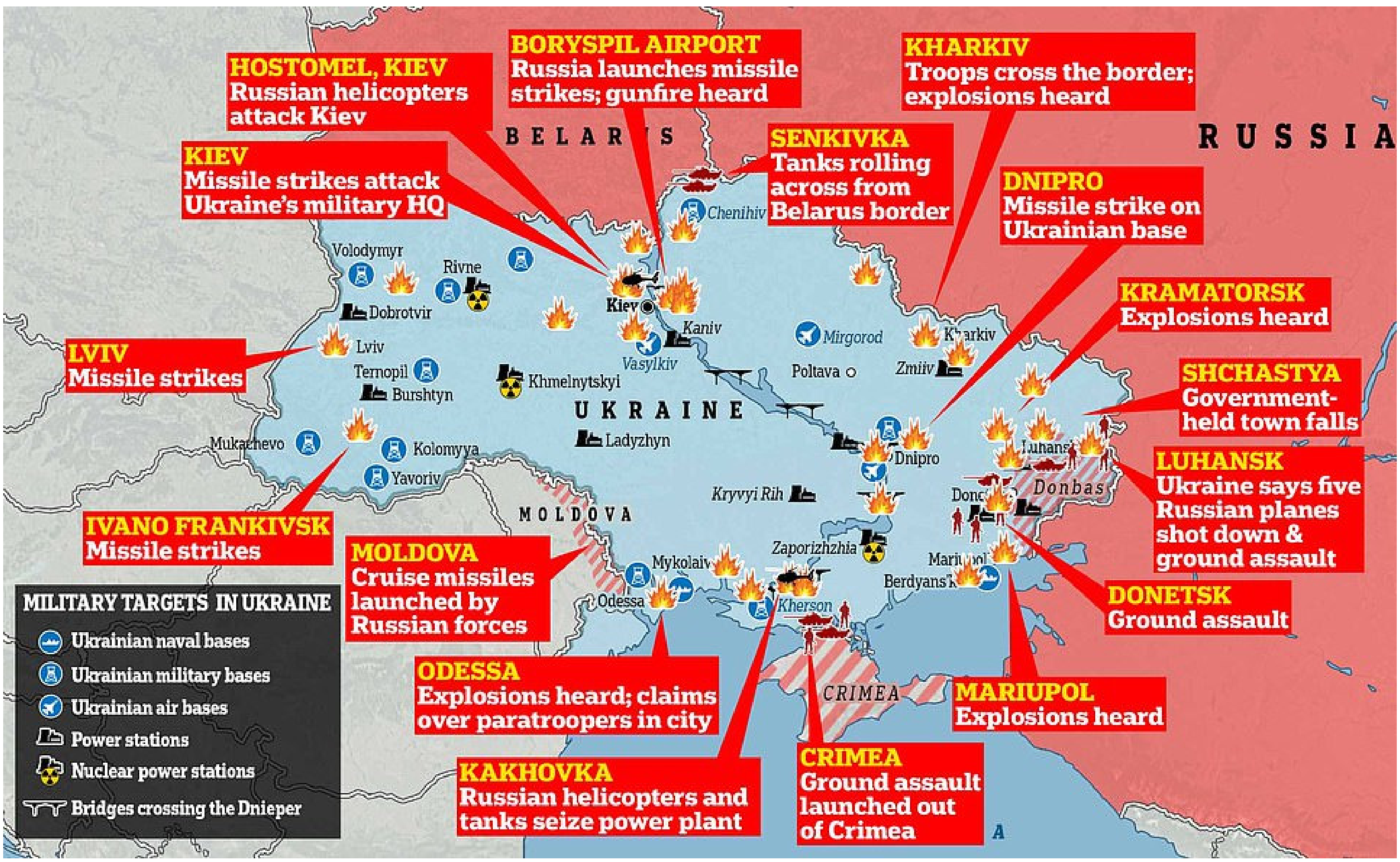
For starters, it is important to underscore that the battle over Ukraine revolves around economic blocs and zones of influence. In recent years, Ukraine's government has tried pivoting toward the West. This includes aspiring to join NATO. Over the past three decades, Russia has seen its zone of influence shrink as former satellite states and ex-Soviet republics joined NATO. It is strongly opposed to Ukraine following in their footsteps.

While Russia's invasion will have game-changing implications for the global geopolitical landscape, the most important question in the short term is whether the conflict will be brief or drawn out. That is: Will Russia be satisfied with a suspension of hostilities after, say, expanding control over the eastern regions held by pro-Russian rebels or will it want to absorb large swathes of the country and even overthrow the Ukraine government?

While there is no telling for sure, seeing how Russia is currently invading from three fronts (Crimea, Russia, and Belarus), it would appear, at least at this point in time, that its ambitions go beyond merely extending its western border. If so, this would confirm U.S. fears that Russia has much greater territorial ambitions.



Source: The Telegraph, February 24, 2022

The longer this conflict drags on, the greater the impact on the global economy, and the more consumer and business confidence will decline. Inflation is a particular risk in the energy and commodity markets. Russia is not only one of the world's largest producers of oil and gas, it is also a major supplier of industrial metals such as nickel, aluminum, and palladium. Russia and Ukraine are also major wheat exporters. *Moreover, Russia and Belarus are major producers of potash, a crucial input for fertilizers. Market impact: Continued support for energy prices and a variety of other commodities, enabling outperformance for equity markets and currencies with direct commodity exposure.*

However, it is important to note that, regardless of the duration of the conflict, we can expect the sanctions that will be imposed against Russian interests to be much harsher than ever before and to remain in place long after the conflict has subsided. This includes severely limiting access to western financial markets (including restricting the ability to transact in dollars, euros, pounds and yen) and cutting off access to key technologies. *Market impact: Scope for incremental financial stress and market dislocations/volatility, all of which could further impair liquidity and undercut demand for risk assets.*

While Western governments could exempt oil and gas transactions from sanctions on account of Europe's reliance on Russian gas, new restrictions will likely lead many banks to refrain from handling Russian energy exports.

Furthermore, the harsher the economic and financial sanctions that the United States and its allies impose on Russia, the greater the impact on Russia's major trading partners. Countersanctions by Russia on gas exports to Europe, for instance, would add to the disruption.

A massive influx of Ukrainian refugees could also be a source of social instability in the European Union and a destabilizing force to the Euro zone. Unlike past financial crises, there is little the European Central Bank can do to alleviate this challenge. *Market impact: Increased European recession risks could delay onset of interest rate normalization at the ECB vis-à-vis other central bank less directly impacted by the hostilities. A refugee crisis could add fiscal strain on governments still recovering from the pandemic.*

Finally, this invasion will accelerate the trend of the world being divided into geopolitical zones of influence. This includes Russia relying even more for trade and financial ties with China, and countries trying to reduce economic reliance on geopolitical adversaries.

Bottom line: The situation is fluid, with the Western reaction (and potential Russian counter-reaction) still to be fully understood. Quite simply, war in the Ukraine increases the likelihood of at least a technical recession in Europe and has contributed to a further erosion in confidence and overall financial conditions. Russia's actions, and the direct implications for energy prices and aggregate demand, has increased the probably of a stagflation scenario. That in turn makes life potentially more difficult for central bankers under increasing pressure to respond to sky high inflation. Significant/sustained sanctions could have material long-term consequences, which we'll explore in due course.

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