Authored by:

Jon Maier
David Beniaminov

Date: 3/8/2022
Topic: Macroeconomic

Russia's Invasion of Ukraine 2.0

Russia's Invasion of Ukraine: Food Inflation, Energy Costs Spike

With Russia's invasion of Ukraine into its second week, the economic fallout is gradually coming into focus. Prior to the invasion, the global economy was already dealing with inflated food prices and energy price spikes, but not $115 WTI prices. Now, the inflation situation has worsened and lengthened, given Russia's dominance in the oil, gas, aluminum, palladium, and wheat markets. Central banks had a difficult task managing inflation to begin with, and that task amid a war on European soil is that much more difficult.

In our view, it is highly likely that economic growth will slow in the US and globally, but less so in the U.S. There is greater risk of an inflation shock, and less risk of a rates shock and an emerging recessionary concern. We expect market volatility to remain elevated for an extended period given the war's inflationary impacts.

The Fed's Plan

To fight inflation, the Fed will likely stick to a slow and steady path for rate hikes. In a time of extreme uncertainty, Fed Chair Jay Powell was particularly transparent in announcing that the Fed will hike rates by 25 basis points (bps) in March. The decision to increase short-term interest rates slowly is calming. Currently, the consensus is for 5–7 hikes this year, depending on the impact and length of the conflict. The bond market has lowered its expectations for Fed hikes from 167bp to 147bp (as of March 4th).[1]

On the data front, February nonfarm payrolls came in above consensus, growing by 678K, and the participation rate rose to 62.3%. As a result, the unemployment rate fell to 3.8%, which supports the Fed's rate hike agenda.[2]

The U.S is broadly independent from Russian imports, which supports and insulates domestic markets from direct impacts, but not pricing. The little oil that is imported from Russia will likely be eliminated in the U.S. either by mandate or reputational concerns.

What to Expect If Russian Energy Is Cut Off from Europe

A possible scenario emerging is that Russian energy is cut off from Europe, either by Europe's doing or Russia's. The short-term impact would be painful for Europe due to the lack of available fuel and the resultant price spikes. Europe will likely have sufficient energy through this winter, but if restrictions continue into next winter energy rationing is likely. Higher energy prices raise the risk that the growth outlook in Europe could deteriorate quickly and meaningfully.

Divesting from Russian fuel could also slow down the transition to clean energy in some countries, including Germany, which is considering a slow exit from coal-powered energy. However, there is a longer-term story where this crisis accelerates the net-zero transition in other countries. For example, France is pushing for a swift adoption of nuclear energy to avoid severe

long-term supply disruptions. Increased nuclear usage could lead to opportunities in uranium and other participants in the clean technology space.

The duration of this conflict, which now seems long, will dictate the broader impact that it has on the global economy's transition to clean energy.

WHAT IS WORKING AND WHAT IS NOT IN 2022:

Oil	Commodities	Gold	US Dollar	Cash
53.0%[3]	32.0%[4]	7.5%[5]	3.2%[6]	0%[7]
US Govt Bonds	**IG Bonds**	**HY Bonds**	**Stocks**	**Bitcoin**
-1%[8]	-5.9%[9]	-6.0%[10]	-11.6%[11]	-20.7%[12]

Russia Hit with Sweeping Sanctions, Boycotts, and Negative Market Sentiment

In addition to broad government sanctions, companies are reducing exposure to Russia in droves to avoid reputational risk and reduce exposure to future sanctions.

Government sanctions on Russia thus far include:

- Freezing Central Bank of Russia assets.
- Restrictions on the SWIFT payments system.
- Freezing and seizing assets of Russian oligarchs.
- Banning Russian airlines from European airspace.

Non-governmental actions thus far include:

- Halting container shipments from Russia.
- Global firms closing their operations in Russia.
- Expelling Russia and Belarus from the Paralympic Games.
- Pushback against Russian athletes and artists.

Asset pricing is a strong indicator of market sentiment, and the Moscow Stock Exchange (MOEX) has been closed since February 28, which makes price discovery tough. Russian ETFs on U.S. exchanges, which can serve as proxies for the underlying market, indicate that the market is down about 80% for the year. 1USD is now equal to about 140RUB, compared to 1USD equaling about 75RUB before the invasion.[13] Needless to say, investor confidence in Russia is low. From our perspective, we are less concerned about the impact on the Russian economy and more focused on the impact of the war on Europe and the U.S.

Footnotes:

[1] BofA, Global Economic Weekly, 3/4/2022
[2] WSJ, Strong Hiring Low Unemployment Point to Economy Making Post-Pandemic Pivots, 3/4/2022
[3] FactSet, WTI Price, 3/7/2022
[4] FactSet, Bloomberg Commodity Index, 3/7/2022
[5] FactSet, Gold/oz, 3/7/2022
[6] FactSet, ICE US Dollar, 3/7/2022

[7] FactSet, BIL – US TBill, 3/7/2022
[8] S&P US Treasury Bond Index, 3/7/2022
[9] Bloomberg US Corporate Bond Index, 3/7/2022
[10] FactSet, JNK – HY Bond, 3/7/2022
[11] FactSet, VTI – Total Stock Market, 3/7/2022
[12] FactSet, BTC/USD, 3/7/2022
13 FactSet, RUB/USD FX Spot Rate, 3/7/2022