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Russia's Invasion of Ukraine

On Thursday morning Ukraine time (+7 hours from NY), Russia launched a full-scale attack on Ukraine. Assisted by neighboring Belarus, Russia launched airstrikes on multiple cities across the entire country, including Kiev (the capital). At the same time, tanks were moving through Crimea, navy ships ported in Odessa, and cyber-attacks have hit banking and defense systems across the country. The situation on the ground is fluid.

Our thoughts are as follows:

We are going off the base case scenario that Russia expands into Ukraine, with major sanctions imposed, but no military movements from NATO. While higher oil prices are expected, we expect no major disruption to commodity supplies coming out of Russia.

The global macroeconomic and markets impact from this event is likely to be predominantly through higher energy prices. BofA expects brent crude prices to increase to between $110 and $120 / barrel, barring any impact on energy infrastructure because of the war.[1] While sanctions will be imposed on Russia, these sanctions are unlikely to target energy due to the world's reliance on energy from Russia. As the world's largest producer of oil, at 10% of global oil, and the world's second largest gas producer, this production cannot be replaced and thus also cannot be sanctioned. This reduces the probable global market impact of this event while also strengthening Russia's hand.

From a market perspective, geopolitical events typically have a short-term impact on markets (typically less than 3 months). Below are our base case scenarios:

U.S.

- Reasonably small adverse impact on U.S. economic growth expectations provided Russian energy supply is not impacted. Should energy infrastructure be impacted by the war, this is expected to have a larger impact on energy inflation, and this may weigh on consumption and GDP.
- While the consumer in the U.S. may be hit by higher energy costs, we should see little impact on the overall economy in the U.S. because the U.S. is energy independent.
- Market is starting to expect higher energy prices for longer, pushing out longer term breakeven inflation.
- U.S. markets typically recovers earlier from geopolitical events. This is due to its safe haven status. This may provide less support currently due to portfolio positioning generally already having a U.S. tilt.

Europe

- Europe has more concern than the U.S. as they rely on natural gas from Russia (about 40% energy comes from Russia). Another factor weighing down on Europe is that relatively to the U.S they have seen less wage growth over the past decade. That, coupled with a weaker Euro makes higher crude and gas prices more painful.

- The UK is much less exposed than Europe. Potentially 50 bps of GDP in Europe is at risk from lower consumption due to higher gas prices. Higher energy prices can weigh on profits at a time when demand may be weakened.
- For this winter, Europe will probably have sufficient energy, but if restrictions continue into next winter there is likely to be energy rationing. There is the risk that the growth outlook in Europe could sour significantly.
- There has been a flight to quality in Europe with spreads between bunds vs periphery countries widening. There is the increased probability that the ECB only hike to 0%.

Inflation expectations is the main avenue that this event impacts global economies and markets, impacting both soft and hard commodities. Grain prices are near their highest levels in 20 years further pressuring global consumers at a time when energy prices are elevated. Metals and other commodities may be impacted by sanctions, and this is expected to impact pricing and inflation.

But putting it all into perspective, aside from commodities, Russia does not play much of a role in the global economy. We (the U.S) do not rely on Russia for components that fit into the supply chain like we do with China. Europe's non commodity exposure to Russia is quite small and U.S exposure is even smaller. The S&P 500 has less than 0.1% direct sales exposure to Russia.

The tail risk is China using this disruption to escalate tensions with Taiwan. Should this transpire, it would likely have a more severe global and U.S. market impact. Our current base case is that China does not feel emboldened enough to move against Taiwan.

And, once again, the situation is fluid, but geopolitical events typically only have a short-term impact on markets. Remember, markets like certainty – we now have certainty on Russia's intentions.

Footnotes:

1. BofA Securities, EEMEA Conference: Russia / Ukraine: Global Implications, 2/24/2022