Newton: Macro Views on Russia/Ukraine

Newton senior research analyst Richard Bullock looks at the possible investment and geopolitical implications of Russia's invasion of Ukraine, (as at 25 February).

KEY POINTS

- Russia's position as a commodity powerhouse, coupled with high commodity prices, is likely to be what emboldened President Putin in his recent moves.
- We expect accelerated defence spending within European budgets and for this to be an important area of growth in future years.
- We think completely alienating Russia from the Western economic system is not a viable path, as this would create immense self-harm for Western economies.
- The medium-term implication of dependence on Russian commodities will be a concerted effort by Europe to diversify to other suppliers, and also to boost investment in renewable sources of energy.
- We anticipate Russia and China will double down on their efforts to cooperate in trade and technology.

Russia's invasion of Ukraine shocked financial markets. As is often the case with geopolitical events, we believe this event itself is likely to signify peak fear for investors, so investors may find opportunities to tactically add to risk assets.

However, given the profound geopolitical significance of this particular event – the first time a great power has invaded a fully independent sovereign state since World War II – we also believe it has more fundamental medium and long-term implications for economies and markets than most 'typical' geopolitical events. This could present both opportunities and risks for investors.

SANCTIONS

To fully appreciate the new landscape post Ukraine invasion, investors need to understand the nature of Western sanctions that have been imposed on Russia. A wave of sanctions had already been implemented following Russia's recognition of the separatist republics in Donetsk and Luhansk. These included the sanctioning of two Russian state banks, individual sanctions on specific oligarchs and members of Russia's Duma (the legislative body in the ruling assembly), and the certification suspension of the Nord Stream 2 pipeline. They were all targeted measures but generally non-systemic in the economic pain they would likely cause Russia.

By contrast, the latest wave of sanctions (25 February) is far broader and more systemic, and will likely have a significant impact both on Russia's economy and Russia's integration with the West. Sanctions encompass export restrictions on semiconductors, software and other technologies that target Russia's defense, aerospace and life-sciences industries, plus sanctions across 80% of Russia's banking system.[1] Importantly for Western economies (and a potential lifeline for Russia's), payments for energy purchases will be carved out of the sanctions. Lastly, the US, Europe, UK and Canada have pledged to block access to the SWIFT international payment system for some Russian banks.[2]

[1] Reuters. Explainer: Russian banks face exclusion as EU jins new round of sanctions. 25 February 2022.
[2] Guardian. US, UK, Europe and Canada to block Swift access for some Russian banks. 26 February 2022.

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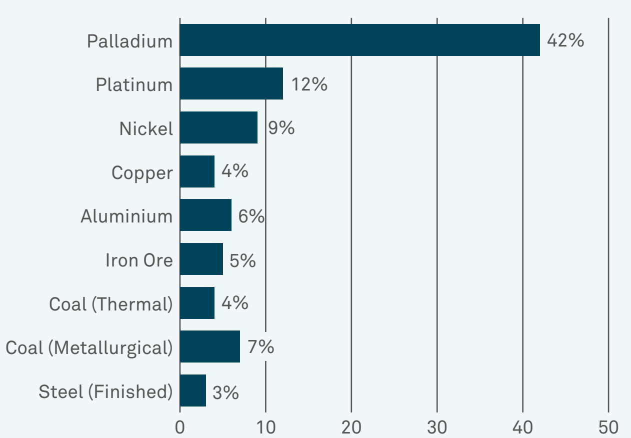
INVESTMENT IMPLICATIONS

1. Commodities: inflation, disruption, larger Western investment

Russia is the largest natural-gas exporter in the world, exporting equivalent volumes to the number two and three players combined. Significantly, Russia supplies about 40% of Europe's gas[3], a share that has been growing in recent years as domestic sources have matured. In oil markets, Russia is the second-largest producer and exporter after Saudi Arabia. In metals, the country has an approximately 5% global production market share in most categories[4], but this is significantly higher for precious metals including the PGMs (platinum-group metals) that are strategically important for CO2 emissions reduction and managing climate change.

Lastly, in soft commodities, Russia and Ukraine have been notable success stories since the end of the Cold War in raising farm yields and productivity. While the Soviet Union was a periodic importer of grains, Russia and Ukraine now account for about 25% of world grain exports[5], so hold considerable control over food markets. These statistics serve to indicate Russia's importance to the global economy, to supply chains and to inflation at this particularly sensitive time. Therefore, completely alienating Russia from the Western economic system is not a viable path, as this would create immense self-harm for Western economies.

Russia's global share of metals production



Source: Bank of America Global Research, 2020.

While we expect that commodity trade will continue between Russia and the West, the continuing geopolitical tensions and confrontational relations will make for a bumpy journey and periods of heightened volatility. For example, there have already been reports of Western banks refusing to grant letters of credit to purchasers of Russian oil owing to sanctions. Commodity markets, by their fungible nature are normally clear, but we see scope for commodities trade between Russia and the West to become more indirect, inevitably creating opportunities for traders, but also raising costs for the end user. Furthermore, investors cannot rule out periods of supply disruption as Russia becomes a less dependable partner, with a particular risk for natural gas given Europe's high energy dependency.

The medium-term implication of Russian commodity dependence will be a concerted effort by Europe to diversify to other suppliers. In the natural-gas space this would include Qatar, Australia and the US, which are all likely to see accelerated investment in their liquefied natural gas (LNG) capacities. Qatar, for example, has already been in close discussions with the West throughout the recent Ukraine tensions regarding emergency gas supplies. In the medium term, Qatar has said it plans to increase its LNG production from 77 million tonnes per year (mtpa) today to 126 mtpa by 2027[6], and a sizeable portion of this incremental growth will find its way to European markets. The second implication is likely to be an even more accelerated path towards renewable energies as these are seen as an important basis for national security in addition to the green agenda. We expect the nuclear, hydrogen, wind and solar industries to take on added importance in the wake of the Ukraine geopolitical event.

WHAT'S NEXT?

WESTERN SECURITY

Throughout history, emboldened great powers have typically proceeded to seek greater territorial expansion. Putin has stated that Russia has no intention of occupying Ukraine. However, he also repeatedly stated that Russia had no intention of invading Ukraine, and that the West was suffering from paranoia and hysteria. His recent actions serve to highlight the heightened distrust European countries will likely have towards Russia in the future.

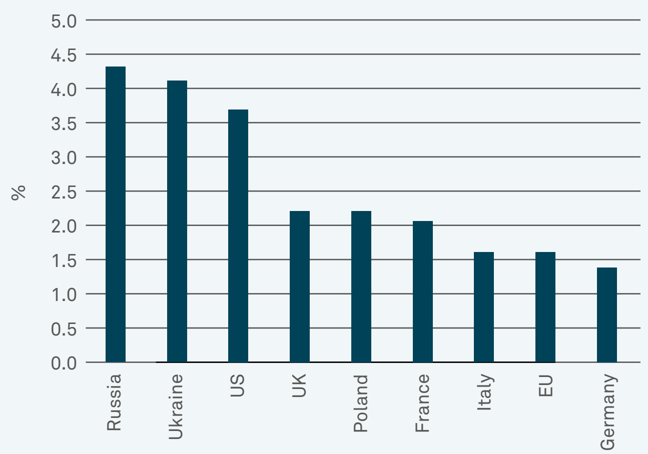
This distrust could evolve in the shape of a new Cold War, which could necessitate a sharp increase in defense spending, particularly by European countries.

Most European countries have increased defense spending in recent years, but several countries have remained well below the 2% of GDP NATO target (Forces Net. NATO: Which countries pay their share on defence? 24 February 2022). We expect accelerated defence spending will be an important feature of European budgets, and an important area of growth for the market in future years.

While a large portion of national-defence spending would likely be state-led in critical areas of contestation such as space, hypersonic weapons and drones (and should benefit the European and US defence primes), there will be an ever-growing portion of private-sector defence spending as companies allocate a growing share of spending to the protection of their critical infrastructure and IT systems. The growth outlook for the cyber-security industry looks strong in any case, but even stronger with a hostile and alienated Russia.

[3] Fortune. Putin might have just kick started Europe's green energy revolution – too bad Germany doubled down on natural gas. 25 February 2022.
[4] Wood Mackenzie. Bulks most affected by Russia-Ukraine conflict; rising prices a key concern. 15 February 2022.
[5] Fortune. Bread may be the first thing to go missing from our tables as Putin wages war on Ukraine. 24 February 2022.
[6] Hellenic Shipping News. Qatar plans to boost LNG production to 126 mln T by 2027. 26 November 2019.

US, European and Russian defence spending as % of GDP



Source: Stockholm International Peace Research Institute, Newton. As at end 2020.

INFLATION AND CENTRAL-BANK POLICY – THE DREADED 'S'-WORD

Putin's invasion of Ukraine has been carefully and tactically orchestrated not only to coincide with Europe's seasonally high demand for Russian gas but also with a period of high commodity prices, excessive monetary and fiscal stimulus and supply-chain disruptions, which have fed through to the highest consumer-price inflation in almost 40 years. The invasion of Ukraine and political after-effects will almost certainly add further proverbial fuel to the inflationary fire.

We believe the underlying supply-demand fundamentals of the energy market would put Brent crude oil at around US$85 a barrel, so the current US$101 oil price (on 25 February) implies a geopolitical-risk premium (to compensate for possible disruption) of around US$15 per barrel of oil. This is not an unusually high level of premium compared with previous geopolitical risk events, and we expect that the premium could persist for a lot longer than has been the case with many other events as the confrontation with, and alienation of, Russia will endure.

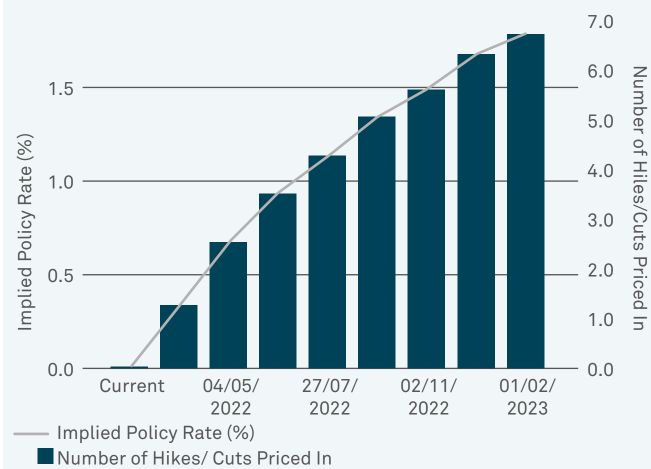
This dynamic presents a natural headache for central-bank policymakers. Just as the US Federal Reserve is expected to make its first rate hike in mid-March, and the European Central Bank (ECB) seeks to wind down quantitative easing and follow with a rate hike of its own later in the year, the spectre of stagflation now confronts the monetary-policy establishment.

Higher inflation prospects would naturally prompt central banks to tighten policy, but at the same time – particularly for the European economy – the Ukraine invasion and prospect of energy-supply disruptions will have a dampening effect on business and consumer confidence. Economic data over the coming months will need to be watched closely to determine whether geopolitics is affecting economic sentiment.

As things stand, we fully expect the Fed's Federal Open Market Committee (FOMC) to press on with its first and subsequent rate hikes in the first half of 2022, but remain to be convinced that the Fed will execute on the full seven rate hikes implied by money markets – particularly given the sharp flattening of the yield curve that has occurred in recent months. For the ECB, withdrawing liquidity from markets is likely to have an outsized impact on corporate credit spreads given its substantial buying activity in credit during the global pandemic. Therefore, the ECB could find itself with the uneasy prospect of having to sell corporate bonds back to the market just as Russia-Ukraine uncertainty is beginning to feed into European corporate credit malaise.

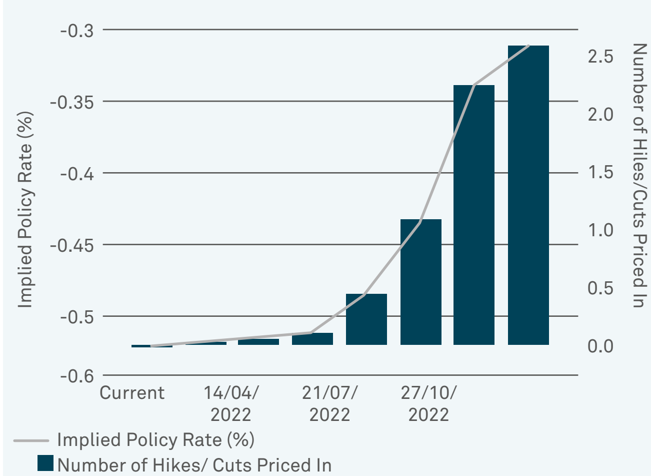
We would expect the threat of further sanctions and heightened tensions to keep energy prices high, but unless there is a material interruption to the energy supply the economic hit (thereby causing stagflation) could be less. This, in turn, will allow the central banks to start their tightening cycle, but may reduce the terminal rate.

US Federal Reserve implied rate hikes in 2022



Source: Bloomberg as at 25 February 2022.

ECB implied rate hikes for 2022



Source: Bloomberg as at 25 February 2022.

SINO-RUSSIAN COOPERATION – STILL A RELATIONSHIP OF CONVENIENCE, BUT GETTING CLOSER

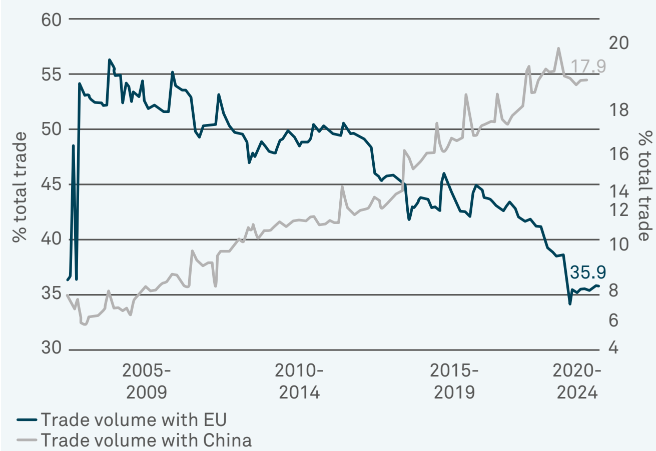
Following Russia's invasion of Ukraine, the US announced tough export restrictions on critical technology applications to Russia, including software and semiconductors. The EU has also said it will put export restrictions on industrial technologies that are valuable for Russia's growth. Although technology sanctions will cause deficiencies for Russia in certain areas such as defence technology, the country's lack of dependence on high-end manufacturing will be likely to prevent significant disruption. One effect could be to see Russia and China double down on their efforts to cooperate in trade and technology. Both countries already have a strategy to increase bilateral trade from a level of about U$140bn in 2021 to US$200bn in the medium term[7].

The long-term Sino-Russian cooperation strategy was in clear evidence in Putin's statement to President Xi and the Chinese people that accompanied his recent visit to the Beijing Winter Olympics. Putin referred to 65 bilateral investment projects currently in the pipeline worth a prospective investment sum of US$120bn[8]. Already, within the technology sphere, Russia provides civil nuclear assistance to China, but the speech listed a wider range of areas where technological cooperation and partnerships can be expanded, including in IT, medicine and space exploration, the latter being an area with significant scope for civilian technology spin-offs.

Despite closer Sino-Russian cooperation expected in the coming years, the asymmetric economic balance of power between the two countries, with China's GDP some nine times larger than Russia's in nominal terms, means that Moscow won't want to become overly dependent on Beijing. Memories of Cold War enmity between China and the Soviet Union and caution over spheres of influence in Central Asia will be ever present. We do not anticipate an official mutual defence pact between Russia and China to be a likely prospect. Instead, the Sino-Russian relationship will be one of economic and diplomatic convenience.

Given the latest sanctions, Russia will become practically isolated from the Western financial system, save for payments to purchase its commodities. As the Russian state and Russian companies become increasingly self-funded but unable to import from the West, the country will have few demands for US dollars. In anticipation of Western financial decoupling, since 2018 Russia's central bank has already reportedly reduced its US Treasury holdings to close to zero (FT. The $300bn question facing central banks. 02 March 2022).

Russia trade volume with EU and China (% total trade) 2003-end of 2021



Source: Bloomberg, As at end 2021.

President Putin's recent Beijing Winter Olympics statement highlighted a growing propensity for Sino-Russian trade to take place in local currencies, highlighting that the two countries "are consistently expanding settlements in national currencies and creating mechanisms to offset the negative impact of unilateral sanctions".

Meanwhile, Chinese officials are also pushing for greater local-currency usage as they support economic development across the Indo-Pacific region. By economically and financially alienating Russia and pushing the country into a closer embrace with China, the contours of a new global currency regime are perhaps beginning to take shape. The US dollar will likely retain its primacy for some time yet, but this dominance is coming into question and being eroded at the margin, with Russia's exclusion from the dollar-based system the latest development in this long-term trend.

At the same time, the People's Bank of China (PBOC) is elevating itself as a paragon of monetary discipline: real rates are positive, Chinese consumer-price inflation is benign (0.9% year on year in January), and there is a strong reluctance to slash rates to restart an aggressive credit cycle (FT. The $300bn question facing central banks. 02 March 2022). Global investors may need to consider the evolving position of the US dollar and other currencies as they perform their continuing asset allocation in a world in which Russia and China are more closely economically aligned.

[7] Business Standard. Russia-China trade to reach new peak in 2021 despite Covid: diplomat. 09 December 2021.
[8] Newton Investment Management Research. February 2021.

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