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Research & Strategy Insights

Russia Ukraine: Frozen conflict heats up

The macroeconomic and market consequences of Russia's attack

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Key points

- At the time of writing, Russia had embarked on what appeared to be a full-blown invasion of Ukraine.
- Many relevant factors remain uncertain, but we will provide guidance on how we may adjust our baseline outlook.
- We assume that oil and gas prices stay elevated for much longer driving headline inflation around 1 percentage point (pp) higher across key regions this year.
- Price rises will exacerbate real income squeezes, resulting in global GDP slowing to 3.6% this year (from 4.0%), with output falling by 0.6 to 0.3pp in key economies.
- Beyond Russia and Ukraine, European economies look to be most affected. We assume little change to our monetary policy outlook but further fiscal easing is possible in the Eurozone and UK. In the US, we consider an adjustment in our outlook to Federal Reserve tightening to stabilise growth.
- Financial markets have reacted bearishly, with the US dollar gaining most safe-haven flows. Yields fell back, equities were lower and corporate spreads widened. However, moves initially were modest and orderly.

Economic and market impacts of Russian invasion

With Russia having invaded Ukraine in what appears to be a full-blown military offensive, we consider the possible economic and market implications. At the time of writing, there are more uncertainties than certainties in terms of the outlook, especially given the fluidity of the situation. The following note reviews the key issues which are likely to be at play and examines the important channels through which these will affect international economies and markets, beyond Russia and Ukraine.

Given this uncertain backdrop, we will look at the adjustments we are likely to make to our global forecasts as presented in our recent publication[1]. We will detail our broad expectations for key markets – specifically in energy – and how these developments are likely to impact global growth, inflation in key economies, economic policy responses and broader reactions across financial markets. We analysed the impact primarily in the Eurozone, as well as in the US, UK, China and specifically Russia and Ukraine – as well as considering the broader issues for emerging markets.

The long, slow path to war

In the early hours of Thursday 24 February 2022, Russian President Vladimir Putin announced on state television that he had decided to "commence military operations in Ukraine". In the hours that followed, reports of artillery,

[1] "Frozen Conflict", AXA IM Research Monthly Investment Strategy, 23 February 2022.

missile and air force strikes on target in Ukraine emerged. Tanks have been reported entering Ukraine from at least four different areas, with Russians working alongside Ukrainian separatists and Belarusian forces.

While developments have accelerated in recent days, tensions have been escalating for some time. Troops had been gathering along the Ukrainian border since late last year. President Putin delivered a key speech on 17 December outlining a range of broad demands including the exclusion of Ukraine from any future NATO enlargement; restrictions on NATO members that joined after 1997; and respect of the Minsk agreement. More recently – and following the US's written rejections of Putin's demands – Russia's recognition of two separatist states within Ukraine's Donetsk and Luhansk regions narrowed the prospect of a diplomatic solution, clearly diverging from the Minsk agreement. Thereafter, Russian troops entered Ukraine.

The West, including US, the EU, UK and Canada, imposed new sanctions earlier this week in response to Russia's initial steps. These included targeting individuals close to Putin, two state-owned banks and a ban on secondary market trading of newly issued Russian government debt. Following Russia's invasion, further "severe" sanctions were added. These included freezing assets of Russian banks (targeting 70% with EU sanctions, 80% US); prohibiting debt and equity issuance of private, state owned and sovereign issuers; further restrictions on individuals, entities and subsidiaries; restrictions of technological exports, including dual-use technology, biotech, semiconductors, and aerospace and mining equipment. London also banned Aeroflot flights and accelerated a crime bill to target illicit Russian money.

Broad economic assessment

We expect the direct disruption of trade links between Russia, Ukraine and the rest of the world as unlikely to be the main risk to economic growth for the global economy. Exhibit 1 presents key economies trade share links with Russia and Ukraine (as a % of GDP). While, as we discuss below, some of these imports are key, their magnitudes are not large.

Exhibit 1: Direct trade links with Russia/Ukraine

	Russia (to/from)		Ukraine (to/from)	
Country	Exports % GDP	Imports % GDP	Exports % GDP	Imports % GDP
Euro area	1.4	1.9	0.3	0.2
Germany	1.8	2.4	0.4	0.4
France	0.8	0.9	0.2	0.1
Italy	1.0	1.8	0.2	0.4
Spain	0.6	0.7	0.2	0.3
US	0.0	0.1	0.0	0.0
China	0.4	0.6	0.1	0.1
UK	0.2	1.2	0.0	0.0

Source: Eurostat, United Nations and AXA IM Research, 2020 data

We consider the biggest economic shocks to be transmitted through energy markets. Rising European natural gas prices are likely to be a key risk to household real income growth in the Eurozone and the UK, which in turn would likely further reduce consumption. Business sentiment may also weaken and rising energy costs are likely to reduce profits and investment for Europe-based companies. By contrast, US exposure to natural gas price increases is anticipated to be smaller, but the indirect, upward pressure we expect on oil prices is likely to have a more direct impact on the US consumer. Moreover, our growth forecasts are based on this assumption of where energy prices might trade as the conflict continues. Yet we additionally warn that we do not assume different outcomes will impact the forecasts linearly. We are wary that if prices move by double what we have assumed, growth impacts could be more than twice as large – a real risk if the conflict becomes more extreme.

Finally, while direct exposure to Russia/Ukraine is not considered a large threat to activity, the co-ordinated softening in global demand likely to follow the indirect effects is likely to have a knock-on effect in other regions. Developing markets face a softening in key export markets, on top of rising inflation pressures, and the prospect of more domestic monetary policy tightening. China is likely to see a drop in overseas export demand as an additional headwind for domestic authorities to navigate.

Exhibit 2: Assumptions and projections

Summary of Russia-Ukraine conflict assumptions and projections

Assumptions		2022	2023
Oil price (WTI)		$125 (peak)	$100 (end)
European gas price		€125/MWh (peak)	€80/MWh (end)

Projections (%)		Projected new forecast		Current forecast	
		2022	2023	2022	2023
Global	GDP (avg)	3.6	3.2	4.0	3.5
Euro area	GDP (avg)	3.0	1.6	3.4	2.1
	CPI (avg)	5.1	2.2	4.0	1.7
	Policy rate (end yr)	-0.25	0.00	-0.25	0.0
US	GDP (avg)	2.9	2.2	3.2	2.0
	CPI (avg)	5.8	3.1	5.0	2.9
	Policy rate (end yr)	1.25	2.25	1.25	2.75
China	GDP (avg)	5.0	5.0	5.0	5.3
	CPI (avg)	2.5	2.8	2.0	2.3
	Policy rate (end yr)	2.65	2.65	2.75	2.75
UK	GDP (avg)	4.0	1.7	4.3	2.1
	CPI (avg)	6.3	2.4	5.5	2.1
	Policy rate (end yr)	1.00	1.00	1.00	1.00
EM	GDP (avg)	4.0	3.9	4.4	4.3

Source: AXA IM Research, 25 February 2022

Exhibit 2 shows our key assumptions with regards to energy price developments and a summary of our projected impact on GDP, inflation and central bank policy rates. In summary, we consider the conflict likely to lift inflation even further and more persistently over the coming two years. We forecast Eurozone inflation 1.1 percentage point (pp) higher in 2022 (US 0.8pp and UK 0.8pp) and 0.4pp higher in 2023 (0.2pp and 0.3pp).

We estimate that this would reduce global GDP to 3.6% from 4.0% in 2022, and to 3.3% from 3.5% in 2023. The severity of reduced growth outlooks for both Russia and Ukraine will be highly dependent on the specificity of the conflict and sanctions, but certainly for the latter the precedent is for a sharp drop in activity. Yet overall global growth is likely to be dominated by the relatively smaller moves in the larger economic regions. For example, we estimate GDP to be 0.4pp and 0.5pp lower this year and next in the Eurozone (0.3pp and 0.4pp in the UK) where gas price increases will reduce real incomes further. Estimated growth declines could be mitigated by additional fiscal stimulus, but we see little meaningful change in outlook for either the ECB or the Bank of England (BoE) relative to current forecasts. In the US, we estimate a 0.3pp dip in activity this year but expect the Federal Reserve (Fed) to ease its pace of tightening. This should lead to growth of around 0.2pp more in 2023. Chinese activity is expected to be broadly stable, with the authorities providing more stimulus to achieve this outcome. The outlook for emerging markets (EMs) will be mixed, reflecting their heterogenous characteristics.

The fog of war

Of course, this evolving situation presents several uncertainties. At this stage, we do not know what Russia considers to be its ultimate goal. A widespread invasion appears underway and is towards the more adverse of the end of the scenarios we have considered. However, it is unclear for how long this will persist and the degree of effective resistance invading forces will encounter. Moreover, Western powers have announced a range of more severe sanctions, but it is unclear whether these will influence the conflict on the ground, and whether they will be supplemented in due course. Finally, despite Russian assurances that it would not cut energy supplies, it is unclear whether this will prove the case in the face of sanctions.

All of these factors will have a material effect on energy markets. European natural gas markets are likely to be the epicentre of this shock, to which Russia supplies 40%. Gas prices had risen 20% from already elevated levels after Russia's recognition of the separatist states. They rose a further 40% after the announcement of invasion. But this is not an isolated shock. Liquified Natural Gas (LNG) prices – the internationally-traded portion of natural gas – surged across the globe. This will see natural gas prices rise in most regions, albeit with smaller amplitude than in Europe.

Oil prices have also been impacted, with prices initially soaring past the $100 a barrel mark, for the first time since 2014 (when Russia invaded Crimea) reflecting the risk premia associated with Russian oil supply and demand substitutability in the face of tighter gas markets. Russia's supply response to sanctions will have a key bearing on energy market prices. The US has announced that it will release some of its Strategic Petroleum Reserve (SPR) to help mitigate any short-term oil price pressures – although for now we do not know how much. Separately, the independent progress of discussions on the Iran Nuclear Deal could also impact the outlook, with Iran plausibly able to increase global oil supply by 1mn barrels of oil per day within months, and having the world's second largest gas reserves.

Energy markets remain our principle concerns, but Russia and Ukraine are also important suppliers of wheat and corn, with supply disruption aggravating already elevated food prices. Russia is also a leading producer of palladium (more than 35% of global production), essential for many memory and sensor chips. Several gases, such as neon and helium, also used in the chipmaking process, are by-products of Russian steel production, which are then refined by Ukrainian firms for use by semiconductor manufacturers. Further supply disruption of specific commodities could add to pressures already endured by the global economy.

More endogenously, material uncertainty surrounds specific policy responses. In each region we consider the implications of developments for specific policies, considering a more material fiscal response in the Eurozone, a shifting monetary policy dynamic in the US – and both in China. These decisions would dampen the real impact of the broader exogenous shocks and likely spill over into other regions. In addition, financial market reaction will also impact real effects and is also uncertain. Early market reaction saw a predictable weakening in risk assets and gains in considered safe-haven assets, including the US dollar – in total a net tightening in financial conditions. Yet so far, overall adjustments have been modest and orderly. The evolution of market sentiment will have a bearing on the economic outlook.

The long game

The focus of our attention is on the medium-term implications of the unfolding conflict. However, there are many longer-term implications and the uncertainty around these increases with the timescale. In brief, we consider the following to be important.

Developments will alter the European security landscape. This may see a greater need for more defensive deployment to NATO signatories and other worried Russian neighbours. We can conceivably see this as ushering in a period of greater armament and defence spending among NATO members, particularly in Europe. Moreover, with more unconventional conflicts emerging, this could increase Western investment in cyber-defences. In total, this looks like a further pressure for public funding when many European economies are already more indebted in the wake of the pandemic.

This crisis will also influence climate change preparations and the transition to zero carbon. The transition already underway has left the West particularly vulnerable to recent developments. The phasing out of some fossil fuels has left many economies unable to tap natural energy reserves like coal, under-provisioning natural gas reserves and may yet dampen the response to elevated prices even now. This has contributed to and may prolong a period of elevated prices in reaction to these developments. It may, however, also serve to accelerate transition – certainly from Russian gas – but plausibly from fossil fuels in general, as the 1970s prompted a transition away from oil. The precarious point of this transition is likely to have been a factor in Russia's strategic calculus, not least as Russia is not the foremost advocate of greenhouse gas reductions, with both less to lose from climate change than other regions, and more to lose from transition. Longer term, any accelerated transition may also include carbon border taxes, which could now be more forcefully applied against Russia in the future.

Longer-term strategic geopolitical relationships should also be considered. China has avoided condemning Russia for its invasion of Ukraine and has rather urged all sides to deescalate tensions. However, sanctions on Russia since its invasion of Crimea have resulted in increased engagement between these two countries. This engagement has included increased direct energy supply, coordinated military manoeuvres and could conceivably increasingly include combined payment systems. The degree of future interaction might add to US and China tensions in the future.

Perhaps most ambiguously, recent developments may also have an impact on Western politics. The last decade has seen significant Russian-backed funding of Western political parties and accusations of cyber-interference in the Brexit referendum and 2016 US Presidential Election. A stricter sanctions regime, a greater pariah status of Russian money, increased cyber defences and awareness might result in more subtle shifts on national levels.

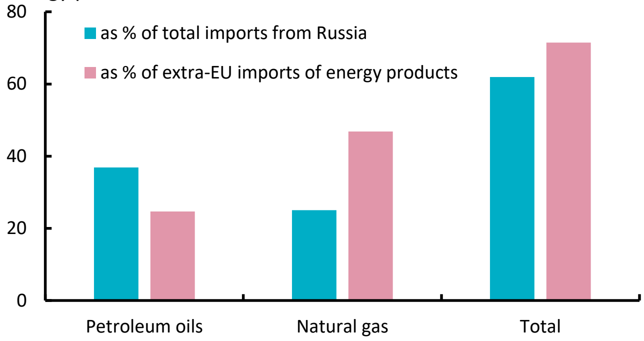
Eurozone – inflation jumps, growth lands softly

A persistent armed conflict between Russia and Ukraine would likely affect euro area activity first and foremost via the energy channel, which would lead to persistently higher oil, gas and electricity prices[2] that would in turn affect domestic demand (Exhibit 3). Beyond the direct impact on consumers (see below), company investment may also be impacted by squeezed profit margins – and lower sentiment – although we are mindful that persistent higher energy prices may also reinforce efforts towards the green transition. We have not accounted for potential gas supply limitations which could severely disrupt industrial output. Trade and financial channels are likely to be less impactful.

Foreseen tensions on energy prices throughout our forecast horizon would push euro area headline consumer price inflation higher by 1.1pp this year and 0.4pp in 2023 to 5.1%yoy and 2.2% respectively. Having not accounted for food price adjustment, risks to this forecast are probably skewed to the upside. Although Eurozone employment would adjust lower, affecting household's disposable income – more likely in 2023 – we do not think core inflation would be significantly negatively impacted owing to lagged energy effects (transport prices), and wage rigidities from the labour market.

Exhibit 3: Europe's hands are tied

European countries import a sizable share of energy products from Russia



Source: Eurostat and AXA IM Research, 24 February 2022

Dented euro area household purchasing power would suggest private consumption growing by 3.7% and 0.9% this year and next (-0.8pp and -1.2pp versus our baseline). We have assumed that households' saving rates would go down swiftly to pre-COVID 19 crisis levels and stay there until the end of the forecast horizon. Although not envisaged, any use of households' excess savings accumulated since Q1 2020, estimated at €800bn in Q3 2021 – circa 10% of annual disposable income – would brighten the picture.

In all we suggest that Eurozone GDP would grow by 3.0% and 1.6% this year and next (-0.4pp and -0.5pp from current baseline), more or less at potential growth rate in sequential terms in 2023.

Despite this deteriorating outlook for growth, we are sticking to our previous assumption that the ECB will cease net Asset Purchase Programme (APP) purchases around six months after the Pandemic Emergency Purchase Programme (PEPP). We think that such an adverse macro scenario would not sufficiently derail growth and inflation for the ECB to continue with net QE purchases without an end date. A limited widening in peripheral spreads meaning that funding rates remain low so far concurs with this assessment. Given the likely persistence of an extremely uncertain environment, we continue to think that flexibility and optionality are likely to be front and centre of the ECB narrative. We cannot rule out that the ECB could extend APP beyond October at a slower pace, to help rein in confidence. Furthermore, we recall the ECB's commitment last December to reinvest flexibly matured PEPP investments, and Chief Economist Philip Lane emphasized in an interview on 23 February that "we will always be vigilant, we care about fragmentation risks".

[2] Moec, G., "Money, it's a gas", Macrocast #124, AXA IM research, 21 February.

We maintain our call for a first 25bp hike in December but think a normalisation path beyond this first step may be more gradual given the foreseen negative impact on demand, as well as inherent uncertainty. As a result, we would see a second hike postponed by at least three months from our current baseline (March 2023).

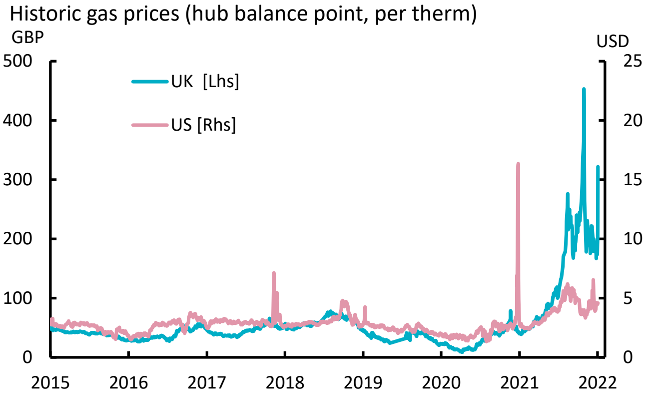
Fiscal policy is also a non-negligible wild card. Although there is very little visibility at this stage – and thus not something we include in our baseline – we think fiscal policy is likely to be used again to protect household income and company margins, similar to measures deployed after last summer, and most recently by Italian Prime Minister Mario Draghi – an additional package of some €6bn presented last week – with Italy and Spain standing the most vulnerable to a protracted energy crisis. With no nuclear-based energy output, Italy is vulnerable to gas price increases, gas amounting to around 40% of the country's primary energy consumption (similar to oil), with fossil fuels accounting for around 60% of electricity production. Although Spain is also vulnerable with more than 80% of contracts on variable tariffs, Italian public debt amounts to 155% of GDP (35pp higher than Spain) in 2020, leaving it less fiscal leeway.

The EU could also join forces with respect to fiscal policy. Although different in nature, the characteristics (exogenous and asymmetric) of such a shock are similar to COVID-19, which saw the Eurozone employ mutualised debt support for member states. Although the latter would be difficult to replicate in the short term, we cannot rule out the EU stepping up - all the more under the French Presidency of the EU Council – and reviving tools such as 'SURE' financial aid, additional resources from the EU budget and European Stability Mechanism credit lines to ensure low financing costs especially for most fragile member states' public finances.

US outlook – cushioned by the Fed

Compared to the impact on Europe, a fuller Russian-Ukraine conflict should be less severe for the US. Direct trade links between the US, Russia and Ukraine are smaller than Europe's. The US exports just 0.35% of total exports to Russia and 0.13% to Ukraine; it imports 0.76% of total imports from Russia and just 0.059% from Ukraine. Of course, broader global demand is likely to soften. In the Eurozone, we consider a 0.4pp and 0.6pp reduction in GDP for this year and next. The Eurozone constitutes a much bigger 15% of US trade (2021). However, US exports constitute just 12% of GDP – far smaller than euro area trade and most other developed economies. Accordingly, we do not expect a large direct trade impact on the US.
The energy price impact is again likely to be the main transmission channel in the US but should also be less severe than in Europe. Exhibit 4 illustrates that while US natural gas prices have risen in sympathy with global pressures, they currently stand around 65% higher than the average of H1 2021 – below Europe's 185% rise. A further surge in European gas prices would be expected to have a similarly milder impact on US prices. Moreover, the US electricity network is not as gas-centric as in Europe, meaning the pass through from gas to broader power prices should be less in the US.

Exhibit 4: US gas prices less affected than European



Source: Bloomberg and AXA IM Research, 25 February 2022

However, the conflict would still likely provide an energy price shock to the US. Driven by the rise in gas prices, oil prices have also increased, surpassing the $100/barrel mark. West Texas Intermediate crude futures are some 50% higher than they were in H1 2021 and we expect these to rise further and stay elevated for longer. This would exacerbate already-elevated rates of US inflation and further delay any meaningful easing. We currently forecast US inflation averaging 5.0% in 2022 before falling back to 2.9% in 2023. A rise in oil prices to around $125 would likely lift our inflation forecast to 5.8% and 3.1% respectively. However, we reiterate that the US may tap its Strategic Petroleum Reserve to alleviate short-term price spikes.

Such an oil price shock would add additional headwinds to US growth. In the first instance we consider the impact on household spending, where real incomes would be further squeezed. In broad terms, with consumption accounting for 70% of GDP, a 0.8pp reduction in real incomes could lower growth by around 0.5pp.

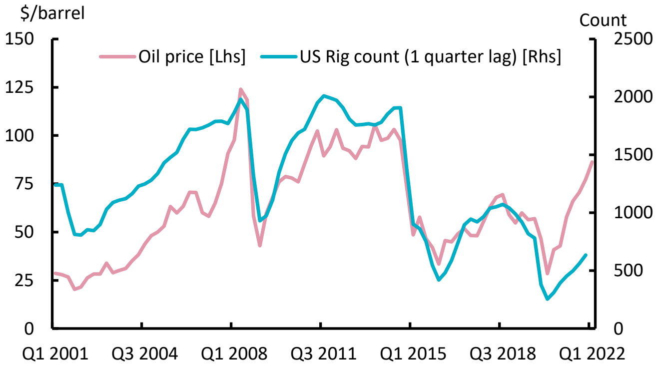
In recent history oil price shocks have had less of an overall impact on growth. The negative impact on consumption has been partially offset by rising investment in oil and gas. The Fed's macro model suggests a growth impact of just 0.2pp, while other forecasters estimate an even smaller impact[3]. Yet to date, the US response to higher oil prices has been relatively muted (Exhibit 5). We are wary the investment response to higher oil prices may continue to be weaker

[3] By our calculations, Goldman Sachs ready-reckoners consider an impact of 0.08pp based on a $25 rise in oil prices, comprised of a near 0.4pp drop in household spend, but offset by a 0.3pp rise in oil investment.

reflecting the risk of other supply boosts dampening prices and with the possibility of a swift end to the crisis. Investment may also remain subdued where concerns of impending climate change legislation reduce investment incentives. This appears to have been the case in Canada, where oil investment has been more subdued relative to oil prices since around 2015. On balance, a conflict-driven energy shock on the scale we anticipate would likely lower growth by around 0.3 to 0.4pp.

Exhibit 5: Rig count reacts slower to rising oil prices

Rig count and oil price



Source: Our World in Data and AXA IM Research, 24 February 2022

The Fed would also likely react to deteriorating geopolitical conditions. We currently forecast it to raise the Fed Funds Rate to 1.25% by end-2022 and to 2.75% by end-2023. However, the Russian invasion is already tightening financial conditions, and growth looks set to slow. This process should achieve some of the economic deceleration the Fed would otherwise be trying to achieve through tighter monetary policy. The Fed is likely to remain concerned about inflation expectations as headline rates continue to rise, and so we do not expect the Fed to alter its expected path this year. However, as inflation begins to ease towards end-2022 and into 2023, the Fed will likely need to tighten policy less than in our baseline. We suggest a gradual path of tightening of one quarter point by one quarter taking rates to 2.25% by end-2023 and peaking at 2.5% in 2024.

A softer monetary tightening profile should cushion some of the impact on growth. The crisis would still likely reduce GDP growth this year and we forecast growth falling to 2.9% (from 3.2%), but growth in 2023 should be firmer 2.2% (from 2.0%).

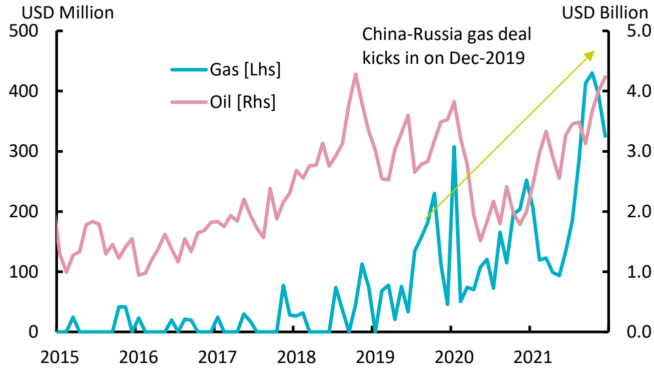
China – impact via financial markets

China's small trade exposure to Russia and Ukraine should keep the economic fallout from the escalating tensions manageable. Russia accounts for less than 2% of China's total exports, while Ukraine is even smaller at 0.3%, with the sales concentrated in consumer products (42%) and capital goods (39%). On the flipside, China is a major buyer of Russia's oil and gas, which account for around 14% of China's annual energy purchases (Exhibit 6). Hence, a sharp contraction in the Russian and Ukrainian economies – as a result of a severe military conflict – would unlikely be a major setback for China's exports, but Russia may seek to increase energy sales to China to circumvent Western sanctions.

However, a broader softening in global aggregate demand because of the indirect effects of the conflict, including for example energy price pressures on European growth, will provide more of a material headwind to China's already softening activity.

Exhibit 6: China is a major buyer of Russia's oil and gas

China's oil and gas imports from Russia



Source: CEIC and AXA IM Research, 24 February 2022

Moreover, the near-term impact on China will be exacerbated by moves in financial markets in the form of rising commodity prices and risk aversion. We estimate rising energy prices accounted for about a half of the consumer price increase over the past year. A further increase in these prices will add inflationary pressure, although with CPI inflation currently well below the People's Bank of China's target, we see little risk of this derailing Beijing's policy easing agenda. Instead, higher energy costs will serve as a de facto 'tax' on purchasing power of households and businesses. This, combined with sharp declines in asset prices due to risk aversion, could add pressure on the economy prompting Beijing to do more to support growth and markets ahead of the once-in-a-decade leadership reshuffle later in the year.

Beyond the near-term impact, increasing tensions between Russia and the West may lead to further economic engagement between the Kremlin and Beijing. The two countries have just signed a new energy supply deal which would increase Russia's gas exports to China by 26%. Russia is also planning to construct a new gas pipe to China via Mongolia that would see its gas exports more than double once completed. The two sides have also agreed on increasing oil trade and strengthening cooperation on nuclear power generation. An enduring Russia-Ukraine/West conflict could therefore reshape the global energy market – by changing the behaviour of a major energy supplier and the world's largest energy buyer – leading to profound and complex geopolitical consequences in the future.

UK – terms of trade shock intensified

Similarly, energy prices are likely to be the main problem for the UK economy. Energy futures prices had suggested a slight easing of the regulatory price cap when it is next adjusted in October 2022. However, if the conflict leaves gas prices higher for longer as looks likely, the energy price cap would likely be adjusted further upwards in October, by over 15% even with current levels of government support. This will drive inflation higher in H2 2022, when we had previously expected prices to be falling. Indeed, on our new energy price assumptions, we forecast inflation in 2022 averaging 6.3%, up from 5.5% and 2.4% from 2.1% for 2023.

These developments will contribute to an intensifying real income squeeze and act as a drag on UK growth. Although this should in part be cushioned by households drawing down on savings, the uneven distribution of these savings, the sharp expected scale of real income squeeze and the added uncertainty that this conflict brings raises the chances of a more material slowdown in consumption despite the savings buffer. We forecast that growth would be lower by 0.3pp in 2022 and a further 0.4pp in 2023, leaving growth at 4% in 2022 and 1.7% in 2023 (compared to 4.3% and 2.1% currently).

The government is likely to continue to come under pressure to provide further support for households amid an intensifying cost of living squeeze. This could reignite calls for the Government to scrap the National Insurance hike planned for April. Public finances figures suggest space to do so with the government deficit year-to-date at £17.7bn less than forecast. An adjustment at the upcoming Budget on 23 March could reduce the expected negative growth impact somewhat.

At present, we do not change our previous call for the Monetary Policy Committee (MPC) to hold rates at 0.5% in March. The increased escalation likely intensifies the UK’s terms of trade shock, but in the short term the uncertainty over the conflict and risks to growth provide strong reasons to delay further tightening. We continue to expect the MPC to raise rates in May (by 0.25% to 0.75%) and again in August but we accept there is greater uncertainty around this call given how the conflict evolves and how economic agents react to now expected higher peaks in inflation. In 2023, we now see a greater risk that the BoE may be more likely to consider unwinding some of the hikes, when we now expect inflation to begin to ease more rapidly and a with a more subdued growth profile. This will be particularly the case if concerns about rising inflation expectations force the MPC to tighten rates by more than we expect this year.

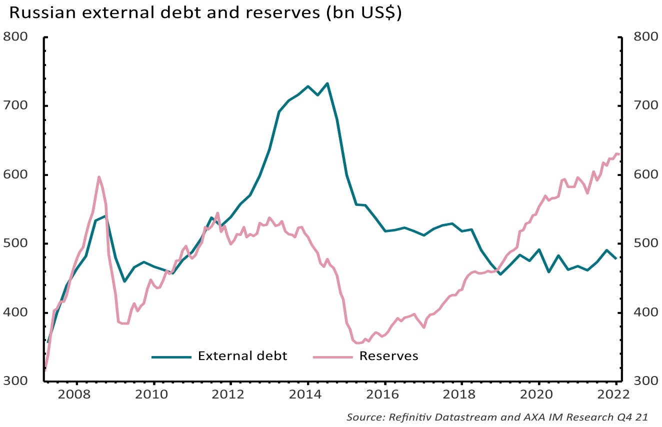
Russia

At the time of the Crimea annexation, the International Monetary Fund estimated the impact of sanctions on growth at around 1% to 1.5% through their effect on investment and consumption. GDP growth contracted by 3.2% from mid-2014 to mid-2015, a period during which oil prices fell from $115/barrel to $47/barrel. The economic contraction was nonetheless shallower than previous crises, thanks to Russia’s strong external position and the authorities’ swift implementation of various economic measures which cushioned the shocks, helped restore confidence and stabilised the financial system.

Since 2014, Russia has been operating under various sanctions imposed by the US and the EU and has adapted to these constraints. The government and the Central Bank of Russia (CBR) have together drastically reduced the role of the US dollar in its trade flows, financing and savings. Its banks and corporates have deleveraged since – total external debt reached 27% of GDP or 87% of exports last year. The macroeconomic framework now relies on the fiscal rule which sets the spending ceiling for the federal budget but also helps the real effective exchange rate to align to the non-oil sector productivity growth through foreign exchange sterilisation of the excess of oil and gas exports revenues.

Russia’s currency reserves stand at US$640bn, or 36% of GDP, having seen a gradual divestment from US dollar holdings into the euro, Chinese renminbi and gold. Fiscal metrics are strong, government debt was below 20% of GDP last year, and its issuance plans can easily be absorbed by local institutions (Exhibit 7).

Exhibit 7: Russia’s strong external position



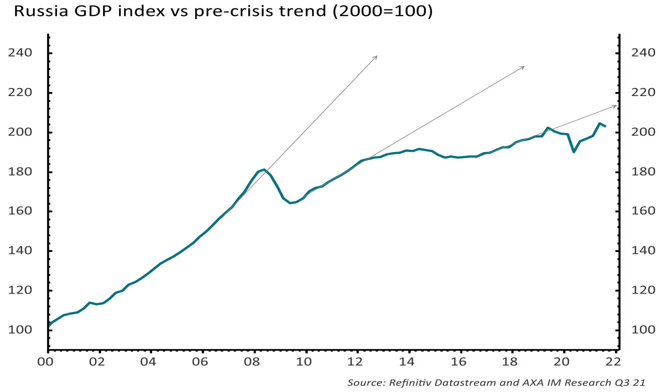
Source: Datastream and AXA IM Research, Q4 2021

The key channel of transmission from geopolitical tensions has been the rouble’s depreciation. The currency depreciated by 5.7% versus the US dollar since the start of the year even as oil shot up to $97/barrel from $78. The CBR is no longer adding to depreciation pressures as it has paused its foreign exchange purchases under the fiscal rule. Additionally, the regulator introduced forbearance measures allowing financial institutions to recognise stocks, bonds and foreign exchange rates as per their 18 February market value. Inflation pressures are likely to persist, suggesting policy rates have yet to peak and growth will likely slow from 4.7% in 2021, likely dipping in negative territory this year.

Unlike 2014, commodity prices will provide an additional buffer to Russia, an important global producer not only of gas, oil and coal, but also of base and precious metals, platinum group metals, fertilisers and soft commodities. The tenure of sanctions is so far relatively modest but a high uncertainty surrounds whether President Putin has reached his final goal. Extreme international sanctions could exclude Russia from the SWIFT financial system, an option that was considered but not taken at the time of the Crimea annexation. Russia has subsequently developed its own domestic settlement system, but its exclusion from SWIFT might bring it closer to the Chinese Cross-Border Interbank Payment System (CIPS), further polarising the geopolitical panorama.

Importantly, prolonged sanctions would affect capital accumulation and technological transfers leading to significant cumulative output loss over the medium term, although this may be somewhat mitigated by increased trade with China. Given adverse demographics and already weak productivity growth, such an outcome would be an additional burden for the already poor potential economic growth outlook of Russia, estimated to be at around 1.5% over the medium term, and dampened permanently after each past economic crisis (Exhibit 8).

Exhibit 8: Weakening growth profile in Russia



Source: Datastream and AXA IM Research, Q3 2021

Ukraine

2014 was a costly historical event for Ukraine, both in terms of human losses as well as economic pain. GDP contracted by 6% in 2014 and roughly 10% in 2015. In 2015, Ukraine's creditors agreed to write off 20% of their original holdings as part of a sovereign debt restructuring. Public debt declined to 54% of GDP by mid-2021 from beyond 80% in 2014 – external debt is slightly more than half of the total, bearing a relatively high cost. A full-blown conflict would trigger a collapse in GDP, further exacerbated by a negative terms-of-trade shock via energy prices. This would require additional public spending to support the economy and state-owned enterprises (SOEs), but it is unlikely to trigger yet another restructuring given the much lower debt ratios. High energy prices would feed into increased external financing needs via higher current account deficits, but its financing appears relatively comfortable given foreign aid (€3.8bn from multinationals) and foreign exchange reserves.

While a full-blown balance of payments or debt crisis may be averted, a prolonged war would have massive negative implications on the growth potential of Ukraine, estimated at around 4%. In 2019, prior to the pandemic, GDP per capita was still below the 2013 level.

The Ukrainian economy also lacks diversification. It remains largely dependent on trade with Russia, and on the weather, as its agriculture sector accounts for 40% of its exports. In the case of a material loss of territory, it would dramatically reduce the government's fiscal capacity and the country's export sector; the damage to GDP would be massive and unlikely to be recouped. Foreign direct investments will not return until there is a clear resolution to the conflict, leaving Ukraine's medium-term economic fortunes reliant on the domestic structural reform drive, which may be more difficult to handle in the current volatile environment.

Broader emerging market implications

The economic and market repercussions of the current crisis on developing countries will depend on the scale of the conflict, its duration and reactive measures taken by the US and Europe. The 2014 Crimea annexation event is likely a poor comparison. Oil prices were collapsing at the time, while Europe was barely emerging from its sovereign crisis and was caught off-guard. While Europe is now recovering from the COVID-19 pandemic, Russia appears in better shape, having built financial buffers since 2014. Naturally, Russian and Ukrainian economies and financial assets will be at the front line of any escalation of the crisis. The economic impact on the rest of EMs will primarily come through three main channels: A shock to energy prices (which may play out as an income transfer between cohorts), a re-assessment of the monetary policy stance as result, and the resilience of global demand.

Given the heterogeneity among EMs, persistently high global energy prices will support some but be detrimental to others, thus the overall growth impact will be mixed. Net exporters of fossil fuels, like Kuwait and the United Arab Emirates, or Colombia, Angola and Azerbaijan, will benefit from a supply-driven energy shock. Conversely, commodity net importers would face a negative growth shock and a deterioration of their external accounts. EM currencies, particularly the net importers, generally depreciate in risk-off environments as investors turn to perceived 'safe haven' assets like the US dollar. It's trickier to predict the net effect for energy exporters as elevated energy prices should help offset depreciation pressures.

Higher energy prices will push inflation rates persistently above central bank targets. Latin America or Central and Eastern Europe will probably have to speed up (and perhaps prolong) monetary policy tightening. Eastern Europe is particularly vulnerable. CPI baskets place more weight on energy prices than in other regions. Their growth profile depends on the health of the Eurozone economy. Sentiment may also be more vulnerable given the relative proximity to the conflict. Meanwhile, the direct impact for most parts of Asia is likely to be manageable given the region's more local production. Given that growth recovery remains the key focus this year, we expect most countries in the region to remain on hold for now. However, a hawkish turn could emerge sooner than expected on the back of heightened risks. Above all, the path of monetary policy will be driven by the Fed's stance, which for now we maintain as less hawkish than markets anticipate. Nevertheless, risks are skewed towards more monetary tightening that will weigh on domestic growth, at a time when a lot of countries have not caught up to pre-pandemic trend growth.

The energy price shock will undoubtedly also further test the resilience of global demand. Whether current excess savings in advanced economies and potential additional fiscal support will be sufficient to compensate for the purchasing power losses will determine the strength of the external demand for emerging markets. The determination of Chinese authorities to pursue an easing in the policy mix going forward would prove an additional support.

The current geopolitical crisis could also have a particularly pernicious effect on low-income countries through the knock-on effect on food prices. Russia is the world's largest supplier of wheat, and together with Ukraine it accounts for almost one quarter of total global exports. Similarly, Ukraine is the world's fourth largest exporter of corn. Any disruption to the flow of grains out of the Black Sea region would likely push up global food prices at a time where the pandemic has significantly increased food insecurity in the poorest and most vulnerable countries.

Market implications: Russian bear(ish)

The initial market reaction to the invasion was inevitably negative for risk assets. Government bond yields moved lower, equity indices lower and credit spreads wider. US stocks flirted with bear market territory, as Nasdaq futures before the market open pointed to a 20% drawdown from last year's all-time high. Some market patterns worth highlighting:

- In contrast to Monday (after Russia recognised the Eastern Ukraine breakaway regions), the reaction by the UST curve was not a clear bull flattening where the 10-year point yield drops but the 2y yield does not. Both the 2y and the 10y points of the curve declined with the shorter end a bit more than the longer end. This behaviour is closer to the typical bull-flattening behaviour in the UST curve in times of material risk-off episodes. A potential of hostilities and signs of a more protracted conflict could bring about some bull-steepening in USTs, as Fed hike expectations for 2022 could partially unwind (say, from 6-5 hikes currently back to the 4-5 hikes we consider).

- While credit spreads have widened consistently so far in 2022, the spread ratio between high yield (HY) and investment grade (IG) had been falling, in a bearish compression pattern. This changed this week, with the HY/IG ratio exhibiting a bearish decompression. This suggests credit is starting to price for a more material slowdown in growth and/or recession risk compared to simply reflecting a reset in risk premia, due to a more hawkish central bank outlook. In European credit default swap (CDS) indices the HY/IG ratio is heading towards five times, which has been approximately the average during 2022. The ratio was closer to six times for most of the 2020 pandemic shock after briefly spiking to 6.5 times.

- The reaction in European risk premia has been more severe than US risk premia. This is consistent with the closer proximity of the Eurozone to the conflict and the larger macro impact due to the spike in energy prices. Within Europe, credit and equities reacted evenly. CDS index spreads were wider by approximately 8%, which is just less than twice the 5% drawdown in equities: Within the historic norm of 1.5 to two times. Cash credit appears to be underperforming CDS, but this is partly due to the mechanical impact on spreads (wider) due to the big drop in the underlying government bond yields.

- There has not been a notable appreciation in the traditional safe haven currencies, like the Japanese yen or the Swiss franc. The former is perhaps a reflection of heightened energy input cost for Japan that now depends a lot on natural gas post its nuclear shutdown. The latter is perhaps a reflection of potential Swiss franc outflows if draconian sanctions on Russia force oligarchs to liquidate their holdings. As such, most of the safe-haven reaction has been in the dollar, with the US Dollar index (DXY) +1% on the day and the EURUSD dropping to near 1.11 before rebounding towards 1.12.

- The relationship between real rates and equities has worked in reverse on the day of the Russian invasion. A simultaneous jump in US inflation breakevens on the back of the oil/energy shock and a drop in US nominal yields, led to a notable drop in US real rates. This is contrary to the customary spike in real yields during market shocks like the global financial crisis and COVID-19, that tend to cause a collapse in inflation breakevens.

- Amid the downdraft in equity prices, the decline in real rates should support the outperformance of the Growth over the Value factor. This was evident in European bank stocks, which fell by twice as much as the broader market (-9% vs -4.5%), driven by their broader exposure to Russia and recession risk. US stocks staged an impressive rebound from the day's lows, with the decline in real rates and rotation out of European stocks two possible drivers.

Further market reaction will obviously depend on how the conflict evolves.

- The upside scenario for markets could be that Russia prevails within a week or two. This should hopefully minimise loss of life, albeit at the expense of Ukrainian democracy, with the longer-term negative of potentially emboldening Putin towards further aggression against other neighbouring countries later. Even then, assuming draconian sanctions on Russia and energy-related retaliation from them would still mean that energy prices remain elevated.

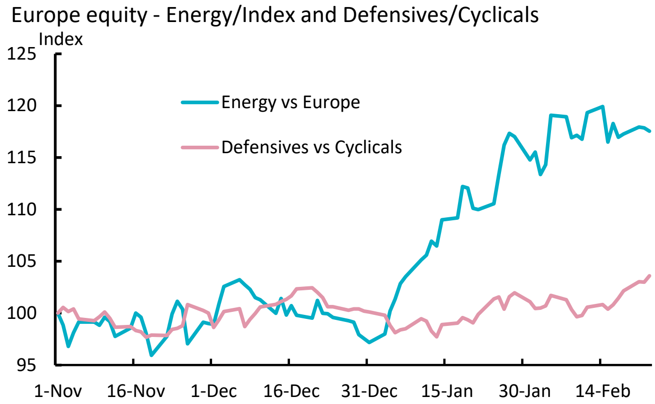
- A protracted conflict almost automatically implies material casualties on both sides. This would heighten geopolitical tensions and likely drive a larger risk-off move in equity and spreads. This would be partially offset by a dovish turn from central banks. Again, energy prices will remain elevated.

Equity – opportunities in despair

Fundamentally, the shock of the Russo-Ukrainian crisis is expected to have a mixed impact on earnings growth expectations for European stock indices (developed market country indices most exposed to this crisis). Considering that the nature of this shock is likely to drive commodity prices to higher levels, oil and gas companies' earnings should benefit However, the capital goods and chemicals sectors are likely to struggle as commodity price takers (Exhibit 9).

The impact of the crisis on sentiment will make market participants reluctant towards risky assets and redirect investments towards more conservative assets. For short-lived geopolitical crises, historically we observe a drop in multiples of the order of one standard deviation. Currently, this would translate into a decline in PE ratios by up to a fifth for the European market. If earnings growth remains in line with current consensus estimates, the impact on European equity markets could potentially be material.

Exhibit 9: Market reactions are already noticeable



Source: MSCI and AXA IM Research, February 2022

Added to this is a tricky macroeconomic complex - central banks may have to maintain their hawkish stance due to high inflation despite the further dampening impact on growth by the conflict in addition to already elevated energy costs. This mix is not positive for equities, but it does suggest more interesting entry points in certain market segments that could be beneficiaries in the future, such as European renewable energy.

Our Research is available on line: http://www.axa-im.com/en/insights

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