Playing Out the Ukraine Hypotheticals

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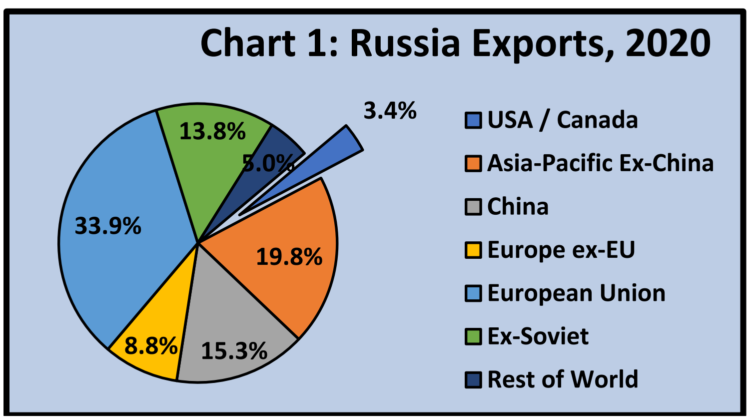
The standoff in Ukraine has rightly captured the attention of global securities markets, as investors speculate about Russia's next moves in a fast-moving and unstable situation. More than 100,000 Russian troops are massed near Ukraine's border, and President Vladimir Putin has shown few signs of backing down despite U.S. and European warnings of retaliation.

Let's stipulate here that Mr. Putin is not a stupid man. He certainly knows that he would provoke a response from the West if he were to order an invasion of Ukraine. So far, the U.S. seems utterly loathe to engage Russia militarily, so its response would be through economic sanctions such as trade embargoes, exclusion from global payments systems, freezing of Russian financial assets, and so on. The chess game, as it were, revolves around the question of who retaliation would hurt more: Would American and European economic sanctions cause more self-inflicted damage to Western economies than they are willing to bear, and would they hurt Russia's economy enough to cause Mr. Putin to reconsider his options?

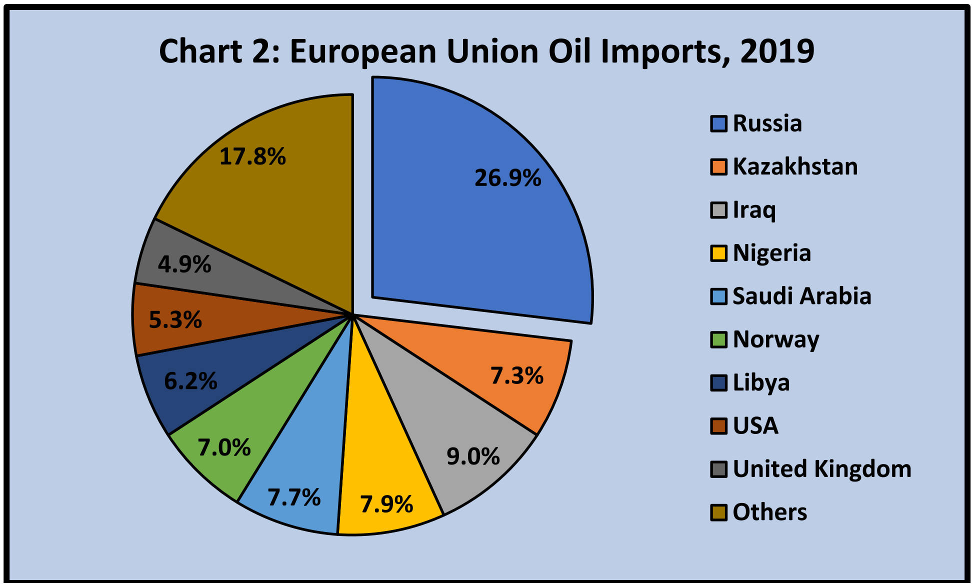
A quick look at Russia's international trade balances suggests that economic sanctions may not have much deterrent effect unless all major Western democracies act in unison. The United States, in particular, has almost no economic trade leverage against Russia, as Chart 1 shows: Barely 3% of Russia's exports come to our shores. Russia really doesn't care whether the U.S. is buying Russian goods.

Europe, however, is a very different story: The European Union purchases about one-third of all Russian exports, and other European countries (most notably the United Kingdom) buy another 9%. These countries, if they act in unison, can hope to exert some financial pressure on Russia by threatening to block imports of all Russian products.



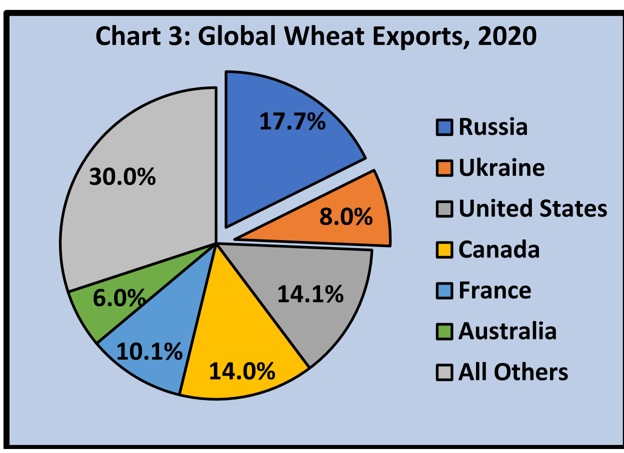
Source: www.tradingeconomics.com

The problem for Europe is that Russia has economic leverage over Europe, too. The NordStream gas pipeline has been in the headlines for good reason: Europe needs Russian natural gas. According to Eurostat, the European Union relies on Russia for 42% of its imported natural gas, 27% of its imported oil (Chart 2), and 47% of its imported coal. If Russia were to cut off supplies, Europe could not replace its fossil fuels quickly; no other country could step into the breach quickly enough to avoid a major supply shock to Europe's economy.

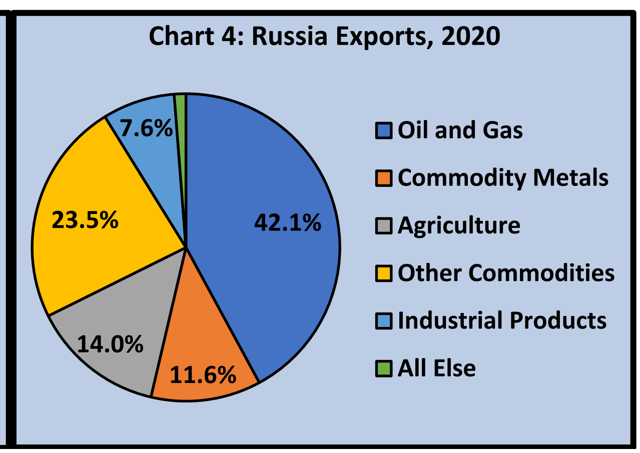


Source: Eurostat

Russia has similar leverage in other markets, too. The country is a major exporter of agricultural products. Indeed, as Chart 3 shows, Russia exports more wheat onto global markets than the United States does. Together with Ukraine, Russia controls about one-quarter of the global wheat market. It is likewise the largest global exporter of corn. While the U.S. doesn't need Russian agriculture, much of the rest of the world relies on it; other countries probably don't want to punish Russia for aggression toward Ukraine if doing so means cutting off their own food supplies.



Source: www.worldstopexports.com



Source: www.tradingeconomics.com

Fossil fuels and agriculture aren't exceptions – they are the heart of Russia's international trade. Fundamentally, Russia's global trade picture is more akin to a Middle Eastern oil state than it is to the industrial West: Raw materials and commodities dominate exports, while manufactured goods are a tiny portion, as shown in Chart 4. Commodity products can be sold anywhere; if the U.S. or European countries choose to embargo these items, Russia can easily find markets elsewhere for them.

Lurking behind the scenes is China, which could well be Russia's trump card in its Ukrainian chess game with the West. China has two complementary ambitions: It wants to take control of Taiwan peacefully, and it wants to assert global financial leadership. Russia's threat to seize Ukraine – whether fulfilled or not – serves both ambitions very well.

From a political perspective, the Russia-Ukraine and China-Taiwan situations are remarkably parallel. In both cases, the larger country sees the smaller as a temporarily-wayward province that must be brought back to the motherland; both Russia and China have the military capability and situational advantage to force the issue if necessary; and both see substantial economic benefit from reclaiming these lands.[1] To China, the world's acquiescence to Russian aggression (or at least failure to inflict severe pain on Russia in response) would indicate that seizing Taiwan would similarly engender a meek global response. Both Russia and China benefit from the status quo, too. Even if Russia backs down this time, the sword of Damocles will still be hanging over Ukraine; likewise with China and Taiwan: The threat will always be there, whenever it serves China's interests to rattle some chains.

Economically, steep Western sanctions on Russia would most likely cause Russia to shift its exports from Europe to China. Freezing Russia out of the global payments systems – the major source of *financial* leverage the U.S. has over Russia – might cause Russia to begin conducting its foreign currency transactions in Chinese yuan rather than in American dollars; from China's perspective, this could be the first crack in the dollar's seemingly insurmountable position as the world's reserve currency. Fully 60% of all foreign currency transactions – and nearly *all* oil sales – are transacted in dollars, a position China would dearly want to undercut.

In short, China and Russia may both see the Ukraine crisis as a welcome first step toward building deeper ties between them. Although their communique following the Xi-Putin summit earlier this month was largely ignored as propaganda, its language strongly implies that the two countries are fully intending to set common cause against NATO over the long term.[2]

In this context, it seems reasonable to suggest that President Putin is fully prepared to accept American and European economic retaliation against a Russian invasion of Ukraine. Russia doesn't have much to lose economically; it has a ready partner to absorb any surplus production that would otherwise have gone to Europe; and it has reason to believe that neither Europe nor the U.S. has the stomach for a serious conflict.

Perhaps this means that Ukraine will be forced to cede portions of its territory – or maybe the entire country – to Russia, in the form of either a bloodless coup or a blitzkrieg invasion. Or perhaps Mr. Putin has no intention of invasion or coup, and is merely using Ukraine as a ruse to get something else from the West. At the moment, it's impossible to know for sure.

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[1] There are important differences, too, of course. Most notably, China would very much prefer to take Taiwan peacefully, since much of the island's value comes from its immense industrial and technology infrastructure. Russia, by contrast, probably wouldn't risk destroying much economic value if it were to take Ukraine by force.

[2] The entire 19-page text is available at www.en.kremlin.ru/supplement/5770. I am indebted to my colleague and friend Carl Weinberg at High Frequency Economics for his insights on China's role in the Ukraine crisis.

Even so, investors must consider the potential outcomes of this standoff, and evaluate the impact on the world's economies and financial markets. As Lake Street Dive noted in their hugely popular economic treatise last year,

> *Obviously, we're at the beginning of something*
> *I don't expect you to know how it's gonna go*
> *But I believe we might be onto something*
> *And I just thought maybe you should know*
> *I've been playing out a lot of hypotheticals in my mind.*

As investors have been playing out the hypotheticals, they are becoming increasingly nervous. The evolving market narrative is that the potential economic implications of this standoff are rather easy to foresee, and they are not good. In a nutshell, the evolving conventional wisdom suggests that investors should expect:

- *Supply shocks in energy and food*, if a major global provider is cut off from its largest export markets; Europe would have a very difficult time finding substitute sources quickly, potentially leading to rationing or other extreme measures last used in the 1970s to combat the Arab oil embargo.

- *Sustained high inflation due to the abrupt reduction in supplies.* Note that this inflation, were it to occur, would be categorically different from the demand-driven inflation that often emerges in overheating economies. Inflation from supply shocks is not usually responsive to higher interest rates, limiting the utility of the most common monetary policy prescription.

- *Supply problems that could extend far beyond energy and food.* Automobile catalytic converters, for example, require palladium – and Russia is the world's largest producer; even though that palladium represents a tiny fraction of the production cost of a new car, a politically-generated shortage could wreak havoc in the industry just as it is beginning to recover from semiconductor shortages. Many similar examples exist across a wide range of industries.

The threat of Russian aggression has already scared many investors into selling stocks and buying safe Treasury debt. Oil prices have skyrocketed in anticipation of supply shocks, taking energy sector stock prices higher even as the rest of the stock market has tumbled. Corporate bond yields have risen as the risk of recession has come into focus. With the Federal Reserve committed to raising interest rates several times later this year, short-term bond prices have slipped, flattening the yield curve.

In this environment, the bulls clearly have their work cut out for them. Political crisis in Ukraine, high inflation at home, and rising interest rates are enough to send many investors to the hills. In theory, stagflation will ensue just as surely as it did in the wake of the Arab oil embargoes in the 1970s. Those episodes were horrific for investors, leading to deep bear markets and "double-dip" recessions. Are we destined to repeat that miserable experience?

It’s possible that the U.S. markets may have a more sanguine path in front of them. The country has evolved significantly from the that earlier stagflation era. In contrast to the 1970s, our economy today is dominated by services and consumption. Manufacturing has shrunk significantly as a fraction of the total economy. Thanks to the shale revolution and changes in consumption, we also depend far less on imported oil, which further insulates the U.S. from whatever outcome emerges in Ukraine. And even though Europe isn’t as fortunate, it is still unlikely that a possible recession in Europe would meaningfully slow the American economy.

We think that Presidents Biden and Putin will eventually find a way to avoid military action or severe economic sanctions, at least for now – if for no other reason than each has a substantial incentive to retain those options in reserve for some future occasion. Ukraine will eventually subside from the headlines, but persistently high inflation will remain a factor for the U.S. financial markets. Earnings growth remains solid, and corporate forecasts for the rest of this year are probably overly conservative. All in all, we think the year will ultimately shape up much as we anticipated in January, with plenty of volatility but ending up not far from where it began.