BRIEFING

Update on the Ukraine crisis: Context for Investors

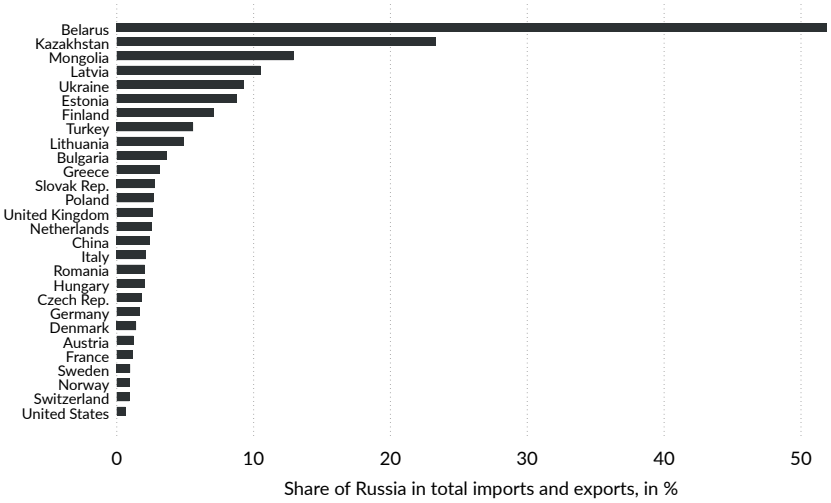
The Ukraine conflict continues to escalate. A solution anytime soon does not seem to be in sight. As the news flows in, assessments are changing almost hourly. This note provides a brief update on how we are currently thinking about the potential impact on the global economy and on financial markets.

The direct economic impact via trade is limited

Our starting point is to look at the target of the sanctions, Russia. The Russian economy is significantly more affected by sanctions than is the case for the global economy. If we were to jump ahead to one of the extreme forms of potential sanctions mentioned, banning Russia from the SWIFT international payments system, the consequence would be a sharp fall in trade between Russia and its key trading partner, the EU, given that about half of Russian exports go to the EU. Beyond the EU, the trade impact would differ from country to country and from product by product. Only about 14 percent of Russia's exports go to China, and those two countries have set up their own payments arrangements. An additional restriction on Russia is that it cannot easily redirect natural gas intended for Europe to China or the global market because of the way the infrastructure is currently set up.

Seen from the EU's perspective, only about 5 percent of the EU's trade in goods is with Russia. Even for most eastern European countries, Russia's share of total imports and exports is low, and even for Ukraine the figure is below 10 percent (see Figure 1). Thus, the risk to the Russian economy to declining revenue streams from exports is large, whereas for the EU and the rest of the world it is relatively small.

Figure 1: Low importance of Russia in global trade



The figure shows the importance of Russia as a trading partner for various countries. For most countries, the share of trade handeled with Russia is low. Russia is poorely integrated into global trade. Disruptions in mutual trade would therefore have little consequences on the global economy.

Europe could survive this winter without Russian gas

Europe's dependence on Russian gas supplies is an Achilles' heel, but diversification efforts have reduced dependence on Russian gas so far this winter.

Whereas the EU has traditionally relied on Russia for around 40 percent of its natural gas, in the first six weeks of 2022, this share fell to about 25 percent as Europe sought to diversify via liquefied natural gas (LNG) imports and by increasing imports from other markets.

Should the rest of this winter be relatively mild, increasing liquefied natural gas supplies from other regions, together with existing, albeit low, EU gas reserves could be sufficient for this winter, even if Russian supplies were to cease completely. This is not to say that there might not be temporary disruptions in parts of the European gas markets, but the situation is far from as bad as it could have been. Yet, since Europe typically fills up its underground gas reserves from March onwards, this means that pressure on LNG prices are likely to remain.

Global financial problems unlikely

Russia's exclusion from SWIFT would have significant consequences for Russian banks. However, Russia is comparatively self-sufficient overall; for example, its foreign exchange reserves exceed its foreign debt and the central bank has high reserves, which partially mitigates the risks of sanctions – for Russia as well as for most foreign banking systems. There are, of course, some countries whose banking systems are relatively more exposed to Russia according to BIS lending data (e.g. France and Austria), and there are some individual banks with large exposures, but overall this is not considered to be of systemic relevance to the EU.

Given the above, further levels of escalation should tend to only cause short-term turbulence in the financial markets, unless – and this is the big caveat – energy prices remain high globally and begin to impact economic fundamentals. From an investment point of view, however, we would not advise trying to play tactics with an hourly news flow on what the parties to the conflict may or may not do. The global macro fundamentals matter far more for internationally diversified portfolios.

The course of the conflict is unpredictable

While the individual components discussed above allow us to view the financial exposures in isolation, the Ukraine conflict is obviously not taking place in isolation from the many other aspects that could impact portfolios:

- *Geopolitical spillover risk scenario:* If there were to be a geopolitical spillover, i.e., for example, if the Taiwan conflict were to escalate further in parallel to what is happening in and around Ukraine, then the economic uncertainties could potentially increase in more places. In conjunction with central banks, whose hands are at least partially tied by persistently high inflation rates, such a potential stagflation scenario would be very unpleasant. For now, this does not appear to be a central case scenario.
- *Further inflation shock:* A further rise in energy prices is more likely. A further price shock would increase the already high risks that inflation expectations in the US and Europe could become unanchored. Central banks would be under even greater pressure to act. Anticipating such a potential scenario, financial markets would anticipate and discount central banks' next moves by causing sharply rising interest rates, which would put equity valuations under pressure.

In conclusion, for internationally diversified investors the direct exposure of the impact of Russian sanctions is small, with the key channels to investor portfolios coming via energy prices (volatility and how long prices remain high) and via central banks' responses to prevent longer-term inflation expectations becoming unanchored. We would, therefore, keep a close eye on energy prices and inflation.

Given the expected volatility, investors who wish to protect their capital, are advised to hedge a part of their risk asset exposure.

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