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Elston Insights

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War in Ukraine: sanctions, energy & inflation

- Russia/Ukrainian conflict unleashes a European tragedy
- What does it mean for markets
- Focus on energy supply and associated risk to growth and inflation

This war unleashes a European tragedy. In this insight, we outline what this far larger war means for Ukraine and Europe, how it could potentially stop, the impact on markets – with a focus on energy supply and associated risks to growth and inflation – and finally on portfolio positioning.

A tragedy

Russia's full-scale invasion of Ukraine is a dark day for Europe. The spectacle of mechanised warfare in 21st century Europe is horrific and our thoughts are with those living through this nightmare.

A limited operation in the Donbass which has been at the centre of a semi-frozen conflict for the last 8 years always a risk. It would have had both local and domestic support and prompted a more limited reaction from the West. This "South Ossetia" scenario would have been a repeat of the 2008 playbook in Georgia, and was one of our central scenarios outlined in our 21st January analysis on the risk of War in Europe.

But, it became clear in the early hours of 24th February that Putin was going all-in for a full-scale invasion and potential regime change. The scope for loss of life – military and civilian – is therefore far greater, and this a tragedy for Europe and a failure of diplomacy. It is also a departure for Russian foreign policy that traditionally would seek to create a fig-leaf of legitimacy under international law in order to act. This time round, there has been no such effort. This took us – and markets – by surprise. Western intelligence warnings have proven not to be sensationalist, but entirely correct.

We do not see Russia as likely to target the Baltics or any NATO ally. NATO will shore up support on its Eastern flank. Aside from Ukraine, the former Soviet republic of Moldova, with its pro-Russian enclave of Transnistria, may potentially be at risk of being drawn into an extension of the conflict.

How does it stop?

We don't believe that Putin's regime will be put off by Western sanctions, however extreme. They are expected and Russia has been living with significant sanctions since 2014.

The regime has "nothing to lose" – they already have pariah status. And it's this "nothing to lose" approach that enables them to act so brutally and aggressively in unleashing this conflict. This in itself is a policy failure all round, and will be one for historians to figure out.

While war, by definition, creates uncertainty, we see four potential ways this conflict could end:

1. Regime change: Russia openly wants regime change in Ukraine, and would seek to topple the current government and install a more pro-Russian regime. The longer the war goes on the less likely this is achievable – bloodshed and occupation is hardly the way to win hearts and minds.
2. Redrawing the map: we also see a risk that Russia fundamentally redraws the map of Ukraine, recreating the historical regions of "Novorossia" (incorporated into Russia) and "Malorossia" (centred around Kiev), and if at all, a truncated rump of Western-recognised Ukraine, centred aroud Lviv. Ukraine's borders in their current form may cease to exist.
3. Domestic outrage: like it or not, there may have been some domestic support for recognition of the Donetsk and Luhansk Peoples' Republic, given the suffering and blockades they have experienced over the last 8 years. However with a full-scale invasion underway, there is genuine shock and outrage across Russia about what is being done "in their name" by the Putin regime. As civilian casualties mount – including friends and relatives of Russians in Russia – domestic outrage could undermine the legitimacy of the Putin regime in the eyes of its traditional supporters. Finally the knowledge that the Western world will do everything it can to destroy Russia's economic future – as Western politicians are now calling for – may also swell the ranks of the opposition. In this respect, Putin's actions this week have potentially sown the seeds for his regime's own domestic demise.
4. Return to diplomacy: a return to diplomacy could potentially end the war once Ukrainian military capacity has been (euphemistically) "degraded". Russia would seek Ukraine to agree by treaty to be neutral, non-aligned, non-NATO and demilitarised. This would be a capitulation by the Ukrainian government, and is hard to envisage with the current regime. Any negotiated settlement would also need to include security guarantees that Russia has sought from US/NATO. But given the failure in diplomacy thus far, any such negotiated agreement currently seems remote.

What does it mean for markets?

The initial shock of war, and the fear it could spill over into a broader or even nuclear conflict explains the nose-diving in markets on Thursday and the flight to safe assets. Looking through this from an outlook perspective, we would note the following;

- Russia impact: very severe but immaterial for portfolio investor: the Russian equity market and Russian rouble have tanked in the face of protracted sanctions. However Russian equities make up just 0.4% or so of MSCI All Countries World Index ("ACWI") and 2.7% of MSCI Emerging Markets. So investors with a globally diversified portfolio have negligible exposure to Russian equities.

- Geopolitical risk impact: severe and moderately material: The risk of a full NATO/Russian ground war is still remote, so the reactive "fear-trade" over a European or even nuclear war is potentially over-done. However risk of long-term, complex Western-Russian relations however means geopolitical risk remains high. China is watching closely to calibrate what the Western reaction might be to its own potential campaign to control Taiwan. Geopolitical risk raises the equity risk premium and means volatility could be here to stay in the medium-term.
- Energy/inflation impact: very severe and very material: The largest impact of this crisis is on the ongoing energy crisis. The impact of rising oil and gas prices, and the risk of accidental or deliberate transit disruption and or supply disruption is the most severe and material impact of this conflict. It would have a knock-on effect as a risk to growth and further pressure on inflation, and therefore policy rates.

We explore the different energy and sanction scenarios, and their respective impacts on key macro factors namely growth, inflation and interest rates.

Fig.1. Sanctions and Energy scenarios

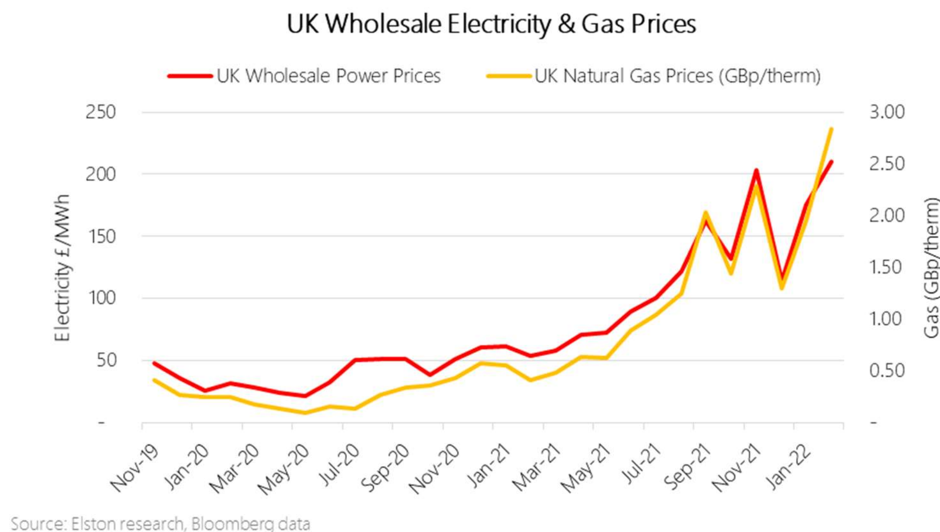
	Base case	Bad case	Worst case
Energy Scenario	No Russian energy supply disruption	Russian energy supply disruption	Russian energy supply stops
Sanctions Scenario	Sanctions targeting regime	Broad sanctions, targeting economy, excluding energy	Complete sanctions including energy or Russian retaliation to sanctions by stopping energy supply to US/Europe (divert to China)
Macro Factors:			
Growth impact	Low risk to growth recovery	Moderate risk to growth owing to higher energy/power input costs	High risk to growth and greater risk of recession
Inflation impact	Existing inflation trajectory, but reflecting elevated energy price risk	Steepening and more protracted inflation trajectory	Extended and more severe inflation shock
Interest rates impact	Central banks have to become slightly less hawkish	Central banks shift concern from inflation to growth, become more dovish	Worst case energy spike means inflation is out of control and Central banks have to react against struggling growth backdrop

Source: Elston research

What's happening to UK energy costs?

UK wholesale baseload electricity prices are up +294%yy in February, compared to +187%yy in January. UK Natural Gas prices are up +588%yy in February, compared to +255%yy in January, so a further acceleration in inflationary pressure becomes directly linked to sanctions as outlined above. This will require careful political as well as monetary policy calibration.

Fig.2. UK energy markets



As outlined in our 2022 outlook, we are watching UK electricity and gas wholesale prices as a key metric for evaluating inflation pressure in real-time. The pressure on the UK energy market shows that we are not yet past the peak in the ramp up in inflation.

What does it mean for portfolios?

From a portfolio perspective, we would note the following. The ongoing energy crisis and resulting inflation pressure remains the biggest risk to portfolios. To mitigate this:

1. Within equities: A bias towards Value means that energy and other commodity-related companies have a relatively higher exposure in value-bias equity funds. A bias towards Income can help underpin equity returns
2. Within alternatives: Investors can access direct energy exposure using an ETP, or a broader commodity ETP. Gold & Precious metals can act as a shock absorber in times of market stress and is a useful diversifier. Liquid Real Assets – which include exposure to higher risk real assets such as Energy, Commodities and Gold & Precious Metals – can provide an inflation-hedge.

3. **Within bonds:** inflationary pressure and interest rate risk means bonds remain unattractive in absolute terms, and are not as “safe” a safe-haven as they are during lower inflation regimes.

Summary

The news from Ukraine will be tragic and the primary concern is the human cost of modern-day warfare. Our thoughts, prayers and support should absolutely be with those suffering.

We don’t see selling risk assets to cash to crystallise losses as a prudent strategy given how quickly markets can rebound after a geopolitical risk events. Indeed, if markets become over-sold, it may be prudent to add to risk assets.

From a markets and portfolio perspective, the focus remains on energy supply and the read-through into risks to the key macro-factors to growth, rates and inflation.

This reiterates, and make more or urgent, our key calls for 2022 on adapting portfolios for inflation, with a tilt to value for equities, dialled-down duration for bonds, and inclusion of real assets for inflation protection.

Henry Cobbe, CFA

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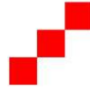

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