Russia/Ukraine update

In this report we will explore why Russia has invaded Ukraine and what it means economically and politically. We will also take a look at the implications for financial markets.

Why has Russia invaded Ukraine?

If we look at the map of Europe below, we can see that Ukraine and Belarus are key border states to Russia to the east and Poland, Slovakia, Hungary and Romania to the west. To the south, Georgia is a key border state to Turkey.

Now Estonia, Latvia, Lithuania, Poland, Slovakia, Hungary, Romania and Turkey are all members of NATO and Russia wants Belarus, Ukraine and Georgia (all previously Soviet States) to remain aligned with Russia. Russia has been able to influence the governments of Belarus and Georgia but it has repeatedly failed to control the Ukraine government, given a majority of the population (to the west of the country) support alignment with Europe, rather than Russia. Only the Eastern states of Ukraine support Russia. Russia believes it is vulnerable to Ukraine joining the EU and NATO, which will place NATO right on its doorstep.

After Ukraine ousted a Russian leaning President in 2014, Russia immediately annexed the strategically important Crimean Peninsula (located in the Black Sea) and subsequently encouraged separatist rebels in Eastern Ukraine. In 2022, Russia recognised the independence of the Donetsk and Luhansk regions to the East and launched a full scale invasion of Ukraine.

Map of Europe

What does it mean economically?

Russia has a population of 146m and GDP of US$1.5bn. Russia's economy is about the same size as Australia's and is small in a global context, representing around 1.3% of the global economy. Ukraine is much smaller with a population of 44m and GDP of US$155bn.

However, Russia is a key global supplier of natural resources, including oil, gas, nickel, aluminium, copper, titanium, platinum, palladium and neon. Russia and Ukraine are also major wheat exporters.

It is estimated that Russia accounts for around 40% of Europe's gas supply and 25% of its oil supply. Russia and Ukraine represent around 25% of the global wheat export market, with most of the crop going to North Africa and the Middle East.

Sanctions on Russia and/or disruption to supply chains may result in shortages of these commodities and hence the main short-term impact on the global economy is via higher commodity prices and inflation.

Over the medium term, we would expect Europe to become less reliant on Russian oil and gas and the US may even consider bringing Iran back into global oil supply.

Longer term, a global move to clean energy away, from fossil fuels, will be further encouraged by high oil and gas prices.

Overall, the main economic risks are around higher commodity prices, with the main impact felt in economies reliant on Russian exports, such as Europe for energy and North Africa and the Middle East for wheat.

What does it mean politically?

The political implications are probably more significant than the economic implications.

Here we have Russia invading a peaceful neighbouring democracy of 44 million people, with the apparent support of China.

The motive is to keep Ukraine aligned with Russia, but the people of Ukraine have repeatedly expressed a desire to align with Europe, since the 'Orange' revolution in 2004 and further political protests in 2014. Polls suggest that 68% of Ukrainians favour joining the EU.

Russia is likely to set up a 'puppet' Ukrainian government, like it did in Crimea, but will the people accept it? The answer will determine if this turns into an ongoing war fought by Ukrainians against Russian rule.

Europe and the US are unlikely to directly intervene in Ukraine as it is not yet a member of the EU or NATO. However, they may support any Ukrainian rebellion with weapons. For now, NATO is bolstering its forces in neighbouring member states.

The hard truth: Ukraine wants to be a member of the EU but the EU doesn't necessarily want it, as this will antagonise Russia - a key energy supplier to Europe. As war unfolds in Ukraine, Europe now has a moral dilemma over how far it goes in supporting Ukraine. We note that sanctions on Russia do not include removing it from the SWIFT payment system, which means Russia can continue to receive payments from Europe for its gas supply.

A successful annexation of Ukraine under Russian rule could inspire China and its ambitions around Taiwan. Russia itself might be inspired to take more old Soviet states back like the Baltic states - Estonia, Latvia and Lithuania. This would be a major test for NATO, as the Baltic states are members of NATO.

Finland on the northern border of Russia would also be concerned about its security. Russia has warned Finland of "serious military and political repercussions" if it opts to join NATO.

Turkey to the south of Ukraine (on the other side of the Black Sea) is a NATO member but is caught in a delicate position of trying to be friends with both Russia and the West.

We would expect the conflict to be contained to Ukraine and it is unclear how long this will go on. We don't expect Russia to advance any further to the west but its intentions around bordering states will now be the big question, particularly for the Baltic States and Finland. And to the south, will Russia advance any further past Georgia towards Syria and Turkey? Russia has already been meddling in Syria.

We think Europe will be the most alarmed by Russia's move on Ukraine and will definitely bolster its defence forces and diversify its energy supply. The US is more likely to be concerned about China than Russia, as China has a much greater economy and military force. The main concern for the US would be China aligning with Russia and its rhetoric.

The US will obviously meet its NATO commitments but is not likely to be an aggressor in Europe. Europe is going to have to take a greater interest in its own security and its influence over NATO.

Overall, the geopolitical stakes have gone up with a resurrection of authoritarian regimes against western views and interests. It is likely that the western world is going to have to rethink the security of its supply chains and its people.

What does it mean for financial markets?

As discussed above, Russia and Ukraine are relatively small economies and won't have much impact on global GDP. The main impact is around potential disruption to the supply of key Russian exports (oil, gas, nickel, aluminium, copper, titanium, palladium, platinum, neon and wheat) and Ukrainian exports (wheat and sunflower oil).

Given Europe relies on Russia for around 1/3 of its energy needs, Europe is the most exposed to any disruption to the supply of oil and gas. Russia and Ukrainian wheat exports make up around 25% of global wheat exports that mostly go to North Africa and the Middle East.

In the short term, the main impact on the global economy is via higher energy costs. This is likely to keep inflation elevated but given this is 'cost-push' inflation, central banks will recognise that increasing interest rates is unlikely to do anything helpful. In fact, there is a risk of economic disruption and lower growth, particularly in Europe. This seems to be why bond yields have remained contained, despite a spike in the oil price above US$100/bbl.

The normal scenario with the outbreak of war is short term market volatility followed by a reversion to market fundamentals. Given the Russia/Ukraine situation is unlikely to affect the US and other developed markets in a major way (unless Russian energy supply is disrupted), we expect a similar response.

At this stage, we remain cautiously optimistic on equity markets. We expect a 'muddle through' situation this year. The positives of a COVID recovery in developed markets should outweigh current worries over Russia/Ukraine and inflation. Indeed, inflation should fade with COVID restrictions rolling off. And Central Banks are likely to be cautious on increasing rates too quickly for fear of snuffing out any economic recovery from COVID.

The market correction could continue over the March quarter, but we think there is a good chance of a recovery in stocks during the remainder of the year.

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