4 March 2022

Our thoughts on Russia and Ukraine

Recent events in Ukraine have shown that in 2022, dominant powers cannot simply walk into a country and seize power. The Ukrainian resistance, largely bolstered by volunteer fighters, have held a strong line of defence in the face of a formidable Russian army over the first week of the conflict. Concurrently, NATO members have shown impressive coordination and speed in applying strict sanctions on Russia with strong economic impact.

The question still remains, why did Russia decide to invade Ukraine despite the obvious economic and political costs they would pay?

It is probable Russia would like Ukraine to be within its sphere of influence again, as it sees it as a strategically important landmass. Another school of thought suggests that this may be an attempt by Russia to reset the current geopolitical alignment in Europe, given the shifting weight in global economic powers such as the United States.

The exact outcome of the conflict is difficult to ascertain at this stage. Despite the impressive Ukrainian resistance, without direct intervention from NATO members on the ground in Ukraine, it is likely that the Russian military will eventually take control.

Ukraine is a large country by population, with over 44M people, many of whom appear ready to defend their nation. Ukraine will be a difficult country to rule effectively, even with the elimination of the current leadership. Unfortunately, a probable outcome is that of long-term social and economic instability in Ukraine. It has been suggested that Ukraine might become the Iraq or Syria for Russia. As the battle continues, immediate economic impact to Ukraine will come through increased destruction of infrastructure in the conflict.

Economic sanctions aimed at impacting the Russian economy have been swift and severe. The exclusion of prominent Russian banks from the SWIFT banking system makes it very difficult for the Russian economy to interact with the outside world, especially while continuing the export of oil and natural gas to the world.

The Russian Central Bank has also been restricted from accessing its USD600B in foreign currency reserves. Consequently, it has been unable to defend the Russian Ruble, which has come under significant pressure. The Central Bank of Russia raised interest rates to 20% and imposed capital controls to help deter further devaluation earlier in the week.

Figure 1: Currency composition of Russia's international reserves

	EUR	USD	Gold	GBP	CNY	Other
Jun-21	32.3	16.4	21.7	6.5	13.1	10.0
Jun-20	29.5	22.2	22.9	5.9	12.2	7.3
Jun-13	36.9	41.1	7.5	8.2	-	6.3

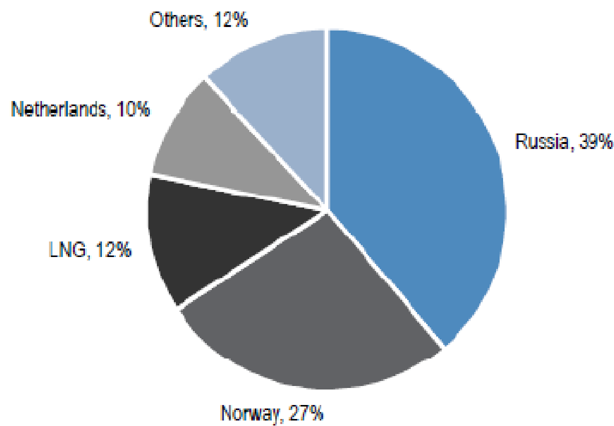
Source: CBR, JPMorgan

At this stage, the outcome for both Russia and Ukraine looks dire.

Although not all of the following scenarios are likely, potential further escalation of the current situation could occur. This might include some of the following measures if tensions are not abated: financial sanctions on a wider range of Russian banks and exports, expulsion of Russian companies from Western markets, sanctioning of Russian exports, particularly oil, gas and minerals, or Russia blocking exports to the West, direct military intervention from the West, and social instability in other neighbouring European countries spilling over from Ukraine.

Economic instability in other parts of Eastern Europe and even to some extent globally, will likely persist as an immediate result of the situation in Russia and Ukraine. Russia is the second largest oil producer globally and a significant gas exporter, making up over 10% of global oil supply and nearly 40% of European gas. Any escalation of the current sanctions and retaliatory actions from Russia may disrupt the flow of these key energy commodities to the rest of the world. If supply is limited, this will significantly impact the prices of industrial gas and oil, hurting its consumers.

Figure 2: Origin of European natural gas



Source: McKinsey, JPMorgan

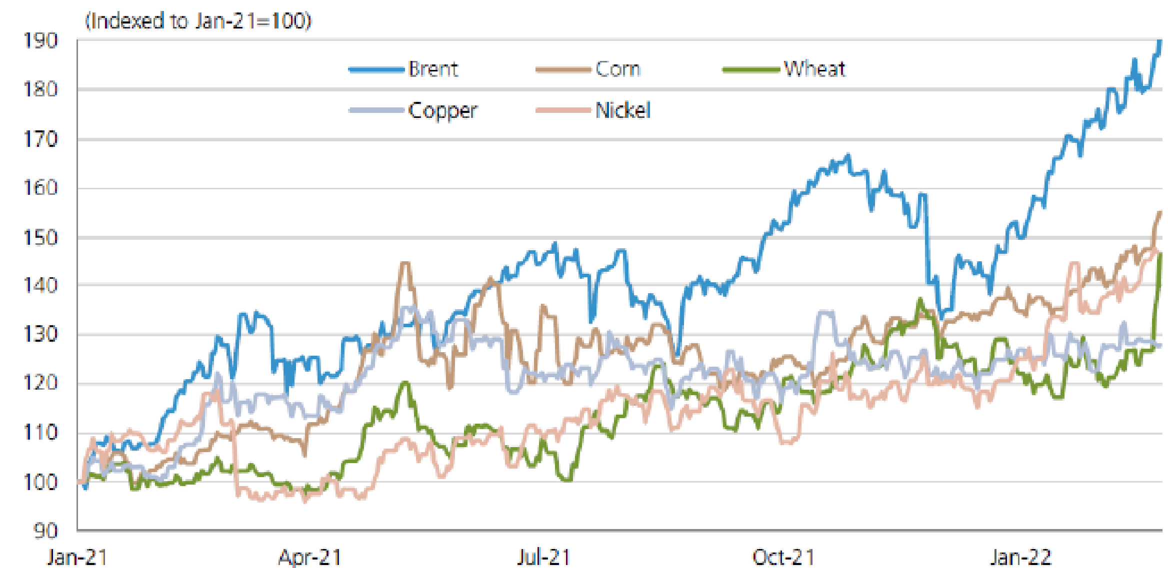
Similarly, Russia is a large producer of nickel, aluminium, palladium, and wheat. These commodities have widely seen price increases over the last year and escalation could see these increase further as a result of supply disruption.

Figure 3: Russia's share in global commodity production (%)

	2018	2019	2020
Oil	12.2	12.3	12.1
Natural gas	17.4	17.1	16.6
Coal	5.6	5.5	5.2
Copper	4.3	4.3	4.3
Aluminum	5.9	6.2	6.1
Nickel	6.8	6.3	6.1
Zinc	1.9	1.5	1.5
Gold	8.1	9.1	9.5
Silver	5.1	5.3	5.4
Platinum	10.8	11.7	14.1
Palladium	39.4	41.0	43.9
Wheat	9.8	9.7	11.0

Source: JPMorgan 21-Jan-22

Figure 4: Select commodity prices



Source: Bloomberg

For other central banks, we have seen rate hike expectations and 10-year bond yields in the United States and Europe both falling as a result of the conflict. The current expectation is that these institutions will soften their approach to upcoming rate hikes in order to preserve growth within the current backdrop of heightened geopolitical uncertainty. This can help risk assets like equities.

Figure 5: US and Germany long term bond yields

Source: Bloomberg

Longer term, the implications vary across markets.

In Europe, the conflict is a large shock to the European Union. They are witnessing a world in which preservation of individual self-interests is increasingly important. Of note, Germany has decided to significantly increase military spending almost immediately. Further, there are discussions being held over increasing their energy self-sufficiency through renewables, with greater time sensitivity. This event has changed Europe in a fundamental way and spending on defence will increase going forward.

China has been careful not to take an active position on the conflict so far. Governments of Europe are pre-occupied with Russia. China will likely benefit, at least over the coming few years, from Russia's endowment of natural resources and reduced number of buyers. Further, Russia may become more dependent on Chinese investment and technology as other international corporations cease business operations in Russia and investors refuse to invest in ventures in Russia.

Western questions surrounding the occupation of Taiwan by China during this event have lingered. However, it is unlikely that we will see an escalation in Taiwan as a direct result of Ukraine. There is a belief in China that Taiwan and China will grow increasingly closer together through greater economic, cultural, and racial linkages over time. Ukraine does not change the timeline for China. If there are any lessons learnt from the conflict in Ukraine, the cost of unprovoked military aggression on another nation in the near future would be very high.

The situation in Russia and Ukraine has had significant market implications. Ox Capital is appropriately positioned in this environment.

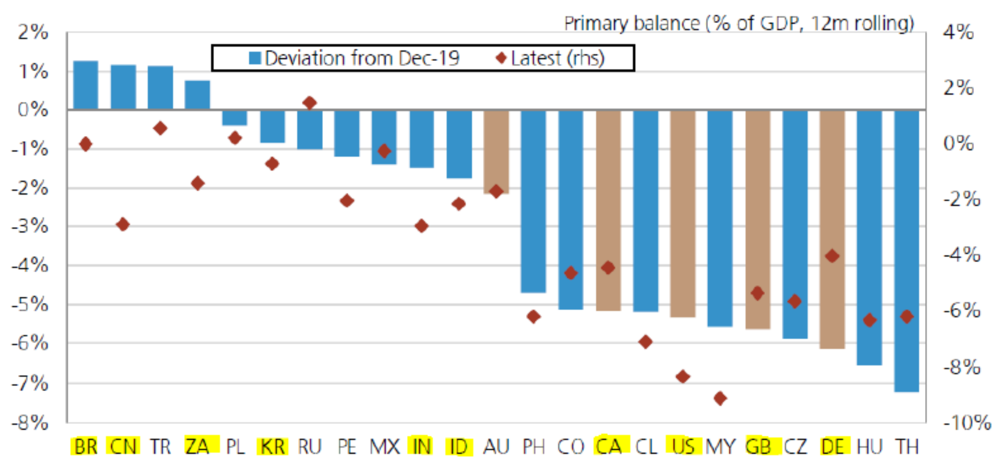
As mentioned previously, Russia is the world's second largest oil producer. Energy upside risk is significant as a result of this conflict. Interesting to note, in the recent United Nations vote against

Russian aggression, the United Arab Emirates, the world's seventh largest oil producer, along with India and China abstained from voting. We have significant positions in the energy sector.

Electric vehicle demand is growing fast. A large quantity of batteries will need to be manufactured for these vehicles. High-grade nickel is a key input in the majority of these batteries and is already running into significant shortages. If Russian nickel exporters are disrupted, the potential for persistent supply shortfall is highly possible. Similar to Russia, Indonesia is a key producer of Nickel, who will be important to the Nickel supply story. We are positioned to benefit from Indonesia's nickel reserves.

Additionally, Indonesia is endowed with other key energy reserves. Higher energy prices will benefit their balance of trade, especially in the face of the lower levels of inflation they have seen domestically relative to other developed nations. Another emerging market which stands to benefit from higher energy and commodity prices is Brazil. We are actively prospecting this market for ideas.

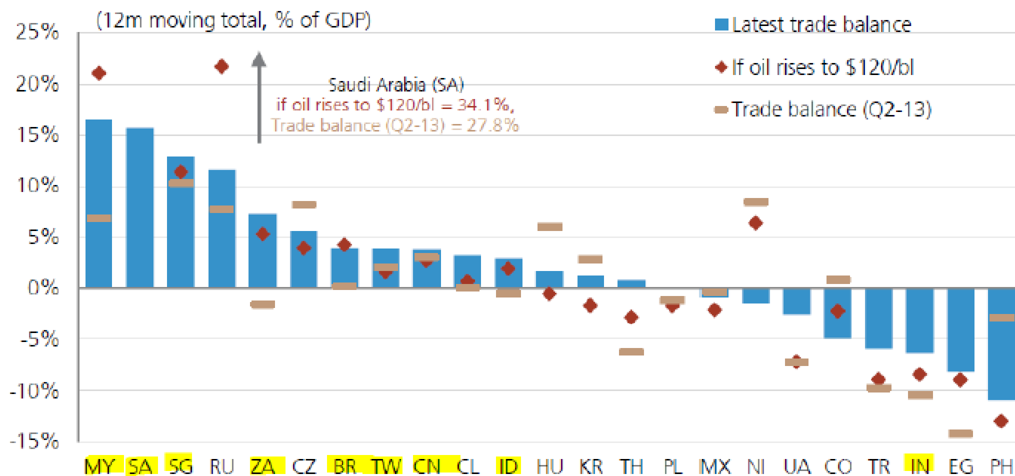
Figure 6: Primary fiscal balances



Source: UBS

Rising energy prices and tightening in the United States will likely hurt the Indian economy. While the long-term prospect of India is strong, the stock market is very expensive relative to other markets. Further, they are dependent on Russia for a large quantity of defence equipment.

Figure 7: Simulated impact of a permanent shift in Brent oil to $120/b on EM trade balances



Source: UBS

Global consumption of electronics and computers has been over-indexed as a result of work-from-home arrangements, and government handouts to consumers over the pandemic. Semiconductor stocks are generally expensive, and with high energy prices and interest rate tightening, demand for these goods can disappoint.

Emerging markets are prospective and have handsomely outperformed developed markets since the beginning of 2022. Most emerging markets have tightened their fiscal budgets post COVID. Hence, they will be in a better position to stimulate if growth slows. Our view is this is the beginning of a long-term reversal of developed markets outperformance.

Figure 8: MSCI EM vs DM

Source: Datastream

We hope that large powers can realise that in 2022, great military power does not lead to economic and political dominance, although developing a strong middle class and a strong and resilient economy does. This is evident in Asia and many other emerging market countries. Our thoughts are with the Ukrainians.