Sixty second summary

Russia-Ukraine: macroeconomic update

Chris Arcari
Senior Investment Research Consultant.

Russia's invasion of Ukraine will likely impact global growth whilst exacerbating existing inflationary pressures.

While the situation is rapidly deteriorating and we recognise the tragic humanitarian situation that is unfolding, we focus our attention here on our early assessment of the potential implications for the global economic growth and inflation.

Russia has launched a full-scale invasion of Ukraine with the apparent intention of installing a Russia-friendly government in the country. In terms of general market moves:

- Global equity markets initially fell, though have retraced some ground, with Russian markets seeing particularly dramatic falls, core sovereign bond yields have fallen, albeit modestly, and gold prices have also seen modest rises.
- The rouble has fallen, and Russian local currency sovereign bond yields and hard currency sovereign yields spreads have risen –an extension of prior moves seen over the course of 2022 in anticipation of sanctions.
- Commodity markets have been heavily impacted given the importance of Russia (and Ukraine) in commodity production
  - Oil and gas prices have risen and natural gas and wholesale gas prices have surged higher.
  - Russia and Ukraine are also two of the largest wheat producers globally, where prices have risen sharply.
  - Metal prices have also risen given Russia is a key producer of aluminium, copper, nickel, platinum, and palladium.

Russia's actions demonstrate a period of prolonged instability, with impacts for predominantly Europe but also the world, is now clearly a potential outcome.

Higher European gas, oil and food prices over the medium-term, alongside financial market disruption and tougher US, UK and EU sanctions on Russia will likely have a negative impact on global growth this year whilst adding fuel to already elevated inflation pressures. We expect to see modest downwards revisions to global growth forecasts for 2022 and 2023, and upwards revisions to inflation forecasts, for most advanced economies in the coming weeks.

Russia itself is likely to see the worst of the economic impact but with Europe also at risk of a reasonably significant growth impact.

A series of harsh sanctions are expected to be imposed on Russia. Prior to the invasion the US had extended sanctions on Russian debt, preventing US investors from trading newly issued Russian debt in the secondary market (they were already prevented from purchasing newly issued Russian debt in the primary market). The EU and UK also announced measures to prevent Russia raising new debt in their markets earlier in the week. Further sanctions announced target Russia's strategic sectors, block Russian state assets, and potentially ban Russian banks from executing dollar and euro transactions with US and European banks.

The Nord Stream 2 pipeline is likely to be mothballed, potentially permanently. Russian gas will probably continue to flow but there is considerable risk of disruption in Russia's gas supplies to the EU in response to sanctions.

Risk premia on Russian assets are rising – equity markets have plummeted, Rouble has touched record lows and local and hard currency sovereign debt yields and spreads, respectively, have risen. While Russian assets have cheapened significantly, and Russia is not overly reliant on access to external financing, risk premia could remain elevated for some time.

As we have noted above, the main channel of transmission to other economies, from a macroeconomic perspective at least, is via higher oil, gas, and other non-energy commodity prices. Higher inflation will increase the ongoing squeeze on real disposable incomes, weakening the economic outlook. Therefore, the main downside risk we see in developed markets is for European equities as higher gas and input costs weigh on growth and squeeze profit margins.

The situation leaves major central banks in an even trickier situation than before – inflation is set to rise even further due to higher commodity prices, but the growth impacts may make it more difficult for central banks to raise rates to control inflation without de-railing ongoing economic recoveries from the pandemic.

While the situation remains highly uncertain, it feels that this is both a near-term inflationary and growth negative development simultaneously, which was perhaps the last thing advanced central banks already facing high inflation needed.

Our key takeaways at this stage:

- We expect the higher oil and gas and other non-energy commodity prices to lead to downwards revisions to global growth and upwards revisions to inflation forecasts in the coming weeks.

- In addition to near-term volatility, we expect higher commodity prices to weigh on European growth and squeeze corporate profit margins, putting European equities at risk of underperforming other regions.

- The energy sector, which was already experiencing strong earnings momentum and benefitting from inflationary appeal, may outperform in the near-term but recent events remind us of the value of diversification in the face of heightened uncertainty.

- Developments may give central bankers combatting already high inflation pause for thought, but with the negative impacts having potential to be inflationary, they may have to act, nonetheless.

We'll share further updates as the situation develops, but in the meantime, if you would like to discuss the impact on your scheme or company please do get in touch.