# Escalation is not a given, but tensions might last for longer

## DESPITE RISING TENSIONS, OUR BASE CASE REMAINS THAT A LARGE-SCALE RUSSIAN MILITARY INVASION IN UKRAINE WILL BE AVOIDED

**IN A NUTSHELL**

_ Our base case continues to pencil in only a lasting rise in underlying risk awareness, rather than significant further military escalations.

_ For now, we expect diplomatic activities to continue, with serious efforts to offer Russia face-saving ways to back down.

_ While developments certainly give us plenty to think about, we do not see sufficient reason yet to alter our fundamentally constructive outlook.

## Escalating tensions between Russia and Ukraine: our base case

Belatedly, financial markets around the world have woken up to the rising geopolitical tensions in Ukraine over Russian demands to reverse the decade-long expansion of the Western security alliance NATO. That a resurgent and increasingly assertive Russia might eventually pose a threat to economic stability further afield does not necessarily count as news, though. Our base case continues to pencil in only a lasting rise in underlying risk awareness, rather than significant further military escalations. That is, we can certainly imagine tensions and Russian threats of an invasion to continue at an elevated level for a while yet. Further escalatory steps could include cyber-attacks, more intense fighting in eastern Ukraine and, potentially, Russian aerial bombardment to test the response from Kiev and "the West". These would probably result in additional sanctions being imposed on Russia, while Russia would keep gas deliveries tight. Even a change of the government in Kiev could happen along the way, but it is not our baseline scenario.

One crucial assumption behind our base case of further escalation falling short of a full-scale ground war is that we expect diplomatic activities to continue, with serious efforts to find a way to offer Russia face-saving ways to back down. European efforts to revive the ideas of the second Minsk treaty of February 2015 could yet prove acceptable to both Kiev and Moscow, though the issue of how free and fair elections are to be organized in the breakaway regions of Donetsk and Luhansk could once again prove a stumbling block.[1] In that regard, one positive sign for the prospects for further diplomacy has been the vote in the Russian Duma to refrain from recognizing the self-proclaimed independence of those regions, at least for now.[2]

## Could things get worse? Yes, alas: market and policy implications

But should not economic self-interests alone dictate a diplomatic solution of some sort to emerge fairly swiftly, anyway? Judging by the sharp market reaction, that certainly seems to have been the view in broader equities and fixed income markets.

In our view, Putin has been preparing for a potential conflict for several years. The government has been following a strict fiscal austerity plan since 2017 to reduce the dependency of the Russian economy on external suppliers. It has been ready to sacrifice growth for this (and continues its disciplined saving of oil price windfall profits during the Covid pandemic). Russian corporate sector leverage is down to historical lows. Likewise, unlike 2014, Russia's banking system is now highly concentrated and dominated by state-controlled institutions, while foreign banks do not have any systemic importance. Meanwhile, Europe's dependency on Russian gas remains high and will probably shrink

1 https://www.unian.info/politics/10788002-steinmeier-formula-explained.html

2 https://www.themoscowtimes.com/2022/02/14/russian-lawmakers-to-urge-putin-to-recognize-breakaway-ukraine-regions-independence-a76378; https://intellinews.com/russian-duma-steps-back-from-declaring-donbas-independent-234925/?source=russia

over the next decade or so, as renewable energy continues to expand. Moreover, various pipeline projects have made it possible to bypass Ukraine.[3] None of which means that further escalation is now inevitable. Countless column inches have lately been devoted to psychoanalyzing Russia's leader, or endlessly analyze some particular sentence or phrase.[4] In our view, such attempts to analyze tend to fall short in two critical respects. First, Vladimir Putin can be hard to interpret, even for native Russian speakers. In the earliest days of his presidency, Putin's folksy turn of phrases or cultural references gave rise to handy dictionaries of what this or that "Putinism" might actually mean.[5] Such implausible deniability may partly be deliberate. As an influential analysis widely read in Western security circles put it a few years ago: "Russia's leadership is pursuing an emergent strategy common to business practice and the preferred path of startups (…) The hallmarks of this approach are fail fast, fail cheap, and adjust, (…) prizing adaptation over a structured strategy. This is confusing to follow when Russia's goals are set, and yet operational objectives change as they run through cycles of adaptation. It is also a method whereby success begets success and failure is indecisive, simply spawning a new approach."[6] Whether this is correct or not, it certainly appears to have informed Western decisions to declassify information in order to complicate any Russian plans to invade Ukraine.[7]

Against this backdrop, it is certainly too early to rule out a Russian pivot towards quick de-escalation. Equally, though, any of the parties involved could trigger, or even stumble into conflict that eventually does result in a large-scale invasion by Russia. Needless to say that such a war would not be quick and 'efficient' but instead probably result in long-lasting guerilla type confrontations. Public support in Ukraine for a closer union with Russia was never uniformly high throughout the country to begin with and has probably fallen further in recent years and months. A large-scale invasion would trigger much bigger economic damage on Russia than existing and threated sanctions. Potential allies such as China would not necessarily go along with support in such an extreme scenario. In purely financial terms, Russia could survive such a period of being globally shut out, but not without severe damage to an economy with very low growth potential anyway. Domestic discontent could grow, though, requiring further repression. And the globally most dominant economic worry, broad-based rises in inflation, would spike further, with Europe probably suffering the biggest hit due to continuing dependence on Russian gas supplies.

Overall, that sounds like a very risky proposition for all involved. Spikes in gas and oil prices aside, global food prices, given the importance of Russia and Ukraine for wheat, as well as Russia's role as a commodities supplier or supplier of refined production of aluminum, palladium, copper and nickel would result in further vulnerability, without even counting political and economic second round effects. But while we are certainly keeping an eye on such tail risks, we would argue that there is uncertainty in both directions around our base case. Plainly, not enough has happened, at least not yet, to start pricing in the damage to Europe and the economy of the rest of world via ballooning oil and gas prices.

## Asset-class implications

**Fixed Income & Currencies:** Under our main scenario of ongoing risk-awareness, but no full-blown military escalation, we would expect some relief on energy prices over the medium-term, with further solid GDP growth mainly in Europe, little recession risk over the next 12 months and higher short-term Treasury and Bund yields, along with selective spread compression for risky assets. Under further escalation scenarios, Europe and the Euro would clearly be at risk, though we would argue that a lot would depend on the specifics, including in terms of the timing. Certainly, we would expect even more dispersion in the performance of different emerging markets.

**Equities:** While developments of recent weeks certainly give us plenty to think about, we do not see sufficient reason yet to change our index targets or our fundamentally constructive outlook due to the current tensions. Of course, sector development will be strongly influenced by shades within our main scenario. For example, energy stocks would clearly benefit if tensions resulted in a permanently higher risk premium in oil and gas prices. Under further escalation scenarios, index target cuts would probably be most severe in Europe, with the U.S. being likely to outperform, as probably would growth stocks compared to cyclical and value plays.

**Alternatives:** We do not see any significant implications for global real estate in the short term. Under more extreme scenarios, the hit to consumer and business confidence may dampen demand for retail and office space, and the rise in fuel costs could be a drag on logistics operators. Unless this escalates into something that goes well beyond Russia / Ukraine, we would not see this having a material impact in the short-term. For infrastructure, we have historically observed negligible volumes of allocations to Ukraine private infrastructure assets by private infrastructure funds, as investors tend to focus on infrastructure markets providing strong institutional frameworks and low country risk in the long-term. We therefore do not generally envisage the asset class return profile to be impacted. Though of course, we would closely be watching for second round effects, including certain transportation assets, such as specific ports or toll roads part of trade routes between Russia and Europe, in case of severe sanctions.

[3] https://www.economist.com/europe/2022/01/29/how-will-europe-cope-if-russia-cuts-off-its-gas
[4] https://www.ft.com/content/3d8b94e9-0db7-4aa5-ac6a-9fef2ce43ab6; https://www.rt.com/russia/548669-putin-vulgar-sexual-threat-zelensky/; https://www.themoscowtimes.com/2022/02/14/putin-macron-talks-highlight-gap-in-russia-expertise-a76375
[5] https://www.themoscowtimes.com/2022/02/11/a-russian-sleeping-beauty-a76338
[6] https://warontherocks.com/2017/01/the-moscow-school-of-hard-knocks-key-pillars-of-russian-strategy/
[7] https://www.nytimes.com/2022/02/12/us/politics/russia-information-putin-biden.html

## Glossary

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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