Russia-Ukraine War:

Political and market implications

The Russia-Ukraine conflict has created several ripple effects across the globe.

Beyond the immense suffering of the Ukrainian people, Russia's invasion has roiled global markets, exacerbated geopolitical uncertainty and impacted domestic policy.

As the war entered its third week, a few key questions remain: How long will the conflict continue? What will be the ultimate impact on energy prices? How will the Federal Reserve respond?

To get a sense of what it means from an economic and investment perspective, I recently spoke with geopolitical expert Marko Papic, Partner and Chief Strategist at the Clocktower Group, and Yung-Yu Ma, BMO Wealth Management's Chief Investment Strategist.

The following is a summary of our discussion.

Inflationary pressures

According to Papic, the conflict in Ukraine can be traced to Russia's dwindling sphere of influence since the breakup of the Soviet Union. Russian President Vladimir Putin views Ukraine, the largest European country other than European Russia, as a prized piece of real estate. While Papic doesn't believe the end result will be a Russian occupation and annexation of Ukraine, he does believe the invasion will likely persist for a short-term as Putin searches for a reasonable off ramp.

The longer the conflict endures, however, the more severe the economic implications are likely to be here in the U.S. and elsewhere. Inflation had already been problematic, but expectations were that price pressures would begin to ease in later 2022. The conflict in Ukraine, and the resulting sanctions against Russia, have altered that calculus.

"Inflation expectations are ratcheting up, and to the extent that sanctions remain, those inflation expectations will probably be more persistent than we'd originally forecast prior to the invasion," Ma said.

"We anticipated inflation to level off by the summer months. We might still peak around that same time, but we're going to peak at a higher rate, and when we come down it's not likely to quickly fall towards levels that are more consistent with longer-term inflation targets."

The Fed has already signaled its intent to raise interest rates through 2023. But current events have potentially shifted the medium-term trajectory of those rate increases. Ultimately, Ma said Fed Chairman Jerome Powell will have to get the message across that we're going to have to live with higher inflation for a longer period than anticipated.

"Sooner or later, the Fed is going to message that this 2% inflation target that it once held so dearly is out the window, and what we want is inflation that shows it's declining," Ma said. "Whether or not we get to 2% in two or three years really doesn't matter that much. What matters is that inflation peaks and starts to decline."

Sanctions and the markets

Despite the current volatility, Ma said BMO's positioning is more favorable on U.S. rather than international markets. "Certainly, Europe is in the crosshairs of the energy challenges, of the economic growth challenges associated with the conflict, and of the potentially major disruptions to natural resources that it gets from Russia," he said. "The U.S. isn't immune, but it's still a relatively insular economy. We think the U.S. has strong economic stability. It still has a good growth profile, and once the acute phase of this war has passed, the underlying fundamentals of the economy should hold up well and allow the markets to stabilize."

International sanctions on Russia, however, could be a wild card. Ma said the duration of the sanctions are crucial to the global economy as well as to Russia's economy.

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"Clearly, the risk in Europe is going to be higher, given the dependence on Russian energy and the proximity of those economies," Ma said. "But overall, the risks get spread out pretty far. Emerging markets tend to have more difficulty with inflationary pressures because it often comes with currency devaluation and difficulty paying external debts."

"On the flipside," Ma continued, "China has put forward some modestly aggressive growth targets, which should come with stimulus to try to offset some of that fallout. There are a lot of moving parts right now, and I think a lot is dependent on what the longer-term sanction regime looks like on Russia, and whether or not part of Putin's strategy is to try to negotiate away some of the heavier ones that have been placed on Russia, and whether that's successful."

Even if the conflict were to conclude within the next few weeks, however, Papic doesn't believe the U.S. would be quick to roll back its sanctions, particularly those against the Russian central bank. And that could pose a significant threat to global markets.

"If the Americans don't roll that back," Papic said, "what I fear is that Russia is going to start acting in a way where it's self-embargoes potentially critical commodity exports, whether it's palladium, nickel, aluminum—you'd see wild price actions because of that. Russia produces 16% of the world's potash, which is a key input into food. And of course, oil. The ultimate scare factor would be to self-embargo oil. We've done an analysis that shows that Russians will basically make money—they would replace lost volume with a price appreciation of the commodity."

Papic added that oil prices could still appreciate beyond $130 a barrel of West Texas Intermediate crude if Russia decides to curtail its exports. "That's something I'm very afraid of, because that makes this conflict last a lot longer than the military operations on the ground in Ukraine. And it starts having shades of 1973—the Yom Kippur War, the OPEC embargo, and of course the deep stagflation that followed it."

End in sight?

It's difficult to determine how long the conflict will continue. But for his part, Papic approaches politics from what he calls a "constraint-based framework." That is, focus on the material constraints that policymakers face, not their beliefs or desires, to predict their future behavior. Papic said domestic politics represents the biggest constraint on Putin. Particularly, the social contract Russian citizens expect its government to honor.

"In Russia, the contract is you don't give us the chaos of the 1990s, and we won't ask for a vote," he explained. "The 1990s are embedded in the psyche of the Russian people. The 1990s were a terrible era in which there were bread lines, there was hyperinflation, the ruble collapsed, there were defaults, and there was geopolitical chaos. It was very bad. What I'm seeing right now in Russia is the beginning of the '90s again, and that's something that Putin can't go back to. He will lose the social contract between United Russia, which is his party, and the people."

Another key constraint facing Russia, Papic said, is that the overwhelming majority of Ukrainians are not in favor of the Russian government, which will make it difficult for Russia to occupy the country.

"There's maybe 10% of Ukrainians who will welcome [Russia]," Papic said. "Remember, in 2014 Putin took the two parts of Ukraine [when he annexed incorporated Crimea as the Republic of Crimea and the federal city of Sevastopol] that were the most pro-Russian, so there's nobody welcoming Russians in Ukraine. For them to garrison a country of 43 million people that's rabidly anti-Russian, they're going to need 250,000 troops stationed permanently—the number of troops America had in Europe [after World War II]. The United States is a $17 trillion economy; the Russian economy is smaller than the state of Texas. That's why I think we are in the early stages of the end of this war."

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We covered a tremendous amount of ground in our discussion, including the potential impact on capital investment in energy projects, China's economy and other geopolitical risks. You can listen to a replay of the full event here: https://bit.ly/3NauT1k

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