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War and Peace

In a recent article, we discussed the Russia-Ukraine conflict as one of the critical events that would affect market direction (*Catch phrases*, January 31, 2022). This was highlighted last week when the stock market reacted violently at the prospect of a potential war between Russia and Ukraine. Equities nosedived whenever there were warnings of armed conflict while talks of peace, de-escalation, and withdrawal fueled market rebounds. An understanding of the Russia-Ukraine conflict will help investors navigate the turbulence from ongoing geopolitical tensions and guide investment decisions accordingly.

US warns of imminent invasion

US President Joe Biden warned that the threat of Russian invasion in Ukraine is “very high” and an attack could come within “the next several days.” US Ambassador to the United Nations (UN) Linda Thomas-Greenfield reported that Russia is moving toward “an imminent invasion.” According to US intelligence, a total of 150,000 Russian troops are stationed in the south (Crimea), east (Donbas), and north (Belarus) of Ukraine. Despite Russia’s participation in negotiations and claims of troop withdrawal, on-the-ground estimates show that Russia deployed an additional 7,000 soldiers. Over the weekend, the US accused Russia of staging a large-scale cyberattack on Ukraine.

NATO vs. Russia

Though the conflict is between Russia and Ukraine, the US is at the forefront of fierce negotiations with Russia. The US, Canada, and major European countries are part of the North Atlantic Treaty Organization (NATO), the largest military alliance in the world. From only having 16 members in the early 1990s, NATO has grown its membership to 30 states by expanding in Eastern Europe. Ukraine and Georgia, both former Soviet Union countries, are among the states that are currently vying for NATO membership. As part of his negotiation demands, Russian President Vladimir Putin stipulated that Ukraine should be banned from joining NATO forever. He also called for the withdrawal of NATO forces in Eastern Europe and the removal of US nuclear weapons in Europe.

Putin wants Ukraine

Ukraine declared its independence in 1917 and regained this when the Union of Soviet Socialist Republics (USSR) was dissolved in 1991. Ukraine was an integral part of the Russian empire. Ukraine’s capital, Kiev, had been a major political, religious, and cultural center, and many Russians consider it to be the birthplace of Russian civilization. Putin asserts that Ukraine has unjustly been separated from its motherland and is now being influenced by the West.

Since its separation from USSR in 1991, Ukraine has drifted away from Russia’s sphere of influence. It began relations with NATO in 1992 and applied for membership in 2008. The country’s 2019 constitution enshrined the goals of achieving membership in NATO and the European Union.

West threatens Russia with major sanctions

The US and Europe have threatened Russia with severe financial and trade sanctions. These include USD clearing restrictions, capital market restrictions, asset freezes, travel restrictions, export controls, and a ban on emerging technologies. Among the main targets of the sanctions are Russian banks, energy producers, and oligarchs. Nonetheless, we note that Russia's foreign exchange reserves reached an all-time high of $630.6b in December. This can finance a prolonged attack on Ukraine while insulating the ruble from sharp depreciation and speculative attacks.

Russia – major producer of energy and commodities

Russia is the world's 3rd largest oil producer, accounting for more than 10% of global production. Moreover, about 40% of the natural gas used by European countries comes from Russia. It is the biggest exporter of fertilizers and together with Ukraine, accounts for 25% of global wheat exports. Russia is the world's top exporter of palladium, accounting for 46% of global production. Considering these, many fear that a prolonged conflict involving Russia will exacerbate ongoing shortages in various commodities.

Potential war amid inflation spike, energy crunch

The potential war in Ukraine comes amid a sharp spike in inflation and the worst energy crunch in decades. US inflation in January accelerated to 7.5%, the highest level in 40 years. Natural gas and coal prices have recently soared to all-time highs due to shortages. A war between Russia and Ukraine will stoke even higher inflation and energy prices. This may complicate the problem that central banks face as they seek to normalize monetary policy and tame inflation while also supporting the economic recovery.

War and peace drive market direction

By understanding the role of the US and the West in the region, NATO's expansion in Eastern Europe, and the historical significance of Ukraine to Russia, investors may be able to decipher the reasons behind the Russia-Ukraine conflict. We previously explained that it is important to comprehend Xi Jinping's intentions as China chases its goal of Common Prosperity. In the same vein, it is crucial to understand Putin's mindset because he is another powerful authoritarian that can impact global affairs. More importantly, a grasp of the battle for global supremacy and spheres of influence among the US, China, and Russia is integral for investors.

Moving forward, outcomes pertaining to war and peace will drive the direction of financial markets. A limited incursion of Eastern Ukraine would exacerbate the ongoing correction in stocks. Meanwhile, a full-scale invasion coupled with retaliation by the US and its allies may actually trigger a bear market. Investors would prefer a diplomatic resolution but this would only be possible if Putin is able to extract concessions from NATO. Under the first two scenarios, oil and gas prices would likely move higher, further fanning inflation that is already at an elevated level. This may prompt central banks to hike rates faster than previously expected, thereby posing a risk to global growth. It is thus important for investors to monitor the conflict given Russia's strong linkages to commodity and energy markets.

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