

Research Russia

Russia launches a full attack on Ukraine

- **Russia decision to attack Ukraine will be met with harsh sanctions from the West.**
- **It is a close call whether the West will exclude Russian banks from the Swift system, which would be a major blow to the Russian economy and lead to significant energy shock in Europe.**
- **Higher energy prices and hit to economic confidence will exacerbate stagflation concerns in the Eurozone and pose challenge for the ECB.**
- **The prospects of tough sanctions on Russia create significant upside for both oil and gas prices as well as some metal and wheat prices.**
- **RUB and CEE currencies take a hit while USD and CHF are to benefit.**

Russia has this morning launched a full attack to Ukraine. At this stage, it is unclear what the scope of the attack is and what Russia is ultimately aiming for. In a speech held just before commencing the attack, Putin said Russia is not aiming to conquer Ukrainian areas, and is only aiming at Ukrainian military operations. Nevertheless, missile strikes have been reported in several cities across Ukraine, including the capital Kiev, which means the operations are clearly more widespread than initially feared. Ukraine has also been under continuous cyber-attacks since yesterday evening. Earlier this week, the discussion circled around where Russia sees the borders of the Donbass region in Eastern Ukraine, but now it is clear that the situation has escalated further. Markets have reacted with a broad risk-off, and the Russian central bank is intervening in the RUB markets. Especially energy commodities have sold off, as the potential sanctions limiting international trade with Russia could have a strong impact on the Russian supply.

Western response will go for harsh sanctions

The next step to watch is the Western reaction. There will be an emergency meeting among G7 leaders later today where they will discuss their response politically and economically toward Russia. This will be followed by meeting by EU leaders. We think that NATO will tread very carefully given the threat with regard to military assistance to Ukraine given the warning from Putin about the consequences of any third party involvement in the country. Instead, we think that the West will try to hit Russia as hard as they can economically through harsh sanctions. These will include both restrictions on trade with Russia, likely sanctions on the biggest Russian banks and some kind of restrictions on payments systems. This could be either in the form of exclusion of Russia from the Swift system or a more limited option of the US and UK banning Russian banks from the use of USD and GBP, which the US President Biden and UK Prime Minister Johnson have been alluding to. We think it is a close call but don't think that the West will go for the latter option of banning Russia from the use of USD and GBP. In that regard, the White House alluded to this on Tuesday said when announcing their first batch of sanctions saying that "the Secretary of the Treasury will determine that any institution in the financial services sector of the Russian Federation economy is a target for further sanctions.

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Over 80% of Russia's daily foreign exchange transactions globally are in U.S. dollars and roughly half of Russia's international trade is conducted in dollars. With this action, no Russian financial institution is safe from our measures, including the largest banks."

The sanctions imposed before the escalation will likely have only a moderate effect on the Russian economy and **hence stronger measures are likely coming, which could significantly affect the Russian economy, which is likely to see an economic backlash.** However, we would expect the Russian government to step in with assistance to the economy to cushion the blow to consumers and companies. Russia has been able to reduce foreign debt, the current level is only around 18% of GDP, and the country's high FX reserves cover almost all of the foreign debt. In terms of international trade, Russia has been able to reduce its dependency with EU, while the relative importance of China as a trading partner has increased, which could further mitigate the blow from any sanctions imposed by the west.

European economy is vulnerable to higher inflation and uncertainty.

The European economy is more exposed to the indirect consequences of imposing sanctions on commodity prices than the US. The military confrontation would likely lead to higher energy prices, which would take a toll on the euro area growth outlook and hence exacerbate the stagflationary concerns as private consumers will be hit by higher energy costs and the uncertainty will hit investments. It naturally remains uncertain how large the impact is going to be (gas prices are up 34% this morning). While we believe governments will try to cushion the impact to the euro area economy if a lasting impact. In a piece last week, ECB already estimated that the recent increase in gas prices has taken roughly a quarter of growth off. In terms of ECB response, the direct response from ECB is not straight forward. Naturally geopolitical risks are a concern to ECB, and this issue was also mentioned by Lagarde at the recent press conference. While ECB has to balance the higher inflation vs. the weakened growth outlook in such scenario (increasing the risk of stagflation), we all else equal see a less accelerated monetary policy normalisation path given the elevated uncertainty. In other words, a positive supply shock to inflation, but a negative demand shock to the economy could stagnate euro area growth in the following months, while at the same time eating into the purchasing power of the euro area inhabitants. In conclusion, the key words optionality and flexibility is still key! We still believe ECB will formally put an end to the APP programme as inflation is running high, but likely only by Q3 22, and send no signals of imminent rate hike after the end of QE as further tightening would depend on the size of the negative demand shock. Therefore, going away from the open-ended buying guidance and putting a formal end date to the net APP, is close to being unavoidable at the March meeting.

A key risk for the western economies are possible cyberattacks by Russia versus private companies and government systems in the west similarly to what was seen with Solar Winds in the US.

The crisis reduces the likelihood of a 50bp hike from the Fed in March

The situation with Russia and Ukraine makes the probability of a 50bp Fed rate hike in March less likely. According to market pricing, the probability has declined from 40% yesterday to now around 25%. The current situations worsens the financial conditions, why Fed would tend to be cautious with monetary tightening. It is normal behaviour for central banks to get more cautious when overall uncertainty is on the rise. We argue, however, that the situation drives the prices on energy and raw materials up, which means that underlying

inflation pressure remains very high. The Fed no longer has the same luxury to take several factors into account when adjusting monetary policy. If the Fed decides to hike by 25bp, we still think there is a high probability that the Fed needs to hike by 50bp at a later stage, especially if tensions ease.

The impact on commodity markets—clear upside risks to oil and gas prices

Commodity markets reacted swiftly to the developments. The market price a premium on broad commodity space due the risk that Russia will hit by sanctions which will affect its exports. Energy markets are of key focus. European natural gas prices spike back towards recent highs and Brent jumps above USD100/bbl mark. But it extends beyond the energy space as Russia is a key provide of other commodities. Wheat and aluminium prices have increased sharply today. We see the gas prices could surge to above EUR200 MWH if harsh sanctions are imposed on Russia.

FX markets: RUB and CEE currencies take a hit while USD and CHF are to benefit

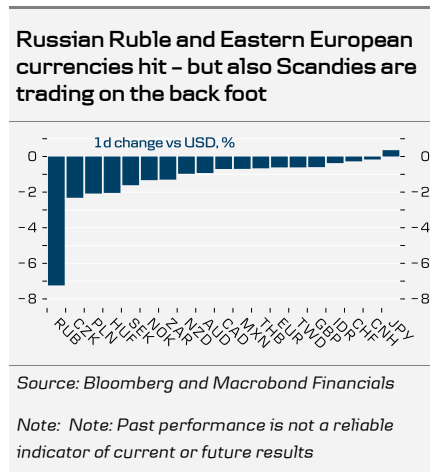
At the time of writing, the market reaction appear very much in line with what one could expect: US treasury bond yields are falling and oil has moved higher overnight to USD102/Barrel from the high 90’s yesterday. Equity futures are printing -5% to -2%, which is in line with recent trading sessions.

In FX, **USD/RUB** has jumped to our estimated ‘worst case’ scenario at 87.00. Naturally, **EUR/USD** has taken the brunt of the effect in non-RUB assets, so far, dropping roughly a small figure from yesterday to 1.1236 and **Eastern European currencies** (especially **PLN**) have weakened. The market reaction appear highly in line with what we would expect from the notion of rising risk aversion towards European assets as well as seeing a negative effect from a further rise in energy prices. Naturally, the next step will be to view the reaction from politicians in terms of sanctions.

Rising risk aversion and energy costs weigh mainly on European crosses and **USD/PLN** is at the forefront of this. In **EUR/USD**, the main effect is from rising energy costs and much less so from risk aversion itself. At present, it seems unlikely to talk about de-escalation and further downside to **EUR/USD** is probably realistic at the present stage in the conflict (as energy costs potentially spike further, spot can drop towards 1.11) - assuming next up we see pictures of war and politicians need to step up. Downside in **EUR/USD** is equally amplified by many turning **EUR**-positive after the recent **ECB** meeting. We continue to forecast 1.08 in 12M.

SEK suffers primarily through the risk off and equities channels, while Sweden’s economic exposure to Russia is not big. The Russian invasion will bring down equities and prompt risk reduction across the investor space. In FX, we have seen a substantial selloff in the **SEK**, partly via pure flight to safety, but also via forced rebalancing flows. It is extremely difficult to pinpoint levels, but the 10-20 figures knee-jerk rallies in both **EUR/SEK** and **USD/SEK** seen today is in line with our expectations. If the conflict goes on and the economic and financial ramifications go from bad to worse, it is not hard to see **EUR/SEK** (b) reaching 11.00 and **USD/SEK** 10.00 over time.

While Norway’s terms-of-trade benefits from the rise in oil and natural gas prices the **NOK** currency is still left highly vulnerable to elevated uncertainty, drop in global asset prices and the hit to the European growth outlook. While the invasion does not put into question Norges Bank tightening cycle short-term the **NOK** rates curve does leave room for pricing in less tightening in the coming years; we still think pricing looks stretched to peers.



Overall, the invasion adds an unfortunate argument to our list for why NOK is set to weaken in H1 this year.

EUR/GBP usually declines when the Ukraine situation worsens, as the negative consequences are bigger for the euro area relative to the UK. If things escalate further, we see downside risks to our short-term EUR/GBP target of 0.84 in 1M and the cross may move below 0.83. There is a limit to how low EUR/GBP can go, both because the UK is not unaffected by the crisis and because negative risk sentiment normally is not good for GBP. If/when tension ease, we expect the cross to move closer to 0.84 again.

EUR/CHF went briefly below 1.03 this morning, as CHF is benefitting not just when markets tank but also in particular when investors would like to get out of Russia, as CHF is considered a “safe haven” currency. As long as uncertainty remains high, EUR/CHF will trade to the low side and is likely to move below 1.03 near-term if the situation escalates further. Whenever the situation eases, we expect the cross to move higher again.

Disclosure

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Expected updates

None

Date of first publication

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