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Research Russia

Hope dies last – Nervous markets are far from pricing in a full-blown war

- **Diplomatic stalemate between Russia and the West remains. Military escalation has already started in Eastern Ukraine and, according to US intelligence, Russia has the readiness for an imminent large-scale attack on Ukraine.**
- **On Monday evening, Putin announced he will sign the decree for recognizing separatist Luhansk and Donetsk People's Republics in Eastern Ukraine – a move previously indicated as a potential deal-breaker for diplomacy by the West.**
- **Considering military escalation in Eastern Ukraine has started, markets remain surprisingly calm with negative reactions thus far contained to RUB-linked assets.**
- **Compared to the situation in January, we now see a diminishing probability for a peaceful solution and raise our estimate of a probability for a full-blown war. The latter would trigger a substantial fall in RUB, weaker EUR and weaker Scandies. Safe-haven assets would benefit, while rising uncertainty would hit stock markets.**

The threat of war is rising but diplomacy is still alive

Last week, Russia published its response to the US/NATO proposal that addressed the security guarantees presented by Russia in December. The stalemate continues: Russia was unsatisfied with the US/NATO response which unsurprisingly rejected Russian demands to halt NATO's expansion to the east and a major rollback of the alliance's presence in its current eastern member states. **The US/NATO insist on maintaining the 'open-door' policy, while Kremlin repeatedly calls it their key priority.** While the Russian response does not raise high hopes for a diplomatic solution, Russia has not fully closed the door for further diplomatic talks regarding other issues such as arms control and military exercises.

The two sides publicly disagree on a number of other issues regarding the current state of affairs. The US has announced, based on intelligence, that Russia has the readiness to launch a large-scale attack on Ukraine any time now. Media reports have indicated that Putin may have already made the decision to invade. Meanwhile, Russia insists they are not planning to attack and accuse the West of constant provocation. Russian reports that they have been withdrawing troops from the vicinity of Ukraine since last week have been disputed by the West. On the contrary, US and NATO report that Russian buildup of troops (now accumulating to more than 150,000) and artillery at the Ukraine border has continued.

Military escalation in Eastern Ukraine is already happening. Since last Thursday, we have witnessed a number of reports on shelling incidents and ceasefire violations along the line of contact between Ukraine and separatist-held regions. Based on media reports, the security situation in Eastern Ukraine is getting worse by day and for example water supplies have been cut off in some areas.

What's happening?

- Military escalation has started in Eastern Ukraine. Since Thursday, multiple shelling incidents and ceasefire violations have been reported.
- Russia has continued moving more artillery and troops towards the Ukrainian border. Troops have not returned to barracks from Belarus despite military drills ending on 20 Feb. The US has warned that Russia could launch a large-scale attack any time now.
- US-Russia foreign ministers Blinken and Lavrov are due to meet on Thursday. A summit between Presidents Biden and Putin could take place thereafter. Biden has agreed to the summit 'in principle', while Kremlin says there are no concrete plans yet.
- Putin's recognition of the two breakaway regions in Eastern Ukraine casts a shadow on whether there still remains room for diplomacy.

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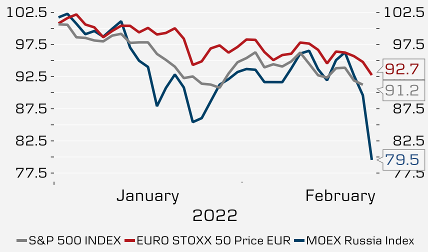
Hope dies last. The French President Macron has taken a leading role in facilitating a peaceful solution. His efforts have succeeded in securing **a new round of talks between foreign ministers Lavrov and Blinken for Thursday 24 Feb**. A high-level summit between Biden and Putin is also on the cards and Biden has agreed 'in principle' as long as Russia does not launch an attack. Kremlin has said there are no concrete plans for the summit yet.

On Monday evening address 21 Feb, Putin announced he will sign decrees recognizing separatist-led Luhansk and Donetsk People's Republics. He also signs agreements on cooperation and friendship with breakaway regions and orders peacekeeping operations implying Russia will start providing military support to separatists. Western officials have earlier communicated that a Russian recognition of separatist-held regions would torpedo all remaining efforts to find a diplomatic solution to the crisis so Monday's announcement could jeopardize what could be the last attempt to avoid a full-blown war in Europe.

Russian stocks underperform



Source: Bloomberg
Note: Past performance is not a reliable indicator of current or future results

Updating our scenarios – higher probability of a full-blown war

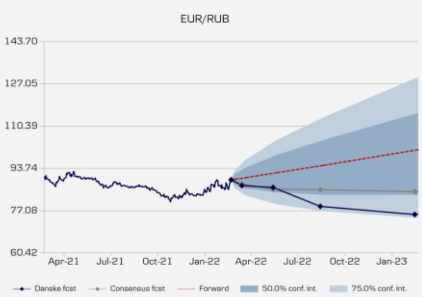
In our paper *Research Russia – Expect serious market disruptions if a war breaks out*, 14 January, we outlined three scenarios for what might happen over the next 4-6 weeks. Five weeks on, our main scenario, suggesting a contained military re-escalation in Eastern Ukraine, seems to have become a reality. Same time, we see that **the probability of a diplomatic solution has diminished, while the threat of a full-blown war has risen. We now place a 50% probability of the conflict remaining contained in Eastern Ukraine but update our probabilities for other scenarios.** We see a 30% probability of a large-scale Russian attack on Ukraine, including invasion of key cities like Kiev, and only a 20% probability of a de-escalation as a result from a diplomatic deal (see Summary Chart on page 4).

Market reactions thus far have been contained to RUB-linked assets – room to go if a full-blown war breaks out

In terms of markets, **thus far, the Ukraine-Russia conflict has had a very limited impact beyond directly RUB-linked assets**. RUB has moved from being a bit strong to now fixing at PPP fair-value estimates. As long as the military escalation remains contained in Eastern Ukraine, we see USD/RUB in 77-80 range in the short term, but in case of a full-blown war, USD/RUB could go above 85.

The USD/RUB 6M risk reversal is at 10 (an exceptionally strong market bias towards calls in the cross) and CDS- jointly with foreign-currency bond spreads have moved to their COVID highs (300-400bp). In case of a full-blown war, these risk premia could double or triple, but for now, they appear well in line with the level of conflict. Globally, we see equity markets, EUR/USD and Eastern European currencies quite resilient, while Russian stocks have clearly underperformed (falling 10% on Feb 21 alone). This resilience remains but **the day-to-day correlation has gone up between non-RUB and RUB assets since last Friday** – in tandem with rising expectations towards a skirmish.

Our baseline for a stronger RUB over the next 12M remains in the absence of a full-blown war

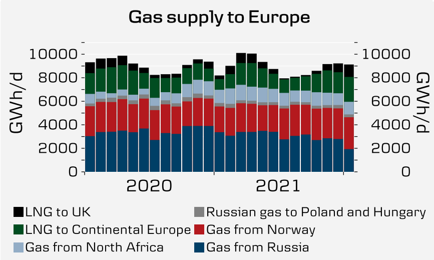


Source: Bloomberg
Note: Past performance is not a reliable indicator of current or future results

In case of a de-escalation, the largest effects would be on RUB-denominated assets – like in FX. In case of an escalation, we should expect to see markedly lower EUR/USD (e.g. 2-3 figs) and Brent above USD100/barrel. In currencies, Scandies and Eastern Europe can drop 1-3% versus the EUR and equity markets can probably (initially) drop a few percent in the worst-case scenario. The lack of current correlation implies these **risks are binary in the sense that nothing is priced until outright war becomes evident, in which case markets jump in a one-off re-pricing.** Markets remain quite upbeat about the prospects of (not) seeing a war.

Russia is a key producer and exporter of oil, gas and metals and, hence, a war could entail severe disruptions for commodity markets. The price of Brent oil has already climbed from USD 77/barrel in early January to USD 94/barrel, some of which is due to the Russian situation. European gas prices, however, remain far from December highs of 180€/MWh at around 76€/Mwh despite Russian gas supplies to Europe being at their lowest level for seven years. The *White House has warned* that a Russian invasion and resulting sanctions could also exacerbate bottlenecks in semiconductors industry, as Russia is a key supplier of e.g. neon and palladium. Furthermore, *Russia and Ukraine account for almost a third* of global wheat exports. We have estimated earlier that disruptions in Russian gas deliveries to Europe alone could lead to prices spiking above €200/MWh, or in a case of a full stop, above 300€/MWh. The rise in gas prices alone could add 0.7-1.2% to our baseline inflation projection of 3.2% for euro area this year.

Russian gas supplies to Europe at their lowest level in seven years



Source: Macrobond, Refinitiv

More questions than answers regarding sanctions

There remains little clarity on potential sanctions should Russia launch a large-scale attack. While Ukraine has already appealed to the West to impose sanctions against Russia as a response to the military escalation in Eastern Ukraine, the White House has abstained saying that the deterring impact from sanctions will be lost the moment they are imposed. **The US and UK officials have warned that in case of an invasion Russian financial institutions would be punished cutting them off from access to USD and GBP**. Potential new sanctions against Russian individuals, businesses, as well as sanctions targeting US technology exports to Russia, have also been flashed.

The EU has been very quiet giving only some vague indications that its first line of response to a Russian invasion would include **sanctions targeting the Russian energy sector without providing any details.** The meeting between German Chancellor Scholz and President Putin produced nothing concrete in terms of the destiny of Nord Stream 2 should Russia launch an attack. Apart from Germany, many Eastern European countries such as the Czech Republic, Latvia, Hungary, Slovakia, and also Finland *import more than 60% of their gas from Russia*. No doubt, any sanctions would weigh much more heavily on European economies that they would on US. The economic impact from sanctions imposed after Russia annexed Crimea in 2014 *had almost a similar impact in absolute terms on the German economy than it did on Russian economy*.

Conclusion – hope for the best, prepare for the worst

Diplomacy is not dead yet, and the set date for Lavrov-Blinken meeting gives us some calm, that the worst-case scenario of a full-blown war could be avoided still. However, considering no rapprochement between the two sides on key issues, Putin's recognition of the two breakaway regions on Monday, and the evident Russian military preparedness for an imminent large-scale attack, the threat of a full-blown war (our initial tail risk scenario), has increased**. In the worst case, market reactions in RUB-linked assets could be extreme, while broader market reactions could still be relatively short-lived.**

Much depends on the West's response, and obviously, on Russia's counter-response. Sanctions targeting individuals or businesses would have marginal macro-level impacts, but **sanctions targeting Russian financial institutions or its energy sector could have far-reaching negative effects on trade, inflation and growth, particularly in Europe, less so in the US.** Finally, referring to Biden's remarks of sanctions having their greatest power as a deterrent, we conclude that the West will do their utmost to maintain diplomatic dialogue which can prevent the crisis from escalating – knowing very well that imposing sanctions would sabotage that pursuit.

Crisis scenarios

20% Scenario 1: A deal is reached as a result from concessions by the West – market relief	50% Scenario 2: Military re-escalation of conflict in Eastern Ukraine – limited negative market impact	30% Scenario 3: Russia initiates a large-scale attack on Ukraine, significant negative market impact
The West makes concessions and Russian troops return to their barracks from the Ukraine border. No new sanctions.	Russia pushes to increase its territory of control in Eastern Ukraine. The West imposes new sanctions regarding exports and targeting Russian individuals, businesses and Fis.	Russia attempts to seize control of the whole of Ukraine. The West responds with unprecedented sanctions, exclusion from SWIFT a possibility.
	Impact on rates and equities markets	
• No reaction in rate markets • No reaction in stock markets	• Bund yields fall 3-4bp • No significant stock market reaction	• Lower bund yields, wider spreads • Negative but short-lived reaction in stock markets, Russia underperforming
	Impact on gas markets	
• Prices moderate from current levels (normalisation of inventories, Nord Stream 2)	• Immediate price impact with the magnitude depending on the season (LNG deliveries and EU gas inventories) – future price above 200€/MWh	• Prices spike if Russia excluded from SWIFT, future price could exceed 300€/MWh
	Impact on RUB	
• Relief rally drives RUB stronger	• USD/RUB in 77-80 range	• USD/RUB above 85 levels

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Expected updates

None

Date of first publication

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