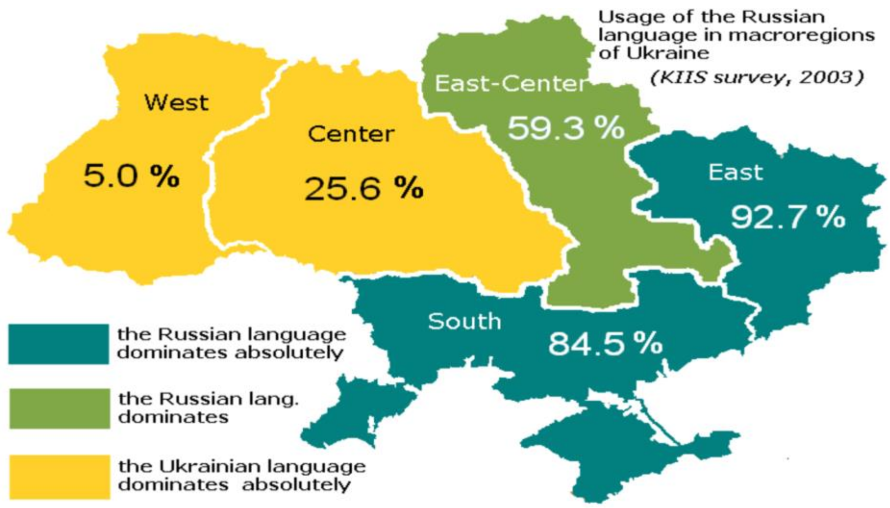
MAKING SENSE OF *THIS* WORLD

28 February 2022

R&R Weekly Column
By Brunello Rosa



Russia's Invasion of Ukraine: Possible Endgames And the Wider Implications of the War

In spite of all of the intelligence provided by the US and UK security services, which warned about Russian President Putin's belligerent plans, the world was shocked by last week's images showing Russian tanks crossing the borders of Ukraine and beginning a full-scale invasion of the country. In the days preceding the invasion, we had assigned a probability of 25% to an immediate de-escalation taking place, with the remaining 75% divided between a 55% chance of there being a controlled escalation and a 20% probability of a full-blown invasion. Though the escalation has been ratcheted up gradually, we were also surprised by the intensity of the attack. The decision by the Russian army to directly target the capital Kiev suggests that we are clearly in an open conflict aimed at a full-scale invasion.

We *could* discuss how we got to this situation. Russia annexed Crimea in 2014, so eight years have passed without the West being able to offer a possible solution to a crisis that was clearly brewing, while Putin had all the time in the world to carefully plan his country's actions (starting from the constitutional change that will allow him to stay in power potentially until 2036). At this stage, however, we believe it is more relevant to discuss what a possible endgame could look like, and what the wider implications of the invasion might be.

From a geopolitical perspective, Russia is likely to have the upper hand here. NATO cannot intervene in defence of a non-member state, and even if it decided to do so, what would it do? Bomb Ukrainian cities? Attack the Russian army? Both options seem unfeasible, for easily understandable reasons. Other possible retaliatory strategic measures (such as including Finland in NATO, annexing Kaliningrad's enclave, aiming at a regime change in Russia, re-integrating Moldova into Romania, or similar) all seem totally out of reach, unless one wanted to entertain the idea that WW3 is an immediate possibility (as President Biden put it). Hence this is, and will remain, an asymmetric war.

This asymmetric war in which Russia can use tanks and the West only sanctions means that Putin will soon control the entire Ukrainian territory. At that point, it will be able to negotiate from a position of strength. We do not think it will proceed to an annexation of the entire Ukrainian territory to Russia: this would defeat the purpose of the invasion, i.e. preventing Russia from sharing a large border with NATO countries (such as Poland, Hungary, Romania and Slovakia). It is more likely that Russia will proceed with an annexation of the Russian-speaking regions of Ukraine (the central-east and south-east regions of the country – see map above). In the west and the centre of the country Putin may want to install a puppet government which will guarantee that what is left of Ukraine will never join the EU or NATO.

If this plan succeeds, Russia will have gained total control of the Azov sea. It will have achieved, among other things, a full continuity of navigation between the Caspian Sea and the Mediterranean Sea, via the Black Sea, by way of the navigable Don and the Volga rivers and the Volga-Don Canal. For this reason, Turkey decided to ban access to Russian military ships via the Turkish straits, which link the Mediterranean to the Black Sea. More importantly, however, Russia will have secured the so-called "geopolitical depth" it is looking for, with a series of "buffer states" between NATO and the Russian motherland: Belarus, (the remnants of) Ukraine, Georgia, Armenia and Azerbaijan. The recent advances made in Kazakhstan will have also secured the southern front, toward the borders with China.

In future columns and pieces of research, we will also discuss the macroeconomic and financial implications of this war, which have been recently discussed in an article by Nouriel Roubini. Roubini highlighted how this war will impose another stagflationary shock on the global economy, making it even harder for central banks to respond to the slowdown in economic activity and rise in inflation that has been taking place in the last few months.

Our Recent Publications

- *Flash Review: Hawkish RBNZ Rises Rates and Announces Further Future Hikes, by Brunello Rosa and Nato Balavadze, 23 February 2022*
- *Kazakhstan: The Power Struggle Behind the Unrest, by Marco Lucchin, 18 February 2022*
- *Flash Review: The Riksbank Narrowly Keeps Its Policy Stance Unchanged in February, by Brunello Rosa and Nato Balavadze, 10 February 2022*
- **GEOPOLITICAL CORNER:** The Geopolitics of Cyber, *by John C. Hulsman, 22 February 2022*

Looking Ahead

The Week Ahead: The Unemployment Rate Is Expected To Decline In the US, While Remaining Unchanged In the EZ

In the US, February's labor market data is expected to show: *i)* non-farm payrolls decelerating to 318k (*p:* 467k); *ii)* unemployment rate decreasing to 3.9% (*p:* 4.0%); and *iii)* average hourly earnings falling to 0.5% m-o-m (*p:* 0.7%).

In the EZ, in January, the unemployment rate is likely to stay unchanged at 7.0%. February's inflation flash estimates are expected to show: *i)* inflation rising to 5.3% y-o-y (*p:* 5.1%); and *ii)* core inflation surging to 2.5% y-o-y (*p:* 2.3%). Retail sales are expected to increase by 1.5% m-o-m (*p:* -3.0%) and 9.5% y-o-y (*p:* 2.0%).

The Quarter Ahead: Russia's Assault Began On Thursday; Western Countries Unleash Additional Sanctions On Russia; Ruble Plunges

Russia begun its invasion of Ukraine from the three fronts on February 24, following an announcement by President Putin. Ukraine imposed a state of emergency, as Kyiv residents were told to seek the bomb shelters. At least 137 Ukrainian soldiers were killed on the first day of the attack, officials reported. Moscow first attacked Ukraine's military infrastructure and border guard units. Russian forces also seized control of the Chernobyl nuclear plant in addition to Hostomel airport near Kyiv, which was then recaptured by Ukrainian armed forces. These military operations are likely to last for months, especially if Western countries will provide weapons to Kiev's army.

US, UK, and EU target Russia with sanctions. Following the imposition of the US embargo on the separatist regions, the US fully blocked the two largest Russian banks, VTB Bank and Sberbank, and prohibited trading of Russian government debt. New sanctions were unveiled by the UK as well, which mainly targeted Russian banks and oligarchs. Individual sanctions were announced by Johnson on over 120 individuals. Both US and UK sanctioned exports of high technology. EU sanctions target Russian assets in the bloc and energy and transport sectors of Russia. Germany halted Nord Stream 2, which had been designated to ease the increasing energy prices. Western countries have also started to disconnect selected Russian banks from the SWIFT messaging system.

Ukraine President Zelensky criticized the US and the western allies and NATO's response in general. NATO's secretary general Stoltenberg said: "We do not have any plans [to deploy] NATO troops to Ukraine," instead the organization plans to increase "the presence of NATO troops in the eastern part of the alliance on NATO territory". Zelensky questioned US and EU leaders over Ukraine's NATO membership and said that Ukraine was left alone to defend itself and urges civilians to fight and embrace firearms for self-defense.

Ruble plunges to a record low, as Russian stocks crash. The ruble hit 89.6, and the Russian Central Bank vowed to intervene in order to provide extra liquidity to the banking sector. Russia's largest bank Sberbank and Rosneft, in which BP owns roughly a 20% stake, both lost 43% of the value. Gazprom also was down 35%. For the first time since 2014, the oil prices soared above USD 100 pb.

Last Week's Review

Real Economy: Business Activity Picked Up In the EZ, UK and US In February. US Economy Advanced In Q4

In the US, Q4 GDP rose by 7.0% q-o-q (*c:* 7.0%; *p:* 2.3%). The February's IHS Markit PMI flash estimates showed: *i)* Composite PMI rising to 56.0 (*p:* 51.1); *ii)* Manufacturing and Services PMI increasing as well to 57.5 (*c:* 56.0; *p:* 55.5) and to 56.7 (*c:* 53.0; *p:* 51.2) respectively.

In the EZ, business activity expanded as February's IHS Markit PMI flash estimates showed: *i)* Composite PMI rising to 55.8 (*p:* 52.3); *ii)* Manufacturing PMI declining to 54.8 (*p:* 58.7); and *iii)* Services PMI increasing to 55.8 (*p:* 51.1). In January, inflation was up to 5.1% y-o-y (*c:* 5.1%; *p:* 5.0%) and core inflation decelerated to 2.3% y-o-y (*c:* 2.3%; *p:* 2.6%).

In the UK, February's IHS Markit/CIPS PMI flash estimates showed: *i)* Composite PMI rising to 60.2 (*c:* 55.5; *p:* 54.2); *ii)* Manufacturing PMI staying unchanged at 57.3 (c: 57.2; *p:* 57.3); and *iii)* Services PMI increasing to 60.8 (*c:* 55.5; *p:* 54.1).

In New Zealand, the RBNZ increased its key interest rate by 25bps to 1.0%, as widely expected.

Financial Markets: Stock Market Sinks As Russia Moves Towards Kyiv; Volatility Rises Above Average; Oil Prices Soared

Market drivers: Russia's invasion of Ukraine weighed on the stock market, but there is a tendency to recover as investors welcome coordinated Western sanctions against Russia. Investors fled to safe havens to protect their portfolios, as treasury yields dropped.

Global Equities fell w-o-w (MSCI ACWI, -0.7%, to 698). The US S&P 500 Index rose slightly (+0.8% w-o-w, to 4,384). In the EZ, shares were still down (Eurostoxx 50, -2.5% w-o-w, to 3,970). In EMs, equities declined too (MSCI EMs, -6.2%, to 1,155). Volatility rose considerably to 27.5 (VIX S&P 500, 52w avg.: 21.2; 10y avg.: 17.9), while reaching almost the 30 mark during the week.

Fixed Income: *w-o-w*, UST yields increased (+1.2 bps to 1.97%) even if they traded as low as 1.85% during the week. German 10-year bond yield were up too compared to the last week (+0.6 bps, to 0.21%), but fell to 0.17% during the week as investors rushed into safe assets.

FX: w-o-w, the US Dollar Index rose (DXY, +0.6%, to 96.53; EUR/USD -0.6%, to 1.1268), as the euro heads to its lowest point since June 2020 versus the greenback. In EMs, currencies plunge against the USD (MSCI EM Currency Index, -0.9% w-o-w, to 1,734).

Commodities: w-o-w, oil prices retreated at the end of the week after hitting $102 (Brent, +0.17% to 93.7 USD/b). On a weekly basis, gold prices also declined (-0.5% to 1,891 USD/Oz), albeit hitting around 1,974 USD/Oz due to its traditional safe-haven status.

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Nato Balavadze *contributed to this Viewsletter.*

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*