MAKING SENSE OF *THIS* WORLD *30 May 2022*

R&R Weekly Column
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Russian Oil Embargo vs Price Cap: When Ideology Trumps Economic Logic

Oil prices have risen substantially in the last couple of years. In April 2020, at the beginning of the pandemic, Brent crude oil was trading just above USD 20pb (after having dropped briefly into negative territory, as the price of storage soared as a result of widespread lockdowns that prevented super-tankers from docking in ports). Currently oil prices are trading well above USD 110pb, as a result of the reopening of economies and, especially, the war in Ukraine and the further disruption in global supply chains. Lockdowns in China, commanded by the ill-conceived Zero-Covid policy, have disrupted the port of Shanghai, and are making the situation worse.

For gas prices the situation is similar. The US liquefied natural gas exports price is currently trading at 10.17 USD per thousand cubic feet, up from 8.56 last month and 6.52 one year ago. This is a change of 18.81% from last month and 55.98% from last year. According to the EAI, natural gas spot prices are rising at most locations. The Henry Hub spot price for example rose to $9.30 per million British thermal units (MMBtu) last week, from $8.45 the previous week. These increases are completely attributable to the war in Ukraine, as gas had continued to circulate freely during the pandemic.

The negative supply-side shock represented by the massive increase in energy prices discussed above will have its traditional impact on the economy: it will reduce economic activity while increasing price inflation. This will be felt more strongly by those countries more dependent on energy imports, such as Eurozone countries, with Germany and Italy the most reliant on Russian gas imports. Various national governments have tried to reduce the impact on households and companies with tax rebates and the freezing of fuel duties. But at EU-wide level, a different solution is emerging.

In Brussels, there are two lines of thought regarding this subject. One is that there should be an embargo on oil and gas imported from Russia. The other is that there should be a price cap; a limit on the amount the EU can spend on oil and gas imports. So far, the idea of the embargo is having the upper hand in the discussion, as politicians believe it is the quickest way to stop financing Putin's regime and its war in Ukraine. But there is another reason why the Europeans prefer the solution of the embargo to that of the price cap.

The price cap solution was suggested to the Europeans by the US Secretary to the Treasury Janet Yellen, on at least two occasions (the latter occasion being the G7 meeting in Germany on May 18-20). The proposal was to set a price limit to how much the EU would be willing to spend for oil and gas (a price cap), and the US would help enforce the cap by applying itself to its own trades. Also it would ask all its trade partners to help enforce the cap, in an extraordinary example of extra-territorial coordination of policies and sanctions.

Facing this generous offer, the Europeans preferred to opt for the embargo, to show some form of strategic autonomy from the US. In doing so, they choose an illogical solution from an economic standpoint. The embargo will reduce the quantity of energy in circulation and will increase oil and gas prices, as the Europeans will be forced to make agreements with other sellers. Conversely, the price cap would have kept the same amount of energy at Europe's disposal, at a reduced price.

A third possibility that has been flagged recently is a sort of "punitive EU tariff on Russian oil, proposed by the US and others," which would pave the way to an oil embargo at a later stage. According to its proponents an EU-wide tariff on Russian oil would "compel buyers to demand an offsetting discount from Russian sellers, cutting Moscow's profit, or go elsewhere. A tariff that successfully forced Russia to cut prices would in effect transfer tax revenues from Moscow's coffers to the EU's."

Regarding Europe's strategic autonomy, the EU may decide not to follow the lead of the US on the price cap, but it will eventually be forced to follow the US lead on military strategy, which – as we discussed in previous columns – diverges from that of the Europeans, insofar as the US will want to continue the war for longer, whereas the Europeans are aiming at an immediate ceasefire, at almost any cost.

For the US, the war has produced the following tangible results: it has re-aligned its historical and potentially reluctant allies; it has induced the Europeans to contribute more to the NATO budget (a long-standing request by the US); it has led to an increase of NATO membership (with Finland and Sweden likely joining); and it has implied that the US will start exporting its energy (in particular LNG) to Europe. *The Europeans*, on the other hand, have a lot to lose from a continuation of the war, as they are the most exposed to the sanctions, and to the "collateral effects" of the war, such as the rise in refugees. Since the war has polarised the world, the dream of the European strategic autonomy by way of the EU, or even of a European neutrality between US and China, has clearly vanished

Our Recent Publications

- *Financial Warfare Against Russia: Stakes for Gulf Investors and Funds, by Gulf State Analytics, 12 May 2022*
- **GEOPOLITICAL CORNER*:*** *The West and the Rest: The War In Ukraine Has Exposed The New Global Division Of Power , by John C. Hulsman, 17 May 2022*

Looking Ahead

The Week Ahead: US Unemployment To Decrease; EZ Inflation To Rise; PMIs Expected to Decline In Developed Markets

In the US, May's unemployment rate is expected to decrease to 3.5% (p: 3.6%) with NFPs rising by 350K (*p:* 428K).

In the EZ, May's inflation rate is seen rising to 7.6% y-o-y (*p:* 7.4%). In April, unemployment rate is expected to edge down to 6.7% (*p:* 6.8%) and retail sales are likely to accelerate to 5.4% y-o-y (*p:* 0.8%) and 0.1% m-o-m (*p:* -0.4%). ***Among the largest EZ economies,*** France's Q1 quarterly GDP is expected to stagnate (*p:* 0.7%), whereas the Italian economy is likely to shrink by -0.2% q-o-q (*p:* 0.6%)

In DMs, in May, final PMIs are expected to soften as: i) EZ manufacturing (*c:* 54.5; *p:* 55.5) and services (*p:* 5.7.7) slow down and as a result composite PMI decreases (*c:* 54.9; *p:* 55.8); *ii)* UK's manufacturing indicator shows weaker activity (*c:* 54.6; *p:* 55.8); *iii)* US manufacturing (*c:* 57.5; *p:* 59.2) and services (*c:* 53.5; *p:* 55.6) activity decreases and composite PMI is down too (*c:* 53.8; *p:* 56.0); and *iv)* Japan's manufacturing activity is slightly down (*c:* 53.2; *p:* 53.5).

The Quarter Ahead: Lagarde Thinks Crypto Assets Are Worthless; UK Hits Oil And Gas Firms With Tax; Davos 2022

ECB President Christine Lagarde said that cryptocurrencies are 'worth nothing'. Lagarde pointed out that crypto assets are risky and speculative with no underlying asset to act as an anchor of safety. In addition, ECB warns that the crypto industry is becoming more connected to banks, posing a risk to financial stability. Lagarde also called for a regulation on cryptos to protect inexperienced investors from making big bets on digital assets. So-called "cryptocurrencies" fell this year, with Bitcoin losing approximately 60% of its value since November 2021. In her blog post, Lagarde also anticipates two rate hikes in July and September.

The UK announced a windfall tax on oil and gas companies. Amid the worst cost-of-living crisis, the government introduced 25% windfall tax on the profits of the companies such as BP and Shell in order to soften the pain of increasing energy prices weighing on consumers. Alongside a tax that is expected to raise £5 bn in the next 12 months, Britain announced £15bn package of support for vulnerable households finding it difficult to meet surging energy bills.

Twitter shareholders sue Musk, accusing him of 'unlawful conduct'. The lawsuit claims that Musk sought to drive down the stock price for his own gains. Tesla shares decreased by 40% since Musk's stake in Twitter was publicly disclosed.

World Economic Forum 2022 annual meeting in Davos came to an end on Thursday. Business and government leaders are becoming more fretful about darkening economic outlook. IMF Managing Director Georgieva said that: *i)* the Russia-Ukraine war, *ii)* tightening *iii)* financial conditions, *iv)* dollar appreciation; and *v)* the slowdown in China all weigh on the global growth prospects.

Last Week's Review

Real Economy: US Inflation Slows As PCE Shows, Whereas Economy Shrinks; EZ Consumer Confidence Still At Lower Levels

In the US, in Q1 to the second estimate of GDP, the economy is shrank by -1.5% q-o-q (*c:* -1.3%; *p:* 6.9%). In April, PCE and core PCE eased 6.3% (*p:* 6.6%) and to 4.9% (*p:* 5.2%) as expected.

In the EZ, consumer confidence rebounded slightly in May to -21.1 (*c:* -21.5; *p:* -22). ***Among the largest EZ economies***, Germany's Q1 GDP advanced by 0.2% q-o-q as expected (p: -0.3%) and at 3.8% y-o-y (c: 3.7% *p:* 1.8%).

Financial Markets: Stock Market Is Up; Yields Are Down; Oil and Gold Up As Dollar Index Is Sharply Down

Market Drivers: Investors paid close attention to FOMC minutes, which indicated that consumer spending remains robust despite soaring inflation. With inflation falling in April, every sector in S&P 500 advanced. In Europe, shares rose as expectations strengthened that inflation may be peaking and monetary policy tightening would be gradual.

Global Equities: Increased *w-o-w* (MSCI ACWI, +5.0%, to 652.8). The US S&P 500 index rose (+6.58% w-o-w, to 4,158), snapping seven straight weeks of losses. Tech shares climbed, as inflationary pressures eased. In the EZ, shares were up (Eurostoxx 50, +4.15% w-o-w, to 3,808.9), as European stocks increased, posting their best weekly gain since mid-March. In EMs, equities rose (MSCI EMs, +0.76%, to 1,043). Volatility rose to 25.7 (VIX S&P 500, 52w avg.: 22.0; 10y avg.: 18.0).

Fixed Income: *w-o-w*, 10-year US treasury yields declined (-4.5 bps to 2.74%), as Fed's favoured inflation gauge cooled off. The 2-year US Treasury yields are down too (-10 bps to 2.49%). German 10-year bund yield increased (+3 bps to 0.97%).

FX: *w-o-w,* the US Dollar Index declined (DXY, -1.5%, to 101.6; EUR/USD +1.7%, to 1.07), as expectations on aggressive monetary policy tightening are lowered. In EMs, currencies were up (MSCI EM Currency Index, +0.5% w-o-w, to 1,694.65).

Commodities: *w-o-w,* oil prices were up (Brent, 2.5% to 115.32 USD/b). W-o-w, gold prices increased (+0.5% to 1,851.6 USD/Oz).

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*