

Letter n°52

Between resistance and reticence, what do the markets think of the Ukrainian conflict?

"The opposite of despair is to believe" Kierkegaard in The Sickness unto Death.

- **Ukrainian resistance:** Russia's military superiority over Ukraine is undeniable and may have made us assume a lightning victory, but this was without considering the resistance of the Ukrainian people, the patriotic fibre, the national feeling sharpened by the aggression. **"It is men and not stones that form the best rampart of cities"** said **Pericles** in his warning to the Athenians during the Peloponnesian War.
- **The reluctance of the Russian people and the oligarchs:** The Russian people do not want to die for Kiev, to kill cousins who share the same culture, the same religion, and may not tolerate for long the growing number of deaths in Ukraine. Let's remember how close the cultural links are. Bulgakov, one of the greatest Russian writers was born in Kiev, Nicolas Gogol is a Russian writer with Polish roots. **"Politics is the art of deceiving men by letting them believe that one is working for their happiness,"** said **d'Alembert**, but there are demonstrations and certain oligarchs, such as Deripaska, Mikhail Fridman, Oleg Tinkov, Andrey Yakunin and Abramovich, have expressed their discomfort and their desire for peace. That is to say, in this context, Putin needs a quick victory and fears stalemate. Even if Putin has shared his vision with part of the Russian people, the violation of borders is not acceptable and the demilitarisation of NATO countries in Eastern Europe is not an option. We will not go back thirty years.
- **Vladimir Putin's isolation:** he had said he did not want war but a few days later violated the UN Charter, invaded Ukraine and, worse, raised the prospect of a nuclear war. In the space of 48 hours, he has caused a German U-turn on the taboo of arms supplies and a military budget of 2% of GDP, he is leading many Swedes and Finns to consider joining NATO and he has alienated the sympathies of far-right parties and leaders like Viktor Orban in Europe. At the UN, China did not veto a resolution condemning the invasion but chose a middle way, abstention.
- **Putin's economic mistake:** Russia, thanks to its human capital, financial reserves and abundance of raw materials, is one of the richest countries in the world, but its GDP per capita is barely higher than that of Bulgaria, the poorest country in the European Union. Russia, the largest state in the world, perhaps the richest in raw materials, underpopulated and struggling with an ageing and declining demography, has no need to conquer territory. In the 21st century, people expect a government to have a policy that will increase their standard of living. Between military budget and purchasing power, many have no hesitation.
- **The wrong pretext:** accusing the West of wanting to invade Russia does not withstand analysis since the West is not sending even one man to defend Ukraine.

This Letter will analyse the Russian position and reflect on the consequences of sanctions.

Russia's mistake and its weaknesses:

- *The political error:*

Boris Yeltsin had wanted to do away with the USSR and concentrate on Russia. Putin does not see the situation that way. According to him, the fall of the Berlin Wall is a humiliation that must be avenged, just as Hitler, in Munich, wanted to erase the humiliation of the Treaty of Versailles. Putin, by speaking of "denazification" wanted to awaken the memory of June 1941, the invasion of Russia by the Nazis and the 28 million deaths that followed (including 8 million in Ukraine) but this interpretation does not hold because the far-right parties in Ukraine only weigh 2 to 3% and because everyone keeps in mind the precedents of Georgia in 2008, Crimea in 2014 and the six secessions provoked: Ossetia, Abkhazia, Transnistria, Crimea, Lugansk and Donetsk.

On the ground, Putin is seeking to extend his control to the northern canal, which is connected to the Dnieper and which, until the seizure of Crimea, supplied it with water. Since then, the Ukrainians have built a dam at Kakhovka that deprives Crimea of water.

- *The risk of stalemate: hot war and cold war.*

Putin, worried about Russia's declining population, 1 million by 2021, and obsessed with his idea of a besieged fortress, seeks to have undemocratic and vassalized buffer states on his periphery. Today, Putin has to deal with a hot war with Ukraine, a cold war with the rest of the Western world, and the game is not going as he thought.

The war:

Winning is a possibility, but pacifying Ukraine, a country of 43 million, is a delicate challenge. The memory of Afghanistan is vivid.

Certainly, the Ukrainian economy is fragile with, on the eve of the conflict, an unemployment rate of 9.3%, inflation of 10%, a trade deficit, foreign exchange reserves of \$30 billion, an industrial sector, 20% of GDP, dominated by coal mining, shipbuilding and steel production, a poor country with a GDP per capita that is a third of that of Romania, and high corruption.

But Putin has underestimated Ukrainian national sentiment. The country still remembers the 3.5 to 4 million deaths during the famine orchestrated by Stalin in 1932-1933, the "Holodomor". In 1991, independence was approved in a referendum with over 90% of the votes. Since 2014, Ukraine has suffered 14,000 deaths due to the conflict with Russia and has reoriented its economic exchanges, decreasing them with Russia from 25% in 2013 to 6% in 2020, increasing them with the EU from 26% to 38%. Only 20% of Russian speakers seem to be in favour of Moscow and today, the exodus is to Poland or Romania but little to Russia.

The Cold War:

Putin despised Europe for its divisions, but Europe has shown remarkable unity against him. He despised German weakness but the Germans decided to increase their military budget to 2% of GDP, a first since 1945, and, another first, they agreed to deliver arms. Putin had forgotten that European progress has always been achieved during crises. The unanimous adoption of sanctions against Russia and, probably in the long term, the move towards a European defence, the constitution of a common army or at least the strengthening of Franco-British cooperation, two nuclear powers, members of the UN Security Council, are proof of this.

The Europeans are concerned about the small peripheral countries, the Baltics, Moldova and Georgia, but measures are being taken.

Moldova, led by a pro-European, has 900 kilometres of borders with Ukraine and Russian soldiers in the separatist region of Transnistria.

In Georgia, let us recall that in 2008, the elected president, Saakashvili, bombed the separatist enclave of South Ossetia to bring it back into the Georgian sphere. At the time, 25,000 Russian soldiers occupied part of the

territory and Putin, furious, wanted to get rid of Saakashvili and pushed the Georgians back in a few hours. Nicolas Sarkozy had succeeded in mediation and Russia had not invaded the country but it occupied 1/5 of the territory and might now want to extend its influence.

- ***The impact of economic sanctions on Russia:***

Russia is inevitably affected by the European sanctions because, in 2020, 37% of its trade was with the EU, while with China, it only accounts for 15% of its exports and 20% of its imports.

The relationship with the EU is asymmetrical as only 4% of European exports is bound for Russia, i.e. €90 billion. Almost a fifth of Russia's machinery imports, €6 billion, come from Germany.

After the 2014 sanctions, the Russian economy went into recession in 2015 and 2016, with the rouble losing over 40% of its value against the \$. This time it will be worse even though, since the implementation of sanctions in 2014, Russia has become more self-sufficient in many sectors, notably agriculture and industry, as detailed in Letter 51. But the ban on exports to Russia of capital goods or components for certain sectors such as semiconductors or aeronautics will weaken the country.

- ***The scope and limits of financial sanctions:***

The ban on international financing might not have affected Russia because the gross public debt is less than 20% of GDP, because less than 15% of this debt is held by foreigners, because the country has \$630 billion in foreign exchange reserves, because the country has diversified its reserves away from the \$ and hardly holds any US Treasury bills, and because the country has a budget surplus, a trade surplus of \$92 billion in 2020, equivalent to more than 6% of GDP, and a current account surplus of nearly \$20 billion.

In addition, to prevent the effects of a blockage of Swift, the Russians, since 2014, have developed their own system, SPFS, and are considering connecting to the Chinese Cross-Border Inter Bank Payment System network.

Notwithstanding these assets, since the decision to freeze the central bank's reserves, the markets are worried: some \$100 billion of the \$630 billion in reserves held outside Russia have been frozen and apart from \$80 billion in Yuan reserves, \$390 billion of these reserves in foreign currencies, \$, €, £, are unusable. That leaves about \$130 billion held in gold as Russia is the 5th largest holder of gold in the world with over 2,300 tonnes.

The Russian central bank, faced with the collapse of the rouble, 52% since the beginning of the year, has had to raise interest rates from 9.5% to 20%, ban money transfers abroad and oblige exporters to convert 80% of their foreign currency earnings into roubles. But none of this is very effective in a context of savers' panic.

After a weak average annual growth rate of 1.5% between 2016 and 2019, the sanctions are fuelling inflation, pushing the Russian economy into recession and sharpening popular anger.

Nevertheless, the decision to block Sberbank and VTB, the two major Russian banks, from making foreign currency transactions is not radical as it is aimed at sparing Europeans from buying hydrocarbons. Thus, Sberbank is targeted by the Swift ban but not payments for gas and oil products. And Gazprom Bank, the country's third largest bank, is spared.

In short, sanctions will be unevenly effective.

- ***The limits of the Chinese partnership:***

Sino-Russian relations are cordial but ambiguous. In 1992, Russia's GDP exceeded China's and today China's GDP is almost ten times higher.

Russia's trade with Europe is more than double that with China. Therefore, China will not be able to compensate for the reduction in trade with the EU.

China is cautiously supportive of Russia because it is Ukraine's largest trading partner, a buyer of Ukrainian arms and a supplier of Huawei telecommunications equipment. China has therefore called for Ukraine's sovereignty and territorial independence to be respected.

With less than one-fifth of China's trade with Russia being in Yuan or Roubles, China will avoid exposure to retaliatory measures.

While 70% of Russian gas exports go to the EU and are an essential component of trade with the EU, it is impossible to redirect them to China due to the lack of infrastructure. Gazprom's gas sales to China represent only one-tenth of its sales to Europe. In 2021, only 17 billion m³ of Russian gas entered China, i.e. 4% of Chinese needs. Recently, China decided to acquire an additional 10 billion m³ per year from 2030 onwards, but this requires the construction of a gas pipeline. This is a far cry from the 55 billion m³/year initially planned with Nord Stream II.

China will also buy 10 million tonnes/year of oil, but this is little compared to the 230 million tonnes exported by Russia each year.

The same applies to wheat: the bulk of Chinese purchases in 2021, more than 50%, were made from the United States and Canada. Russian deliveries represented only 1% of Chinese needs.

On the international scene, it is unclear whether China, with \$3.22 trillion in foreign exchange reserves, will provide assistance if needed. Only one Chinese bank, Bank of China, has connected to SFPS, Russia's Swift, which was established in 2019.

The major Asian countries, Japan and South Korea, which kept a low profile during the 2014 invasion of Crimea, are gradually joining the Western sanctions, halting exports of materials to sensitive sectors and adhering to the exclusion of Russian banks from the Swift network.

Other Asian countries, with the exception of Singapore, are still very timid in their condemnation of the Russian invasion.

Important, however, is Taiwan's decision to stop supplying Russia with semiconductors.

Western dependencies and stock market implications:

- Energy:

Hydrocarbon sales bring Russia \$240 billion in revenue, or 15% of its GDP. There are no sanctions on these products but banks are reluctant to finance the transactions.

Gas: Russia accounts for 1/4 of world trade and 85% of sales are to Europe.

The suspension of Nord Stream II deprives Gazprom of the sale of 55 billion m³/year and will have cost \$11 billion. Admittedly, German reserves represent a little less than a third of consumption, a low level, but this is bearable because the end of winter is approaching and because Nord Stream I, 55 billion m³, is functioning and supplies from Norway and the Netherlands remain.

Europe will not go further with sanctions because the gas and oil markets offer little flexibility. Gas is very much the subject of long-term sales and it is difficult to redirect sales. Moreover, while the Americans can offer additional quantities of LNG, the available port capacity is limited.

It is unclear whether Russia will maintain gas deliveries or not. The presence of three liquefied natural gas tankers off the Russian enclave of Kaliningrad cannot be ignored. Is this in response to a possible Lithuanian blockage of the pipeline carrying gas to Kaliningrad or is it because the Russians are considering closing this pipeline?

Oil: Russia is the world's 3rd largest producer, with 10% of supply and exports covering 5% of world consumption.

Almost 3Mb/d of the 5Mb/d exported are to China and should not be threatened by sanctions. In Europe, a quarter of oil imports come from Russia.

Russia also exports 2.5 million barrels per day of refined products, or 1/10 of the world trade in these products.

If Russia were to interrupt energy supplies to Europe and the Saudis refuse to increase production, prices would reach a record high, inflation would rise by more than two points, growth would slow and there would be a risk of stagflation. But an agreement with Iran would bring 1Mb/d and quickly 2Mb/d to the market and for households, the loss of purchasing power would be cushioned by the surplus savings accumulated during the crisis.

These risks of shortage will accelerate the deployment of renewable energies and Germany, which is opposed to nuclear power, is preparing for a project in this direction for the next few weeks.

- ***Cereals:***

Russia and Ukraine account for 80% of world trade in sunflower, 30% of wheat and 20% of maize. As a result, the price increases for these products are brutal.

Wheat had risen to €310/tonne in the autumn and then fallen back to €275 but is now at €340/tonne.

Russia accounts for 10% of world production, i.e. 75 million tonnes, and nearly 20% of exports.

Before the conflict, Ukraine produced 33 million tonnes and exported some 23 million tonnes. Ukraine is the 5th largest exporter of grain and the 4th largest exporter of wheat, and there are fears that these sales will dry up as a result of the conflict.

Ukraine and Russia account for a quarter of world exports. Global demand, from China to Saudi Arabia, is strong.

Ukraine also produces 40 million tonnes of maize, of which 32 million tonnes are exported. 40% of this production is in the east of the country, in regions exposed to conflict.

Another fear is nitrogen fertilisers, as Russia accounts for 15% of world trade and their price is influenced by the price of gas used in their production.

The last fear is that the ports, especially Mariupol, are under bombardment and are the point of departure for grain produced in the East, and many shipowners are withdrawing their ships from the Black Sea.

- ***Metals:***

Many metals are experiencing record prices. This is obvious for palladium, which is useful for catalytic converters and semiconductors, as Russia produces nearly 45% of world production, but it is also true for aluminium, even though Russia accounts for only 6% of world production.

Let's mention Titanium, which is essential for the aeronautics and arms industries, as 30% of the world's production, 50% of the titanium used by Airbus and Boeing, would come from VSMPO, a proportion that the American competitor TIMET would not be able to compensate for if necessary.

Nickel is also essential for battery production, as 10% of the world's production is in Russia. The same goes for cobalt and copper, which are essential for batteries, as Russia provides 4% of the world's supply.

The German automotive industry, both manufacturers and equipment suppliers, is already being affected by supply disruptions from Ukraine.

- ***The consequences of price increases:***

The Ukrainian crisis comes at an inauspicious time, as inflation is at its highest in 40 years. For the world as a whole, but more specifically for emerging countries, higher food and energy prices would mean higher inflation.

Developed countries are better protected because food represents a smaller percentage of the household budget and because they have the means to cushion the extra cost through 'energy vouchers', temporary caps or VAT relief.

Industrial sectors, such as chemicals, which are dependent on energy costs, will experience pressure on their margins.

Conclusion: "One might say that the old world was ending, and the new beginning. I behold the light of a dawn whose sunrise I shall never see." Chateaubriand.

- ***One thing is certain: the lasting weakening of Ukraine.***

Before the conflict, 1 million Ukrainians were living in Poland. With the conflict, the country could, according to the UN, lose 5 million of its 43 million population, many young people who will go to work in Europe and, for the most part, will not return. Potentially, they will face integration difficulties in the receiving countries of Eastern Europe but, let us not forget, these countries must compensate for their demographic decline, 20%, over the last thirty years.

- ***One probability: the relative effectiveness of sanctions.***

Historically, the boycott has been a weak weapon against smaller countries such as Cuba, North Korea, Venezuela and South Africa. In South Africa, it was initiated in 1962 and it was not until 1991 that the regime fell. In Cuba, sanctions have persisted for decades, both Castros are dead, the regime survives. The same is true of North Korea. And, let's not forget Iran, unsuccessfully ostracized by Trump. In each of these cases, one gets the impression that far from weakening these regimes, sanctions have hardened them, and it is the people who bear the cost.

What can we expect from sanctions against a huge and rich country like Russia? It is difficult to quantify because we don't know how long these sanctions will last. Many say that sanctions have never been so restrictive, but this is not true because the Swift ban does not apply to energy trade, which is potentially \$230 billion in exports, or some 15% of GDP. At the same time, sanctions for Western countries mean more inflation and the risk of stagflation.

- ***One risk: a halt by the Russians of hydrocarbon exports.***

Putin, in retaliation, could decide to block gas and oil sales to Europeans, which would cause a new oil shock. This is his real nuclear weapon.

- ***Contingencies: Russian political destabilisation and Western stagflation.***

World growth prospects will be revised downwards, but there are three reasons for ruling out a short-term risk of recession: firstly, the low sensitivity of the world economy to oil, which now accounts for only 2% of world GDP, between a quarter and a fifth of what it represented during the two oil crises. On the other hand, Russia's GDP is 1.3% of the world's GDP, while Ukraine's is 0.15%, so a slowdown in Russia as a result of the sanctions and in Ukraine because of the destruction will have little impact on the world economy. Finally, the savings accumulated during the lockdowns are still worth €1 trillion in Europe and \$2 trillion in the United States, amounts that are much higher than the increase in the price of these commodities.

Destabilization would mean the fall of Putin, as it did for the regime during the stalemate in Afghanistan. Clearly, he has succeeded in making everyone against him, but who will be after him? No one knows, but we keep in mind the Iraqi chaos since the fall of Saddam Hussein in 2003, the Libyan vacuum since the elimination of Gaddafi in 2011.

Stagflation would be the return of weak growth in the world combined with an increase in inflation due to the rise in the price of cereals, metals and energy. This could lead to pressure on purchasing power, social unrest and the fear of a slowdown in growth.

- **Stock market opportunities:**

The stock market since the invasion, as with the Crimea invasion, has fallen. Another reference is the Iraqi invasion of Kuwait in 1990 and the fall of a quarter of the market without any direct impact on the economy and without any lasting implication on the stock market indices.

Since the highs, 2/3 of Nasdaq stocks and 30% of S&P stocks have lost more than 20%. But the likelihood of more accommodative central banks will benefit the markets.

Groups with subsidiaries in Russia, such as Total Energies (19% of Novatek, 17% of hydrocarbon production), Renault, BP (19% of Rosneft, worth \$25 billion), Société Générale (less than 2% of the group's earnings), etc., should be watched, as the declines are sometimes excessive.

The energy, commodities and defence sectors are favoured in the short term and the winners are the Americans, the leading exporters of liquefied natural gas and arms. Renewable energies will receive a further boost.

The appreciation of the Yuan, the Swiss franc and the \$ may continue: the first benefits from an acceleration of the diversification of Russian foreign exchange reserves, the other two are traditional safe havens.

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