Mizuho Flash: Geo-Politics

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MIZUHO

Bye-Bye Diplomacy, Hello Devastation & Dilemma

Russia's unmitigated attack on Ukraine to "demilitarize" its neighbour has **set off convulsions of "risk off" in the markets**. Understandably so, as this marks the **end of diplomacy** and the **start of devastation**; ***both human and economic***. Moreover, Russia's "unprovoked and unjustified" (in Joe Biden's words) attack also **sets off an intensification of policy dilemma**; posed not only to **geo-political pitfalls** but also for **monetary policy binds**.

Surging energy costs and commodity price shocks set the stage for **stagflation-type ripples** while **policy trade-offs sharpen precariously**. Policy clarity is obscured as global central banks led by the Fed may not be able to afford obsessing over inflation at the exclusion of downside risks to growth; although the bar for a shift remains high.

Meanwhile, Europe's significant reliance on Russian energy and commodities means that **escalating sanctions** will come at a **rising and disproportional cost to Europe** initially. Although the **conspiracy of surging food and energy costs threaten to set back EMs profoundly for longer**.

Aversion & Stagflation

The **most visceral impact** has been **to risk sentiments**. **Sharp bouts of risk aversion** have been triggered by the prospects of rapidly tightening sanctions that could have a wide reach into the recesses of asset markets. Moreover **soaring crude** (Brent at $103-104 at the point of writing) and energy prices **threaten to unshackle the demons of stagflation as acute cost-push collides with the potential for adverse demand shocks**. And to be sure, **Oil leads, but is not isolated in**, the **stagflationary ripples from the Russian geo-political triggers**.

Central Bank Dilemmas Accentuated

As a result of which, the **central bank policy dilemma is accentuated**. The **cruel irony here is that inflation is set to surge even higher** just as vulnerabilities to adverse demand mount. And **central banks are forced on to the sharp edge of the policy knife**; having to pick between the devil and the deep blue sea. Point being, the *baggage of being behind the curve raises the bar on backing down from tightening commitments, yet a mis-step in tightening* to get ahead of cost-push *could cost dearly.*

The **Fed is at the fore of this dilemma**. And while Russia may water down the odds of a 50bps hike in March, the wider point is that it is **unclear what the thresholds are for rescinding on earlier calls for 125-150bps of tightening for the full year**. The increasingly sharp and precarious trade-offs for the Fed though stop short of providing policy clarity.

Geo-Political Pitfalls: Self-Harm Undermines EUR Assets

The **escalation in geo-political risks** entails associated **policy pitfalls**. The **unanimous call for tightening sanctions masks conflicted interests**; given the fact that ***entrenched inter-dependence with Russia*** (especially for Europe) in terms of energy and key industrial commodities. This means that the **harsher the sanctions** laid on Russia **the greater the self-harm**. Not just by way of supply-chain disruptions and cost implications, but also potentially staggering balance sheet impact (e.g. significant BP interest in Russia's Rosneft).

This **obscures the (not so) diplomatic policy path** forward. The tensions between political moral outrage and economic self-harm mean that **European asset markets and the EUR will inevitably remain at the sharp end of rolling geo-political risks**. Especially if this reinforces Fed-ECB divergence, though the broader global policy winds may change abruptly and unexpectedly.

Differentiated Haven …

It is **apparent that Gold**, *both the black and (yellow) shiny variety,* have **come on top of market convulsions amid Russia risks**. Whereas, there is other traditional other haven assets such as US Treasuries (USTs), JPY, CHF and even the USD are not unequivocally getting a boost. Partly, this is due to an aggressively hawkish Fed dampening USTs (propping up yields) and by extension holding back JPY and CHF appreciation.

USD is also playing second fiddle, as it usually does in the initial phase of "risk off" although much more intense fears could see USD emerging in prominence as forced liquidation amplifies USD demand.

… China's Haven Admission?

What's **interesting though is that the CNY has displayed characteristics of haven asset**, appreciating through most of the Russia crisis. Whether this has to do with the **economic buffer of China as relatively more self-contained manufacturing power-house** that is ***less impacted by the geo-political stagflationary risks*** or the geo-political shifts that allow China some benefits from Russian diversion of resources (both commodities as well as CNY swap facilities Russia has alluded to) is anyone's guess given we are in rather uncharted territory.

While this has some echoes of CNY's quasi safe-haven allure during North Korea's missile agitations, we **stop short of declaring CNY as a bona fide safe-haven** given impediments to the financial architecture and more importantly, the wider, structural US-China rifts. And so, risks from Russia intensify beyond a tipping point, USD is still likely to rule the haven roost.

Profound Oil & Wider Energy Impact

Oil and energy markets are unsurprisingly remain front and center; as Russia is a global energy behemoth, supplying 10-13% of global oil and 40% of Europe's energy (natural gas) needs. As a result of which, it is **there are no viable, cost-effective, substitutes to Russian oil and energy**. In fact, it will be an exorbitant endeavor to boycott Russian energy.

Russia Supply: Russian global exports share renders prices disproportionally sensitive to just the prospects of disruption. Back on the envelope estimates suggest that just a **50% dent to Russia global oil and European gas exports** can *lift global Oil prices by 30-40%* and *double European gas/energy prices.*

OPEC+ Bind: **Russia's profound global market impact has little scope to be mitigated by OPEC+** as most members have no effective spare capacity. And the two, *Saudi and UAE,* which have appreciable spare capacity *may be hesitant to be seen aligned against* (worse, conspiring to exploit sanctions on Russia to grab market share) their key cartel stake-holder.

Commodity Cost-push Grains & Metals

And the cost-push shocks do not stop at Oil. Not by a long shot. **Risk of supply shocks to other hard/precious commodities** such as *aluminum* (second largest), *nickel* (12^{th} largest), *palladium* (~40% of global supply) and *platinum* **alongside oil** means that the **cost shock will be acute**. And will **reverberate across supply-chains spanning chips to autos**.

Moreover, the **disruptions/cost additions to grains** such as *wheat* and *corn* could also soar given Russia's global share of production, and will have a **long-reaching impact into food inflation** (via feed). And so global inflation could get even more entrenched and problematic.

EMs to Suffer Worst of Food-Energy Shocks

Especially for EMs that are **particularly vulnerable to food and fuel inflation**. And so, no matter how geographically removed non-European EMs may be from the Russia-Ukraine conflict, the **threats and risks remain real and profound**.