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The Ukraine conflict escalates: Is the USSR 2.0 coming?

After weeks of attempts to defuse the ever-worsening dispute between Russia and Ukraine through diplomacy, Russian President Putin has created facts: By recognizing the independence of the eastern Ukrainian separatist regions of Donetsk and Luhansk from Ukraine and announcing the deployment of "peacekeepers" to both regions, hopes for a peaceful resolution of the conflict were dashed. Russia's blatant breach of the Minsk agreements as well as international law was already tantamount to a partial occupation of Ukraine by Russian troops. That night, moreover, Putin gave the order for military intervention in Ukraine; the invasion of all of Ukraine has begun, and the first troops already appear to be outside Kiev. The ice-cold precision with which Putin has been acting like a general for weeks almost seems to have come from a script. And presumably that script will say that Ukraine's democratically elected government will be replaced by a Russian puppet government in the coming days. A monstrosity in an increasingly Westernized country that is only a ten-hour drive from Berlin. The Russian president actually believes that Ukraine is not a random neighboring state, but because of its history - at least according to Putin's interpretation - is an integral part of Russia and Russian culture. It may be a coincidence that a hundred years ago, on December 30, 1922, the USSR was founded, a merger of the previously independent states of Russia, Ukraine, Belarus and Transcaucasia (today's Armenia, Georgia and Azerbaijan). Perhaps Putin has in mind to create the USSR 2.0 in time for the big birthday? In any case, it looks like Putin's Russia does not want to be part of today's international order, but wants to take it apart and reassemble it in its own way. Further annexations of former Soviet republics can thus not be ruled out. Unfortunately, the West must now admit that Putin is not the reasonable geopolitical partner it had hoped for, but a totalitarian despot who wants to turn back the clock. If this is the case, and from today's perspective there is much to suggest that it is, a new Cold War between East and West is looming.

The recent events are above all a humanitarian catastrophe. From an investor's point of view, however, the question arises as to what economic implications will result from this conflict, because the further development of the capital markets depends above all on this. However, no one can accurately predict at the moment how the situation between Russia and Ukraine will develop. We do not expect the war to spread to other Eastern European countries, because we cannot (and do not want to) imagine that Putin is aiming for an armed confrontation with NATO. Moreover, Putin's statements do not suggest that he is planning to do so - quite the opposite of Belarus, which Putin also sees as needing to be brought "back into the empire".

Fortunately, the current economic situation here and in many other countries is very robust: The negative economic effects of the Corona virus are receding further into the background, and the financial situation of most private households and companies is sound. The threat of an economic shock due to sharply rising oil and gas prices or other commodity prices is unlikely to cause much damage as long as it is short-lived. However, if prices were to rise massively and over the longer term, or if energy supplies were to be affected, the economy would suffer more severely. This cannot be ruled out.

If the pipelines in Ukraine were damaged or deliberately destroyed in the course of hostilities, there would be a serious supply problem in Germany and Europe. This also applies in the event that Russia turns off the gas tap in response to Western sanctions. After all, Germany gets about 55 percent of its gas from Russia, while in Europe the figure is about 47 percent. There is no need and no way to sugarcoat it. In view of the many nuclear and coal-fired power plants that have been shut down in Germany and the large number of nuclear power plants undergoing maintenance in France, the loss of the main gas supplier would lead to major supply insecurity for electricity. At the same time, the chemical industry could also run into difficulties, as a replacement for such huge quantities of gas is likely to be difficult to obtain in the short term. It is likely that production volumes in Norway and North Africa can be increased slightly; the supply of U.S. liquid gas could also help to reduce the bottlenecks. However, a complete replacement within a few months seems almost impossible. The decisive question is what probability of occurrence one assigns to such a scenario. A rationally economically acting Russia would not have the slightest interest in letting it come to that. Putin's actions in recent days, however, show that economic rationality cannot automatically be assumed in his actions. We therefore estimate the probability of a temporary loss of Russian gas supplies in the coming months to be at least ten percent. An economic downturn with at least temporarily very high inflation rates (i.e. stagflation) or even a recession could then no longer be ruled out. However, this is not yet our main scenario.

How has the West responded to the escalation so far? On Tuesday, the U.S. already launched the first sanctions against influential Russian individuals and families who belong to Putin's inner circle, as well as against some banks. In addition, trading in Russian government bonds issued from March 1 will be banned on the secondary market. The German government also reacted and stopped the certification of the Nord Stream 2 pipeline. However, this did not mean the definitive end of Russian gas supplies to Germany, but was aimed at bringing Russia back to the negotiating table - just like the other sanctions decided so far, with which by no means all possibilities have been exhausted. Now that this has become obsolete, the Western countries will decide on further measures. For example, Russia could be excluded from the international payment system Swift. This would cut off all Russian financial institutions from international payments. However, such an exclusion would not only have negative consequences for Russia. Russian companies would no longer be able to settle their debts with Western banks, and all trade between Western and Russian companies would probably come to a standstill. This would include the otherwise expected halt in exports of important technology goods to Russia. In addition, Russian oil and gas could no longer be paid for, so that Russian deliveries could be expected to cease.

The direct negative economic implications of a trade embargo with Russia should be manageable for Western countries. For example, only just under two percent of all German exports go to Russia; this corresponds to an equivalent value of around 25 billion euros. For the EU as a whole, exports to Russia account for about 1.5 percent, and for the United States, trade with Russia plays virtually no role: Russia's share of U.S. exports is 0.3 percent. Nevertheless, there will be a noticeable economic impact because not only will oil and gas prices rise, but the prices of other commodities will also skyrocket. Ukraine is the breadbasket of Europe, so a prolonged military conflict would affect the food supply chain. Although the harvest season is still a few months away, there could be a shortage of grain and a rise in bread prices in the fall.

But even if there are no extreme developments, the environment on the capital markets is currently more than uncomfortable. We expect uncertainty to remain very high in the coming days, which is why we recommend taking a more defensive stance in one's portfolio. The reason lies in the continuing uncertainty, which is likely to paralyze market participants for the time being. The capital markets have reacted to the current news with typical "risk-off" behavior. Stock markets are under pressure, while government bonds are sought as "safe havens". As the conflict is taking place in Europe, the US dollar has gained strength against the euro. It can be assumed that the stock markets will initially continue to react very sensitively to any new news from the crisis region. Any further escalation will put pressure on prices, while possible diplomatic solutions would cause prices to recover.

But even if the facts are now comparatively clear on the table, all investors are likely to rack their brains over how to interpret them. Because there is simply a lack of good rebound scenarios. Although the world has repeatedly had to contend with geopolitical uncertainties in recent decades, these have rarely directly affected Europe. The old stock market adage that you can buy shares again as soon as the negative facts are on the table is probably not a good guide at the moment. On the other hand, it should not be overlooked that the current worsening of the situation is likely to prevent the ECB, at least for the time being, from raising key interest rates in the current year and completely discontinuing its bond-buying programs. Viewed in isolation, this could in turn provide a tailwind for the stock markets after they had suffered since the beginning of the year from the prospects of a looming tighter monetary policy. The already very negative investor sentiment prior to the Ukraine conflict could also help to dampen the downward pressure on the stock markets, as historical evaluations show that when there is such a high degree of skepticism, as has already been observed recently, the stock markets normally show a positive performance over a period of three, six and twelve months. This fact reminds us that even on dark days we should not lose our optimism and overreact accordingly. At the moment, it can hardly do any harm to make one's own portfolio more weatherproof with the help of short-dated US government bonds or deep discount certificates.

Market data

Stock marktes	As of 25.02.2022 10:08	Change versus 17.02.2022 -1 week	21.01.2022 -1 month	23.11.2021 -3 months	23.02.2021 -1 year	31.12.2021 YTD
Dow Jones	33224	-3,2%	-3,0%	-7,2%	5,3%	-8,6%
S&P 500	4289	-2,1%	-2,5%	-8,6%	10,5%	-10,0%
Nasdaq	13474	-1,8%	-2,1%	-14,6%	0,1%	-13,9%
DAX	14116	-7,5%	-9,5%	-11,4%	1,8%	-11,1%
MDAX	31018	-7,1%	-7,8%	-11,5%	-2,0%	-11,7%
TecDAX	3125	-4,9%	-10,8%	-18,9%	-7,4%	-20,3%
EuroStoxx 50	3858	-6,2%	-8,8%	-10,0%	4,6%	-10,3%
Stoxx 50	3570	-4,4%	-5,6%	-4,4%	12,3%	-6,5%
SMI (Swiss Market Index)	11706	-3,1%	-5,3%	-5,3%	10,3%	-9,1%
Nikkei 225	26477	-2,8%	-3,8%	-11,1%	-12,2%	-8,0%
Brasilien BOVESPA	111592	-1,7%	2,4%	7,7%	-3,2%	6,5%
Russland RTS	889	-38,7%	-36,6%	-46,5%	-38,9%	-44,3%
Indien BSE 30	56045	-3,2%	-5,1%	-4,5%	12,7%	-3,8%
China CSI 300	4573	-1,2%	-4,3%	-6,9%	-18,0%	-7,4%
MSCI Welt (in €)	2906	-1,7%	-2,5%	-8,4%	13,2%	-8,9%
MSCI Emerging Markets (in €)	1155	-5,5%	-5,8%	-7,3%	-10,2%	-5,0%
Bond markets						
Bund-Future	166,93	109	-336	-388	-742	-444
Bobl-Future	131,45	35	-143	-366	-311	-179
Schatz-Future	111,82	5	-23	-61	-41	-22
3 Monats Euribor	-0,53	5	5	4	1	6
3M Euribor Future, Dec 2017	-0,02	-4	29	55	52	0
3 Monats $ Libor	0,50	2	24	32	31	29
Fed Funds Future, Dec 2017	1,57	5	57	149	147	1
10 year US Treasuries	1,94	-4	20	29	60	45
10 year Bunds	0,17	-3	27	40	52	35
10 year JGB	0,22	-1	10	14	10	15
10 year Swiss Government	0,25	-1	27	41	51	39
US Treas 10Y Performance	668,58	-0,2%	-2,2%	-2,5%	-3,3%	-4,3%
Bund 10Y Performance	639,20	0,0%	-2,8%	-4,0%	-4,6%	-3,5%
REX Performance Index	483,30	0,6%	-1,0%	-2,1%	-2,2%	-1,5%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	1,08	8	54	70	89	60
IBOXX BBB, €	1,73	12	72	92	109	86
ML US High Yield	5,86	1	67	88	111	95
Convertible Bonds, Exane 25	7543	0,0%	-5,5%	-9,0%	-8,4%	-7,9%
Commodities						
MG Base Metal Index	496,71	1,1%	2,2%	9,5%	23,0%	7,7%
Crude oil Brent	100,96	8,4%	14,8%	22,7%	54,2%	28,8%
Gold	1911,16	0,8%	4,3%	7,2%	5,9%	4,9%
Silver	24,51	3,0%	0,7%	4,9%	-11,3%	5,3%
Aluminium	3321,00	0,2%	8,9%	24,5%	55,7%	18,4%
Copper	9906,50	-0,8%	-0,8%	1,0%	7,3%	1,7%
Iron ore	142,66	-0,8%	10,2%	51,8%	-13,1%	26,8%
Freight rates Baltic Dry Index	2187	16,0%	54,6%	-19,4%	26,6%	-1,4%
Currencies						
EUR/ USD	1,1175	-1,7%	-1,5%	-0,7%	-8,0%	-1,3%
EUR/ GBP	0,8351	0,0%	-0,2%	-0,9%	-3,1%	-0,5%
EUR/ JPY	128,86	-1,5%	-0,2%	-0,4%	0,7%	-1,2%
EUR/ CHF	1,0348	-1,1%	0,0%	-1,4%	-5,5%	0,2%
USD/ CNY	6,3155	-0,3%	-0,4%	-1,2%	-2,3%	-0,6%
USD/ JPY	114,99	0,0%	1,1%	-0,1%	9,3%	-0,1%
USD/ GBP	0,75	1,8%	1,3%	0,0%	5,5%	1,3%

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