

The Ukraine crisis

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Key points

- > The situation in Ukraine could get worse before it gets better and so it remains a threat for investors to keep an eye on in the short term.
- > Ultimately, it poses a greater threat to the Russian economy than to European and global growth.
- > While uncertainty regarding Ukrainian tensions could weigh further on shares in the short term, it's unlikely to be enough to derail the global economic recovery and cyclical bull market in shares.

Introduction

It seems there is always something for investors to worry about and right now the crisis involving Ukraine is it. Following its latest "revolution" tensions in Ukraine threatening a war on the European Union's doorstep, which could disrupt Eurozone gas supplies and possibly drag in the US and Europe against Russia, investors have been rattled for several weeks now.

Background

The Soviet Union may be long gone but given its common border, similar ethnic makeup and shared history, Russia sees Ukraine as a brother country and part of its sphere of influence. This is particularly so for Crimea where the population is 60% Russian and up until 1954 was part of Russia, when Khrushchev (a Ukrainian) gave it to Ukraine.

It also sees Ukraine as a key member of its alternative economic union to the European Union – without which it would be composed of a bunch of small tin pot economies (Belarus, Kazakhstan, Armenia, etc). Unfortunately it knows it has little to offer such countries – beyond cheap gas – compared to the superior trade opportunities and living standards offered by the European Union. And so it feels compelled to intervene militarily when any of the countries in its sphere of influence threaten to break away and go west. Against this backdrop its current actions – under the pretext of protecting Russians – is somewhat understandable (even if it's not acceptable by global standards).

The risks of wider conflict?

With Crimeans' voting in favour of joining Russia (this seemed likely whether the referendum was fair or not), the immediate issue is how Russia responds and how the US and Europe respond to that.

- If Russia feels that it has proved its point it may use it as a bargaining chip in negotiations to ensure that Ukraine does not stray too far to the west. In which case the crisis could settle down a bit.
- Alternatively it may make Russia emboldened to do more perhaps moving into the eastern regions of Ukraine. This will see the crisis escalate.
- An escalation could also occur if ethnic tension in eastern regions (where Russians are a significant portion of the population, but not the majority) results in open conflict, possibly leading to a broader civil war between east and west Ukraine, which Russia would likely become involved in.
- Much would then depend on how far the US and Europe are prepared to get involved. Targeted sanctions against those seen as supporting the Kremlin may be likely, which could then prompt Russian retaliation such as reducing gas supplies to Europe. Direct military involvement would be a risk but very unlikely though given the US and Europe know how much Ukraine means to Russia – it would be like, for the US, Russia meddling in Canada – and given that Russia has nuclear weapons.
- At this stage, Crimea going to Russia with limited trade sanctions but ongoing sabre rattling on both sides and tensions on the ground in Ukraine would seem the most likely outcome. But the risks of a broadening conflict are significant.

What is the threat to the global economy?

The Ukrainian economy is too small and its problems too specific to have a direct impact on the global economy or an impact via contagion. The main risk has always been that it triggers further conflict in Ukraine and a wider Russian/west conflict.

Beyond effecting short term confidence, the impact on the US economy would be minor as it trades little with Russia – only about \$US40bn a year. Europe would be more at risk, as having a major military conflict on its doorstep would not help confidence (at least initially) and it trades much more with Russia. The biggest risk relates to gas supplies as the Eurozone obtains 25% of its gas from Russia (but with a huge variation, for Germany its 35% and for France its 15%) – half of which flows through Ukraine. This could be threatened by civil war in Ukraine or if Russia decides to punish Europe.

However, Europe is not as vulnerable as perhaps feared. The mild winter has left gas stockpiles above normal levels and a Russian supply disruption would likely speed up a shift to alternatives including US LNG exports over time. So while there may be a dampening impact on Eurozone growth it may only be minor and temporary.

The biggest threat would be to Russia, which could lose its biggest gas market as it became seen as an unreliable exporter. Its gas exports to Europe are worth much more to it than they are to Europe. The threat to the Russian economy explains the sharp collapse in the Russian share market over the last few weeks and the fall in the Ruble. Its economy is already slowing and measures to support the Ruble will only accentuate this. President Putin is not too fussed about this in the short term, but it will undermine his support long term. This would be particularly so if it became isolated economically, via some sort of return to the cold war.

The blow to Russia's economy – one of the BRICs – adds to the cloud hanging over the emerging world and their investment markets at present.

The direct impact of the Ukrainian conflict on Australia is trivial as it has little trade with Ukraine. Rather the impact will be felt if there is a flow on to global economic growth and confidence and this explains why our share market is also affected by worries about Ukraine.

What to watch?

Obviously much is uncertain regarding Ukraine at present. The key things to watch to gauge whether the crisis is going to be contained (to the loss of Crimea to Russia, with trade sanctions and ongoing tensions but no major economic threat) or escalate into something more threatening are:

- The Russian reaction to the Crimean vote – does it negotiate now or push for more territory in Ukraine;
- The extent of pressure from the US and Europe on Russia – trade sanctions, military build-up, etc;
- The amount of economic support the west offers Ukraine – so far it's been relatively minor;
- Violence between ethnic groups in Ukraine; and
- Whether the May Ukrainian election results in pragmatic sensible leadership or more extreme anti-Russian leaders.

Concluding comments

My suspicion is that Ukraine is just another distraction for markets that will fade in the months ahead, but it may take a while to settle down and the uncertainty could get worse before it gets better. As a result it could remain a threat for investment markets for a while yet.

Ultimately though, any weakness or correction that results would provide a buying opportunity for investors as the situation in Ukraine is unlikely to derail the global economic recovery or cyclical bull market in shares.

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