SPECIAL REPORT | Monday 28 February 2022

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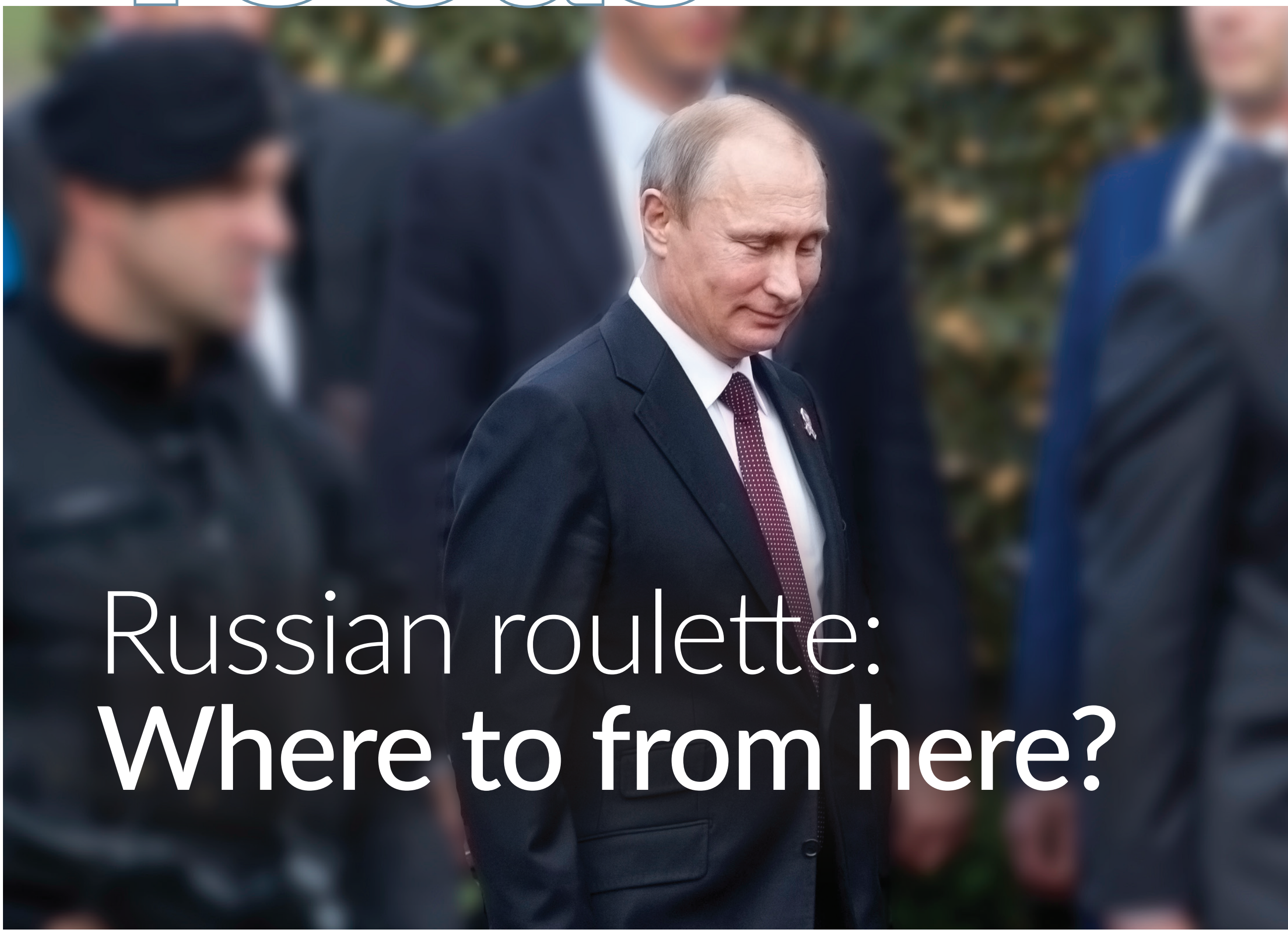


Russian roulette: Where to from here?

Russia's invasion of Ukraine is shocking. It is Russia's first military engagement in Europe since 1945. Sadly the early signs are that the fighting will be bloody. Russia's effrontery clearly emphasises the world has become a much more fractious place and geopolitical shocks are on the rise. That said, whilst the human cost of the Ukraine invasion is tragic, we expect the economic cost will most likely be contained and the market's current heightened concerns will ease.

FORSYTH BARR

Red alert

There has been much conjecture as to Russia's exact rationale for invading Ukraine. We can't add a lot to that discussion. The real reasoning sits firmly inside Vladimir Putin's head. Motivations probably include broadening Russia's sphere of influence and preventing Ukraine from building (military in particular) ties with the West.

Russia likely viewed the risk of other nations supporting Ukraine with troops as low – Ukraine isn't part of any broad alliance such as NATO (the North Atlantic Treaty Organisation). And current high commodity prices benefiting the Russia economy, providing some insulation against international sanctions, may have also emboldened Putin.

Russia is a relatively small economy, but a major provider of commodities

Despite Russia representing 11% of the world's land mass it is a relatively small economy. Its US$1.6 trillion GDP is roughly the same as Australia. Ukraine's is US$155 billion, around three-quarters the size of New Zealand. Shocks to these two economies will not have a material effect on global demand.

Where both of these countries do have an outsized influence, however, is in commodities. Russia is the third largest oil producer in the world after the United States and Saudi Arabia. Even more significant is the European Union's reliance – about 40% of its consumption – on Russian gas to fuel its energy system.

Ukraine is also an important commodity supplier including agricultural products like wheat and corn, industrial metals such as copper, nickel and steel, and other essential raw materials like neon, palladium and platinum (all critical to the manufacture of semiconductors).

Any disruption to commodity supply, either due to destruction or international sanctions, will put further pressure on already lofty inflation and global supply chains struggling with COVID caused imbalances.

How will the international community respond?

Western countries have universally condemned Russia for its attack. The United States and many European countries have provided military aid to Ukraine. All have stopped short of direct involvement. The main tool being used to punish Russia is sanctions.

It is still early and countries continue to consider options. So far the United States, European Union, United Kingdom, Japan, Canada, Taiwan, Australia and New Zealand have all announced some sanctions against Russia. Nothing announced will have a significant impact on those countries' economies.

We expect sanctions will likely be focused on finance and technology. The most notable so far have been the exclusion of the Russian central bank from the global financial system and the removal of some Russian banks from the SWIFT global payments system.

What markets are most concerned about is any disruption to Russia's energy supply either because of sanctions or Russia turns off the tap. At this stage we believe both are unlikely – both sides have a vested interested in keeping gas flowing. Constraints would cause European energy prices to soar, likely pushing many countries into recession and threatening the future election prospects of existing leaders. And Russia needs the revenue, even more so now to finance its military.

...Russia is the third largest oil producer in the world...

History supports the view European energy security will likely take precedent. Germany agreed with Russia to build the Nord Stream 2 gas pipeline, lifting direct capacity between the countries and bypassing Ukraine, despite public opposition from the United States, Poland and Ukraine concerned about it providing Russia with greater geopolitical leverage. Russia had already annexed Ukraine's Crimean peninsula at that time. (Germany has halted certification of Nord Stream 2. The pipeline, however, was not yet operational so the sanction has not reduced any existing gas flows.)

NORD STREAM GAS PIPELINE

Source: Aljazeera

Heightened geopolitical risks to be increased feature of markets

Any armed conflict is troubling. Aggression from a nuclear power is particularly alarming. Conflicts can escalate. In saying that, we expect both NATO and Russia have a huge aversion to direct conflict – the threat of mutual destruction through nuclear weapons is a considerable deterrent! So long as the conflict remains isolated to Ukraine we expect market concerns will ease. History supports this view.

Whilst our base case view outlined above provides a somewhat comforting scenario for investors, we do want to emphasise two key thoughts.

Firstly, the chaos of war brings risks and can develop in unforeseen ways. As we've been repeatedly reminded over the past two and a half years the world is unpredictable and can change quickly. The market was already nervous about soaring inflation and central banks withdrawing monetary policy. The Russia-Ukraine conflict (and our view) could evolve and cause further market concern. Cyber-attacks, for example, are one way it could escalate beyond Ukraine's borders.

Secondly, the world has become more fractious. The post-Cold War period of relative calm has ended and authoritarian states China and Russia

Market concerns around geopolitical shocks can be short-lived

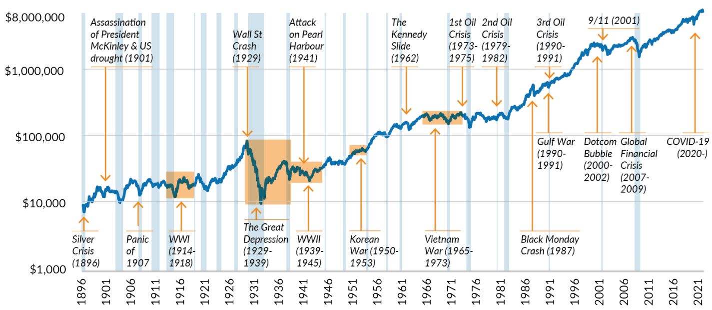
Source: Refinitiv, Forsyth Barr analysis

...Cyber attacks are one potential way it could escalate past Ukraine's borders...

are increasingly challenging the United States/United Nations-led world order. Tensions between NATO and Russia have not been this high since before the Berlin Wall fell and the relationship appears now permanently fractured. Germany has already announced a €100 billion lift in military spending. Furthermore, divisive politics within the United States is reducing its ability to be effective within the international community. We expect, going forward, geopolitical shocks will be more frequent.

These risks, whilst worrying, do not mean investors should completely bunker down. Through history share markets have navigated numerous and all types of crises to provide attractive long-term returns. And instability in markets can give rise to opportunities for the long-term investor. But an important message is, after a period of extended relative calm, investors should be prepared for more volatility in markets in the years ahead.

DOW JONES INDUSTRIAL AVERAGE: SHARE MARKETS HAVE NAVIGATED NUMEROUS AND VARYING CRISES OVER THE DECADES



Source: Refinitiv, NBER. Dow Jones Industrial Average Capital Index, Forsyth Barr analysis

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