Trend Macro

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MACROCOSM

Crimea River

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Donald Luskin

Putin stand downs, blames the Fed. And the world survives another test of contagion.

Russian President Vladimir Putin has taken the edge off the Ukraine crisis by declaring in a press conference, "If I decide to use armed forces, it will be in line with international law." This is being interpreted in some headlines as a declaration of intent not to annex Crimea.

Putin said in the same press conference that yesterday's market sell-off was "mostly due to the steps taken by the Fed." But in fact it was all about why Russia would have to stand down in Crimea. Global markets' biggest loser yesterday was Russia's MICEX Index, off 12.5% in dollar terms (please see the chart below). Even Ukraine's PFTS Index -- the equity market of a nation supposedly facing virtual annihilation -- was only off 4.7%. And even *that* put Ukrainian stocks up 13.2% year-to-date -- and up

Update to strategic view

EMERGING MARKETS MACRO, EMERGING MARKETS STOCKS: Putin has strongly hinted that Russia will stand down in Crimea. The big drop in the Russian equity market on Monday mandated that, showing…

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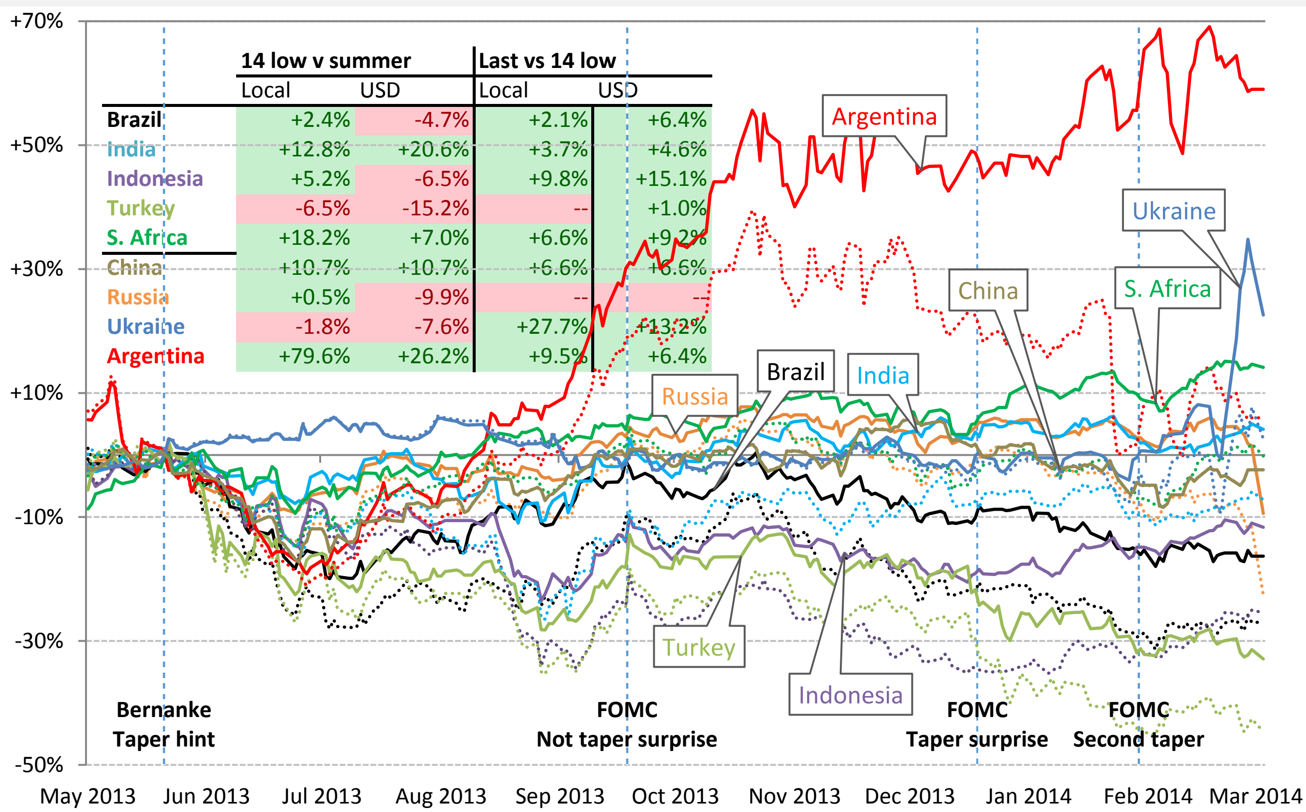
Equity performance rebased to May 21, 2013 — Local currency ··· USD Source: Bloomberg, TM calcs



	14 low v summer		Last vs 14 low	
	Local	USD	Local	USD
Brazil	+2.4%	-4.7%	+2.1%	+6.4%
India	+12.8%	+20.6%	+3.7%	+4.6%
Indonesia	+5.2%	-6.5%	+9.8%	+15.1%
Turkey	-6.5%	-15.2%	--	+1.0%
S. Africa	+18.2%	+7.0%	+6.6%	+9.2%
China	+10.7%	+10.7%	+6.6%	+6.6%
Russia	+0.5%	-9.9%	--	--
Ukraine	-1.8%	-7.6%	+27.7%	+13.2%
Argentina	+79.6%	+26.2%	+9.5%	+6.4%

Natural gas supplies sourced from Russia	
Estonia	100%
Finland	100%
Latvia	100%
Lithuania	100%
Slovakia	98%
Bulgaria	92%
Czech	78%
Greece	76%
Hungary	60%
Slovenia	52%
Austria	49%
Poland	48%
Germany	36%
Italy	27%
Romania	27%
France	14%
Belgium	5%

Source: European Commission, TrendMacro calculations

27.7% in local currency terms -- while Russian stocks have fallen to lows not seen since 2009.

- This means President Obama probably has it right when he said yesterday that the West has the power, through sanctions, to make invading Crimea "a costly proposition for Russia."
- The conventional wisdom for seeing systemic risk in the Crimean crisis is that Ukraine is a pinchpoint for transmission of Russian natural gas to Europe (please see the table at left), giving Russia the option to cut off critical energy supplies in mid-winter (see "When PIIGS Fly" February 10, 2014).
- *But in fact Europe has never been less vulnerable to such pressure, with huge gas stockpiles presently available. It is Russia, with an economy dangerously dependent on energy exports in a world of stagnating energy prices, that is vulnerable.*
- *Over half of Russia's federal budget revenues come from energy exports. About 80% of Russia's natural gas exports, and about 84% of its crude oil exports, go to Europe.*
- *So as events continue to unfold, we expect some kind of stand-down solution similar to that in the war between Russia and Georgia in August 2008 -- which centered, as this crisis does, on a breakaway region sympathetic to Russia.*
- Before Putin spoke, Russia had left itself plenty of dignified diplomatic cover for a stand-down. Yesterday Russian Foreign Minister Sergei Lavrov told the United Nations that Russia would stay in Crimea "until the normalization of the political situation in that country." Obligingly, the media played that as Russia's "strong defense" of its actions, but we saw it as Russia's pathway out of the situation.

The Georgia event in 2008 was much broader -- an outright shooting war in which Russian troops moved not only into the breakaway region in question, but into Georgia itself. Yet we hardly remember that now, because it engaged the attention of the United States far less that today's crisis. Remember, when it happened in August 2008, the US was preoccupied with the failures of Fannie Mae and Freddie Mac, and the possibility of systemic financial contagion that they portended.

- Today we have the luxury of worrying about Crimea precisely because, as we've been saying since last summer, the era of systemic contagion is over (see "A Major Upgrade to our Strategic

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... that Russia is simply too vulnerable to economic pressure from the West. The conventional wisdom that Russia yields an energy weapon has it backwards: Russia is entirely dependent on European patronage. Instability in Ukraine is not new, but it's not good -- Ukraine is a large country, and the world's third largest grain exporter. And economically isolating Russia is not good. But there's no systemic event here. Rather, it's likely another likely successful test of the global economy's resistance to contagion, especially for the unloved emerging markets. For the most part, emerging equity markets have put in a bottom-above-a-bottom now. Indeed, two thought most vulnerable -- India and South Africa -- have moved to new all-time highs. And overall, emerging markets offer the world's richest equity risk premia.

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Outlook" September 12, 2013 and "2013: The Year of Living Not Dangerously" December 31, 2013).

- At the same time, we've been *sensitized to the possibility* of contagion, so whenever anything goes wrong, anywhere in the world, the knee-jerk reaction now is to expect a systemic reaction.
- To be sure, the Crimean situation is not good. Ukraine is an economically significant nation -- not only because of the geography of gas pipelines, but also because it is the world's third largest grain exporter. It's risky to mess with it.
- But it should hardly be a surprise to anyone that it is politically unstable. And it shouldn't be a surprise that Russia feels it has strong claims on Crimea. Over the last 231 years, Crimea has only *not* been controlled by Russia for the most recent 20 -- during which it has been an autonomous republic within Ukraine.
- And it's not good for global trade if Russia becomes economically isolated.
- But none of that is to say that the situation in Crimea is potentially systemic, or ought to cause a serious or enduring risk-off reaction in the emerging or developed markets.
- If anything, we see any such reaction as a buying opportunity. Once the Crimean crisis has passed, it will stand as yet another test-case in which the global economy was presented with a situation that was feared to be systemic, but proved not to be (again, see "2013: The Year of Living Not Dangerously").
- With each such test, equity risk premia will shrink, and improving grass-roots entrepreneurship and risk-taking will accelerate growth.

In particular, the Crimea crisis throws light on opportunities in emerging economies -- by and large, the only equity markets where rich risk premia are still available (see "Data Insights: Global Equity Risk Premia" January 25, 2014).

- We continue to think that market perceptions of vulnerabilities in emerging markets have been way overdone this year (again, see "When PIIGS Fly").
- We disagree with Putin -- and the rest of the conventional wisdom on this subject -- that emerging markets are breaking down because of the onset of Fed tapering.
- They are not breaking down at all. Most emerging markets have put in bottoms in 2014 higher than their bottoms last summer, when fears of Fed tapering first triggered fears that hot money would head for the exits in what was thought to be a crowded carry trade.
- Indeed, two among the so-called of "fragile five" -- India and South Africa -- have come out of their corrections last year, after tapering was first announced, and moved to all-time highs.

Bottom line

Putin has strongly hinted that Russia will stand down in Crimea. The big drop in the Russian equity market on Monday mandated that, showing that Russia is simply too vulnerable to economic pressure from the West. The

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Recommended Reading

Charles Koch: business giant, bogeyman, benefactor and elusive (until now) -- exclusive interview
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Wichita Business Journal
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How Cory Gardner changes the Senate landscape
Chris Cillizza
Washington Post
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Suddenly, an Opening for Tax Reform
Phil Gramm and Mike Solon
Wall Street Journal
February 25, 2014

conventional wisdom that Russia yields an energy weapon has it backwards: Russia is entirely dependent on European patronage. Instability in Ukraine is not new, but it's not good -- Ukraine is a large country, and the world's third largest grain exporter. And economically isolating Russia is not good. But there's no systemic event here. Rather, it's likely another likely successful test of the global economy's resistance to contagion, especially for the unloved emerging markets. For the most part, emerging equity markets have put in a bottom-above-a-bottom now. Indeed, two thought most vulnerable -- India and South Africa -- have moved to new all-time highs. And overall, emerging markets offer the world's richest equity risk premia.