

TRENDMACRO LIVE!

## On MH17

Friday, July 18, 2014

Donald Luskin with research input from Lorcan Roche Kelly

**Putin likes looking evil, but not stupid. The tragedy will likely cool things down in Ukraine.**

Markets go at least a little "risk-off" in the face of events like the downing of Malaysian Airlines Flight 17 in Ukraine yesterday, opening as they do a Pandora's Box of possible adverse outcomes. But we think this will end up doing more to end the Ukraine crisis than to exacerbate it.

- Admittedly we have few facts to work with. *But surely this was an accident, albeit a military one.* Media reports have likened it to the [downing of a Korean Air 747](#) in 1983 by USSR fighter-jets. But we think it informs our intuitions better to remember the [downing of an Iranian Air Airbus 300](#) in 1988 by the USS Vincennes, or [the downing of an Aerolinee Itavia DC9](#) in 1980 during a NATO exercise.
- Such accidents happen in environments of hair-trigger military readiness. [As Russian President Vladimir Putin himself put it](#), in the context of implicitly blaming Ukraine, "this tragedy would not have occurred if there were peace in that country."
- We had predicted that Ukraine would meta-stabilize somewhere between ["frozen conflict"](#) (like former USSR regions Abkhazia and South Ossetia in Georgia, Transnistria in Moldova, and Nagorno-Karabakh Azerbaijan) and civil war (see ["Why Putin is Smarter than Stalin..."](#) March 26, 2014). So we were very bullish on Russian equities and bonds, and the ruble, at the worst moments of the Crimea phase of the Ukraine crisis -- and rightly so (see ["Crimea Doesn't Pay"](#) March 11, 2014).
- But after Russian markets entirely recovered after the Crimea panic, we've seen Ukraine as all risk and no opportunity (see ["Russia Recovers, Emerging Markets Re-Emerge"](#) May 21, 2014).
- Now that the risk has eventuated in the form of MH17, where do we go from here?
- The US had already somewhat amped up [its sanctions against Russia](#) this week.
- Europe will probably follow suit to some small extent, but we continue to think that Europe [doesn't have much appetite](#) to come to the aid of a failed state at its borders at the cost of disrupting profitable trade just when economic growth is starting to revive.
- From Putin's standpoint, MH17 is a loser. We think he's happy enough to be thought of as an aggressive bully -- indeed, from the beginning the Ukraine adventure has been animated by his need to

### Update to strategic view

**EMERGING MARKETS MACRO, EMERGING MARKETS STOCKS, EUROPE MACRO:** The downing of MH17 was probably an accident, albeit a military one. It will probably trigger some escalation of European sanctions against Russia, but there is no appetite for a full-scale sanctions war that could interrupt European recovery. And as an accident, the tragedy incents Putin to stand down somewhat, making him look like a fool rather than a bully. So rather than escalating the Ukraine crisis, we think this tragedy has the potential to cool it down, reducing it from civil war to "frozen conflict." Russian equities will likely recover their losses of this week, but Ukraine is all risk and no reward for Russia -- the losses weren't deep enough to warrant the outright bullish outlook we had in March at the worst moments of the Crimea crisis.

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shore up his grip on power in the face of disappointing economic growth (see "[Client Conference Call: Former US Ambassador to Ukraine Steven Pifer](#)" May 2, 2014). The last thing he wants is to look like a fool, or a hostage to fortune -- someone who accidentally caused a tragedy that embarrasses Russia, because he put too much firepower in the hands of trigger-happy thugs.

- So this will tend to move Ukraine away from civil war and more toward "frozen conflict," which at least is a move in the direction of goodness.
- So we don't expect this to spin up into an outright sanctions war -- and certainly not a wider military conflict.
- As the media mania over the matter dies down, we think we'll see Russian equities recover their recent losses. But we don't think the value created by those losses is sufficient to warrant the outright bullish position we took in March.
- Recovery in Europe has already been eroded a bit by the Ukraine crisis, especially in Germany where exports to Russia are significant. In the short term, the MH17 tragedy won't help. But to the extent that it leads to better stabilization in Ukraine, it will have been a net plus.

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### Bottom line

The downing of MH17 was probably an accident, albeit a military one. It will probably trigger some escalation of European sanctions against Russia, but there is no appetite for a full-scale sanctions war that could interrupt European recovery. And as an accident, the tragedy incents Putin to stand down somewhat, making him look like a fool rather than a bully. So rather than escalating the Ukraine crisis, we think this tragedy has the potential to cool it down, reducing it from civil war to "frozen conflict." Russian equities will likely recover their losses of this week, but Ukraine is all risk and no reward for Russia -- the losses weren't deep enough to warrant the outright bullish outlook we had in March at the worst moments of the Crimea crisis. ▶

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