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Our Hot Take on Russia's Attack on Ukraine

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Donald Luskin

Europe can't save Ukraine, but it is in control of what global markets should care about.

With Russia's broad attack on Ukraine overnight, events have moved both further and faster than we anticipated (see "War on Two Fronts: Ukraine and Inflation" January 24, 2022, and "Video: What you're not hearing about fighting the Russian invasion of Ukraine with horse de-wormer" February 23). But our impact-analysis for markets and the economy doesn't change.

- *Ukraine is not a nation of Europe. It is not a member of NATO. It is not even an iron curtain country. Common media narratives that this incursion represents the end of the post-Cold War order may end up being prescient, but they are not describing what is currently happening.*
- *In other words, except for the sake of deterring imagined future incursions elsewhere, Europe, the US and NATO have no vital interest in this matter.*
- *Europe's vital interest is in maintaining Russian energy supplies. Europe imports 30% of its crude oil and 39% of its natural gas from Russia. Boycotting those commodities as a form of sanction would be to sacrifice a vital interest – indeed, to induce a recession – for the sake of a not-vital interest (which it can't influence anyway).*
- *Russia exports about half its crude oil production, and half of that goes to Europe. About 70% of its natural gas exports go to Europe. It runs counter to Russia's vital interest to forgo those revenues.*
- *The equilibrium outcome is that after a great deal of tough talk, the energy flows will be maintained. Obviously, Brent crude above $100 reflects a risk premium that they won't. It's a bad time for Europe to run that risk, with crude storage levels at all-time lows.*
- *Higher oil prices will play into statistical inflation in the US taking longer to prove to be "transitory." We expect the Fed will easily look through that, and if anything, events in Ukraine will move the Fed at the margin more to the dovish, putting March lift-off at risk.*
- *Markets shouldn't care who controls Ukraine. Markets should care about how Europe responds economically when Russia does control Ukraine. The good news is that Europe is in control of the part of this that matters to markets.*
- *Obviously we can't be sure Europe will act in its own interest here. But the smart bet is that they will.*

Update to strategic view

EUROPE MACRO, US MACRO, OIL, FEDERAL RESERVE: Events in Ukraine have moved further and faster than we anticipated. But it remains the fact that Europe, the US and NATO have no vital interest in the matter. Europe's vital interest is in maintaining Russian energy imports. Boycotting Russian energy would induce a recession for no purpose. Russia has a vital interest in maintaining energy exports to Europe. The equilibrium outcome is that the energy flows will be maintained. Europe is in control of the outcome – which is the part of this matter that markets care about. In the meantime, Brent crude is trading above $100. This will play into statistical inflation, but the Fed can look through that. If anything, the uncertainties set in motion here put March lift-off at risk.

[Strategy dashboard]