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MACROCOSM

More Thoughts on the Ukraine Crisis

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Donald Luskin

National security grounds to finally crack down on crypto, and drill baby drill.

Our fundamental take on the Ukraine crisis hasn't changed – what matters to markets is not the geopolitics of it, but whether or not it leads to sharply contractionary energy boycotts/embargoes between Europe and Russia (see, most recently, "Our Hot Take on Russia's Attack on Ukraine" February 24, 2022). *But as the crisis drags on, every day we flirt more closely with the risk of miscalculation in this critical dimension.*

We all need to understand that we are operating in the fog of war with respect to everything we think we may know about the action on the ground, the motivations of the decision-makers, and the likelihood of a conclusion. Remember, all negotiations are played out at the edge of chaos where the computational power in the interaction between the players is maximized. That means the brink of war is indistinguishable from the brink of peace. We are interpreting Russia's statement over the weekend that it put its nuclear deterrent forces on high alert in that light – as an "escalate to de-escalate" strategy. It's not hard to think of any number of mutually acceptable negotiated solutions.

- *For all the uncertainty and volatility in markets, the actual degree of risk-off behavior is weirdly modest*. US 10-year yields are off their recent highs, but still higher than where they began the year just two months ago, and about tied with last year's highs. The yield curve is positively sloped, and above the year-forward funds rate at every tenor beyond three years. There has been the deepest correction in equities since October 2020, yet the US equity risk premium is hugging its post-Global Financial Crisis mean, indicating basically that the quantity of expected risk is precisely normal. It was slightly wider as recently as November just after Thanksgiving when the Omicron variant burst upon the world (see "Video: What you're not hearing about the Omicron variant" November 28, 2021). US stocks are underperforming European stocks year-to-date, despite Europe being in the riskiest impact-zone.
- *WTI oil is trading above $100 in the spot market as of this writing, but the futures curve is highly backwardized, indicating a retreat to $85 a year out.*
- *Despite elevated oil prices, a new high in this crisis, market-implied inflation expectations such as the 5-year five years forward TIPS breakeven, haven't budged.*

Update to strategic view

EUROPE MACRO, US MACRO, OIL, FEDERAL RESERVE: The Ukraine crisis remains in the fog of war. For all the volatility, risk-off behavior in markets is modest. Treasury yields remain higher year-to-date, and the curve is not inverted. The US equity risk premium remains at the GFC mean, indicating the expected quantity of risk is normal. Spot WTI oil is over $100, but the futures curve is at $85 one year out. Market-implied inflation expectations have not budged. This appears to confirm expectations for resolution, which we think is the right bet, but leaves markets vulnerable to shocks. Strong new sanctions court a contagious default event, but central banks have gotten good at dealing with that. Russia can partially evade sanctions with barter, gold and crypto. We expect this will provide national security grounds for a crackdown on crypto by the world's central banks. The threat to oil and gas supplies elevates energy security as both a reality and a political rallying cry, which GOP candidates will use in the mid-terms. A 50 bp hike is totally off the…

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- *Markets seem to be looking across the valley. We continue to think that's the right thing to do probabilistically. But it means that if anything goes terribly, terribly wrong in Ukraine now, there is still plenty of discounting that hasn't happened yet.*

With all that by way of background, here are some of our thoughts about some of the potential risks and opportunities that could arise going forward.

- With a second round of tougher financial sanctions put in place over the weekend – including as-yet imperfectly specified restrictions on Russia's access to the SWIFT payment system and against the Russian central bank – we have to consider the possibility of financial contagion. *Russia's obligations are someone else's assets*. This is how the Global Financial Crisis started, when the Fed opted not to save Lehman, and an unanticipated domino-fall of defaults engulfed the world banking system. Citibank has warned that is has about $10 billion exposure to Russia – that's nothing compared to the stakes in 2008 and 2009, but it's chilling nevertheless (history teaches us that Citi has to go to zero on a regular basis). *So far so good – and remember, with the GFC and the pandemic lockdowns loaded into the experience-set of the current crop of global central bankers, the skills and readiness to deal with contagion are very much present.*
- So far energy trade between Russia and Europe has been carefully carved out of all these sanctions. The US Treasury's new License 8 even excludes wood – after all, you can burn it for warmth.
- There are potentially longer-term consequences to these sanctions that so significantly bar Russia from the dollar-dominated world payments system. *Many clients have asked whether this will be the catalyzing event that finally dethrones the US dollar as the world's reserve currency and primary cross-border exchange medium. We doubt it*. To be sure, the system is less than ideal, theoretically, as is any system that has accreted by custom over many decades. But such systems have tremendous inertia, because they derive their utility from the fact that everyone has agreed to use them, and that very agreement is what makes them work it's a network effect. There is no alternate system that anyone agrees to at all.
- There are competing systems already, such as barter, gold and cryptocurrency. Russia will use all of these to evade sanctions to some extent – perhaps especially crypto. *But that suggests to us not that the US dollar will be made obsolete, but that global authorities will finally have the casus belli to regulate crypto out of existence*. National security grounds, of course, but why not use the opportunity to knock out the one credible competitor to global central banks' monopoly on the creation of money?
- Another secular consequence of this crisis could be the realization that *the West needs energy security, and the only way to achieve that in a hurry is by bulking up production from conventional sources* – that means more drilling for oil and gas, more LNG capacity and more nuclear, concerns about global warming be damned. National security grounds, of course. Already Germany

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… table for the March FOMC, but a small hike remains probable unless the crisis worsens. Higher oil prices will computationally feed into short-term inflation statistics, but the Fed will worry more about their effect on maximum employment than on stable prices.

[Strategy Dashboard home]

has announced a rethink – potentially extending the operating life of its remaining nuclear plants, and permitting more LNG terminals. So far nothing along those lines from the Biden administration. But there's a mid-term election coming up – and we can be sure that every Republican candidate will cite national security grounds as a drop-dead argument for energy policy they support anyway for other reasons, namely, drill baby drill. We don't see a productive counter-narrative for Democrats – their only move would be to "triangulate," and adopt at least some degree of the GOP narrative. *That's good for the US economy and US energy ecosystem – but ultimately it's not good for energy commodity prices, which have panic and scarcity premiums built in now.*

So what about the Fed? We've always thought a 50 bp rate hike at the March FOMC was just a fantasy of publicity hounds like the St. Louis Fed's James Bullard (see "A Turn Signal for the Fed's Off-ramp on the Road to Rate Hikes" January 31, 2022) – but until today, futures markets were giving it some degree of probability. No longer.

- We had thought as recently as January that there would be no rate hike at all in March (see "On the January FOMC" January 26, 2022). Even now that is highly unlikely, but we can't rule it out if the Ukraine crisis worsens, or even drags on too long. The futures curve has taken a full rate-hike out for 2022, versus a month ago.
- *We're not concerned that the temporary elevation of oil prices, and its obvious computational effect on inflation, will hasten the Fed's rate-hiking program. They will easily see through that and will understand that higher energy prices in the context of an international crisis pose more risk to the maximum employment mandate than to the stable prices mandate*.

Bottom line

The Ukraine crisis remains in the fog of war. For all the volatility, risk-off behavior in markets is modest. Treasury yields remain higher year-to-date, and the curve is not inverted. The US equity risk premium remains at the GFC mean, indicating the expected quantity of risk is normal. Spot WTI oil is over $100, but the futures curve is at $85 one year out. Market-implied inflation expectations have not budged. This appears to confirm expectations for resolution, which we think is the right bet, but leaves markets vulnerable to shocks. Strong new sanctions court a contagious default event, but central banks have gotten good at dealing with that. Russia can partially evade sanctions with barter, gold and crypto. We expect this will provide national security grounds for a crackdown on crypto by the world's central banks. The threat to oil and gas supplies elevates energy security as both a reality and a political rallying cry, which GOP candidates will use in the mid-terms. A 50 bp hike is totally off the table for the March FOMC, but a 25 bp hike remains probable unless the crisis worsens. Higher oil prices will computationally feed into short-term inflation statistics, but the Fed will worry more about their effect on maximum employment than on stable prices.

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