Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

The Tide Turns in Ukraine

Monday, September 12, 2022

Donald Luskin

If Russia doesn't nuke Ukraine on the way out, here's where the negotiations begin.

If the profusion of headlines over the weekend are to believed, a strong counteroffensive by Ukraine has encountered little Russian resistance, and from here it's not impossible to imagine some pretty happy outcomes. *But…* any news emanating from within the fog of war in the age of social media-driven information warfare has to be regarded as highly suspect as to purported facts, and all the more so as to possible future implications (see "Video: Conversation and technology demonstration with Justin Peden" June 1, 2022). Maybe a plucky little nation has indeed managed to defend itself against an outsized aggressor. Maybe what seemed to be degenerating into a potentially endless World War One scenario is headed for a resolution. *Maybe… or maybe it plays too perfectly into what we wish. And even if true, maybe it leads to follow-on scenarios that are very much not what we wish*.

Let's assume it's true that Ukraine is indeed making the progress being reported. What would that mean to global markets and the global economy?

Let's get the really bad stuff out of the way first.

- *We can't rule out that Ukraine's recent successes won't draw a draconian response from Russia in a last desperate bid to save the situation*. Surely Russia was hoping, at the outset, to quickly occupy an intact nation, install a puppet government, and gather in a prosperous ally and buffer-state. That has all slipped away – indeed, Russia's failed blitzkrieg has earned Ukraine's eternal enmity, and driven two European nations, one of them Finland, bordering Russia, toward NATO membership. If the one goal that can still be obtained is to make Ukraine a buffer state, at this point the most obvious way to do that is to destroy it (see "Video: Replay of Zoom conference call with West Point's Dr. David Frey, on Russian atrocities in Ukraine" March 3, 2022). Reportedly, last night Russian forces gratuitously destroyed critical infrastructure as they withdrew from Kharkiv.
- *So just at it appears that happy resolution is at hand, this is the moment of greatest danger that Russia would deploy thermobaric weapons or even tactical nuclear weapons in furtherance of a scorched-earth exit.* We know from reliable sources, or at least the most reliable sources among all the unreliable sources, that

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, US STOCKS, OIL: Reportedly advances in a Ukrainian counteroffensive are being met with little Russian resistance. On the dark side, a disappointed Russia seeking a buffer state may pursue a scorched-earth policy on the way out, including use of thermobaric or nuclear weapons. China and India would have to stop buying Russian oil, leading to catastrophic shortages. Regime change in Russia could lead to even more brutal leadership. A Russian defeat leaves it no military leverage in negotiations to have sanctions removed. On the lighter side, Russia can still use access to its gas as negotiating leverage – and Germany and Poland can avoid freezing this winter. This is helped by the European Parliament's decision to designate gas a sustainable fuel. Cessation of hostilities would remove one supply-side risk from the calculus of central bankers obsessed with inflation-fighting. Equity risk premia across Europe are the widest in the world, so in the best-case there is value to be captured; in the worst there is a value-cushion.

Russian nukes have been in-country from the beginning (see "Video: Replay of TrendMacro Zoom conference call with Peter Van Praagh, eyewitness to the invasion of Ukraine" March 11, 2022).

- Setting aside the humanitarian issues, we *believe this would be the worst-case economic scenario*. It would make it impossible for the West to remove sanctions against Russia and normalize financial and energy flows. And *it may be reprehensible enough to require China and India to stop importing orphaned and deeply discounted Russian energy exports* – effectively stranding all Russia's exportable oil and natural gas. For global oil markets, which so far have been able to adapt to western sanctions thanks to China's and India's buying (see "The Bear/Bull Case in the Russian Oil Ban" March 16, 2022), the effect would be to remove something like 7% of global supply overnight. *It's bad enough under present circumstances to have to anticipate how Germany and Poland will get through this winter without Russian gas – but this worst-case scenario would drive shortages and price shocks worldwide*, the magnitudes of which have never been seen before.
- *There's even a dark side to Russia's simply giving up and exiting without scorching any more earth than it already has. The problem is: that would leave Russia with no leverage at all – nothing of a military nature to bargain with in order to obtain rollback of Western sanctions.* It can't promise to leave if it has already left.
- *Finally, any form of defeat in Ukraine raises the risk that President Vladimir Putin will lose his grip on power.* This has been widely discussed in the West from the beginning as a potential side-benefit of the conflict, but *we think it's naïve to assume that anyone who replaces Putin will be any better* in terms of global stability. Why not assume that anyone who replaces him will be, simply by virtue of the fact that he was the one who was able to do it, even more brutal?

Now let's look at the brighter side.

- A Russian failure in Ukraine – with or without scorched earth, and especially one that drives the ejection of Putin – ought to make China think twice before trying to aggress against Taiwan (see "Video: A Conversation with Michael Auslin on potential post-Pelosi post-Ukraine Chinese invasion of Taiwan" September 7, 2022).
- But let's focus on the more direct impacts. A defeated Russia would have little of a *military* nature to bargain with in order to earn relief from sanctions. But *it still has leverage in the form of natural gas supplies to Europe, especially as winter approaches*.
- Russia wants to sell the gas. Europe wants (indeed desperately needs) to buy it. The elites of both urgently want pre-war trade in all goods and services to resume as quickly and robustly as possible. In this scenario *the war that was getting in the way of their mutual satisfaction will have ended, so why shouldn't everybody get what everybody wants? Why shouldn't Germany and Poland not freeze to death this winter?*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
214 550 2121
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

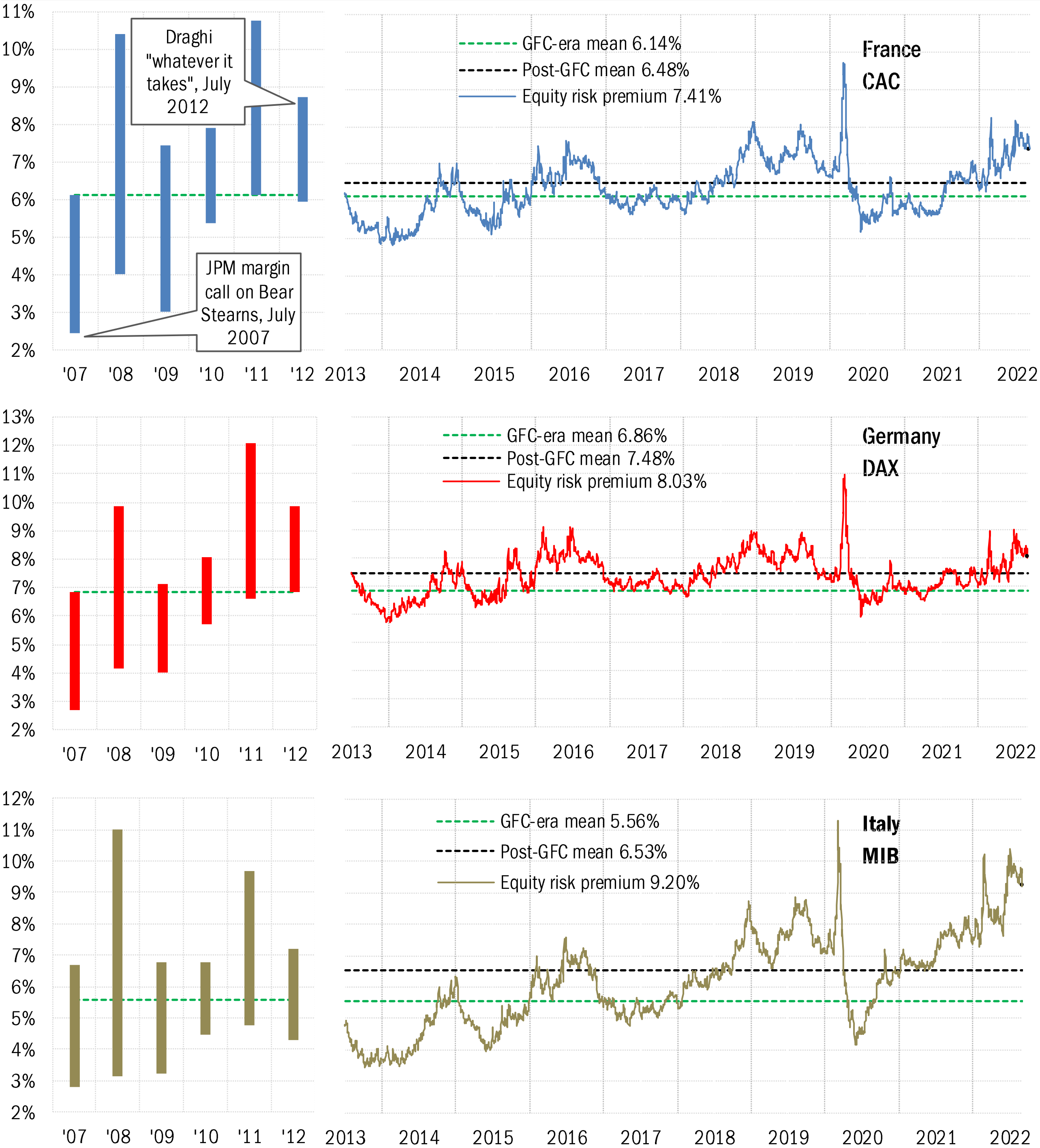
[About us]

- In one important sense this negotiation is already underway. In early July, the European Parliament included natural gas (and nuclear) in their taxonomy of "environmentally sustainable economic activities" – and thus not excluded from European Union subsidies and financing. (The way they did it was quintessentially European – the Parliament *failed to vote to object* to including them from the taxonomy, which amounts to including them without recrimination from environmental extremists.)
- We've been saying that one of Russia's war aims was to focus the European mind on the high costs of its utopian green energy transition plans, and to earn an exit premium on its exports in the meantime (see "Ukraine: A Pawn in Putin's Energy Survival Strategy" July 11, 2022). Whatever else happens on the ground in Ukraine, this EU Parliament vote points, at least at the margin, to Russia having at least gotten something out of this mess.
- But much more important for the global economy, *that EU Parliament vote could be, thanks to the Russian invasion of Ukraine, the first step away from the West's increasingly suicidal utopian energy ambitions*. That, in turn, means all energy exporters, especially the OPEC cartel, no longer need to earn an exit premium on their exports – and that, paradoxically, is a rare case of higher expected demand driving lower prices.
- It's so obvious it barely needs to be said: in the no-scorched-earth scenario, peace in Ukraine and relaxation of sanctions would drive lower commodity prices and remove financial frictions that, all along, have been courting systemic risk that luckily has not materialized. Relief on the supply-side of the global economy is an end in itself, without considering its effect on inflation (which, after all, is always and everywhere a monetary phenomenon). But because the central banks of the world seem, at the moment, bound and determined to cause a global recession because of what they believe is a supply-side-driven inflation, relief on that side is likely to cool their jets at the same time as statistical inflation figures start to come down anyway, simply because global money supply growth has been falling (see, most recently, "Demand and Supply and Things Like That" September 9, 2022).
- While the European Central Bank is part of the pernicious groupthink about inflation-fighting now driving a completely unnecessary hiking regime (see "Why Inflation Is on the Way Down" July 25, 2022), it is one way a special case.
- Throughout the euro crisis of the early 2010's, and again in the pandemic crisis of the early 2020's, the ECB maintained a negative deposit rate – that is, cash deposited by banks on the ECB's balance sheet was assessed what amounts to a fee, rather than paid an interest rate. While intended as an easing measure, this was in fact a tax on the banking system for not lending at a time when no one wanted to borrow. Whatever else we may say to criticize recent global central bank policy, at least the removal by the ECB of its negative deposit rate is a positive for the euro zone.

How do you play it if you want to believe the best about Ukraine turning the tide?

- The best-case scenario has the benefit of being consistent with what is being reported as news right here and right now. The worst-case scenario is all just "what if everything goes terribly wrong."
- Nevertheless this is one of those situations in which the best-case and the worst-case are both credible – and we are necessarily

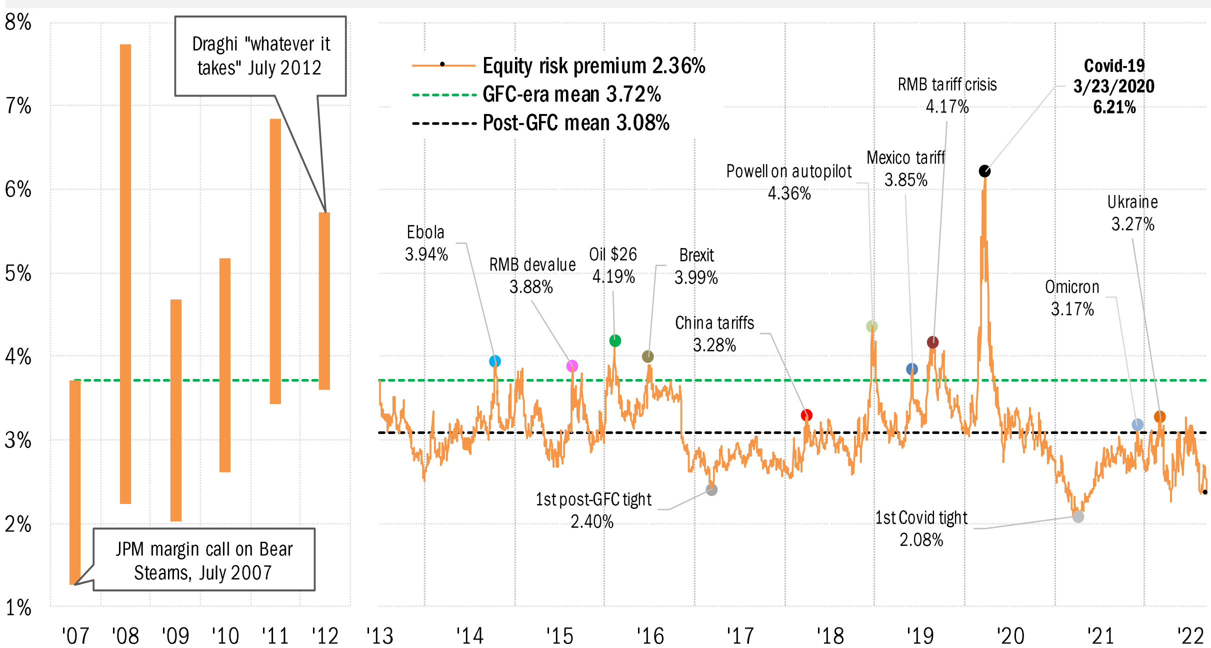
Equity risk premia: consensus bottom-up year-ahead forward earnings-yield minus 10-year sovereign bond yield



Source: Bloomberg, TrendMacro calculations going to have to make decisions in the absence of reliable information in any event.

- So this is a good time to ask which markets are paying you to take on all these ambiguities, and which aren't. In other words, *which offer you a value-recapture opportunity if you are right and, at the same time, a value-cushion in case you are wrong*?
- *European equities, tied to the economies that will most directly be affected for good or for ill as developments in Ukraine unfold, are generally offering the world's most generous risk premia*. Now only slightly off their recent wides, they are nevertheless at levels not wildly less generous than the widest of the last nine years, except for the worst moments of the 2020 pandemic lockdowns (please see the charts on the previous page and "Data Insights: Global Equity Risk Premia" September 12, 2022).
- Across Europe risk premia are above their respective means set in the Global Financial Crisis of 2008-2009, and also above their post-crisis means (which are in all cases higher than the crisis means).
- By contrast, the US equity risk premium is the narrowest in the world (please see the chart below, and again "Data Insights: Global Equity Risk Premia"). In the US, the post-crisis mean is lower than the crisis mean – and the current ERP is well below both (please see the chart below).
- The equity risk premia we are displaying here are all denominated in local currencies (in these cases, the euro and the dollar respectively). In other words, they represent the relative value of stocks *in the local currency* versus bonds *in the local currency*. They do not explicitly take cognizance of the relative values of those currencies themselves (if there even is such a thing as the

S&P 500 equity risk premia: consensus bottom-up year-ahead forward earnings-yield minus 30-year Treasury bond yield



Source: Bloomberg, TrendMacro calculations

value of a currency).
- So comparing risk premia across currencies implicitly assumes that currency exposure is hedged, or that you are indifferent to it.
- Differential central bank policy has probably contributed to the euro's weakness this year, as it has to other currencies. But at least part of the present weakness of the euro is some degree of risk premium discounting something between recessionary weakness in the region due to an impending energy crisis this winter, and a catastrophic redenomination if the euro currency breaks up under related political stress.
- If that's right, then it means that the euro, just like the equity markets in Europe, are offering a risk premium that US equities and the dollar are not.
- If our best-case scenario for the resolution of the Ukraine situation is wrong, at least there's a value cushion. If its right, all that value will be recaptured.

Now – let's see what turns out to be right. We're the first to admit that while we can juggle the what-if balls with the best of them, this is not a time to pretend we know much for sure.

Bottom line

Reportedly advances in a Ukrainian counteroffensive are being met with little Russian resistance. On the dark side, a disappointed Russia seeking a buffer state may pursue a scorched-earth policy on the way out, including use of thermobaric or nuclear weapons. China and India would have to stop buying Russian oil, leading to catastrophic shortages. Regime change in Russia could lead to even more brutal leadership. A Russian defeat leaves it no military leverage in negotiations to have sanctions removed. On the lighter side, Russia can still use access to its gas as negotiating leverage – and Germany and Poland can avoid freezing this winter. This is helped by the European Parliament's decision to designate gas a sustainable fuel. Cessation of hostilities would remove one supply-side risk from the calculus of central bankers obsessed with inflation-fighting. Equity risk premia across Europe are the widest in the world, so in the best-case there is value to be captured; in the worst there is a value-cushion.