

TRENDMACRO LIVE!

## On Ukrainian Drones Hitting the Kremlin: Real? Pretext?

Wednesday, May 3, 2023

Donald Luskin

Just stay alert. This could be a pretext for game-changing Russian escalation.

As of this writing markets have not reacted at all to [news reports](#) and [social media buzz](#) (complete with fuzzy low-res video) about [Russian government claims](#) that downed Ukrainian drones struck the Kremlin in Moscow.

At this time we have no idea what is meant by “drone” – is it a Predator-class pilotless warship, or a little video-drone like [you can buy at Costco](#)? How does Russia know the drones were Ukrainian?

*Did it even happen?* Aggressors have manufactured pretexts, such as, say the Reichstag Fire, since time immemorial. Russia’s statement said, “The Russian side reserves the right to take retaliatory measures where and when it sees fit.” If Russia were looking for a pretext for escalation, this is the kind of thing you’d expect – unverifiable, but with emotional salience (the Kremlin, on “Victory Day”). It strikes us, though, as small-scale – more of a trial run, or a shot across the bow, than a full-blown *casus belli*. But who knows – an assassination of an obscure duke started World War One.

A sufficiently aggressive escalation, involving scorched-earth civilian-targeting using conventional weapons, or God forbid, nuclear weapons, would be a market-moving game-changer.

Setting aside the risks of multilateral military escalation, potentially nuclear, the West would have to “do something” somehow. The only remaining non-military “something” at this point would be total economic isolation of Russia, which would require the West to stop China, and to a lesser extent India, from buying Russian fossil fuels. Getting China’s and India’s agreement may require sticks, if carrots fail – [trade sanctions against them that would disrupt global supply chains that have only now recovered from the Covid lockdowns](#). Even if China and India were to agree, or take the initiative on their own, that would effectively [take Russian oil and gas exports out of global markets, leaving a supply shortfall that would push global energy prices to new highs](#).

None of this is a prediction, and as of this writing oil markets – which ought to be the most sensitive to these risks – are doing the opposite (crude oil is down almost 3% on the day). This is a war-game scenario exercise that today’s headlines make worthy of your consideration. Chance favors the prepared mind.

### Update to strategic view

#### US MACRO, EUROPE

**MACRO, OIL:** The Russian government claims it downed Ukrainian drones that struck the Kremlin. This is the kind of thing that could serve as a pretext for escalation in Ukraine. If it were sufficiently brutal, and certainly if it were nuclear, the West would have to respond. Short of multilateral military involvement, the response would like be economic, and the only course left would be to force China and India to stop buying Russian fossil fuels. Doing so might require trade sanctions that would disrupt supply chains finally healed after the pandemic. But even if China and India were to volunteer without Western coercion, that would effectively take Russian oil and gas off the market, leaving a huge global production shortfall and moving prices to all-time highs. As of this writing markets aren’t concerned – indeed, oil markets are the opposite of concerned. Just stay alert.

[\[Strategy dashboard\]](#)