



While it's still early days in the conflict between Russia and Ukraine, we cannot dismiss its impact on our medium-term outlook. Frances Donald, Global Chief Economist and Head of Macroeconomic Strategy, offers a framework for considering the evolving situation.

Incorporating the Russia-Ukraine conflict in a global macro-outlook

Geopolitical developments are anathema to macro strategists. They're difficult to predict and time, can be violently disruptive to market pricing—although usually for short periods—and they tend to distract market participants from focusing on core longer-term themes. When they occur, seasoned macro strategists typically highlight the benefits of looking past the headlines and focusing on where we are in the business cycle, the direction of interest rates, and the strength of the consumer.

And yet, as we've spent the past several weeks reflecting on the implications of a Russia-Ukraine conflict, we cannot dismiss its impact on our global macro views. Although many assets have already rebounded from their initial sell-off, we'd caution that there are reasons to consider how the situation will affect our medium-term outlook.

A stagflationary economic shock

Indeed, the conflict and its repercussions amount to a stagflationary economic shock, which is hitting the global economy at a moment in which it was already suffering from painful inflation and signs of a growth slowdown to come. While the magnitude of the shock isn't yet known—and will be a function of the evolution of events—the *trajectory* of this particular geopolitical event is sufficient for us to:

- Add conviction to our existing call that the first half of 2022, particularly the second quarter, could be mired in stagflationary dynamics (lower growth, higher inflation), persistent volatility, and more frequent bouts of risk aversion
- Lower our conviction that the second half of 2022 will be an easy return to a Goldilocks scenario (stable growth and lower inflation)

As these are still early days, I'd stress that these are changes in our *convictions* around our base case, not a change in our outlook *overall*.

Commodity inflation is critical

To start, the main channel through which this conflict will affect global growth and inflation forecasts is through commodities. [As Sue Trinh recently explained](#), the Russia-Ukraine conflict needs to be monitored very closely, particularly given Russia's critical role in commodity markets:

"Russia is the world's leading exporter of natural gas (17.1% of global production) and the second-largest exporter of crude oil (12.1%). For context, Saudi Arabia accounts for 12.5% of the crude market."

Russia and Ukraine are also significant agricultural producers: Their combined wheat, barley, and maize exports represent 21% of the global total, and together they supply 60% of the world's sunflower oils. Russia and Belarus also account for approximately 20% of total fertilizer exports, which is vital for global food production.

Meanwhile, Russia is one of the world's largest producers of critical metals. It's the biggest exporter of palladium (20.7% of total volume) and ranks second after Chile in terms of refined copper (7.1%). The country also holds the third position for nickel (11.2%) and aluminum (9.0%)."

Our three-part framework for assessing the situation

Understanding this, we've constructed a simple framework through which we incorporate this evolving conflict in our outlook.

1. **Another stagflationary shock.** Our regular readers may be familiar with our view that the first half of 2022 (especially late Q1 and Q2) is likely to see stagflationary dynamics (higher inflation than comfortable, lower growth than comfortable). The higher-inflation-than-comfortable component of isn't controversial, and the ongoing run-up in energy (and food) prices, exacerbated by the Russia-Ukraine conflict, is readily observed.

But the second-order impact of sharply rising energy and food prices is a growth shock, as energy demand has notoriously limited elasticity; that is, even if gas prices or heating costs soar, we still need to get to work and to stay warm, and consumers either have to use savings or cut back in other areas of spending. This is on top of negative real wage growth and weak consumer confidence data in most major economies. U.S. personal income data also out this week showed income rose 0.0% month over month, and spending only rose off the back of declines in the savings rate. That's not a healthy consumer backdrop for experiencing another price shock. We expect to be thinking much more about the global consumer's exposure to energy in the weeks ahead.

We've already been operating with the expectation that high costs would cramp growth, but the Russia-Ukraine conflict compounds the issue and is consistent with ongoing yield curve flatteners. It also potentially throws a wrench into our expectation that

inflation would begin cooling after February and would sharply decline to 2% in most major economies by year end. We're still comfortable with the *path* of that decline, but its *speed* may be affected by these tensions.

Combined with supply chain disruptions that may limit inventory rebuilds that we hoped would fuel growth in the second half of 2022, our call for a return to Goldilocks by year end is looking less than solid.

2. **A potential slowdown in central bank tightening.** Central bankers were out in droves this week and few could avoid addressing the Russia-Ukraine conflict. Most highlighted the uncertainty this has injected into the outlook and downplayed the likelihood of a 50 basis point (bps) hike in March. Meanwhile, markets have gone from pricing in a 50bps hike as a near certainty two weeks ago to now having a one-in-five chance. That's consistent with [our central bank outlook](#), which has made the point that the odds of a 50bps hike were overpriced. Indeed, we continue to believe the U.S. Federal Reserve (Fed) can hike three times this year in total, along with quantitative tightening, whereas the market is still pricing in six to seven hikes in the next 12 months.

The Fed is once again in a situation in which inflation is coming from global and supply-side developments; interest-rate hikes will do little to cool energy-driven inflation precipitated by geopolitical developments. But both the pressure coming from some moderate increases in services inflation and the political challenges associated with 7%+ year-over-year prints probably mean they're still on the path to normalization.

The biggest reason we expect the Fed to pivot more dovishly this year is because we expect the narrative to turn away from high inflation toward low growth. And if we're correct that the Russia-Ukraine conflict will compound the *growth* shock,

then we have even *more* conviction in our call that the market is overpriced—both in that it still has a 20% chance of a 50bps hike priced into March but also because of how much tightening it believes the Fed will engage in over 2022. Should the Fed pivot, it will be able to re-steepen the curve, which is desperately needed, and support an extension of the cycle.

The Russia-Ukraine conflict isn't solely about the U.S. central bank, of course. We expect more dovish commentary from the Bank of Canada, the Bank of England, and, most important, the European Central Bank as it assesses the stagflationary dynamics at play.

3. **Relative impacts/trades.** We expect the theme of global desynchronization to become more important over the course of 2022. While the stagflationary shock emanating from the Russia-Ukraine conflict is *global* in nature, its effects will be felt unevenly around the world. In terms of major macro economies, Europe is most exposed to the growth destruction from higher energy prices, given its natural gas exposure and existing weaknesses. Indeed, recession odds for Europe will climb in the coming year (although recession isn't our base case). We believe the United States is in a better position to absorb some energy and food price inflation, although the country, in absolute terms, is worse off.

[As Sue Trinh covered](#), emerging markets are, on balance, weakened, but those economies that can absorb higher food and energy prices (e.g., Singapore and Malaysia) or those with least exposure to liquidity shocks (e.g., Indonesia and the Philippines) could be relative outperformers. It's also likely that global export momentum slows somewhat, and so those economies less reliant on foreign demand may enjoy a mild relative advantage.

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