BELVOIR
CAPITAL AG

February 24, 2022

# Macroeconomic Comment

# The Ukraine Crisis

February 24, 2022, Peter von Elten

Russia has abruptly abandoned talks on a solution to the Ukraine conflict and, within a few hours, created facts whose scope cannot be assessed at present. It began with Russia's recognition of the Donetsk and Luhansk sub-regions in the eastern Ukrainian Donbass, which have been occupied by Russian separatists for years, as independent "people's republics". The two pseudo-states were founded in 2014 by pro-Russian separatists with support from Russia, but were not recognised internationally. The subsequent deployment of Russian troops to these areas and the initiated expansion to the areas in the Donbass still controlled by Ukraine were the beginning of the military escalation. On the night of February 24, the Russian attack on Ukraine took place via several flanks. As justification for his actions, Putin accused Ukraine of genocide in the Donbass region and spoke of a pre-emptive action against a planned military attack by Ukraine on Russia. In his incendiary speech on the above-mentioned decision, which could already be interpreted as a declaration of war on Ukraine, he described the emergence of an independent Ukraine as a betrayal of Russia and denied the country any statehood. The speech left little doubt that Russia considers itself entitled to regain control over the whole of Ukraine.

The Western Alliance immediately imposed sanctions against Russia after the above-mentioned recognition, which are to be further tightened in view of the military escalation that has taken place in the meantime. However, even after the invasion, it is considered certain that Nato will not launch a military counter-attack. The previous partisanship for Ukraine is not uncontroversial in parts of the American population and especially in Republican circles. The Trump administration had already openly questioned Nato. The Americans see the greatest challenge for themselves in the emerging China and the Asian region. The unity that the West has shown so far in the Ukraine crisis could become more fragile. In the medium term, therefore, Europe will have to build up its own deterrent potential, which is likely to be a colossal logistical and financial task in the many-voiced chorus of European states.

Russia has significantly improved its economic self-sufficiency in recent years, especially in the agricultural sector, also in response to the sanctions imposed after the annexation of Crimea. Low public debt and the build-up of substantial financial reserves will enable the country to bear the high costs of the invasion, even if the tightened sanctions will significantly restrict the Russian financial sector. Putin's announcement that he does not intend to permanently occupy Ukraine after the military infrastructure has been dismantled is likely to be tied to a ceasefire that allows for a Russia-friendly government in Kiev.

As long as the scope of the military action cannot be estimated, the economic impact on Europe and its allies also remains difficult to assess. The effect on the real economy is likely to remain manageable, however, because trade activities with Russia outside the energy sector are not all that significant. The Western alliance will, however, have to plan many billions for the economic stabilisation of Ukraine. The sanctions against Russia that have been passed and are still planned will, however, also affect Europe and especially Germany in terms of energy supply, whether through price or delivery quantities. Rising energy costs are likely to keep inflation at a high level for longer and slow economic growth. On the other hand, a good employment situation, high order backlogs and considerable pent-up consumer demand after the pandemic has subsided should support the European economy.

## Inflation, the Turnaround in Monetary Policy and the Rise in Public Debt

The Russian invasion has led to short-term declines in equity markets of up to 50% in Russia and up to 5% in Europe. In the medium term, however, increased inflation risks and the turnaround in monetary policy are likely to remain the predominant stress factors for the markets. In the longer term, the sharp rise in government debt as a result of the pandemic fight will come into sharper focus.

After the pandemic has subsided, it will be a matter of correcting the most serious "side effects" of this crisis policy - the government debt explosion and inflation. Inflation above 5% in the Eurozone, around 7% or higher in the UK and in the US are forcing central banks to act. The IMF recently compared the development of public debt in leading countries before the start of the financial and economic crisis from 2007 to today. In the Euro area, public debt in relation to gross domestic product (GDP) has risen by about 30%, in the USA and the UK by almost 70% each. However, absolute debt growth has been much higher, as GDP has risen as a benchmark. When considering debt development, the low interest rate trend must also be taken into account, which has enabled many countries to spend less on debt service despite a massive increase in debt. These times are probably over now. The surprisingly high and prolonged inflation is now forcing a change of course that is tantamount to a turning point. Central banks are being forced to adopt a more restrictive monetary policy to dampen inflation expectations. The excessive supply of liquidity will be scaled back for the time being. In contrast to previous inflation cycles, however, interest rates will only be raised moderately in relation to inflation so as not to corner the highly indebted states and prevent the formation of bubbles in real assets from bursting. As a consequence of this change in monetary policy, we will have to live with negative real interest rates for a longer period of time and continue to accept a creeping devaluation of monetary assets. Despite an expected cooling of the global economy, which we will have to prepare for this year and above all in the coming year, this constellation continues to speak in favour of investments in real assets, even if corrections in equities and real estate are to be expected in times of great uncertainty.

Peter von Elten

**Peter von Elten**

Belvoir Capital AG, Macro Advisor

Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.



CONTACT DETAILS

BELVOIR CAPITAL AG
Beethovenstrasse 9
CH-8002 Zürich
+41 (0) 44 206 30 40
info@belvoircapital.com