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Impact of the Ukraine war on the global economy

Market Comment, May 2022

The financial markets hope that the Ukraine conflict will soon be replaced by “business as usual”. They appear to have got used to the war, as it has not escalated any further to date. Nevertheless, the current state of the conflict, which could last for an extended period, is set to keep inflation historically high. This could lead to slowing growth in corporate profits and a weakening of the global economy. With this in mind, a focus on defensive quality in both the bond and equity spaces remains sensible.

The Russian attack on Ukraine is already more than two months old. Many market participants appear to have got used to this situation. Does this mean that everything is now back to the way it was before the Russian invasion? Hardly, for as long as the sanctions against Russia remain in place, Western companies withdraw from Russia, commodity prices remain at historically high levels and supply problems persist or even increase, the global economy will be negatively impacted by the Ukraine war.

Although one would hope that the war will end quickly, it is probably more likely that it will continue for a longer period of time. It could even escalate further, which may trigger a stepping up of sanctions and place more pressure on risk-oriented assets such as equities. An escalation of the conflict would exacerbate the situation and see the risk of stagnation move towards a risk of recession. Due to Europe’s energy dependence, the European Union (EU) would be more impacted than the US or Switzerland, where only around 7% of the energy supply comes directly from Russia. In some EU countries, this figure is in excess of 50%.

> “Without a swift end to the war, a prolonged period of high volatility is likely.”
>
> Gérard Piasko, Chief Investment Officer

What might be the economic impact of a prolonged conflict without any further escalation?

As around 30% to 40% of European gas and oil imports come from Russia, energy prices would likely remain at historically high levels over an extended period, apart from sporadic consolidations. This would also be the case with deliveries of additional, albeit insufficient, liquid gas from the US or Qatar. Such a high level would lead to price increases and perhaps also temporary interruptions in industrial production in various countries. It would also keep global inflation too high for the central banks’ liking for a longer period. In this case, inflation in the Eurozone would likely be 1.5% to 3.5% higher than it would be if the war were to end or if there was a clear de-escalation in hostilities.

In the emerging markets and the US, producer and consumer price inflation could be 1% to 2% higher than prior to the war. This would lead to increased political pressure on the US Federal Reserve (Fed) to push ahead further with rate hikes. Depending on the development of real interest rates, this could lead to additional burdens for both bonds and equities. As global economic growth would then likely be lower, defensive bonds and equities, i.e. less cyclical securities, would be in greater demand.

Global economic growth could weaken by 0.75% to 1.75% in 2022 due to the Ukraine war, with this figure standing at around 0.8% in the US, 1.5% to 2.5% in the EU and 0.5% to 0.75% in China and Switzerland. On the one hand, the reason for this is slower growth in industrial production due to higher transport and commodity costs as well as temporarily increased supply problems. On the other, disposable income for consumption and the purchasing power of consumers is falling against the backdrop of persistently high commodity and consumer prices by historical standards.

Growth in corporate earnings would also decline relative to the existing market consensus expectation, a development triggered by margin pressure from rising commod-

ity, wage, transport and financing costs as market interest rates increase. However, sales growth is likely to also visibly decline in the event of a prolonged war if the situation becomes gloomier with respect to consumer sentiment and the business sentiment of entrepreneurs, meaning that even corporate investments are hit. This could be countered with renewed financial stimulus from governments (especially in the EU) or postponed rate hikes. Until this is decided, we anticipate an above-average level of volatility on the financial markets for an extended period of time.

Conclusion: The probability of a prolonged conflict in Ukraine, with or without escalation or the imposition of further sanctions against Russia, argues in favour of a clear focus on defensive quality in the sense of more stable profitability, the ability to charge higher prices to end customers thanks to a good market position (in order to offset higher input costs) and lower economic dependence due to the increased risk of a marked weakening of global economic growth.

Gérard Piasko

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