

Exchanges at Goldman Sachs
What the Russia-Ukraine Conflict Means
for the Global Economy and Markets
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Allison Nathan: This is Exchanges at Goldman Sachs, where we discuss developments shaping industries, markets, and the global economy. I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

In today's episode, we're going to discuss the implications of the Russian-Ukraine conflict on the global economy and markets. To do that, I'm joined by my colleagues in Goldman Sachs Research: Daan Struyven, Senior Global Economist; Peter Oppenheimer, Chief Equity Strategist;

and Kamakshya Trivedi, Co-Head of Global Foreign Exchange, Interest Rates, and Emerging Market Strategy Research.

We'll first turn to Daan Struyven for his views on the implications of the conflict for the global economy. Daan, welcome to the program.

Daan Struyven: Allison, thanks for having me.

Allison Nathan: Daan, set the stage for us. In what ways can the Russia-Ukraine conflict affect the global economy?

Daan Struyven: Right. So, yeah, at the end of the day, the most devastating aspect of this war is, of course, the humanitarian costs. That being said, given our expertise, let me walk you through what I think are the key four economic channels through which the invasion will affect the global economy. First of all, the direct hit to GDP in the region. Second, lower exports from the rest of the world to the region. Third, lower commodity supply by Russia and Ukraine to the rest of the world. And then finally, tighter financial conditions.

Starting with the direct effect, the impact in the region could be very large. But given the relatively limited weight of the region in global GDP, with both countries added together accounting for roughly 2 percent of global GDP on the market basis and 3.5 percent on the global EVB [PH] weighted basis, the impact on global growth is just not going to be huge.

To give an example, one potential reference point is the hit to the GDP of Iran in 2012, which was also subject to very severe sanctions. GDP dropped by about 7.5 percent back then. And if you combine that the weight of Russia in the global economy, you get a hit to global GDP growth worth around 2/10 of a percentage point. So, then very big despite huge effects potentially locally.

Similarly, the impact for the second channel, the impact of lower exports from other countries to the region, is probably going to be quite small because trade with Russia and Ukraine accounts for about 2 percent of global trade.

So, the big channels here are really number three and four,

spill overs through commodity markets and financial conditions. Russia is a major player in global commodity markets. Produces about 17 percent of oil globally. 11 percent of global gas globally. And both countries together are also major players in commodity markets such as wheat, fertilizers, several metals [PH], and corn. And of course, Europe is especially dependent on Russian gas.

Finally, the fourth channel is financial conditions. They have responded meaningfully to the geopolitical events. And if the moves in financial conditions are sustained or potentially even amplified, you could have sizable effects on global growth through the financial conditions channel.

Allison Nathan: Let me just talk a little more about financial conditions, what do they actually represent and, you know, how tight are they on the back of all of this at this point?

Daan Struyven: Yeah. So, you know, we define financial conditions essentially as for every given country as the weighted average of asset prices that best predicts growth over the next year. Where, you know, the sharp drops in

risk asset prices that we have seen, equities and corporate credits, have contributed to tightening. On the rates front, you actually see opposite directions with rates, for instance, in Russia rising very spectacularly as the Central Bank tries to limit the inflation. However, on market rates, for instance in Europe and the US, are declining given the risk off and the concerns about growth.

On net, sort of summing the effects overall, the components and across all the countries, so far for global FCI has tightened by about 50 basis points on account of the invasion. That's significant. With much bigger effects, of course, in the region and outside of the region with a tightening in the global FCI excluding Russia of around 25 basis points. Now, of course, these numbers change, literally, every 30 minutes. Because everything is still so fluid, we're also quite reluctant to make the assumption that the impact of financial conditions will be sustained and that we would simply incorporate this into our GDP growth forecast.

Now, I can still do this if we get this 25 basis points, sustained tightening in global financial conditions,

excluding Russia, that would subtract 2 to 3/10 of a percentage point from global growth if sustained.

Allison Nathan: And so, we talked about growth. But as you mentioned, commodity prices, oil, is over \$100 per barrel at this point. And inflation has been the big macro concern in recent months. So, what are the implications of this for our inflation forecast at this point?

Daan Struyven: Yeah. Clearly, high inflation as a result, especially Europe. You know, Europe is particularly vulnerable. About 20 percent of the gas supply in Europe comes from Russia. 60 percent in Germany. And gas accounts for a significantly larger share of the consumer spending basket in Europe than for instance in the US or in China. And so, our commodity strategists have lifted the European gas price forecast sharply, 120 percent larger new price forecast than before the news about the Nord Stream to approval halt.

Working this increase in European gas prices through our inflation models and taking into account that governments are going to partially offset this and that retailers are not

going to fully pass this through, still, we have lifted our Euro area year end inflation forecast by nearly half a percentage points to a very high, especially for Europe, 5.4 percent year over year headline inflation number.

In other countries that are less exposed to gas imports from Europe, most of the inflation effects will come through the oil markets, which are more globally integrated than the gas markets. Brand oil, as you said, is up around 25 percent year to date. Our model suggests that that should boost global headline inflation by around 30 basis points with larger effects in emerging markets for whom oil prices and fuel prices are a bigger deal and a larger part of the basket.

Allison Nathan: So, if we put this together, we have a potential hit to economic growth, particularly focused in Europe, but still a negative for growth. But obviously, upside inflation risk. What does this all imply for central banks that had already started pivoting towards a more hawkish posture?

Daan Struyven: Yeah. So, for sure the implications are

pretty mixed. On the dovish side of the spectrum, we have downside risk to growth, lower growth, especially in Europe. Now on the hawkish end of the spectrum, you clearly have higher inflation and upside risk of even further increase in inflation. Markets clearly seem to be emphasizing the dovish side of the ledger here with a pretty large move in, for instance, front end rates, both in the US, the Euro area, and other G10 markets.

Our own baseline views, both for ECB and the Fed remain quite hawkish. We still expect seven 25 basis points rate hikes from the Fed this year, two 25 basis points rate hikes from the ECB. Now, we have incorporated the geopolitical uncertainty in our ECB forecast. We have tweaked it a bit. We no longer expect the ECB to tie its hands at the upcoming March meeting by saying, "We are going to stop QE." In an environment where everything is so uncertain, we think it makes more sense for the ECB to stay data dependent. But our baseline forecast for what's actually going to happen in terms of liftoff has not changed. We still expect liftoff to come in September as we think that the impact in growth will ultimately prove to be manageable in our base case.

That being said, downside risk to growth from industrial production shutdowns are quite large in Europe. And so, in a sense, I think that the forecast, the outlook for the ECB is pretty bimodal. Either they get started tightening or, you know, things turn sour on the growth front and rates may stay lower for longer.

In fact, in the US, we have added a hike to our forecast over the weekend. Not in 2022 where we still expect seven hikes. But we've added a fourth rate hike to our '23 forecast on the back of sizable upgrades to our inflation forecast, both for this year and for next year. And so, taken together, although there's clearly a left tail here where rates stay low, for instance in a left tail scenario where we start to talk more about nuclear escalation for instance, market pricing, especially of US rates, looks too low to us.

Allison Nathan: The other implication may be a bit smaller, but I think is worth mentioning is the market had increasingly priced in the risk of a 50 basis point hike at the coming meeting or in the first part of this year. And it seems less likely though because of this geopolitical risk.

Correct me if I'm wrong, but that's, I think, another shift we made.

Daan Struyven: Exactly. That's right. We were not looking for a 50 basis points hike before the invasion started. But I think the increase in geopolitical uncertainty has increased our conviction that it's natural for the Fed to start the tightening process with a 25 basis points move. Because I think that the impact on financial conditions is more predictable.

And in this environment, I don't think you want to unduly tighten financial conditions. I think the plan for the Fed here is to gradually tighten financial conditions to lower inflation.

Allison Nathan: And while the focus has been squarely on the monetary policy implications of these developments, we've also had some developments on the fiscal side. Can you talk a little bit about how that factors in?

Daan Struyven: Yeah. Major changes here. You know, Germany, for instance, announced a sizable increase in its

spending on the military with an increase for this year that's expected worth 0.7 percent of GDP on extra defense spending. That would grow [UNINTEL] by probably half of a percentage point in this year already.

If you look at the various Euro area members that are also a part of NATO, most of them are not meeting their 2 percent NATO pledge to spend 2 percent of GDP on defense spending. And so, I think it's reasonable to assume that Germany will not be alone in increasing defense spending. Spain and Italy, for instance, are also well below 2 percent.

Fiscal easing here is not only about military spending. The support of Ukraine refugees could lead to easier fiscal policy. Some estimates estimate now that you could have 7 million Ukrainians moving to Europe to be hosted and helped.

The German government, third, has announced sizable investments to increase its energy dependence by accelerating the transition to net zero, but also by building more LNG terminals.

And then taking a step back, I think that the COVID pandemic has directly changed fiscal policy in Europe through the creation of a recovery fund. There was a major shock that hit some countries, especially in the south harder, than for instance Germany, at least in 2020. And Europe got more fiscally integrated as a result.

Is it possible that this huge shock that hits some economies harder than others, in this case Germany, that this leads to more fiscal integration and perhaps a Recovery Fund 2.0 that helps countries that are most exposed to gas to transition away? I think that's possible. And so, when you get these huge shocks with major, major political effects, I think Europe tends to evolve more than in normal periods.

Allison Nathan: Dan, thank you so much for joining us.

Daan Struyven: Thank you, Allison.

Allison Nathan: We'll now pivot to my colleagues in London, Peter Oppenheimer and Kamakshya Trivedi for their thoughts on equity and macro market implications.

Peter, Kamakshya, welcome to the program.

Peter let's start with you. Global equity markets have been quite volatile, obviously, over the past few days as these events have unfolded. So, how has that evolution looked to you? And where do we stand now in terms of markets?

Peter Oppenheimer: Yeah Allison, thank you. Well, I think first of all, of course, the invasion has a significant humanitarian cost above all else. But there has been a spillover, understandably, into uncertainties about what the economic and the market impact will be.

It is important, I think, to contextualize the stock market reaction, because we were already seeing a correction in most equity markets around the world late last year triggered by concerns about higher inflation and interest rates. And that targeted a derating.

Up until this invasion, Europe had relatively outperformed. Markets had fallen, but perhaps not as much as, for example, the US, because they were cheaper. And because they had more exposure to the more value-oriented parts of

the market that investors were navigating towards as they are bigger beneficiaries of inflation.

I think it's the inflation hit as a result of higher commodity prices and the potential impact on slowing growth that's been the importance and driver of yet further equity weakness. And European markets, given their proximity, have been hit the most. And are now well into correction territory alongside other global economy markets like the US. And it's really the concerns about higher inflation, potentially tightened monetary policy further, at a time when growth is likely to slow, and there's greater uncertainty, which is really what's had the biggest impact on equities as these terrible events unfold.

Allison Nathan: And so, we've obviously had so many different events evolving over the course of the last several days. But given what we know today, do you think most of the news is priced in? Do you see much farther to go? Where do you stand in terms of that?

Peter Oppenheimer: Well, the difficulty when we get a shock event like this, which has so many consequences, of

course humanitarian, economic, and monetary in terms of policy, the uncertainty levels go up. And that's really what we think has happened mainly. The equity risk premium has shot up much more, in fact, than most other geopolitical events have triggered over recent years or even decades. But that's unstable because the consequences of this are far reaching and could be quite long lasting.

That said, because equities were already falling before this had happened, and because, in particular, European markets were not very expensive at the outset, we do think a lot of bad news is priced in. We have two sort of metrics that we look at to assess risks in equities directionally. One of them is our bull and bear market indicator. And this is really looking at the fundamental risks, the drivers of inflation and rates and growth and valuation. And this has been elevated for some time, suggesting to us vulnerability of a correction and lower medium-term returns. But it isn't at elevated levels which would suggest an imminent deep and lasting bear market.

The other indicator we look at is our risk appetite indicator. And this is structured to look much more at tactical

opportunities reflecting sentiment in markets. It's pitching riskier versus less risky investments across many different asset classes and geographies. And this has reached very depressed levels, in fact levels from which typically in the past you've seen quite a strong rebound as the intense uncertainty begins to fade. So, I think there are tactical opportunities. I do think that there's a lot of [UNINTEL] that's been priced into equities now, particularly in those that were not so expensive when this event really hit and started to take place.

Allison Nathan: Kamakshya, let's bring you into the conversation. We've seen dramatic repricing in Russian local assets and currencies. Can you give us some color around that? And, you know, what's driving the extent of that move and how you are expecting things to go from here?

Kamakshya Trivedi: Yes. I mean, I think Russian assets, Russian local assets are very much at the eye of the storm. You know, from the start of the year we've seen the ruble depreciate by something like 40 to 50 percent, so a huge, huge move. Interest rates have gone up very sharply. The

central bank raised rates from a little over 9 percent to 20 percent in order to try and stem the weakness in the currency. There are, essentially, de facto capital controls in place.

And part of the reason is that Russia had a significant amount of external hard currency reserves. But the latest wave of sanctions has made that, essentially, inaccessible for them to be able to use that to support local assets. So, yes, there has been a very significant amount of pressure on Russian local bonds, on equities, on the currency. But I think that given the really historic far reaching and unprecedented sanctions that we are seeing against Russia at this point, I think that that premium or that risk premium in those assets is justified. And we would expect to see that remain in place even as other global markets start becoming less volatile.

Allison Nathan: And when you talk about the sanctions that are particularly relevant here, you're talking about sanctions regarding the use of the Central Bank reserves from the Russian Central Bank, correct?

Kamakshya Trivedi: That's exactly right. I think that, you know, there have been sanctions on their use of swift message system. But I think by far, probably the most important one from a local asset market standpoint is the fact that a lot of the dollar/euro/yen reserves that the Russian Central Bank has is basically now no longer accessible to them in order to intervene and support their local asset markets.

Allison Nathan: Because they've been frozen? I mean, if you could just provide a little more clarity on what happened.

Kamakshya Trivedi: Yeah. I think that essentially the statement from the G7 indicated that those assets would be frozen in custodian accounts wherever they are across the world. Overall, Russian reserves, 2/3 of them, are in things like G10 currencies. And 1/3 of them are in the Chinese yuan and in gold. And so, the share of the reserves that are in G7 currencies have been frozen by the latest wave of sanctions. They're no longer accessible to the Russian Central Bank in order to intervene in these markets.

Allison Nathan: And so, at this point, are we seeing spillover into the broader emerging complex? And/or do you expect to see more spillover?

Kamakshya Trivedi: For sure there have been spillovers in the broader emerging market complex. I mean, if you look at this since the start of the outright hostilities last week, you know, emerging market currencies are weaker. Credit spreads have widened on emerging market sovereigns. You know, the spillovers have been most acute in the emerging markets that are closest to the theatre of conflict. So, countries in Central and Eastern Europe, places like Poland, Hungary, Czech Republic have seen the most pressure on their local currencies and their equity markets.

In general, the other place where you see very clearly spillovers are via the increase in oil prices. The fact that oil prices have moved up has meant that the inflationary concerns across a whole host of emerging markets are now more acute. And you're seeing interest rates in a lot of those emerging markets move up as well.

It's important to clarify that it's not just energy markets. Russia and Ukraine together are also very large producers of food grains and food prices have started moving higher as well. And food prices are an important part of inflation in emerging markets. So, that's been another channel through which we've seen contagion and spillover.

I would say, however, that not all spillovers have been negative. If you are a country or an emerging market that is a big oil exporter and far away from the theatre of conflict, you know, we've seen actually places like Columbia and the Columbian peso actually do well inverse correlation with what is going on with Russia-related risk. Similarly, some of the credit spreads of the Middle Eastern sovereigns, again, big commodity producers fairly far removed from the theatre of conflict. They actually benefit from some of the tailwinds of higher commodity prices. And that's something that we're also seeing.

Allison Nathan: And what about the implications for the dollar and other sort of macro G10 assets?

Kamakshya Trivedi: So, the dollar has trended over this period not unlike other periods of higher degree of risk aversion. You tend to see the dollar and dollar assets, in particular, attract safe haven flows. That's very much been the pattern this time around. I think what's also been important a little bit as Peter mention earlier, is that this occurred and came at a time just as people were getting more cautiously optimistic on the Euro area and the prospects for the euro itself. And so, given that this is a conflict where it's closer to Europe, you've also seen the euro come under pressure and reverse a bit of its nascent rally that we saw over a year to date.

More broadly, when you look at sort of global core rates: US yields, US bond yields, we've seen a rally in those as well. But more so at the long end as people have sort of built on a kind of risk aversion. But also, people have raised the uncertainty pricing in the kind of longer data prospects for growth and inflation. Less so at the very front end where the near-term inflationary impacts might actually be worse given the increase in commodity prices. And so, we have seen global curves flatten somewhat as a result of this crisis.

Allison Nathan: And so, Peter, as we sit here today, what are you watching in terms of thinking about the risk and the outlook ahead?

Peter Oppenheimer: Well, from an equity market perspective purely, in the end the critical driver is growth and how much this really spills over into a weaker economy, particularly at a time when central banks may be facing very difficult choices about whether to protect their economies or contain inflation and raise rates. And the combination of raising rates and slower growth, the kind of stagflationary type outcome, is the worst for equity markets.

And watching the data relating to the momentum of growth, I think, is going to be absolutely critical. So, that's the most important thing.

And then more medium term, given that we have already seen announcements, particularly by Germany, about a ranking up of spending on defense and the urgency increases for the European union in particular to increase

its spending on energy transition and energy security, this is going to increase budget deficits in Europe, and perhaps beyond. And the question then for equities will come down to, you know, what does that do to the cost of capital and long-term interest rates.

Allison Nathan: And Kamakshya, I'll ask you the same question. So, what are you most focused on to gauge how this will evolve?

Kamakshya Trivedi: I think there are two areas that I would be most focused on. I mean, first off, you know, the overall cyclical and growth risk as I think Peter mentioned as well. I think so far, the market is pricing this as though there is very severe cyclical growth risk, downside risk in Russia and the immediate vicinity, but not much further than that. That seems like a rational way of differentiating the impact given the very severe sanctions and the hostilities in Ukraine and Russia.

But I think that one thing that we have to be aware of from a global asset perspective is that if that perception of cyclical risk broadens out, either because the crisis

escalates or because the inflationary impact is seen as being big enough or important enough that central banks have to raise rates further, I think a lot of risky assets like EM assets that are levered to cyclical risks, I think, could see more pressure.

I think the second is oil prices. I think, you know as I mentioned already earlier, I think the much more significant mover higher in oil prices that worsens that trade-off that policymakers face between growth and inflation, and just simply worsens the terms of trade for large parts of the global economy that import oil. Think about large parts of Asia, for example, and are big oil importers, I think that's going to be key to seeing whether the economic and the market impact remains confined to Russia and the immediate vicinity, which is what the market is pricing right now, or whether it broadens out beyond that.

Allison Nathan: And one last question, Kamakshya. You began to touch on this, but as you look at all of this uncertainty and the risks ahead, are there areas that could provide better hedges? And Peter, in your universe as well,

are there places that look safer at this point in time?

Peter Oppenheimer: From an asset allocation perspective briefly on my side, you know, we have raised our weight in cash. And against that, also have an overweight in risk assets like equities given what has been, we think, priced in. And we are overweight in commodities. And this is an area where we've had a structurally positive view, or at least a view that commodity prices will go up for other reasons. And this, obviously, adds to those underlying pressures.

Within the equity market, we see energy and energy related equities as being a good hedge, partly because a rise in commodity prices will boost their cash flows. The cash flow yields are very high. And this is true across resources and the energy sector. And their valuations are very low, both in the US and Europe. The sector trades roughly at about a 40 percent discount on a PE basis to the broader market. So, those are areas that we're focused on from an equity and asset location perspective as a hedge.

Kamakshya Trivedi: Very similar themes in the macro

space. I mean, I think there are obviously the typical areas that tend to do well or better in crisis times or macro hedges like the Japanese yen. Those are assets that I think people look to. The dollar, as I mentioned, tends to do well in this area.

But then apart from that, I would say looking at places that are commodity exporters and investment grades, so it's the safer commodity exporters we like. Places like the Canadian dollar is one example of that in the G10 FX space. Investment grade credits that are energy sector or energy sovereign related are another that can be fairly resilient at a time like this.

Allison Nathan: Well, we will continue to watch how this all evolves. Peter, Kamakshya, thank you so much for joining us.

Peter Oppenheimer: Thank you.

Kamakshya Trivedi: Thank you.

Allison Nathan: That concludes this episode of

Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts, Spotify, or wherever you get your podcasts, and leave a rating and comment.

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