It's starting to show

128 – 21 March 2022

Key points

- While market stress has receded last week, hurdles on the road to a settlement in Ukraine should not be underestimated.
- The first signals from the real economy suggest business and consumer confidence are visibly hit.
- The Federal Reserve (Fed) fell on the hawkish side last week, while C. Lagarde was more dovish than at the Governing Council meeting press conference. This may be informed by lack of progress on a joint fiscal response.

The level of stress on the energy and equity markets has declined over the last two weeks. This was fuelled by some positive noises around the negotiations between Moscow and Kyiv. Yet, the hurdles on the road to a settlement should not be under-estimated in our view. While some form of "neutralization" is acceptable to Kyiv, demilitarization probably is not. Moreover, Ukraine will want more solid third-party security guarantees than the "Budapest memorandum" of 1994. Finally, it's highly likely that Moscow would request the sanctions to be lifted in exchange for a ceasefire or a proper peace agreement, which the West is likely to be reluctant to grant. A "proper deal" would be complex and involve many more parties than "just" Russia, Ukraine, and a go-between. In the meantime, Moscow is likely to try to push further on the ground to try to maximize its leverage in future negotiations. This in turn could lead to an even deeper humanitarian crisis, with more public opinion pressure on western governments for more sanctions. This would be consistent with further spikes in stress and hence with more episodes of market volatility.

The somewhat better mood on the markets contrasts with the first signals from the real economy which suggest that even in countries such as France which are relatively well protected against the economic fallout from the Ukraine war, business and consumer confidence is visibly hit. We are not in recessionary territory, but manufacturing is struggling. We are concerned by a possible "inventory whiplash": it's precisely when the "inventory glut" – legacy of the reopening of the economy – was starting to be satiated that firms are facing yet another cost shock and are revising their demand expectations.

For now, the Fed is "unmoved" by the developments in Ukraine and is intent on proceeding with a fast pace of normalization. Apart from the decision to hike by 25 basis points and not 50 as Bullard was calling for, the Fed's statement and Powell's press conference were on the very hawkish side. Conversely, we found Christine Lagarde's latest speech less hawkish than at the Governing Council meeting press conference. Her willingness to insist on data dependence and gradualism, as well as finally the (imprecise) recognition that a new programme could be set up to deal with fragmentation may be informed by the lack of progress on a joint fiscal response at the European level.

Impatient markets

Judging by the drop in oil and gas prices from their recent peak two weeks ago (see Exhibit 1), energy markets are now anticipating at least an absence of escalation in the western sanctions/Russian reprisals , if not a swift resolution of the war in Ukraine. The same optimism prevails on the equity market. This can be gauged by looking at the performance of the defence sector in the Eurostoxx 600 relative to the names in the index which are the most hit by the sanctions against Russia, either directly via their operations over there or reliance on Russian demand, or indirectly via the rise in energy prices. The defence sector's outperformance is still very substantial but has significantly declined relative to the peak on 7 March. This is now disconnected from the expectations of a Russian sovereign default, as proxied by the CDS market (see Exhibit 2). As of the end of last week, the "collective wisdom" of investors was thus that although the current sanctions are tough and may ultimately impair the Russian government's capacity to repay its debt, the impact on Europe of the whole crisis could be smaller than feared. **This "risk-on" attitude was fuelled by some positive noises around the negotiations between Moscow and Kyiv. Yet, the hurdles on the road to a settlement should not be under-estimated in our view.**

Exhibit 1 – Volatile, but lower

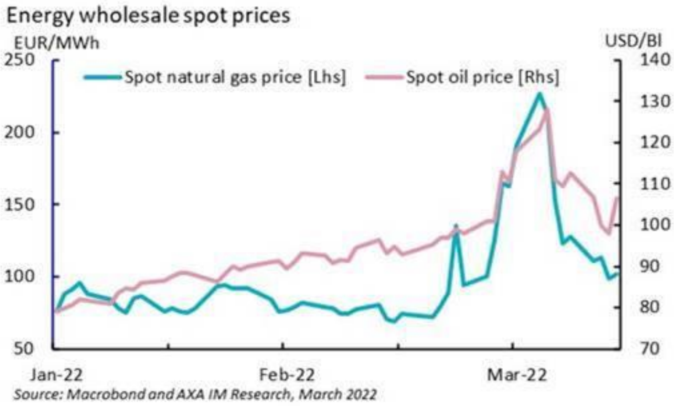
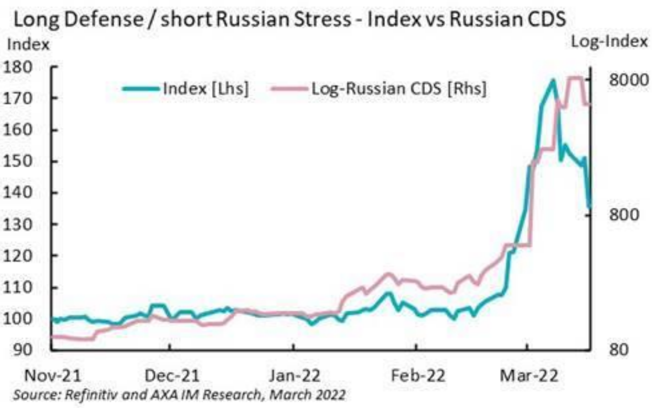


Exhibit 2 – The equity market is less fearful



Negotiations are probably making some tentative progress – that is at least what both parties are publicly reporting - because the two belligerents have come closer to the conclusion that they can't realistically secure what would be their best possible outcome. Russia's "maximal" goal was to swiftly take control of Ukraine and change its government. Lack of decisive military progress possibly means Moscow would revert to a "fallback" plan of ensuring some form of neutralization of Ukraine. This is at least what Russian Foreign Minister Lavrov has been publicly stating. Symmetrically, while Ukraine can probably continue to offer staunch resistance against the Russian attack thanks to western support, faced with mounting civilian casualties and massive destruction, preserving its democracy and full internal sovereignty within the de facto borders as of 23 February 2022 against a limitation of its international sovereignty would probably look like an acceptable outcome, even if *formally* renouncing on the territories lost in 2014 (still officially Kyiv's goal) remains a step too far for Kyiv.

Yet, while some form of neutralization of Ukraine could well be the "landing zone" for any peace process, its precise definition is likely to be everything but swift. Lavrov explicitly used Sweden and Austria as possible precedents for post-war Ukraine. The mention of Sweden may be more a message to Stockholm to avoid joining North Atlantic Treaty Organization (NATO) than a real "blueprint". Austria is interesting since, unlike its Swiss neighbour, it did not develop strong military capabilities after WW2, even though it was bordered by Warsaw Pact countries. Russia is after both neutralization and *demilitarization* (Lavrov used the word publicly). After the Russian invasion, Ukraine would be extremely reluctant to accept a significant and permanent haircut to its armed forces.

Moreover, **while Ukraine has already explicitly conceded that it would not join NATO, its authorities have also been quite clear they would want some solid guarantees of its security from third parties**. Kyiv is after much more than the memorandum signed in 1994 in Budapest by Russia, the US, and the UK to protect Ukraine, in exchange for the transfer to Russia of the nuclear warheads stored on its territories. Crucially, the memorandum did not contain a promise of military assistance from any of its signatories. The full text can be found here, but the key part is the following: "The *United States of America, the Russian Federation, and the United Kingdom of Great Britain and Northern Ireland, reaffirm their commitment to seek immediate United Nations Security Council action to provide assistance to Ukraine (…) if Ukraine should become a victim of an act of aggression or an object of a threat of aggression in which nuclear weapons are used".* Since its merely promised to seek "*UN Security Council action*", and since Russia holds a veto right at the Security Council, by construction the memorandum never protected Ukraine against a Russian aggression.

There are probably some possible trade-offs which Ukraine may look into – e.g. the size of the national military against the solidity of any new security guarantee regime – but a key question would remain anyway: who would be the third parties which would be militarily credible enough to provide security assistance – and ready to take this responsibility - while being acceptable to Moscow?

Another issue to consider is Ukraine's European Union (EU) membership. This would be a lengthy process (Dutch Prime Minister Rutte declared in Versailles that there is "*no fast track for EU membership*") but the door has not been shut. According to the conclusions of the European summit in Versailles, "*on 28 February 2022, exercising the right of Ukraine to choose its own destiny, the President of Ukraine submitted the application of Ukraine to become a member of the European Union. The Council has acted swiftly and invited the Commission to submit its opinion on this application in accordance with the relevant provisions of the Treaties".* Even if the process would take years, the principle of EU membership is a central matter for the Ukrainian government which was re-stated last week: for Kyiv, staying out of NATO is acceptable, while voluntarily excluding the possibility to join the EU is not. In a way, this is what the conflict is fundamentally about from a Ukrainian's point of view: the right for the country to join a "club" to which it considers it already belongs culturally**.**

A snag – from the Russian point of view - is that the EU treaty contains a form of mutual security assistance clause (article 42.7) which states that : "*if a Member State is the victim of armed aggression on its territory, the other Member States shall have towards it an obligation of aid and assistance by all the means in their power, in accordance with Article 51 of the United Nations Charter. This shall not prejudice the specific character of the security and defence policy of certain Member States".* In the usual interpretation, article 42.7 would not force *military* action from the other member states. Each national authority would still decide what form of "aid and assistance" would be appropriate. Note however that this may be too subtle to Moscow's taste. After all, the NATO treaty in its article 5 does not guarantee automatic *military* assistance either (for a "third party" analysis of the EU's article 42.7 in contrast with the provisions of the North Atlantic Treaty, see here).

Finally, how a ceasefire/peace agreement would interact with the sanctions would be crucial for Russia. It's highly likely that Moscow would request the sanctions to be lifted in exchange for a ceasefire or a proper peace agreement. This might not be in the West's interest. Beyond the deterrence aspects – lifting the sanctions too quickly could encourage Russia to adopt an aggressive stance towards NATO or some of its neighbour immediately after the Ukrainian issue is "resolved" - now that Russia is forced to take another look at the real state of its military after a month of mediocre results in Ukraine, the EU and the US may not warm to the idea that the economic normalization allowed by a quick lift of the sanctions would provide the Russian government with the financial means to engage in further defence spending.

Our general point here is that a "proper deal" would be complex and involve many more parties than "just" Russia, Ukraine, and a go-between. This is thus likely to take time. In the meantime, Moscow is likely to try to push further on the ground to try to maximize its leverage in future negotiations. This in turn would lead to an even deeper humanitarian crisis, with more public opinion pressure on western governments for more sanctions. This would be consistent with further spikes in stress and hence with more episodes of market volatility, even if our baseline remains that European governments will not voluntarily turn the tap off Russian gas without a realistic plan – so far elusive - to minimize the ramifications for their overall energy security.

It’s starting to show: risks of inventory backlash rising

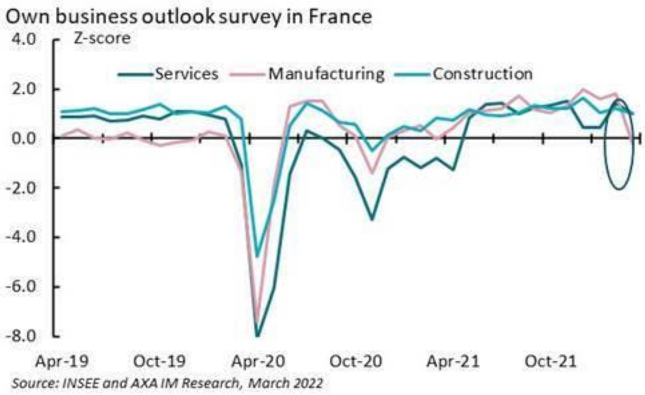
As of the end of last week energy prices were still significantly below assumed levels in the macroeconomic simulation, we discussed last week (resulting in a haircut to Euro area GDP by a very significant 1.8 percentage point). Still, **the dataflow is already reflecting a very significant deterioration in business and consumer confidence in Europe.**

The steep decline in the German Zentrum für Europäische Wirtschaftsforschung (ZEW) index last week was the first signal, with a drop in its “expectations” component from 54.3 in February to -39.3 in March. The ZEW survey is more a gauge of the financial investors’ mood rather a direct foray into the behaviour of the business sector as it collects the opinion of financial analysts. The downward revision in profits expectations in the most energy-sensitive sectors is impressive (see Exhibit 3). Yet what we are most interested in at this stage is the size of the immediate impact on the real economy. Institut National de la Statistique et des Etudes Economiques (INSEE) – which continues to produce a sterling job in assessing the state of the French economy in real time after its innovations on the onset of the pandemic – decided last week to publish the preliminary results of its March business and consumer surveys to offer a first glimpse of the real effect of the geopolitical crisis. **Unsurprisingly, the deterioration in the “personal production outlook” is more visible in manufacturing** (a 2 standard deviations move from February) than in services which at this stage seem to be unscathed, in a mirror image of what had been happening during the pandemic (see Exhibit 4).

The preliminary consumer survey suggests that the “preference for saving” remains very high, with a further decline in the “opportunity to spend” on big ticket items contrasting with a still historically elevated balance of opinion on the “opportunity to save”. This is for us a key area of risk for the growth trajectory into the middle of the year. Indeed, to offset the impact of the inflation spike on purchasing power (real wages have already fallen by 1.6%yoy in France in Q4 2021, although France is among the Euro member states with the slowest inflation), some spending of the saving overhang accumulated during the pandemic is needed. The stress related to the war in Ukraine may impair this process, which would then affect the services sector more.

Exhibit 3 – Sectoral dispersion

Exhibit 4 – French manufacturing correcting



Another potentially adverse development to monitor is the behaviour of inventories. The rebound in demand triggered by the reopening of the economy colliding with the persistence of supply-side constraints had triggered a “thirst for inventories”, businesses and distributors seeking to rebuild as thick buffers as possible. This inventory glut was starting to be satiated just when the shock of the Ukraine war came up. Judging again by the INSEE survey, in March inventories are now seen as too heavy in the wholesale sector relative to the long-term average (see Exhibit 5). This is exactly the kind of configuration which can trigger a significant “whiplash” effect on output.

Exhibit 5 – Inventories are starting to feel heavy

One can find comfort in the fact that even in manufacturing, business confidence is still in line with the pre-pandemic long-term average, i.e. not in recession territory, given the high starting point, while across all sectors hiring intentions are not yet affected. Note however that among the big member states of the Euro area France should be the least sensitive to the economic ramifications of the Ukraine war, with weak trade links with Russia and a higher capacity than Germany, Italy and Spain to mitigate the impact of higher wholesale energy prices on consumers' purchasing power. The specialization of the French economy (services and inwardly driven, and with a relatively small contribution from energy-intensive industries) should also help. The release of the "flash" PMIs for March this week for the Euro area as a whole and Germany in particular should provide a more accurate picture of the economic fallout from Ukraine, together with the Information and Forschung (IFO) survey on Friday. If we take ZEW as a harbinger of what is coming to Germany, we should brace ourselves for weak readings.

Fed on the warpath

In our view, the most important segment in the statement the Fed released last week upon hiking its policy rate by 25 basis points was this: *"the implications for the U.S. economy [of the war in Ukraine] are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity".* Faced with the combination of the lingering effect of the pandemic exogenous shock on costs and labour market-led second round effects, the Fed is unwilling to take risks and will focus on the potential additional impact of any contingent event – such as the Ukraine war – on inflation rather than on growth. Clearly, the Fed believes the acquired speed of the US economy is so high that it can easily withstand a significant monetary tightening. Quite simply, with the unemployment rate now below what the central bank believes is its natural level, some slowdown in the pace of job creation would be warranted without jeopardizing the Fed's full employment mandate. The Federal Open Market Committee (FOMC) is focusing on keeping inflation expectations in check and the rise in oil prices triggered by the Ukraine war is not helping in this respect.

While the immediate reaction of the market to the Fed's announcement was positive, most likely because some investors were still concerned the FOMC would open its salvo with a 50 basis points hike, everything else in the Fed's communication last week was on the hawkish side.

The acceleration in the projected pace of tightening is impressive relative to the December batch, with the median FOMC member forecasting the Fed Funds rate to hit 1.9% for end-2022 (+100 basis points relative to December), 2.8% for end-2023 (up 80bps) and end-2024 (up 30bps). On top of this new trajectory for policy rates, Powell confirmed that the Fed is inkling towards a fast pace of balance sheet contraction, stating that the Committee had made "*excellent progress*" in determining how the balance sheet would be unwound. He said that details would emerge in the upcoming minutes, but the process would be familiar from the last unwind – only sooner and faster. He also suggested that balance sheet unwind this year would likely equate to around one more Fed Funds rate hike.

The Fed will have to deal with the market's doubts on its capacity to deliver on its planned trajectory. Since Powell's press conference, inflation expectations have stabilized and so have real rates (see Exhibit 6), but we still find it striking that nominal 10 year yields remain slightly below the Fed's estimate of the long-term level of the Fed funds (even if the latter has been revised down from 2.5% to 2.4%). We are a bit worried the Fed is planning a too steep pace of tightening. Beyond the uncertainty created by the Ukraine war, we continue to focus on the likely fiscal stance for 2023. With political paralysis looming if the Republicans win the mid-terms, the combination of ambitious rate hikes, purchasing power erosion and a reversal of the fiscal stance could stop the US recovery in its tracks. This risk is clearly informing the bond market pricing. It's still unclear though if the equity market has fully woken up to his potential configuration.

Exhibit 6 – Expected inflation stabilised in the US…

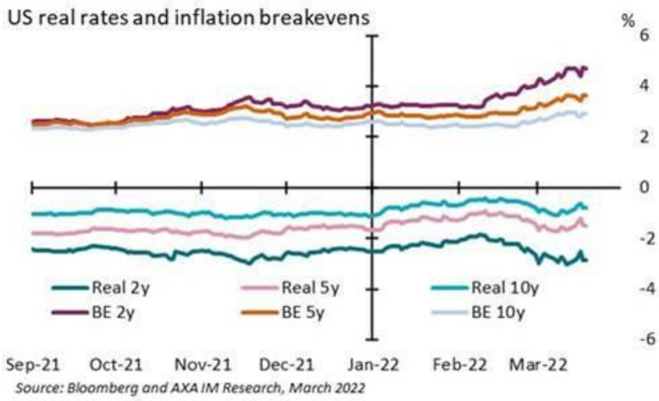
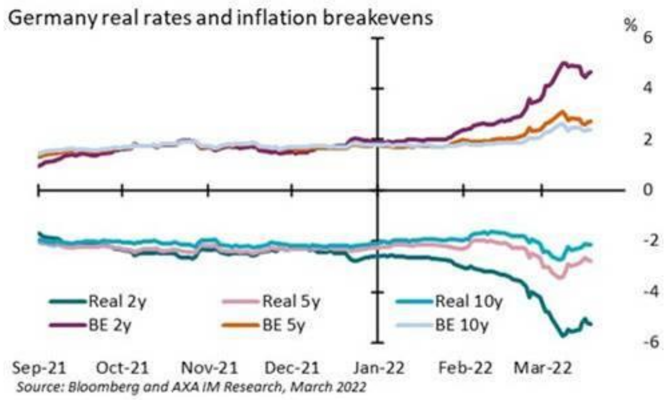


Exhibit 7 - …and fell in the Euro area



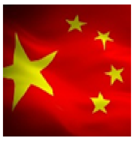
ECB in fine tuning mode

The impact of the European Central Bank (ECB)'s Governing Council meeting on the market has been significant: inflation expectations have receded, and real Bund yields have risen (see Exhibit 7). In her latest speech **though, Christine Lagarde has in our opinion sought to reassure investors**. The "direction of travel" – the normalization of monetary policy – is crystal clear but the President of the ECB insisted on the data-dependent and gradual aspects of the trajectory. We had been impressed by the fact that at the press conference she had not mentioned – even vaguely – the possibility to come up with a new Quantitative Easing (QE) program which could deal with fragmentation in case peripheral spreads were to rise too quickly. Conversely, we were reassured by this segment of her latest speech: "*exogenous shocks can affect economies asymmetrically. If this leads to financial fragmentation, the transmission of monetary policy can be disrupted. To reduce uncertainty under these conditions, the Governing Council has reiterated its commitment to flexibility (..) If necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalization, as we have shown on many occasions in the past".* As we have discussed before, the bar for this is probably high, but at least there is an openness there.

Christine Lagarde's more dovish tone may have been informed by the difficulty to mount a joint fiscal response to the crisis. At the national level, more support packages are being announced (e.g. in France the "resilience programme", out of which the "energy tariff shield" alone – protecting households and businesses from the rise in energy prices – will cost the government EUR 22bn). Yet, no additional resource has been found so far at the European level. For now, what's on offer is to repurpose the unused capacity of the Next Generation Pact. But it's mostly the "loan bucket" part of the package which still offers some room for manoeuvre, while the "transfer bucket" has been almost fully used. In the case of Italy, even the "loan bucket" has already been tapped, which leaves the country with no additional joint resources to deal with the additional shock – substantial in its case given its reliance on natural gas - of the Ukraine war.

The Eurogroup statement on the fiscal guidance for 2023 released on 14 March is a compromise – with little concrete outcome – between potentially contradictory objectives: *"we support the Commission's view that, on the basis of its Winter Forecast 2022, transitioning from an aggregate supportive fiscal stance in the euro area to a* *broadly neutral aggregate fiscal stance next year appears to be appropriate while standing ready to react to the evolving economic situation"*. In a similar fashion, the text duly notes that some countries will be hit more than others but also that highly indebted states should start a gradual adjustment to reduce their debt, *"if conditions allowed*".

It's early days, and we expect the gradual recognition of the depth and duration of the shock to unlock more creativity on debt mutualization, but as often, it may be more reactive than pre-emptive. Hard – and adverse – facts will be needed to sway some of the "frugals". The same probably applies to the ECB. Christine Lagarde's speech contrasted with the more hawkish tone of other ECB speakers at the "Watchers' conference". Lagarde acknowledged a high level of division within the council. This won't help making swift decisions.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC raised FFR +0.25% to 0.25-50%, first hike since 2018. Dot plot saw material rise in projected hikes. We expect 1.75% end this yr and 2.5% next • Retail sales (Feb), beyond headline control - 1.2%mom, but after +1.9ppt revision to Jan. • PPI inflation (Feb), headline stayed at 10.0%, but core dipped to 8.4% from 8.5% • Fed surveys (Mar) diverged, Empire sharp drop to -11.8 from 3.1, Philly rose to 27.4 from 16.0 • Business invents (Jan) +1.1%mom – solid again	• Durable goods orders (Feb, p) watch for softening investment • Michigan consumer sentiment (Mar, f) – watch inflation expectations • Weekly jobless claims • US new home sales (Feb) – higher mortgage rates weighing on activity • Manu and servs PMIS (Mar, p) – gauge impact of higher energy prices on activity
	• German ZEW fell abruptly in March, with largest drops recorded within manufacturing • Euro area final February headline inflation was slightly revised up (+0.1pp to 5.9%yoy, +0.8pp from Jan). Core inflation was unrevised at 2.7%yoy (+0.4pp from Jan)	• Euro area flash PMIs – France INSEE - surveys for March (Thur.) will be critical to assess the first economic impact of conflict. German IFO (Fri.), EA Mar flash cons. confidence (Wed.) • EU leaders summit on Thur -Fri. • Several ECB speakers including Lagarde, Panetta, Lane
	• BoE raised Bank Rate +0.25% to 0.75%, 8-1 (+ vs unch). Future hikes "might" follow (from "likely"). Expect May and June +0.25% hikes • Strong labour market report (Jan/Feb), payrolls +275k, unemp 3.9% and earnings rose to 4.8% (3m yoy)	• Spring Statement focus on cost of living squeeze - modest fiscal help likely. OBR economic and fiscal projections watched • CPI inflation (Feb) expected 5.9% - a 30y high • Retail sales (Feb) downside risk to consensus 0.8%mom expected gain • Flash PMIs
	• Status quo and dovish statement by the BoJ, which does not expect any normalisation soon • CPI (Feb) rose to +0.9%yoy, above consensus • Tankan indices (Mar) were mixed: Mfg (+8 from +6); Non-Mfg (-1 from 3)	• Flash PMIs (Mar) to assess the impact from conflict in Ukraine • CPI Tokyo (Mar) to assess upward pressure from rising energy prices and nationwide services producer price to gauge contagion
	• Official activity likely overstates economic strength at the start of the year. Policies to restore investor confidence gives markets a shot in the arm	• A reduction of LPR rates is possible despite the PBoC keeps MLF rates on hold
	• CB: Brazil hiked +100 bps to 11.75% & Taiwan +25 bps to 1.375%. Indonesia (3.5%), Russia (20%) & Turkey (14.0%) stood on hold • Feb CPI (yoy%) picked up in Romania (8.5%), India (6.1%) & Nigeria (15.7%). It moderated in Poland (8.5%) • Gustavo Petro (left wing) had a very strong showing in Colombia's presidential primaries	• CB: Mexico is expected to hike +50 bps to 6.50%, Hungary +100 bps to 4.40% & South Africa +25 bps to 4.25%. Philippines (2.0%) to stay on hold • Feb CPI (yoy%) to gain steam in Malaysia, Singapore & South Africa • Industrial production figures for Russia, Taiwan & Singapore

Upcoming events

US :	Wed: New home sales (Feb); Thu: Weekly jobless claims (19 Mar), Mfg & Services PMI (Mar,p); Fri: Michigan consumer sentiment (Mar), Pending home sales (Feb)
Euro Area:	Mon: Ge PPI (Feb); Wed: EU19 Consumer confidence (Mar,p); Thu: EU19 PMIs (Mar,p), Ge & Fr Mfg & Services PMI (Mar,p), Fr Insee Mfg confidence (Mar); Fri: M3 Money supply (Feb), Ge IfO business climate index (Mar), It ISTAT business & consumer confidence (Mar), Sp GDP (Q4)
UK:	Tue: PSNB (Feb), CBI Industrial trends survey (Mar); Wed: Inflation (Feb); Thu: PMIs (Mar,p), BoE's Financial Policy Summary, CBI Industrial Trends survey (Mar); Fri: GfK consumer confidence (Mar), Retail sales (Feb)
Japan:	Wed: Leading index (Jan); Thu: Mfg PMI (Mar,p)
China:	Mon: One-year loan prime rate

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