NATIXIS
CORPORATE AND INVESTMENT BANKING

Ukraine Crisis Impact

25 February 2022

- **The sharp escalation of the Ukraine crisis has reverberated across the markets**
- **The immediate impact has been felt on energy commodities**, which have priced in a significant geopolitical risk premium as the risk of disruption to Russian oil and natural gas flows grows.
- **We have upped our base case TTF forecast to €78.8/MWh and Brent to $89.8/bbl for 2022.** In our high case scenario with transit via Ukraine disrupted, TTF is expected to average €100/MWh with Brent at $106/bbl.
- The **rise in energy prices will have significant impact on the global economy. In Europe,** the negative income shock for households along with higher costs for companies are expected to shave 0.5% off our prior Euro Area growth forecast.
- **Emerging Markets impact differs between oil importers and exporters.** Poland, Hungary, Czech Republic and Turkey are particularly badly hit, given net energy importer status and exposure to the Russian economy. In Asia, although less direct exposure to Russia, India and the Philippines are most affected by higher commodity costs, while Indonesia and Malaysia more resilient.
- **What about Russia?** Surging revenue from oil and gas sales through 2021 has left Central Bank reserves in a healthy position, whilst Moscow has diversified away from dollar-denominated assets in recent years. We may see a pivot towards China, although not all trade with the west is substitutable. This is especially the case for natural gas exports.
- We also find **potential impacts on the metals markets and for European banks**.

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CROSS-EXPERTISE RESEARCH

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1. EDITO

Jean-François ROBIN

Global Head of CIB Research

The world woke up on Thursday February 24th to the news of the Russian invasion of Ukraine. Following the first move into the self- proclaimed independent republics of Luhansk and Donetsk in the Donbass region on Monday, Russia deployed a massive land military operation all over the Ukrainian territory at dawn. Although the ultimate Russian goal seems more and more clear – meaning the removal of the current government and the installation of a pro-Russian one - the situation remains highly uncertain. Where do we stand so far?

- The Russian invasion of Ukraine is ongoing. On February 24, Russian troops took control of the Chernobyl nuclear plant and a military air base only 25km away from the capital Kyiv.

- The ultimate Russian goal is still unclear, but it obviously goes beyond Donbass and Crimea. Most likely, the idea is to remove the current government and to install a pro-Russian one (like in Georgia or Belarus).

- Europe and the United States have and will enact stronger sanctions, but the big question is how effective they will be?

- That same day, US President Joe Biden unveiled a new round of “harsh” new sanctions on Russia targeting banks, exports and elites aiming at limiting Russia’s ability to refinance itself abroad through banks, markets, and sensitive technologies. US will forbid dealing Russian debt issued after the 1st of March and Russian Banks will be expelled from European capital markets for instance. Swift is off limits for now, although Nordstream 2 is stillborn.

- The China-Russia axis seems to be strengthening as China refuses to condemn the invasion.

- The macro effect will be mostly a stagflation one, with more “flation” than “stag”. We calculate in our baseline scenario “only” 0.5% of a negative impact on European growth. The bigger impact of this conflict will be on oil and gas prices. Our extreme scenario would be the one of significant disruptions of gas flows whose impact would go beyond price effect as some energy-intensive activity may shut down (chemical sector would be the most at risk). Were supply and/or production to be disrupted, food and fertilizers prices may also rise; Russia and Ukraine are the world’s top and fourth wheat exporters, and Russia is the world top ammonium fertilizer exporter.

- Some risks also on the metals side, with a very tight market already. Any cuts by Russia may hurt Western companies (aluminum, copper, palladium for automotive sector, titanium for aerospace). Russia is responsible for 40% of palladium and 30% of titanium output.

- Central Banks: we are comfortable with our current scenario. Forget about a 50bp from the Fed but 25bps remains a done deal. The ECB is going to keep it sequence but any rate hike seems very unlikely (as hiking rate in front of a commodity related inflation shock, during an ongoing war would be counterproductive). ECB 25bps in December remains our main scenario.

In this paper, we present the views of our experts on the possible impact this war would and will have across the global economy and markets.

2. Market impact

Florent POCHON, Emilie TETARD

Cross Asset Strategies

After a rather mild market reaction early this week following the recognition of the Ukrainian separatist republics by V. Putin and the announcement of a forthcoming intervention, the reaction was much stronger yesterday as Russia launched its military attack.

If the intervention in the Donbas region was no longer in doubt, the scale of Russian operations carried out in Ukraine suggests a worst-case scenario with an intervention across the entire country. Hence the market reaction was significant yesterday with a **classic flight to quality** with an "energy specialness". Most of the stress happened during the early European session and flight to quality weakened during the US session.

Chart 1: Cross-Asset moves (close on close)

		level	24-Feb	WTD
Safe Havens	Gold	**1903.89**	-0.3	0.3
	DXY	**97.14**	1.0	1.1
	CHF	**1.08**	-0.8	-0.4
	JPY	**0.01**	-0.4	-0.4
	UST 10y (var. bp)	**1.96**	-3	3
	Bund 10y (var. bp)	**0.17**	-6	-2
	UST 2y (var. bp)	**1.58**	-2	8
	Bund 2y (var. bp)	**-0.42**	-6	-13
Cdties	Brent	**99.1**	2.3	5.9
	Brent Prompt Spread (var.)	**3.7**	0.9	1.5
	Gas Netherland TTF	**114.5**	30.9	58.7
	Gold	**1903.9**	-0.3	0.3
	Palladium	**2418.8**	-2.4	2.9
	Nickel	**24716.0**	1.3	2.4
	Copper	**9864.0**	0.0	-0.9
Russian assets	RUB	**84.59**	-3.0	-8.1
	RUB Implied Vol 1M (var. pp)	**52.8**	47	99
	Russian Equities RTS I$	**742.91**	-38.3	-46.6
Monitor	Euro Stoxx 50	**3829**	-3.6	-6.0
	CAC	**6521**	-3.8	-5.9
	EUR/USD	**1.12**	-1.0	-1.1
	Banks Euro SX7E	**96**	-8.4	-11.6
	Banks US S&P500	**409**	-2.5	-4.8
	iTraxx Europe 5Y (var. bp)	**75**	3	4
	X-Over 5Y (var. bp)	**370**	18	24
	iTraxx Senior Financials (var. bp)	**84**	3	4
	EUR Implied Volatility 1M (var. pp)	**7.5**	0.5	0.3
	FX 1M Impl. Vol (var. pp)	**6.7**	0.4	0.1
	V2X (var. pp)	**38.1**	5	7
	VIX (var. pp)	**30.3**	-1	3
	VIX 1st vs 2nd Slope (var. pp)	**0.8**	0	0
B/E I nflation	B/E Inflation Germany 2Y (var. pp)	**3.61**	39	76
	B/E Inflation Germany 10Y (var. pp)	**2.10**	13	24
	B/E Inflation US 2Y (var. pp)	**4.04**	8	37
	B/E Inflation US 10Y (var. pp)	**2.58**	2	14
	TIPS 10Y (var. pp)	**-0.62**	-4	-11
	Germany real rate 10y (var. pp)	**-2.06**	-19	-26

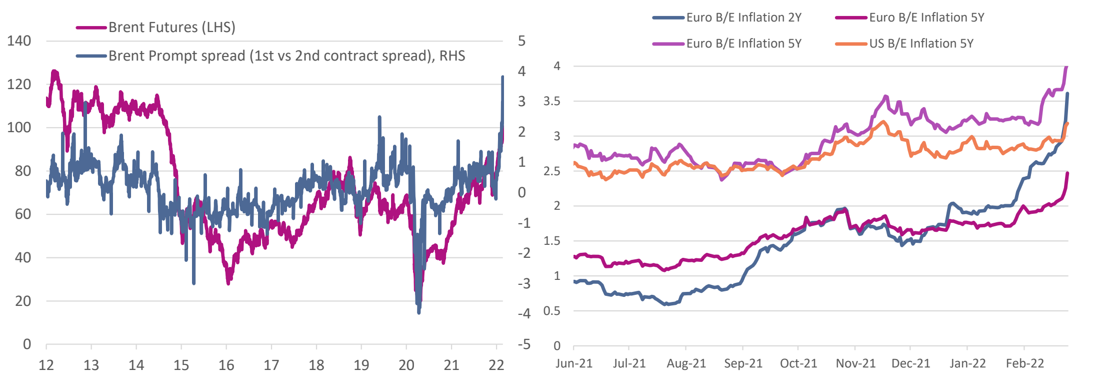
Sources : Bloomberg, NATIXIS

Safe havens. JPY and CHF initially gained but then retraced during the session. It was the same for gold almost back below 1900$/oz already. The US Treasuries curve initially shifted by around 9 bp, but the long end of the curve underperformed later in the session: the 10y T-Notes is down by 3 bp at 1.95%. 10Y Bund is down 6bp. The swap spreads also increased.

Inflation breakevens increased sharply (especially short-term ones) and real rates collapsed: the move was significantly stronger in Europe, as the 2Y German inflation break-even gained 40bp to 3.6%, the 10y B/E is up 13bps.

Stress in commodities increased. European gas jumped: TTF 50% yesterday up to 140 EUR/Mwh intraday. Crude oil price broke through the 100$/bbl for the first time since 2014: the Brent touched 105.79$/bbl yesterday, and the Brent Prompt spread is now up to near an all-time high (max was reached in June 2011). Agricultural commodities jumped, with an outperformance of wheat.

Chart 2 and 3 :Brent price jumps above 100$/bbl and Inflation breakeven increase strongly



Sources : Bloomberg, NATIXIS

Risky assets slumped: the SX5E was down as much as 5.5% yesterday intra-session and closed at -3.6%. European banks were the most penalized sector within the Eurostoxx. Names the most exposed to Russia/Ukraine underperforming sharply: the SX7E index dropped by 8.4%. Energy and mining outperformed. After opening sharply lower, the US indices rebounded gradually throughout the session yesterday to finish sharply higher at the close: The S&P500 was up 1.5%, and the NDX rebounded 3.35% yesterday. **Credit** suffered too, although the move in CDS indices were more a continuation of the upward trend. The Bitcoin Galaxy index rebounded **to +3.1% after an intraday maximum loss of -10%. Emerging debt indices (local and USD) dropped by 3% and** MSCI EM dropped by 4.3%.

Volatility jumped across the board. VStoxx jumped up to 42% intraday on Thursday. The **VIX curve** inverted sharply. The first-versus-third VIX futures spread has inverted and is trading at -3. While that's obviously a much smaller inversion than we saw at the height of the pandemic, most orthodox episodes of risk aversion over the past decade have seen inversions peak close to current levels. Longer-term volatility, while elevated, barely moved, suggesting investors are pricing a rather short-term knee jerk reaction.

Russian assets crashed with no surprise: MOEX was down 38% on the session yesterday and rebounded at the open today. The current drawdown from peak is -55% as compared to -37% during the Crimea crisis and -75% during the GFC. RUB touched an all-time low at 90, with a spillover effect on HUF, PLN, CZK. The Russian 5Y CDS spread exploded from 250 bp last week to 870 bp.

Impact on monetary repricing? Money Market curves now price a more gradual normalization path in the US and to a lesser extent, in Euro area. The probability of a 50bp hike in March has decreased. The first 25bp ECB hike is still priced in September for EUR OIS curve. Yesterday, ECB's Holzmann declared that Ukraine conflict may delay ECB's stimulus exit.

All in all, after the initial severe flight to quality yesterday morning, markets have already started to stabilize with the US markets showing the way. The road for risky assets will remain choppy though in our view (it was already our view before the war was declared) as beyond geopolitical shocks, the risks of a stagflation scenario has increased materially. The persistence of higher commodity prices should continue to weigh on inflation breakevens. The defensive play in equities will also persist and would probably penalize European markets more than the US, and sector dispersion will remain brisk.

3. What impact on European growth?

Dirk SCHUMACHER

Head of Europe Macro Research

There are several channels through which the Russian invasion of the Ukraine will impact the growth and inflation outlook for the euro area. The main growth impact will be felt through a further increase in energy prices that will translate into a negative income shock for households and higher costs for companies. Based on the new price scenario for gas and oil from our commodity experts, growth in the euro area could be 0.5% lower this year than we previously expected. This moderate decline also reflects our view that governments will extend their financial support further to offset the negative impact on income. Overall, euro area growth this year could be still around 3.5%.

Things would be different if gas supply would be significantly disrupted for some time. Given that many industrial sectors cannot easily substitute away from gas, this – together with a further price increase – would potentially tip the economy into recession.

The negative income effect: it will be crucial how governments will respond

Energy prices have gone through the roof in Europe over the last 12 months on the back of higher oil and gas prices. The energy component of producer prices was running at more than 70% by the end of last year (see Chart 1), while the energy component of consumer prices stood at 29% in January.

Consequently, the oil and gas import bill rose sharply for the euro area (see Chart 2).

Chart 1: Euro area energy prices (%, YoY)

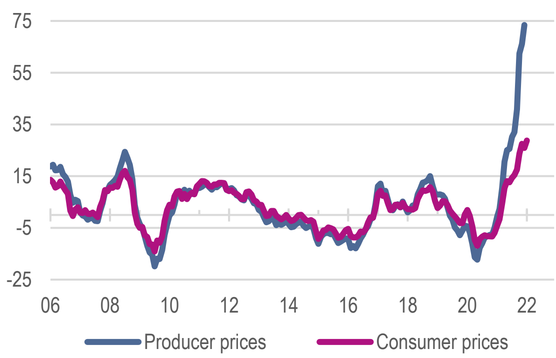


Chart 2: "Oil bill" – monthly imports (bn EUR)

Sources : Datastream, NATIXIS

Based on our forecast of continuing high energy prices, we were already expecting before the invasion that the energy bill for the euro area would increase further this year by around 1.5% of GDP compared to last year. These estimates assume broadly stable demand and should be seen as an upper limit. Demand is likely to decline, though it is difficult to say by how much.

Our new oil and gas price scenario now foresees a higher oil and gas price throughout this and next year than previously assumed. In our new baseline scenario, the gas prices will be close to €80 for this year and €53 for 2023. This would push the oil and gas bill for imports to €690 billion this year (all else equal) and around €527 billion for 2023 (see Chart 3). In terms of GDP, this would imply that the oil and gas bill would be now 0.5 percentage points higher than previously expected.

In an extreme scenario – with significant disruptions of gas flows - our commodity experts see the possibility of an average gas price of around €100 per €/MWh and an average oil price of $106/bbl for this year. This would push the oil and gas bill a full percentage point of GDP higher.

Chart 3 : Euro area Oil and Gas bill (bn EUR)

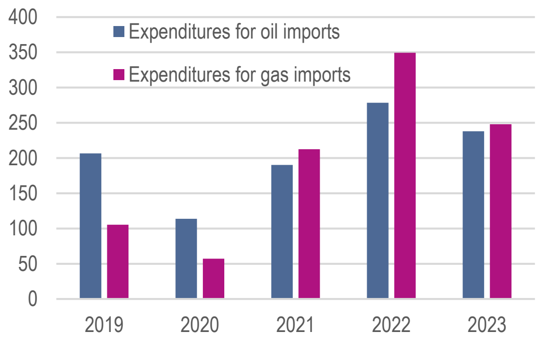
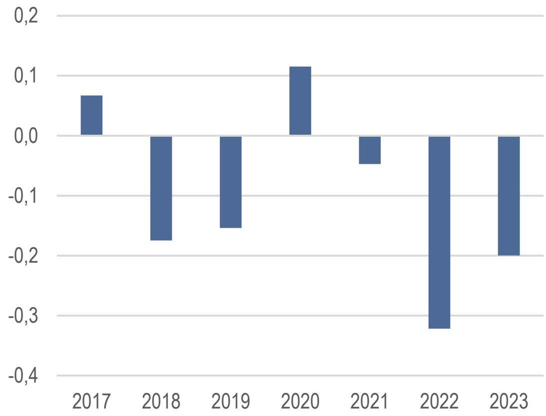


Chart 4: Growth impact from oil price changes (as %)



Sources: Natixis, Datastream

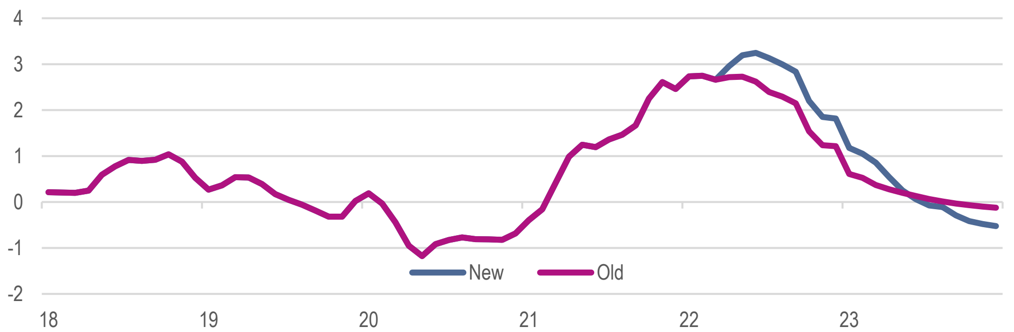
Based on past correlations the rise in expected path for the oil price alone would reduce growth by around 0.3 percentage points this year (see **Chart 4**). These elasticities, however, may underestimate the impact. This is because a high oil price in the past usually coincided with strong global growth, offsetting some of the negative impact from high oil prices. This is different now as the high oil price is triggered by geopolitical tensions and not strong demand.

That said, a positive off-setting factor to consider is financial help provided by European governments. Many governments have support programs in place that are partially shielding households and companies from the negative impact. It is difficult to quantify all the different measures put in place. But in France alone, the support is estimated to be at least €8 billion. The oil import bill for France stood roughly around €16 billion last year, showing that these figures are significant. Taking all this into account, our best guess is that the growth impact of the higher gas and oil price relative our previous baseline scenario is around 0.5% of GDP. While we are still in the process of "fine-tuning" our growth forecast this could imply that euro area growth could be still around 3.5% this year.

Inflation to be pushed higher by half a percentage point

The new path for the oil and gas price will also push euro area inflation higher. The contribution of the energy component to inflation this year will be around 2.7 percentage points compared to 2.2 pct points in our previous scenario (see **Chart 5**). This is abstracting from any additional second round effects triggered by the higher energy prices. Euro area inflation would come in at 4.2% this year and 1.9% this year in this new baseline scenario. Owing to potential additional second round effects, the risks to this forecast are clearly to the upside.

Chart 5 : Euro area - Contribution of the energy component to headline inflation (percentage points)



Sources: Natixis, Datastream

A significant reduction of gas flows would put the recovery at risk

The further increase in energy prices will dent growth in the euro area but not push by itself the economy into recession, especially if governments were to extent their financial support measures.

The situation, however, would look differently if gas flows from Russia would be reduced significantly. Given that some sectors and companies cannot easily substitute away in the short-run from using gas and outright rationing of gas would likely lead to production decline in energy intensive sectors. Thus, the negative growth impact would go beyond the price effect as an important input in the production process would be missing. As **Chart 6** shows, the chemical sector would be one area that would be at risk from an outright rationing of gas supplies.

Chart 6 : Euro Area - energy use of gas per industrial sector (% of total industrial, 2019)

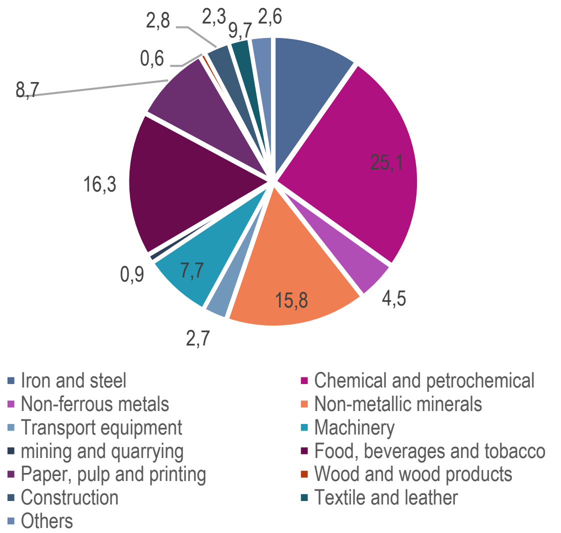
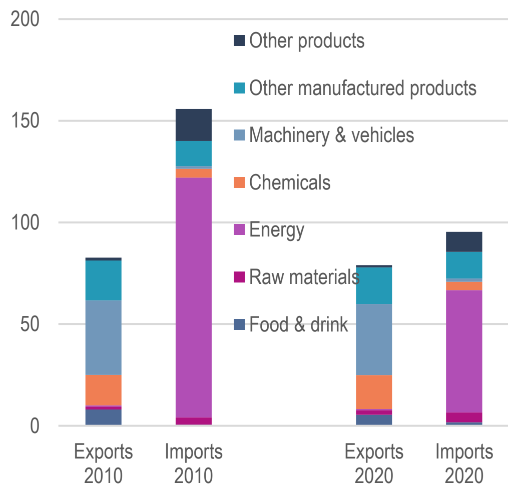


Chart 7:EU trade with Russia (bn EUR)



Sources: Natixis, Datastream

Trade shock to be small

Although the exact scope of the sanctions that will be imposed is unclear at this stage, there can be little doubt that trade in goods between the euro area and Russia will be adversely affected, potentially in a very significant way. But the volume of euro area exports to Russia is rather small and by itself not big enough to make a significant dent into growth.

A negative confidence shock

The final channel though which the euro area economy will be adversely affected is a confidence shock. The fact that the world now looks a lot more uncertain, could make households and companies hesitant to spend and invest. It is not possible to know ex ante how big this effect will be. Next month’s business survey will provide a first indication on now relevant this channel is.

4. Energy prices enter the “Putin Zone” – European Natural Gas and Oil Price Outlook

JOEL HANCOCK

Oil&Gas Analyst

The full-scale Russian invasion of Ukraine has significant consequences for the global energy markets, even in a “no export disruption” scenario. In the immediate term, the energy price implications of a full or partial shut-off of Russian oil and natural flows has focussed attention. But on a longer-term basis, European involvement with Russia’s energy economy will step back (with the Nord Stream 2 pipeline currently dead in the water), with significant implications for global energy markets.

The most extreme commodity market risk centres on natural gas, for several reasons. First, in a worst-case scenario whereby Russia weaponizes exports, **natural gas is a cheaper tool than oil from a Russian budgetary perspective**. In the Jan-Nov 21 period, production and export taxes on oil and condensate provided ~30% of Russia’s federal budget revenues, compared to ~6% for natural gas. Second, from a broader market perspective, natural gas is a highly “localised” market with A to B pipelines delivering gas from producer to consumer, meaning precise economic damage could be delivered to Western Europe. This compares to a globally traded oil market, where higher oil prices would impact all consuming nations, including China. Finally, Russia’s natural gas exports to Europe cannot readily be replaced, making weaponization more potent.

We see several scenarios for energy flows going forward. The first, and our base case, is business as usual. Whilst a significant Western sanctions package will target several key segments of the Russian economy, **the mutual interdependence of the Russian-Western energy trade makes targeting this area unlikely**, at least initially. Any disruption of flows would harm consumers significantly as oil and natural gas benchmarks priced for demand destruction. From the Russian side, being considered a “reliable” producer of oil and natural gas is key to the long-term value maximisation of Russian energy resources, so weaponization is not in the base case.

The next set of scenarios consider the disruption of Russian energy flows. The most likely scenario here is transit via Ukraine being disrupted, perhaps due to military action damaging infrastructure, or if transit operators consider maintaining flows as unsafe. In this case, Europe would lose 109.6mcm/d of gas transit capacity and the Southern leg of the Druzhba oil pipeline system (0.23mn b/d of the total 1.0mn b/d system), which transits Ukraine. Our modelling implies Europe could manage without these volumes, although the price implications would be significant. A full-scale disruption of Russian energy flows could be triggered by Western sanctions (like US sanctions on Iranian oil exports) or strategic Russian export halts – either scenario would result in energy shortages and parabolic energy prices searching for marginal demand destruction, with significant implications for the global economy.

High natural gas prices are here to stay

Front month TTF opened on Thursday morning 33% higher, at €117/MWh. Notably, longer-dated contracts also rallied sharply (Cal23 up 20% to €76/MWh, Cal24 up 12% to €48/MWh) as traders re-rated lower expectations for incremental (above long-term contracted) Russian flows. The move across the longer dated curve implies gas price fall-out from the Russian escalation is now expected to be felt for several years. This is a point that we have been arguing in several reports [1], [2], [3], based on our view that Russia would not send incremental spot supply to Europe, even with Nord Stream 2 operational. Now Nord Stream 2 is effectively dead in the water, there is very little incentive for Russia to send spot supply to Europe – the market will therefore remain tight and prices high beyond 2023.

Chart 1: TTF Cal23, €/MWh

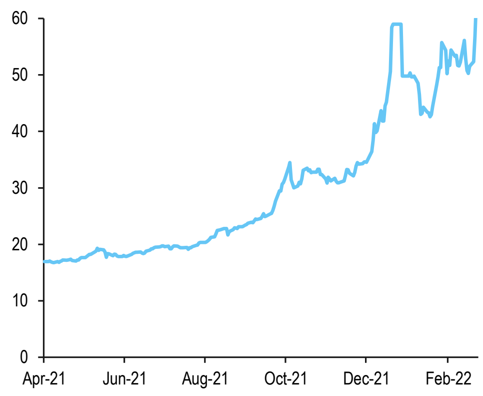
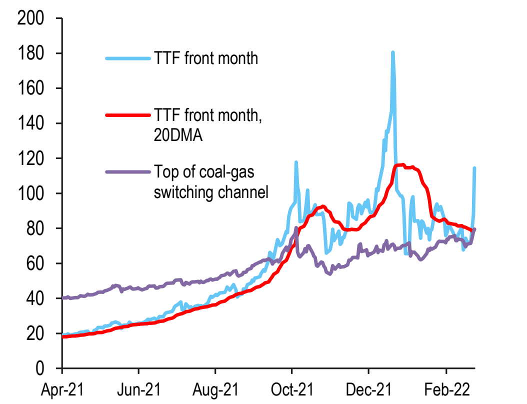


Chart 2: TTF vs upper bound of fuel switch range, €/MWh



Sources : NATIXIS, Bloomberg

Europe has been facing a gas crisis irrespective of potential Russian transit disruption

Beyond the sharp increase in geopolitical risk associated with Russian gas transit, the European gas market has been characterised by a persistent inability to rebalance since the summer of 2021. Both the supply and demand sides of the market have been impacted by inflexibility, with a tightening global gas market and growing import dependency (as indigenous production declines) resulting in significant upside price pressure. Gazprom's exit from the spot market, resulting in Russian gas exports being held at long-term contracted levels, has exacerbated the situation. As such, TTF has been forced to price for demand destruction. Front month prices have remained largely "unanchored", trending far above the upper bound of the coal-gas switching channel as the market has searched for more expensive forms of demand destruction in the industrial segment. TTF has also been forced to compete for spot LNG flows with Asian buyers.

Whilst weak Asian LNG demand through January propelled European LNG imports higher, the re-emergence of Asian spot demand in recent weeks has seen imports fall back. Whilst the surge in LNG imports and weak demand (helped in part by mild weather), has allowed gas inventories to recover somewhat in recent weeks, the market is still finely balanced. **The emerging risk to Russian gas transit has thus come at an inopportune time**, partly explaining the extremely sharp price impact at the front of the curve.

Chart 3: NW Europe gas demand, mcm/d

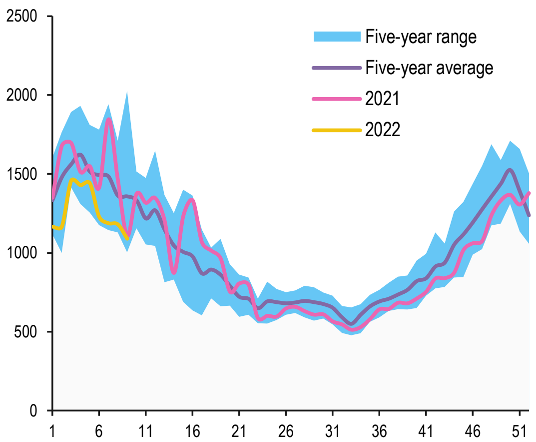
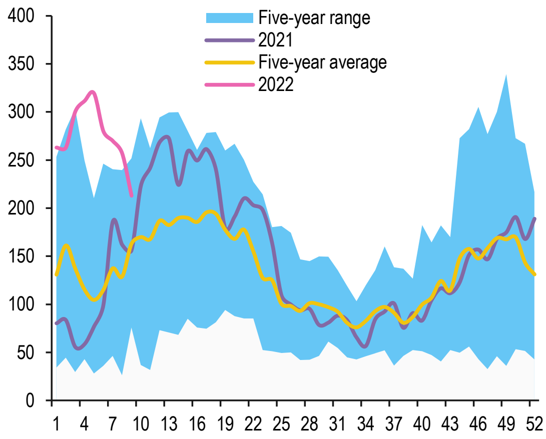


Chart 4: NW Europe LNG imports, mcm/d



Sources : NATIXIS, Bloomberg

Gas market logistics mean Europe is stuck with a Russia problem

How reliant is Europe on Russian gas? Europe and Russia are tightly intertwined in the gas trade, with a long history spanning decades. Russian flows to NW Europe averaged 9.5bcm / month (or 30% of total supply) in the 2017-2019 period. This dropped to 7.6bcm / month, or 25% in 2021. Irrespective of the wider trend in aggregate Russian flows to Europe, the share of Russian gas transiting Ukraine has dropped in recent years as Gazprom has developed other export routes. Looking top-down, natural gas remains a highly localised commodity with significant infrastructure requirements for transit – essentially resulting in buyer – seller relationships being locked in place for decades. As such, diversification of supply sources is challenging. From the Russian perspective, whilst taxes on natural gas production and export provide meaningful government revenues to the federal budget, oil and condensate exports provide far more (6% vs 30% in Jan-Nov21). As such, we can say the natural gas relationship is somewhat one sided.

Chart 5: Russian gas flow to NW Europe, mcm/d

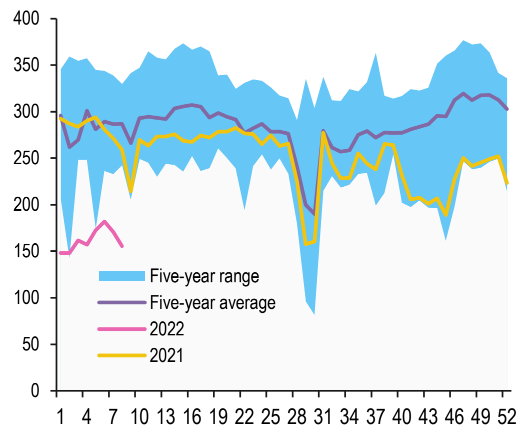
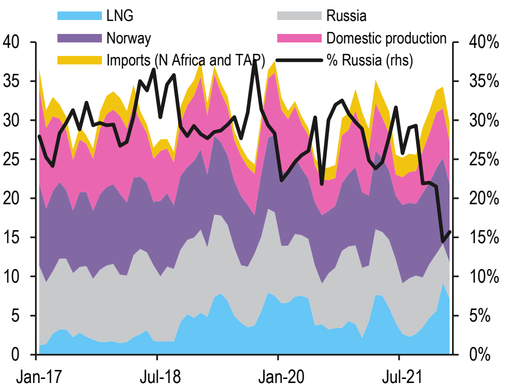


Chart 6: NW Europe supply stack, bcm



Sources : NATIXIS, Bloomberg

What happens to Europe if gas flows are curtailed?

In **WHAT IF RUSSIA SHUTS OFF GAS EXPORTS TO EUROPE**, we modelled the loss of Ukrainian transit of 113mcm/d (the 2021 average flow level) for the remainder of winter. This level represented 11.6% of the total average supply of 973mcm/d through 2021 (although through 2022 to date, Ukrainian flows have averaged just 62mcm/d, or 5.5% of the total gas supply of 1110mcm/d). Taking the 2021 average as the potential loss, the impact of these volumes becoming unavailable will depend on several factors, including:

- When any outage occurs, given the seasonality of gas consumption.
- Whether Gazprom would reroute flows via Yamal (via Poland), given spare capacity on the route.
- The availability of flexibility in other supply sources, most notably spot LNG.

Our modelling implied North Western Europe could manage losing Ukrainian transit outage by leaning on stocks heavily, attracting more LNG and curtailing demand. Still, this would leave prices significantly higher, resulting in a struggle to rebuild inventory over summer for the next winter. A full curtailment of Russian flow would be impossible to manage, given logistical constraints on both the LNG import infrastructure side and the limited availability of spot cargos.

Chart 7: European gas inventory scenarios, bcm

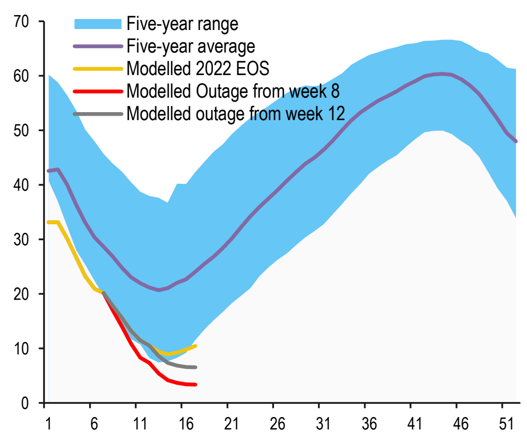
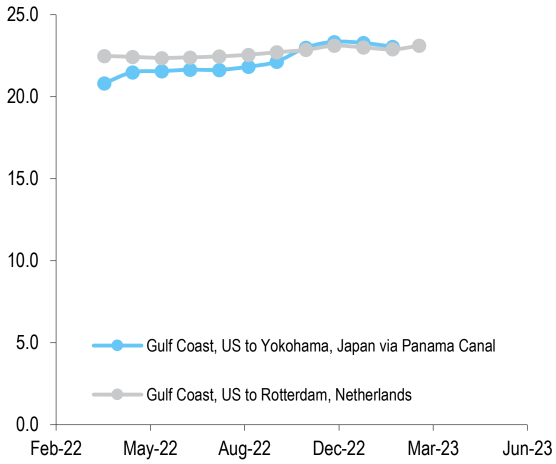


Chart 8: Forward USGC export arb, $/MMBtu (24th Feb)



Sources : NATIXIS, Bloomberg

Even if there is no outage, the natural gas relationship between Russia and Europe is likely to be strained. We consider the Nord Stream 2 pipeline to be off the table, for now. As such, Russian gas flows are likely to be maintained at long-term contracted volumes (with Gazprom able to revenue maximise by keeping hub prices high, rather than pursue a volume-based strategy by returning to the spot market). With European buyers highly unlikely to be willing to sign up to new long-term contracts, Russian gas sales will remain significantly lower than the 2017-2019 period for several years. This will keep European gas prices significantly higher than previous ten-year average levels for as long as Gazprom has market power (which we estimate will be until new LNG projects are operational around 2025).

Implications for European gas price formation

The European gas market must now incorporate a geopolitical risk premium, alongside pricing the existing fundamental tightness. Whilst we have maintained that European gas prices were required to price for marginal demand destruction into 2023 in order to balance the market, **we have increased our base case (no disruption) forecast to €79/MWh, from €71/MWh. In a scenario where Ukrainian transit is disrupted until the end of winter, we expect prices to average €100/MWh**. In this scenario, the market would need to completely curtail industrial demand. This scenario would also bias prices higher than currently priced in by the forward curve. The natural gas balance in any given season is largely a derivative of the previous two seasons. As such, the drawdown used to mitigate loss of transit alongside struggle to rebuild gas stocks over summer would see tighter market for longer. Even in our base case scenario, we still consider the longer-dated curve undervalued.

Chart 9: TTF, base case scenario (€/MWh)

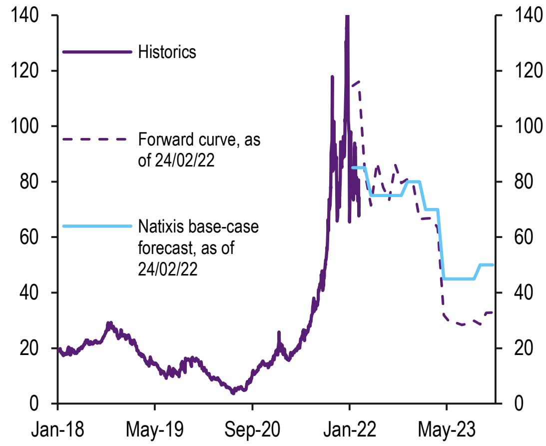
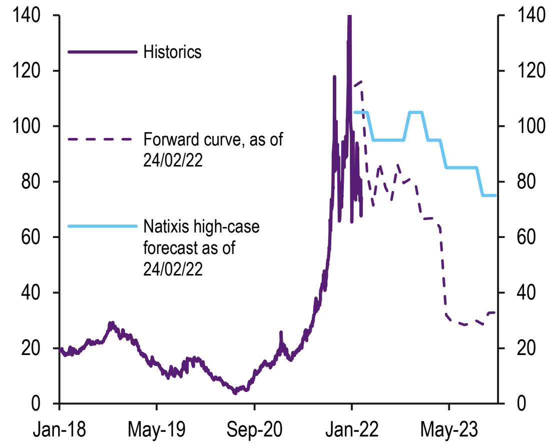


Chart 10: TTF, high-case scenario (€/MWh)



Cold commercial logic prevailing for now

If business as usual prevails, we should see a relatively sharp increase in Russian gas flows to Europe in the coming weeks due to the contractual nuances of pricing under Russian long-term contracts. Long-term contracts are priced off the closing M+1 index for the delivery month, which for February is around €86/MWh. With spot prices breaching this barrier in intraday trading on Thursday and now trading well above €100/MWh, export nominations for Russian gas flows have increased. Reports suggest Ukrainian transit nominations have increased from 35 mcm/d (23/02) to 58 mcm/d (24/02) and 78 mcm/d for (25/02). For now, the gas is still flowing despite Russian *boots on the ground.* **This also highlights the fact the current spike in spot prices is purely precautionary** – prices are rising despite the prospect for higher supply in the coming days and weeks. Whilst some geopolitical premium will be embedded into the curve for as long as the Ukraine crisis continues, prices could come off sharply if the risk of gas transit disruption is re-rated lower.

Geopolitical risk and "supply anxiety" will continue to support oil prices, although the market is not immune to a macro slowdown

Geopolitical risk and a broad consensus view of an upcoming supply shortage are a potent cocktail, with the sharp escalation in the Ukraine crises finally pushing Brent back above $100/bbl on 24th Feb. Our base case expectation is for no supply disruption, although the risk of escalation (via physical damage to infrastructure or exports shut off by either sanctions or Russian policy) will likely support prices across the curve. Ultimately, the oil market has more buffers in the immediate term than the gas market, with some OPEC+ members still holding spare capacity (mainly Saudi and the UAE) and Iran likely to return to the market following positive developments in nuclear deal negotiations with the US. If oil prices are forced to price for demand destruction on a supply outage, history suggests Brent would need to hit an annual average of $117/bbl for the "oil burden" to reach 2011-2013 levels, the last time Brent traded consistently above $100/bbl. This time around, oil prices would be spiking into a slowing global economy (as opposed the previous price spike fuelled by Chinese economic growth), so the ability to bear higher oil prices may be diminished.

Oil market's supply anxiety exacerbating geopolitical premium

As with natural gas, the oil market has incorporated a significant risk premium following the significant escalation in the Ukraine crisis. Indeed, it has been difficult to hold a short-term directional view on oil prices for some time as geopolitical risk has become more influential in price formation, driving significant volatility in the front of the market and across the curve. Oil market volatility has trended above equity market volatility over the past few weeks, despite the equity market itself exhibiting significant volatility given the Fed's hawkish pivot.

Chart 11: Oil vol minus equity vol)

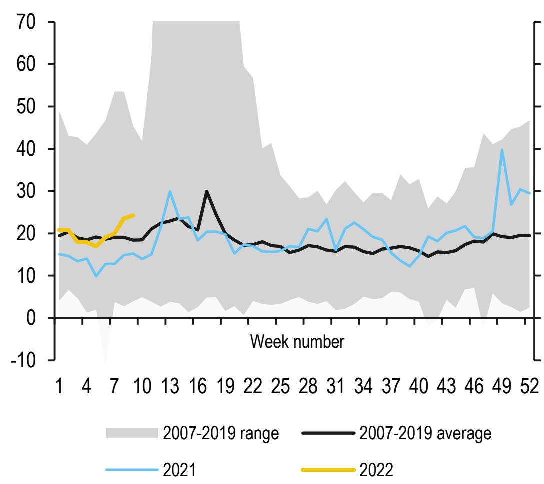
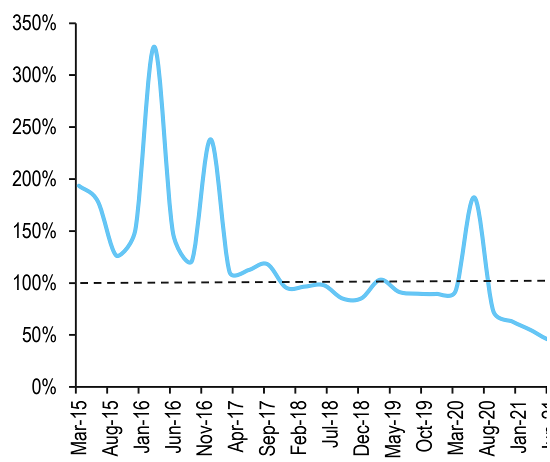


Chart 12: Tight oil reinvestment rates [CAPEX / OCF] %



Sources : NATIXIS, Bloomberg

The re-emergence of geopolitical risk as a major factor in oil price formation reflects the oil market's "supply anxiety" regime. As discussed in [1], [2] this based on view of supply inadequacy, namely that:

- The global oil market has underspent significantly in recent years, with CAPEX insufficient to meet demand growth.
- Short cycle US shale is constrained by investor pressure to maintain profitability over volume growth, biasing reinvestment rates structurally lower (chart 12).
- OPEC spare capacity is overstated and unable to offset weak non-OPEC supply.
- Demand growth remaining robust as the global economy continues to rebound from the impact of the COVID-19 pandemic

The oil market has more buffers than the European natural gas market

We maintain as a base case that flows of crude / condensate would not be impacted by i) Western sanctions ii) a move by Putin to limit exports. As with our analysis of impact on gas flows, in any "outage" scenario, we assume that only flows through Ukraine would be impacted in the immediate term. Around half of Russia's 6.5mn b/d of crude and product exports are directed towards Europe, in turn representing around a quarter of Europe's total imports. In 2019, Russia represented 26.9% of EU crude imports. We assume that only Russian exports that transit Ukraine would be at immediate risk initially – the Southern leg of the Druzhba pipeline system (0.23mn b/d of the total 1.0mn b/d system) transits Ukraine, although there was no impact to flows when Russia annexed Crimea.

We do not expect energy flows to the target of Western sanctions nor for Putin to weaponize exports. However, reports on 24th Feb suggested several offtakers of Russia's Urals grade crude have turned down loadings given issues procuring letters of credit and insurance for cargos. Indeed, several banks have reportedly refused to provide these documents. If this is the case, Russian crude may de facto be under sanction, even if international level sanctions remain off the table. This would likely result in shifts in physical differentials, rather than flat price – Russian Urals would need to continue to discount to clear into Asia (with some reports suggests offers as low as -$10/bbl to Dated Brent), whilst Western buyers would bid-up alternative medium-sour grades to substitute for Urals.

Chart 13: Urals crude differential to Dated Brent, $/bbl

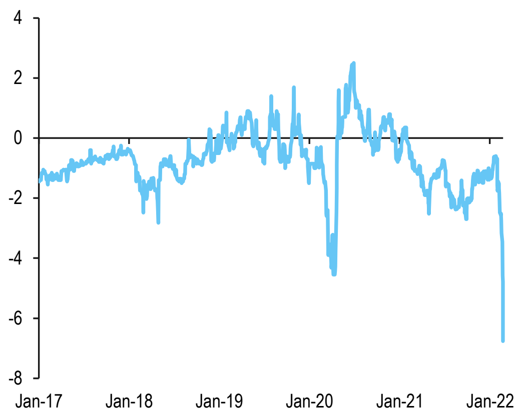
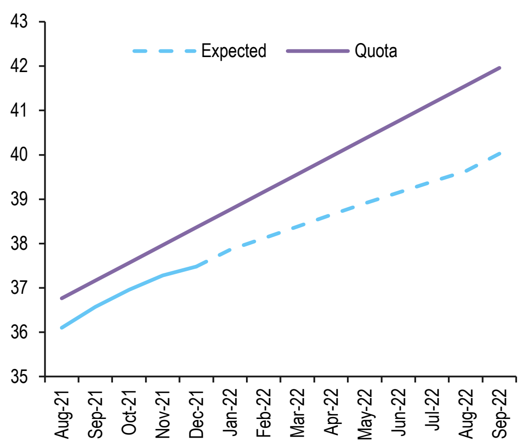


Chart 14: Expected OPEC production trend, mn b/d



Sources : NATIXIS, Bloomberg, OPEC

In the event of an outage that actually reduced supply rather than reshuffled physical cargos, the oil market has more buffers than the natural gas market. Moreover, incremental demand growth (on a month-on-month basis) is relatively tepid at present, with most increase expected over summer as long-haul aviation drives a significant surge in jet demand growth with COVID-19 restrictions eased in the majority of Western countries. Whilst OPEC+ spare capacity does seem constrained over the full lifecycle of the OPEC+ deal (ending in Sep-22), as of right now, several members still hold significant spare capacity – both as part of the deal, and outside of it (namely Saudi Arabia and the UAE). In the event of an oil supply outage, we would expect this excess supply to be tapped. However, for as long as supply outage remains a "risk" and not a reality, we expect OPEC+ to hold off from departing from 0.4mn b/d schedule. Key ministers have re-iterated that the current rise in oil prices is not "fundamental" in nature and thus largely out of OPEC+'s remit. As such, we do not expect any announcement regarding the release of additional barrels to be made at the group's next meeting on 2nd March. The coordinated release of global strategic petroleum reserves is another potential response, although most countries would only tap their SPR in the event of an actual outage, in a similar fashion to OPEC+. An SPR release is designed to counteract a short-term supply shock, rather than a consistent flow deficit, so would be of limited use in the event of a prolonged outage. Moreover, there is some indication that the US may have reached SPR release limits as part of barrels released during the November SPR release, with limited further ability to act.

In our view, the most meaningful "response" would be a return of Iranian barrels to global oil markets following a renegotiated JCPOA (Iran nuclear deal). Progress in negotiations has accelerated in recent weeks with all indications suggesting that negotiations are reaching an end game. We have long argued that returning to Iran nuclear deal remains a key inflation fighting policy of the Biden administration, which will be more laser focussed now given the move above $100/bbl Brent. Iran has been preparing for the easing of sanctions, reportedly loading a significant volume of crude (103mn bbl) ready to export as soon as sanctions on export are eased, whilst we estimate production can also be ramped up by ~1.2mn b/d over a six-month period once sanctions are eased. The timing of barrels hitting the market would be dependent on the confidence of buyers returning to the Iranian crude trade, although the Biden administration could speed the process by reassuring shipping and insurance providers.

What does demand destruction look like for the oil market, and does origin of the oil price shock matter?

In the event of sustained outage that was not fully offset by some combination of the return of Iranian barrels, an SPR release or OPEC+ spare capacity, it is likely that the oil market, like the gas market, would need to price for demand destruction. But what does that look like in the oil market? Oil consumption in notoriously inelastic to price in the short run, meaning large price moves are required to free up a small volume of demand. As a rough guide to the price level the global economy can bear, we have calculated the share of GDP "eaten" by the cost of oil imports (or *oil burden*) in several price regimes. The 20-year average share is 3%, whilst over the 2011-2013 period, with Brent trading above $100/bbl (nominal) consistently, the share averaged 4.7%. For the oil burden to reach this level in 2022, Brent would need to average $117/bbl. However, oil price strength in 2011-2014 was supported by a surge in Chinese crude demand, with increasing fuel prices in marginal demand centres offset by positive income effects. Indeed, in some calculations China implied as having a positive price elasticity for oil demand through this period.

Chart 15: Oil burden, global economy

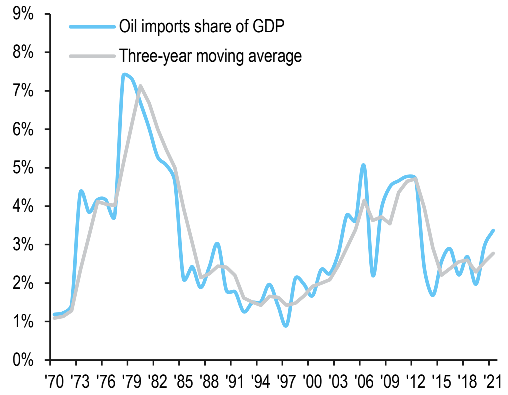
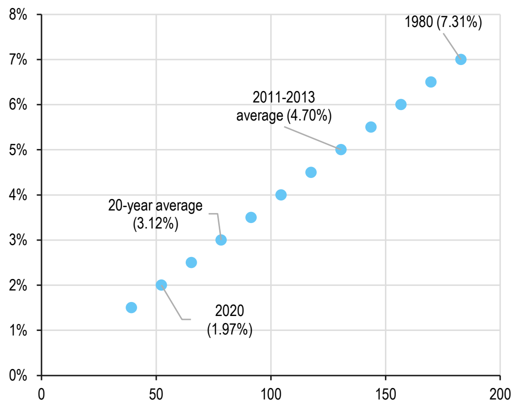


Chart 16: Implied '22 oil price at various oil burdens applied to forecast '22 GDP



Sources : NATIXIS, Bloomberg

The current oil price shock has a very different driver, largely being driven by precautionary demand in anticipation of a supply shortage and is associated with a slowing global economy, with disposable incomes shrinking. As such, the global economy's capacity to bear higher oil prices may be diminished.

Fair value for oil prices increasingly difficult to ascertain as fundamentals take a back seat

We consider oil prices to have overshot in the immediate aftermath of the invasion, given our view that there will be no significant disruption to flows. Whilst some Western buyers will be unable to take Russian cargos, the physical market should be deep and liquid enough to allow reshuffling of flows, even if physical differentials need to do the work to make this happen. As such, we consider the current oil price as overvalued. That being said, the risk of disruption, be it accidental, sanctions-led or as part of the "weaponization" of exports will keep oil prices well bid – as such, we expect Brent to be well supported in the $90s/bbl through H1-22. Prices are expected to ease in the second half of 2022 (largely following our thesis laid out **here)** as rising US shale production, returning Iranian crude and a slowdown of demand growth weigh on balances. **In this outlook, Brent averages $89.6/bbl (up from previous forecast at $83/bbl)**. In a scenario where Russian flows are disrupted, we expect prices to move significantly higher than this forecast to induce supply and demand responses (additional OPEC supply, SPR and demand destruction at the margin) – as such **we have Q2 peak at $117/bbl in this scenario, with average at $106/bbl**. Oil prices trend sharply lower from Q4-22 and into 2023 in this forecast given the dire macro implications of this high case forecast.

Chart 17: Brent base case forecast, $/bbl

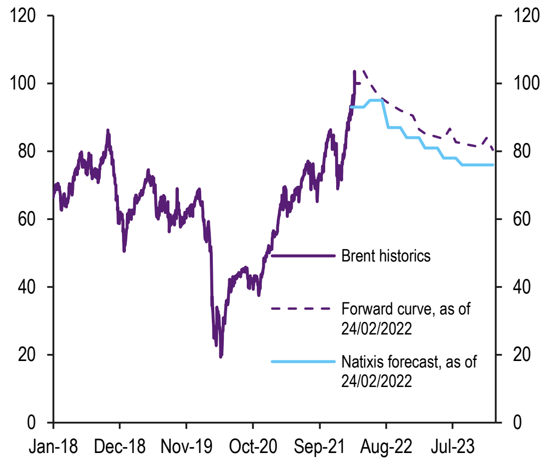
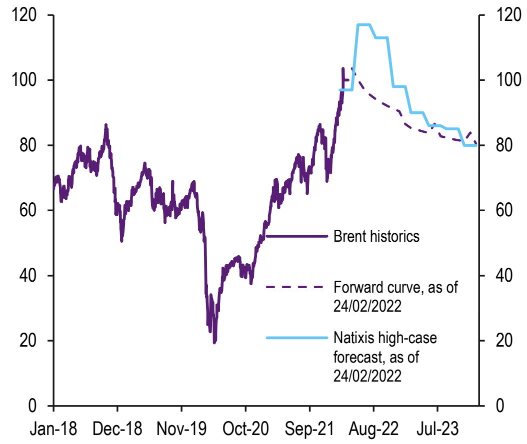


Chart 18: Brent high-case forecast, $/bbl



Sources : NATIXIS, Bloomberg

5. Russia: economic outlook

LYSU PAEZ-CORTEZ

Senior EMEA Economist

Limited impact of additional sanctions amidst rising geopolitical and economic uncertainty

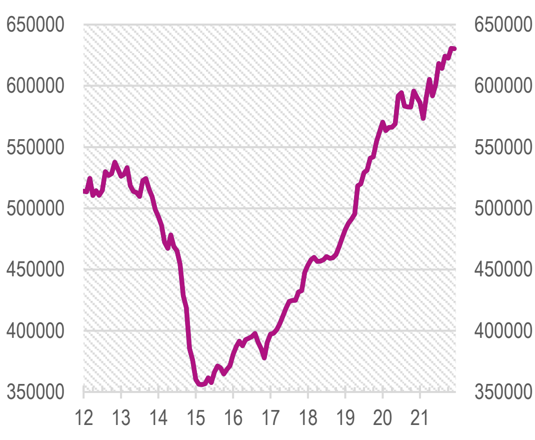
Moscow has been long preparing for military action in Ukraine

Vladimir Putin has carefully chosen the timing for this military action as a moment when the Russian economy seems robust enough to withstand the impact of a new round of Western sanctions. New sanctions may particularly hurt the Russian financial system and its banking sector which has proved resilient during the pandemic. But thanks to the large international revenues from oil and gas exports in 2021, Russia's central bank's international reserves are at their highest since 2013 (see Chart 1), a non-negligible buffer. Also, prospects for sustained elevated energy prices throughout the year (our base case scenario is for Brent to average $89.6/bbl this year and $77.8/bbl in 2023, with risks oriented in the upside), would translate into higher oil and gas export revenues that should remain strong as the Russian economy has continued its diversification towards the east and with its key trade partner China.

A successful diversification from US assets

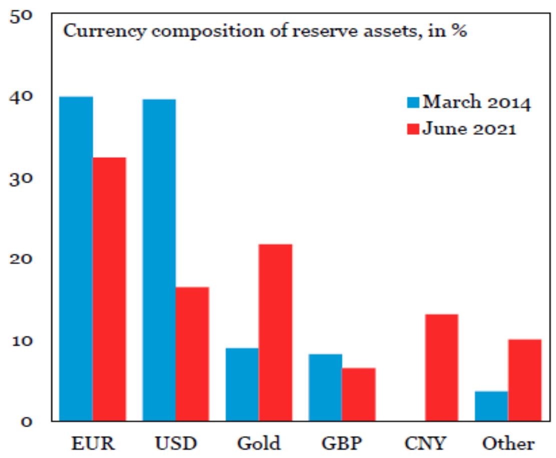
Russia (CBR) on the monetary policy front, the implementation of inflation targeting by the Russian central bank (CBR) and a shift in the currency composition of its official reserves, has resulted in a lower dollarization of the Russian economy. As we can in see in chart 2, between 2014 and 2021, the CBR reduced its share of reserves in dollars and euros, compensated by a substantial rise in holdings of gold and Renminbi, that currently account for respectively 20% and 13% of the total. However, exposure to EUR remains high with assets above 30%. It has also massively reduced its holdings of US Treasuries (Chart 3).

Chart 1. Russia: CBR international reserves (million USD)



Sources: Natixis, Datastream

Chart 2. Russian reserves composition has changed, drop in USD and a higher share of gold and CNY

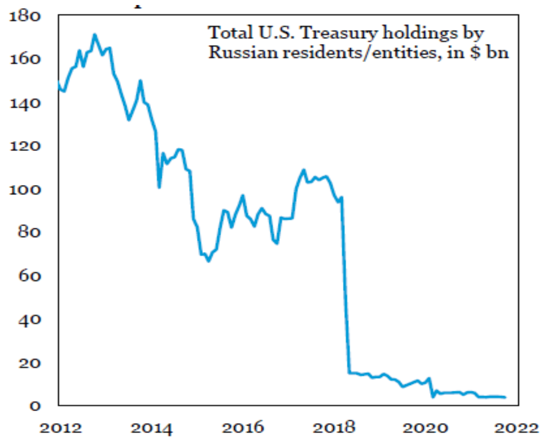


Sources: IIF, CBR

A rather resilient economy

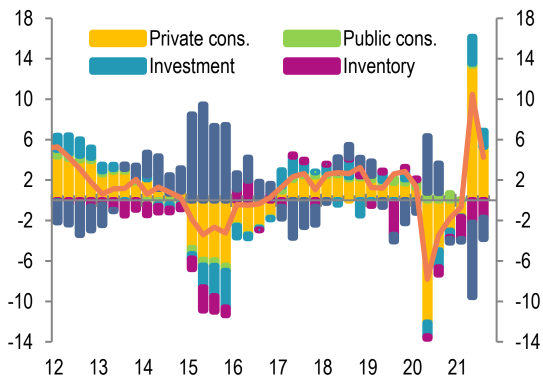
The impact of new financial and economic sanctions on the Russian economy may prove limited but risks to its economic outlook tilt to the downside. The Russian economy weathered relatively well the 2020 Covid-19 impact (2.7% GDP contraction) and bounced back in 2021, with GDP expected around 4.4% YoY. The recovery was driven by the revival of global energy demand, the rise of energy prices and by the sharp recovery of domestic private consumption (+6.4% YoY vs.-8.6% in 2020) and investment, notably in Q2-2021. The current account surplus reached a multiyear high ($82Bn in Sept.2021), benefiting from high commodity prices and reduced outbound tourism. As for this year, we expect GDP growth to moderate to 2.7% YoY, a forecast that heavily relies on a scenario of high energy prices and no international trade blockade that will allow Russia to keep its commodities exports - but most importantly- its imports running.

Chart 3. Russian exposure to US Treasuries



Sources: IIF, U.S. Treasury Department

Chart 4. Contributions to GDP growth



Sources: RosStat, Natixis

The West imposes a new round of sanctions to Russia

Since 2014, following the first wave of sanctions following Russia's annexation of Crimea, access to external financing has become harder and the Russian government and the CBR have been developing a more independent financial system to face current sanctions and limit the impact of potential new ones. Total external debt fell from $733bln in 2014 to $479bln by end-2021, meaning that external assets of the Russian Federation exceed external debt by approximately $575bln. By September 2021, the external assets of Russian banks surpassed their external debt by $104bln, meaning they consolidated their net external debt position by $25bln since 2014. More generally, all sectors have consolidated their position, either deliberately or constrained by a tightened access to external financing, meaning that significant buffers exist to face external shocks. Moreover, Russia has developed its own payment system, the Financial Communications System (SPFS), which could handle all domestic messaging traffic if needed according to the International Institute of Finance. The exclusion of Russian banks from SWIFT, would cut banks from international markets and the impact of such event on the banking sector is hardly quantifiable.

The US, the EU and Canada have announced a new round of sanctions to Russia, most of them focused on limiting Russian financial system operations in the international market and targeting exports to Russia. **Joe Biden unveiled a new round of sanctions on Feb.24**, mainly targeting exports of technological equipment to Russia and announcing a halving of imports of high-tech products from Moscow, the imposition of sanctions on four new banks and ruled out sending US troops on the ground.

In our opinion, the effect of the current sanctions will only playout over the medium term. In our latest note, entitled **"Russia: economic resilience amidst weakening recovery momentum and geopolitical uncertainty"** we explain the outlook for the Russian economy along with an update on the Russian financial system and a summary of the situation concerning the Russian-Ukraine crisis.

6. How much trade support can Russia find in China?

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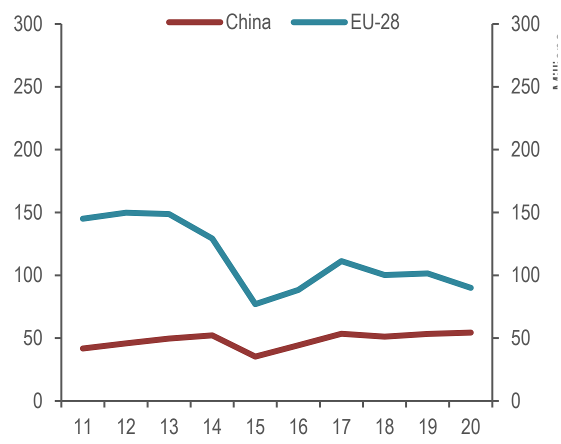
Chief Economist ASIA

Jianwei XU
Greater China Economist

Given the delicate situation in Ukraine and the US imposition of sanctions on Russia, followed by the European Union (EU), it seems important to assess how much Russia can rely on China as a trading partner.

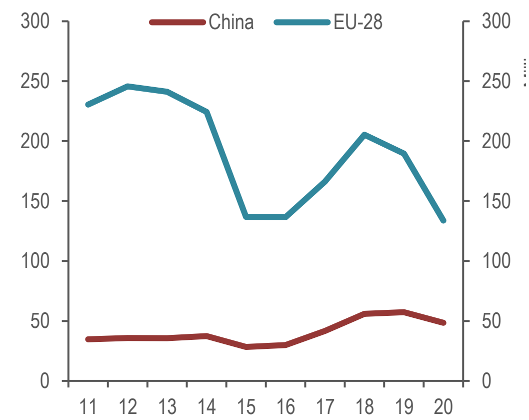
Although trade between the EU and Russia has lost some steam since Putin's "Pivoting to the East" announced during his 2021 campaign and the sanctions imposed in 2014 due to Russia's take-over of Crimea and, the EU is still Russia's largest trading partner. Taking 2019 as benchmark, i.e., before the outbreak of the pandemic, Russia's exports/imports with EU were three/two times bigger than with China **(Chart 1 and Chart 2).**

Chart 1. Russia's Imports from China and the EU (USD Bn)



Sources: UNCTAD, Natixis

Chart 2. Russia's Exports to China and the EU (USD Bn)

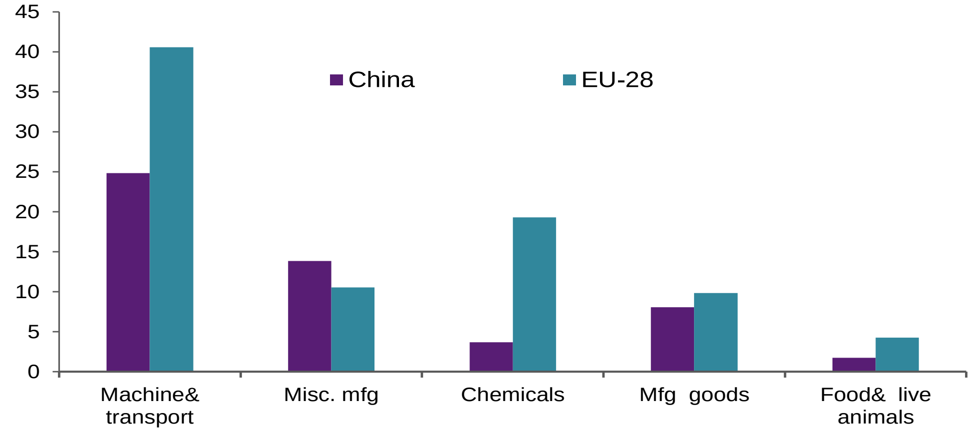


Sources: UNCTAD, Natixis

Given the geopolitical unrest and the closer relationship between China and Russia, there could be some substitution effect on Russia's imports, namely Russia could import more from China if it has to import less from the EU. But for Russian exports – which are heavily concentrated on oil & gas – it will be much harder for Russia to shift from EU to China in the short run, given that the former is much larger than the latter.

The higher sustainability of Russian imports compared to exports, as was quantitatively estimated by Garcia-Herrero and Xu (2016 *), indicates that Russia is bound to see a deterioration in its trade balance following the sanction. Focusing on Russia's imports, a sectoral breakdown shows that China and the EU are mainly competing on exports of machinery and transport equipment to the Russia market. Such competition will clearly tilt in favour of China in the months/years to come **(Chart 3).**

Chart 3. Russia's Imports from China and the EU by type (2020, USD Bn)



Sources: UNCTAD, Natixis

However, the rise of Chinese exports to Russia are significantly smaller than the decline of EU's exports to Russia over the past few years, implying that the substitution will not be full either. This is especially the case for the medical and pharmaceutical goods. In 2019, Russia's medical and pharmaceutical goods imported from China was only $0.2 million while that from EU reached $10.5 million. The strength of medical sector is related to the EU's dominant innovation role in the medical sector.

All in all, a closer trade relationship with China could offer Russia some help in case of the US and EU sanctions, but it is not likely to fully offset the impact of increasing decoupling from EU. This is the case overall but all the more so for energy exports and imports of pharmaceutical products. In essence, Russia's pivot to China cannot offer an immediate solution for Russia's trade, though maybe increasingly so in the longer term.

** Garcia-Herrero and Xu, 2016, "The China-Russia trade relationship and its impact on Europe", Bruegel Working Paper, Issue 4*

7. Russia's capacity to divert European gas flows to China is very limited now

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And by the time it grows, the EU will have other options

The limited prospects of long-term gas consumption growth in a decarbonizing Europe – coupled with problems related to Russia's take-over of Crimea - have enticed Russia's interest to consider alternative export options in recent years. China was the most obvious candidate given its surging gas demand growth and geographical location. Against such a backdrop, and the pressure from Western sanctions after Crimea, China and Russia agreed to build gas pipelines to serve China's gas needs back in 2014, Power of Siberia 1, which is now operational. The Power of Siberia 1 pipeline is fed by dedicated production assets in Eastern Siberia and is not connected to the infrastructure that sends gas to Europe. This first pipeline has resulted in the tripling China's gas imports from Russia in 2019 (Chart 1).

During the Winter Olympics in Beijing, in the midst of a stand-off between the West and Russia because of the threat of invasion of Ukraine, the final agreement for a new gas pipeline was signed. This project, known as the Far Eastern Route, will allow the transit of an additional 10bn cubic meters of gas from Russia's Far East Sakhalin Island to North Eastern China. This equates to a 25% increase of the existing natural gas supply capacity from Russia to China. It should be noted that this new pipeline will still be separated from the Russia gas which is exported to Europe and this is also true for the existing pipeline: Power of Siberia 1.

Table 1. Russia's Imports from China and the EU (USD Bn)

Year of Agreement	Year of Operation	Route Name	Status	Capacity (m^3 of gas per year)	Same source of the gas exported to Europe
2014	N/A	Altai Route	Signed but stalled	Unknown but small	Yes
N/A	N/A	Power of Siberia 2	Under discussion	50bn	Yes
2014	2019	Power of Siberia 1	In use	38bn	No
2022	N/A	Far Eastern Route	Under schedule	10bn	No

Sources: Gazprom, Natixis

While Russia's capacity to provide gas to China will increase over time, Russia still has the issue that most of its gas is directed to Europe. Interestingly, the second project announced during the Olympics by Presidents Putin and Xi could offer a solution. Namely the Power of Siberia 2 pipeline, could potentially enable such substitution as the proposed route connects Russia's Yamal peninsula gas province that feeds Western pipelines directed towards Europe, to Asia. This could offer Russia the option to swing gas exports between China and the EU, which clearly offers important political leverage both to Russia and China.

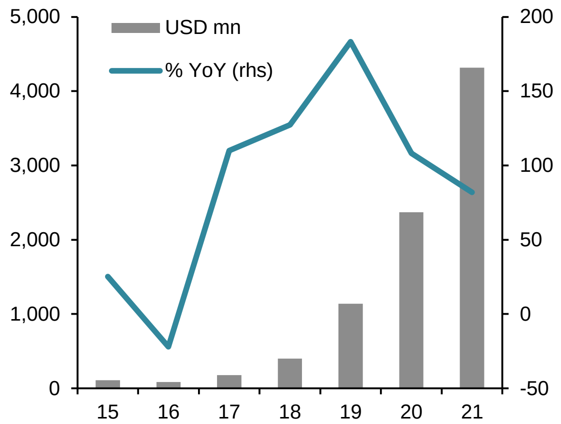
Beyond the increase in supply capacity, the longer-term targets to become carbon neutral by 2060 will also boost China's demand for natural gas as a compliment to the transition to renewable energy. As of now, gas only accounts to 7.3% of China's total energy supply based on IEA estimates, which is significantly lower than that of EU at 25%. This means that there is massive room to boost penetration of natural gas in China, especially as it gradually phases out the use of coal to achieve its climate goals.

From a gas market perspective, Gazprom's future export optionality may not be as "scary" as first appearances suggest. Clearly, in the current global gas market with record high prices and intense competition for spot molecules, the prospect for Gazprom to choke off exports to Europe and prioritise China is evocative. However, we see the current tightness as cyclical, largely based on the long-term capacity addition cycle for LNG projects. Whilst the market is likely to remain tight until 2024, additional LNG supply into 2025 (most notably Qatar's giant North Field expansion) should loosen global gas markets significantly. As such, Gazprom / Russia's market power will be significantly diminished (with the market more likely to resemble the 2018/19 period, with lower prices) by the time Power of Siberia 2 is operational. Recent geopolitical tension, the decarbonisation of the EU economy and European preference for spot contracts all limit the likelihood that European gas buyers will commit to fresh long-term gas contracts with Russia as existing agreements expire in the coming years.

As such, connecting legacy infrastructure (that currently flows gas to European clients) to a growing market (China) has clear commercial rationale. However, as is often the case with Russia (and the gas markets more generally), it is difficult to fully disentangle the commercial rationale from broader geopolitical motivations. Turning to China's gas market, we would largely expect Power of Siberia 2 to represent "baseload" supply for China, rather than flexible swing supply. The comparative immaturity of China's gas market (with no significant spot market and limited storage capacity) limits the ability for marketers to arbitrage gas both spatially and temporally between seasons, a key driver of marginal flow dynamics in Europe. This would also limit the ability to arbitrage between the two gas demand centres on a short-term basis.

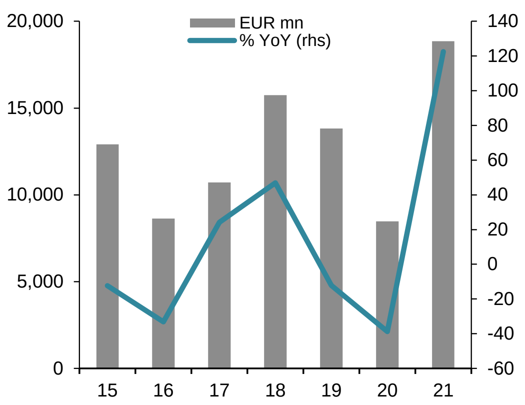
All in all, Russia's pivot towards China to mitigate its problems with the West, especially as regards the linkage of Russia's gas pipelines, is not possible today and, when it finally becomes a reality, it might be too late as global LNG supply will be much larger. Furthermore, The EU will also be more advanced in its decarbonization efforts, which will reduce the share of gas in the EU's energy basket.

Chart 1. China – Gas imports from Russia)



Sources: Natixis, Wind

Chart 2. EU – Gas imports from Russia



Sources: Natixis, Wind

8. Which implications for Emerging Markets?

LYSU PAEZ-CORTEZ

EEMEA Senior Economist

Russia-Ukraine conflict to affect Emerging Markets in multiple ways

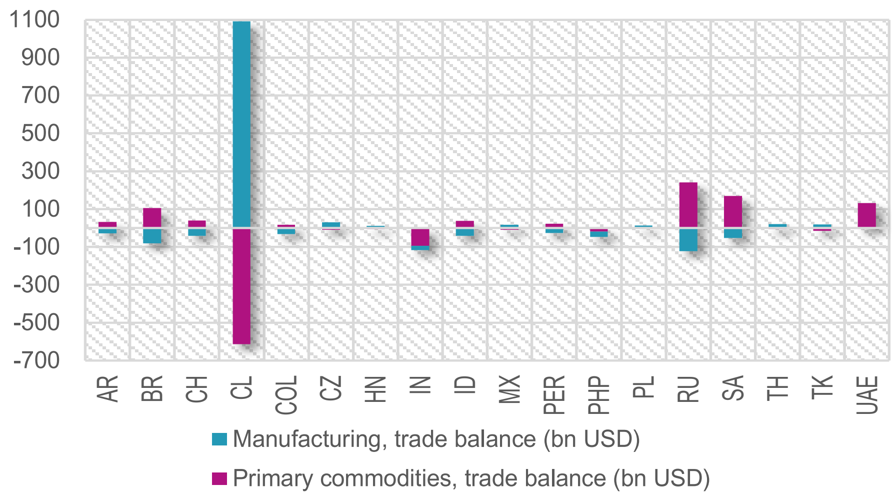
The situation in Ukraine will play in different directions for EMs. The invasion of Ukraine will weigh negatively on the global risk sentiments and add additional inflationary pressures.

This time, inflationary pressures will not only derive from higher energy prices but also from a potential spike in food, agricultural commodities, and fertilizer prices were trade bans, lower supply or supply disruptions to materialize, as both Russia and Ukraine are major grain exporters. Russia is the world's top wheat exporter, Ukraine just behind at the 4th place, exports that are mainly directed to the Middle East countries and Asia (Egypt, Turkey and Bangladesh). As for Russia, it is the world biggest fertilizer exporter; it imposed early February a two month ban on ammonium nitrate exports, potentially jeopardizing supplies to South America, therefore potentially jeopardizing Brazilian soybean crops.

In such context, the condition of being a net-oil/energy importer or a net-oil/energy exporter becomes critical. Our commodities price outlook for 2022 forecasting crude oil and natural gas prices to remain high throughout 2022 (see our dedicated chapter in this report), we see sustained high energy prices having a differential impact among emerging markets.

Consequently, and as we already addressed earlier this year in our report **Which EM economies will benefit or suffer the most from high energy prices?**, the initial prospects for net energy importing emerging economies to suffer from high energy prices, with heightened inflationary pressures clouding growth prospects, and oil exporters' 2022 growth outlook to benefit from higher oil & gas exports returns will accentuate further. For those EMs that have a big manufacturing sector, the high energy cost will translate into higher producer prices and lower profit margins. For those EMs that are net metal and agricultural exporters, the impact of such rise is mixed. Therefore, the growth path divergence between oil (and other commodities) importers and exporters that we evoked in our last EM Monitor and yearly outlook is likely to widen.

Chart 1. EM Trade Balance, selected countries (2019, USD Bn)

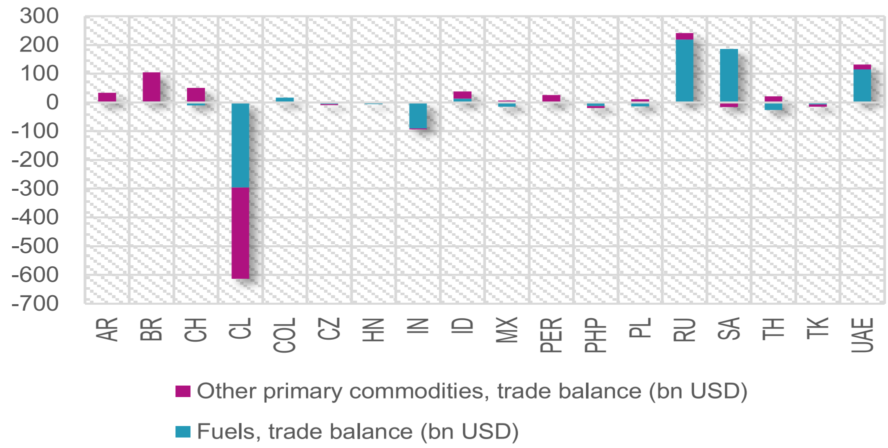


Sources: UNCTAD, Natixs

Net-energy importers, CEE-3 countries Poland, Hungary and the Czech Republic, and Turkey are likely to experience a double pain. On the one side, the impact of the sanctions imposed to the Russian Financial sector will impact the CEE-3 economies and key business partner Turkey.

On the other hand, higher oil prices will fuel inflationary pressures – taking inflation further up from current decades highs. This may be less true for Poland, who is a big coal consumer, but energy, transportation and food inflation will likely rise. De-anchored inflation would add an extra vulnerability to the macro picture and rate hikes may accelerate in H1-2022. For Turkey, that would mean keeping its key rate unchanged for a bit longer (they halted the rate cut cycle in December, and we expected the CBRT to pause until March at 14%; it may be unchanged for a bit longer now, jeopardizing Erdogan's will).

Chart 2. EM Primary Commodities Trade Balance (2019, USD Bn)



Sources: UNCTAD, Natixs

GCC economies that have moderated inflation, will largely benefit from higher for longer oil and gas prices, income from oil exports will be higher. Food prices is an issue in the Middle East, for they import everything and are highly dependent on Russian and Ukrainian wheat imports. Fertilizer cost and supply could affect food production. **Net oil exporting countries (OPEC+ members UAE, Saudi Arabia)** are clearly the big winners of the recent price spike on natural gas and crude markets, their GDP growth prospects for 2022 have been revised upward on the back of higher export revenues.

Net importers of commodities with large manufacturing sectors (such as China, India, Thailand, or Turkey) will suffer from overall increased production costs resulting in lower profit margins. The recent rally in energy prices may have a broader impact in their global economy with higher passthrough effect on headline inflation, challenging policy decisions.

In central European countries (Poland, Hungary, and the Czech Republic), the energy component in the CPI index is higher than for neighbouring countries, with an electricity sector that is more heavily reliant on fossil energies and coal. Diversified economies, with an important manufacturing sector, CEE-3 countries will continue to suffer from higher input prices and supply shortages as well. Inflationary pressures are persistent, CPI inflation having reached multiple year highs, centrals banks may be forced to accelerate their key rates tightening path.

In China and Southeast Asia, demand is hampered by weak consumption and investment due to Covid restrictions. We are seeing PPI rising sharper, hurting manufacturers (China, Japan, South Korea, Vietnam, and Malaysia), CPI is already increasing but to a much lesser extent as demand shocks outweigh supply shocks. Even if activities are picking up marginally, demand remains weak enough to keep central banks at bay from raising rates.

9. Higher oil hurts Emerging Asia, especially India

Trinh NGUYEN

EM ASIA Senior Economist

But capital flows may offset, given relatively less risk economic outlook.

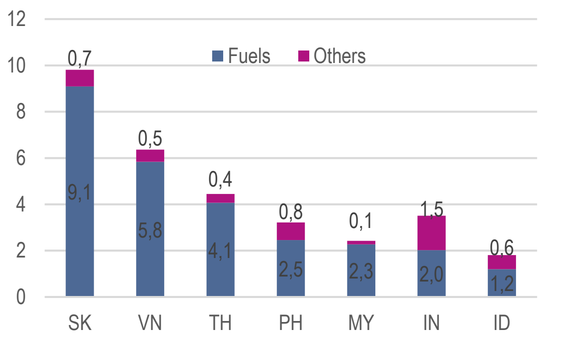
Oil importers to pay more, pushing downward the current account, especially India, but portfolio flows should offset some of the negative impact

The Ukraine and Russia conflict have three channels of transmission to emerging Asia – direct trade, capital, especially portfolio flows, and energy prices as well as other commodities like metals and food. The good news is that EM Asia's direct trade exposure is low, with South Korea and Vietnam having the most direct import vulnerability to Russia, making up 9.8% and 6.3% of total. Regarding exports, South Korea again has the highest exposure but only 1.9%. Given that the exposure is primarily via the import channel, South Korea will have to work hard to find alternative sources of Russian fuels should sanctions reach the energy sector.

More key is Russia's vital role in the supply of oil and gas (#3 and #2 supplier globally, respectively), which means that it has stoked price pressures as the sanctions are likely impacting supply flows via the capital channel even if we do not have direct energy sanctions. The bad news for the region is that we are a net importer of fuels. Within EM Asia ex China, India, South Korea, Thailand are the biggest net importers of fuels, while Malaysia and Indonesia are the only net exporters. Net importers will have to pay higher costs for imports, a challenge particularly for India and to a lesser extent Thailand due to the current account deficit nature.

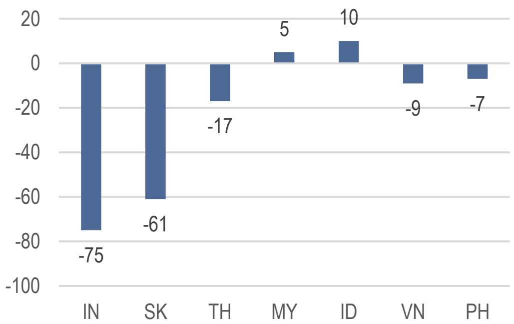
We expect India and the Philippines' current account deficit to widen in 2022 on higher fuel prices for India and both higher fuel and food prices for the Philippines. South Korea's sizeable current account surplus in chips and manufactured goods will offset. Thailand will have to pay higher costs of fuels, but it is offsetting that by attracting more tourists through opening its borders for tourism, which should offset the negative from higher import costs.

Chart 1. Direct import exposure to Russia (% share of total 2020)



Sources: UNCTAD, Natixis

Chart 2. Fuels trade balance (USDbn 2020)

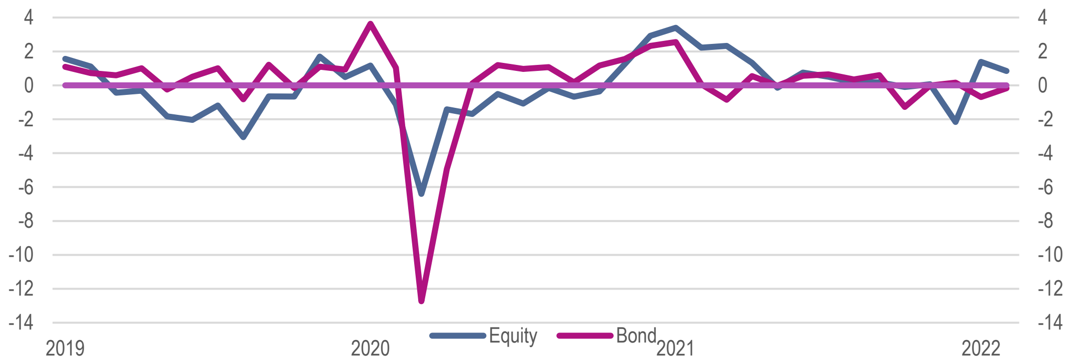


Sources: Natixis, Wind

While net exporters will gain and importers will lose, households will pay more for higher fuels and other commodity prices such as metals and agriculture products. For India, with a big infrastructure investment push, it is unlikely to significantly subsidize the increase of input costs. Thailand, too, has subsidized in the past but didn't fully offset. And Thai budget is already stretched from years of Covid-19 related support and the room to do so is limited. India, Thailand the Philippines have the highest share of food and energy as a share of total. With demand expected to rebound due to normalization of domestic activities and the higher weight of food and energy, items where there are higher import costs, the vulnerability lies rather acute for India. The Philippines is a net importer of both food and fuels, and so household will bear higher costs. In other words, higher inflation pressures across the region and an erosion of consumer purchasing power, but that impact is most acute in India and less for South Korea as the weight of food and fuels are less.

Direct capital exposure is small but given the risk-off sentiment, portfolio flows are impacted. That said, the impact is temporary and if anything, the region may gain from being a relatively less risky region. And let's not forget, the normalization of activities has pushed up demand, and growth is expected to be strong.

Chart 3. EM Asia portfolios to be resilient and may even benefit



Sources: UNCTAD, Natixs

10. Metals: Sanctions vs Weaponization

BERNARD DAHDAH
Metals Analyst

Russia is a major producer of metals (table 1) and as such metal prices can be heavily impacted by Western imposed sanctions or Russian "weaponization" of metal exports.

Table 1: Russian mined output

	Production	Share of world production
Palladium (t)	82	42.8%
Platinum (t)	21.8	14.2%
Nickel (kt)	220	8.4%
Aluminium smelting (kt)	3924	6.0%
Copper (kt)	871	4.1%
Crude steel (Mt)	71.6	3.8%
Zinc (kt)	272	2.2%

Sources: WoodMac, JM

Historical impact of sanctions vs. "weaponization"?

Reviewing **sanctions**, the latest example we have is that of the US sanctions against Rusal which were enacted in 2018. At the time aluminum prices rose by as much as 30% in a matter of weeks. The issue with sanctions on commodity related industries is that it almost inevitably causes collateral damage, especially for the West which is a net importer. As highlighted by the Rusal sanctions, alumina prices doubled and massive supply chain disruption ensued. The impact should also not be separated from the broader market context - this time the industrial metals complex is extremity tight (highlighted by the large percentage of metals trading in backwardation) and as such the implication on prices could be even higher. For instance, even though Russia produces only 4.1% of the world's copper (table 1), export sanctions could lead to substantially higher copper prices given the supply tension.

The big question this time also is, with China and the US becoming more confrontational **whilst Russia and China are getting closer, if sanctions against Russia are put in place will the latter serve as a market of last resort for Russian commodities?** Last year China passed "The Rules on Counteracting Unjustified Extraterritorial Application of Foreign Legislation and Sanctions" which in a nutshell makes it illegal for Chinese firms to comply with US extraterritorial sanctions.

Chart 1: Aluminium ($/t)

Sources: Bloomberg

As for **"weaponization**" of metals, the 2010 Chinese rare earth metals export ban (unofficial) to Japan serves as one example. Back then China reduced its rare earth export quotas by 40% under the pretext of protecting the environment, but it was more likely that it was the result of a dispute with Japan over the Senkaku/Diaoyu islands.

This caused a considerable headache (including some financial losses) to the Japanese high tech industry particularly the automobile industry. Nevertheless, China was also a long term loser as in the following ten years Japan reduced its reliance on Chinese rare earth metals from 90% to 58%, the country aims to reach 50% by 2025. Europe and the US are also actively looking at way to reduce their reliance on China.

As such the issue with weaponization is that for the country imposing it (who has the market advantage) they could burn that card for future use as those who were sanctioned diversify away their supply chain or seek substitution.

So which metals are likely to be impacted?

From a Russian metal "weaponization" perspective, **palladium** is possibly one of the best contenders, as the country accounts for 42.8% of global output. Should Russia head for an export ban or simply slowdown the export process then the loss as a percentage of Russian GDP will be minor, whereas this would prove to be a major headache for automobile makers (so mainly Western and Western allies as they are the main automobile producers) and could end up costing more than the equivalent loss in Russian sales given that palladium is an input to high value products. In 2020 Russia is estimated to have produced the equivalent of $6.3bn worth of palladium which was mainly exported, this equates to roughly 0.43% of Russian GDP.

In 2000, delays in Russian export licenses of palladium drove prices of the metal up by around 220% in a matter of a few of months (chart 2). Between mid- 2001 and the end of that year, when Russia was exporting palladium at normal quantities, prices fell by over 60% incurring heavy losses to some automakers. At the time the mismanagement of palladium stocks led a $1bn loss by Ford Motors.

Chart 2: Palladium prices ($/oz)

Sources: Bloomberg

Another contender is **titanium** which could damage the Western weapon and aerospace industries. The world's largest producer of titanium is VSMPO-AVISMA, located in Siberia and controlled by a close ally of President Putin. Boeing is one such example of how a Western company could be damaged and are "hooked" to low prices. VSMPO-AVISMA was flagged back in November 2019 by the US Bureau of Industry and Security (BIS) as selling titanium at artificially low prices to Boeing: "*Russia's VSMPO-Avisma do not pass on the full cost of titanium sponge to* *consumers and offer artificially low-priced finished titanium goods. This is most notable with VSMPO-Avisma's joint venture with Boeing to produce titanium-based aircraft parts in Russia for use in U.S.-assembled commercial aircraft."* Despite this warning, in November of last year both companies agreed on maintaining "*titanium supplies and technology collaboration for years to come"*, signing a memorandum of understanding which makes the Russian company the largest titanium supplier for Boeing's commercial airplanes.

This is a somewhat similar to the dumping strategy that the Chinese used in rare earth metals in order to capture market share in strategic sectors. Boeing is not the only company impacted, airbus has around half of its supply of titanium coming from Russia and the UK's aerospace industry is also heavily dependent. Similar to palladium, titanium sales contributed marginally to Russia's GDP but are of extreme importance to Western companies including the armament industry.

Conclusion

For Russia mining is of a strong importance to the country's economy as it accounts for about 12% of GDP. Sanctions on that sector could be painful but seem unlikely given how much Europe relies on Russian base metals (table 2) and not just on palladium and titanium. Sanctions on those sectors are likely to harm European industries which could find it complicated to quickly get new suppliers and could also hit the continent's GDP as metals are at the basis of some of their higher value chain products.

Table 2: EU 27+UK metal imports from Russia (2020)

	EU27 + UK estimated Total consumption	Imports from Russia	Russian share of imports
Nickel (kt)	253	160.02	63.2%
Aluminium (kt)	7450	1042	14.0%
Copper (kt)	4411	194.78	4.4%

Sources: Woodmac, European Commission

Be it weaponization or sanctions on metals, all sides inevitably end up losing. In the long term weaponization drives away those who were hit, meanwhile Western sanctions against commodity related entities end up backfiring given the nature of global markets and that the Western world is heavily reliant on commodity imports.

Our view is that even if sanctions or weaponization don't take place, the possibility of one or both happening is enough to drive base and precious metal prices higher in the near term. In a nutshell we are heading into a volatile period, the main three factors that will contribute to this are:

- The weight of Russia in the commodities market.
- Europe's exposure to Russian metal imports and its involvement in the conflict.
- A very tight base metals market that is already in backwardation.

11. European banking exposures to Russia and Ukraine

SAMY LAKHDARI

Banks / Insurance

European banks direct exposures to Russia and Ukraine are limited and concentrated among few players. At the end of December-21, Raiffeisen Bank International (RBI) was the most exposed to Russia and Ukraine followed by Unicredit and Societe Generale.

European banks exposures to Russia and Ukraine

eur m	Exposures to Russia	Exposures to Ukraine	Exposures to Russia and Ukraine in % of total Group exposures	Exposures to Russia and Ukraine in % of total Group op.income (FY21)	Exposures to Russia and Ukraine in % of CET1 capital	CET1 ratio	MDA	Distance to MDA
RBI	11 600	2 200	13,7%	27%	117%	13,1%	10,4%	2,69%
UCG	9 356		2,9%	6,3%	19%	15,0%	9,0%	5,99%
SogGen	18 000		2%	-	36%	13,7%	9,0%	4,68%
ING	4 700	600	0,7%	-	11%	15,9%	10,7%	5,19%
Nordea	864		0,17%	-	3%	17,0%	10,2%	6,80%
BNP	1 800		0,1%	-	2%	12,9%	9,2%	3,67%
ISP		300	0%	0,10%	1%	14,5%	9,9%	4,60%

Sources: Natixis, Company reports Q4-21

In the table above RBI had an exposure of €11.6bn in Russia and €2.2bn in Ukraine (corporate and retail activities) and it represents 13.7% of total RWA Group exposure. In our view, we consider that at this stage the Ukrainian exposure is more at risk than the Russian exposure and Ukrainian exposures are marginal for other banks.

It is important to note that 27% of RBI operating income is related to Russia and Ukraine**. For other European banks, exposures to Russia and Ukraine are limited and we think that the risk is manageable**. Unicredit's management confirmed having ended talks over the acquisition of Russian bank Otkrytié (the 8th largest Russian bank in terms of assets) because of geopolitical tensions.

In case of a geopolitical escalation, we would assume a lower profit contribution from Russia and Ukraine divisions (lower revenues and higher cost of risk) rather than material profitability or capital issues at group level. As a reminder, during tensions in 2014, RBI and Unicredit remained profitable in Russia whereas SocGen was loss making in Russia. Financial institutions tackle this crisis with better fundamentals (lower NPL ratio and higher profitability), are much more capitalised and have a better liquidity position compared to 2014.

The indirect impact on banks would be much more difficult to quantify. Indeed, the indirect risks of an escalation would mainly be via a macroeconomic deceleration and hence would have a much more broad-based impact on our coverage universe by reducing revenue growth (lower economic growth and potential margin squeeze) in our view.

Sanctions would have an impact on local banks, with dollar-market restrictions, imposed export controls and blocked access to global payment systems among further potential measures (as a reminder, in 2014, US and European sanctions did not impact the SWIFT network).

In terms of spreads, high beta debts have widened the most yesterday (subs 15-20bp wider) whereas covered bonds proved resilient with spreads remaining globally stable so far. That said, some Austrian covered bonds and some frequent issuers (i.e some French issuers) on the longer part of the curve underperformed by c.3bp yesterday.

Going forward, covered bond spreads could by contagion effect be negatively impacted. In the SP space, the shorter end of the curve has underperformed this week in particular in Austria leading by RBI.

Euro SP spread change by country WoW (by residual maturity in bp)

	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y
AUSTRIA	17	15	18,0	7,8	13,7	11		4	6	
BELGIUM		6		8	5,52	4				
BRITAIN	16		10	7,4		11	7,6			
DENMARK	8		5							
FINLAND	11	8	5	6	3,52	4				
FRANCE	6,4	7,0	4	7	4	5	9	13	7,25	
GERMANY	6	8	7	5	6,54	10	7,4			
IRELAND										
ITALY	8	9	11	13	8	7	8,39		8	
NETHERLANDS	14	11	5	4,9	7					
NORWAY	13	7	5	4	3	2				
SPAIN	13	10	8	8	5	6				
SWEDEN	7,5	6,6	5	7	6		5			

Sources: Natixis, Bloomberg as of 24-02-2022

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