

# MARKET COMMENTARY

## Fog of war: scenarios and forecast implications

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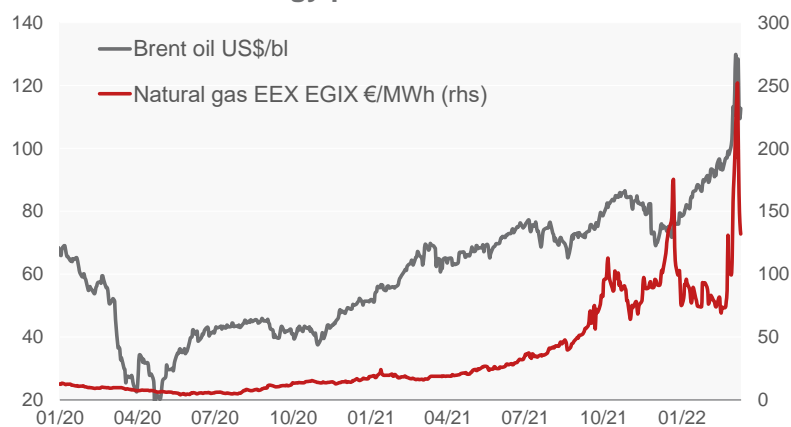
- Russia's war in Ukraine has turned increasingly bloody while meeting fierce military resistance. Talks between the two countries seem to be heating up, yet have not assuaged concerns that fights will extend for weeks if not months.
- Sharp and far-reaching sanctions on Russia, soaring energy prices and mounting supply disruptions reverberate globally, but most so in Europe. The fog of war leaves high uncertainty about military, political and economic outcomes.
- Our updated central scenario assumes prolonged fights and persistent sanctions. We assume the price of oil and gas to settle at even higher levels for longer. Stagflation pressures will be particularly acute in Europe: we cut our euro area growth forecast further to 2.2% (from 3.7% before the invasion), with the economy likely at the verge of recession over spring and summer. US growth will suffer less severely given the lower energy import dependency, while strong domestic stimulus in China will keep the fallout there contained (though the zero-Covid policy remains a drag).
- We see no rush in re-risking and recommend a minor underweight in Equities. Yields are set to rise mildly, with safe-haven bids and economic woes largely offsetting the upside push from inflation and withdrawal of monetary accommodation.
- A less likely favourable scenario sees an earlier ceasefire and a return to diplomacy. Sanctions would still be eased only very gradually. But de-escalation would also help to bring down energy and commodity prices faster, keeping the global stagflation damage much more limited. Equities would then bounce quickly, while the faster recovery and unwinding safe-haven flows would push yields visibly higher – taming the equity rally in the process.
- The risk scenario of a further marked military escalation and punitive sanctions including significant parts of Russian energy exports would send oil and gas prices soaring further. The euro area would face a sizeable spring/summer recession. Amid soaring inflation, cornered central banks will see their hands largely tied. Extended fiscal support would only partially mitigate the drag. Equities would sell off further, with safe-haven flows pushing Bund yields well below water again.

As the Russian war in Ukraine continues unabated, the toll of deaths, injuries and dislocations is rising fast. Negotiations even on most basic humanitarian relief have mostly failed thus far, frustrating hopes of a quick shift from military fights to the negotiation table. Meanwhile, Russian forces are encountering fierce Ukrainian resistance. If Russian president Putin aims for gaining control of most parts of Ukraine as it seems, the war may drag on for weeks if not months. Yet the fog of war leaves high uncertainty about military, political and economic outcomes. We have updated our central forecasts to the recent events (cutting growth and raising inflation forecasts), but also consider upside and downside scenarios on the range and preconditions for alternative outcomes (see also table summaries in 'Scenarios at a glance' at the end of the note).

As illustrated in earlier [occasions](#) (see also our recent [Market Perspectives](#)), Western exposure to Russia both via trade and financial links is relatively small. Yet Russia's key role for global energy markets amid strained demand/supply balances makes the global economy (and Europe in particular) increasingly vulnerable to the escalating war. Soaring energy prices and

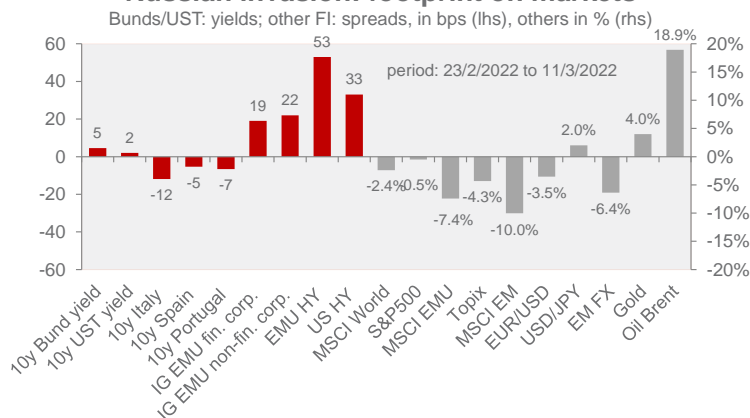
mounting supply disruptions are being felt globally, exacerbating stagflationary pressures that had been building for longer. This very much limits the tools of central banks to assuage the economic fallout: the inflationary impact from the energy supply shock cannot easily be dismissed as transitory as the stage of the recovery had already warranted a tighter monetary stance for the coming months.

### Energy prices on the rise



Source: Datastream, GIAM

### Russian invasion: footprint on markets



Source: Datastream, GIAM calculations

In our updated **central scenario**, we assume military fights to drag on for at least some more weeks, until Russia wins control of the key cities, especially on the coasts. Western sanctions on Russia will be maintained and extended to further key Russian stakeholders and parts of Russian energy exports. Ever more Western companies will withdraw from the Russian market pre-emptively, pushing the Russian economy into a double-digit recession. Russia will likely retaliate by curtailing commodity exports critical for the West. This would make the oil price settle at even higher levels, around or above US\$ 130/bl for longer. Prices for gas, fertilizer and agriculture products are set to rise further in this scenario.

While many EMs will feel the pain of dearer wheat prices, the rising energy bill will be felt particularly in Europe with **57.5% of the EU's gross energy needs covered by imports**. Headwinds to real disposable income will be amplified by a dropping consumer and business confidence and renewed supply chain disruptions. We therefore cut our 2022 euro area growth forecast to 2.2% (from 3.3% at end-Feb and 1.5pp lower than targeted before the invasion), with the economy likely at the verge of recession over spring and summer. The recent ECB's small revisions to +3.7% looks very complacent. Inflation is set to rise further to well above 6% in Q2, mainly on energy and food prices; also core inflation may pick up on higher costs for services and (mildly) higher wage demands. The **ECB has just affirmed** its clear priority for tackling price pressure over growth support. PEPP is expiring (flexible reinvestment maintained though) and total asset purchases will be trimmed to €20bn by June. Given our distinctively more subdued growth expectations, however, we see the ECB waiting until December for its first 25 bps rate hike, even if risks are still tilted towards an earlier move.

US growth will suffer less severely on lower energy import dependency and loser trade ties with Russia. We cut our 2022 growth forecast to 2.7% (from 3.4% end-Feb and -1pp vs. pre-invasion forecast). Nevertheless, inflation will continue to hover at 40-year highs. Commodity and energy inflation will add to an overheating labour market and rising rents. The Fed will thus stick to its tightening bias, with a total of five 25 bps rate hikes likely this year (vs. the market expectation of nearly 7 hikes!). By June, if not earlier, we expect the Fed to also announce the run-off of its balance sheet. A strong fiscal stimulus in China will keep the fallout there contained. The official 5.5% growth target seems overly ambitious, though, given also headwinds from the new Covid wave, the property market and tighter regulation. Mounting energy and food prices will be felt globally, with many EMs particularly exposed due to higher respective shares in consumption baskets.

The fallout may prove to be much less severe in a **favourable scenario** entailing an early ceasefire and a quicker return to diplomacy. Human and economic costs are rising fast also on the Russian side, and Putin needs to resort to mounting internal suppression to maintain his narrative of a 'special operation'. Rising resistance among Russian oligarchs and military elite on the one hand and the enormous human and economic losses in Ukraine on the other may nudge Putin and Zelensky to

compromise on a peace deal around Ukrainian neutrality, recognition of Crimea annexation and independence of separatist regions. That said, the West would still be keen to not let Putin off the hook early. Sanctions would still be eased only very gradually. But de-escalation would help to bring down energy and commodity prices faster. The global stagflation damage would be much more limited. The adverse impact of the war on the global economy would still be visible, but much more muted.

The balance of risks is thus far tilted to an **adverse risk scenario**, though. A further escalation of the conflict may trigger Putin to double down on his threats, potentially even threatening an escalation to other regions or the use of chemical weapons (under pretext of Ukrainian misuses). Europe would ultimately give in to punitive sanctions on significant parts of Russian energy exports, sending oil and gas prices soaring drastically further (we pencil in a protracted period of Brent oil >\$170pb). Export restrictions and deeper supply disruptions would send agriculture and metals prices even higher. The euro area would suffer a sizeable mid-year recession, cutting growth by 2.5-3pp vs. pre-crisis baseline. Soaring inflation, a hit to confidence and tighter financial conditions would push the US economy to the verge of recession too. Cornered central banks would see their hands largely tied by intense stagflation pressure. The ECB would delay the policy normalisation, pointing to the strong disinflationary effect of the recession over the medium term. The Fed would pursue it rate hikes at a much more muted and data-dependent pace. Extended fiscal support could only mitigate the drag. Soaring food and energy prices may lead to social unrest in parts of the emerging world.

### **Implications for financial markets: don't chase the dips yet**

Financial markets have gone through a roller-coaster ride since the Russian invasion. In our **central scenario**, volatility is set to remain very high amid the fog of war. Equities, notably in Europe, have descended to much more attractive valuations, which may ultimately give rise to a healthy rebound. With the risk of a more material escalation still looming, the key turn for markets will likely happen once the focus shifts from military to diplomatic. In our central scenario, this happens only once Russia has secured the control of the key cities, especially on the coasts. In the meanwhile, equities are yet to bottom. We see more value and resilience in IG Credit after the recent significant spread decompression that renders a more attractive carry. Yields are set to rise only mildly, with safety bids and economic woes largely offsetting the upside push from inflation and withdrawal of monetary accommodation. The EUR/USD will face some further headwinds near-term from safe-haven bids and the euro area recession before gaining some traction later in the year.

The pro-risk rebound of markets would be much more vigorous in the **upside scenario**. Equities would bounce quickly as falling commodity prices temper stagflation risks and the geopolitical risk premium plummets. The faster recovery, unwinding safe-haven flows and faster normalisation of monetary policy would push yields visibly higher. The adverse impact of higher yields on Credit would be mitigated by spread compression. The EUR/USD would bounce more quickly as the ECB is set to terminate the prolonged period of negative rates.

In the **adverse scenario**, equities could sell off considerably further as the tail risk of a wider war in Europe would hit confidence and push investors into safe havens, including Bunds. The looming recession and dovish central bank response would drive core yields back deeper into negative territory. Credit spreads would widen materially on rising risks of defaults. Safe-haven flows, the asymmetrically strong adverse impact on Europe vs. US and global slowdown would drive the EUR/USD closer to parity short term. Only later in the year, after the acute fallout has peaked, would asset prices partially revert.

# Scenarios at a glance

| Assumptions  | Base case (tent. prob.: 60%)  | Risk View (25%)   | Upside (15%)   |
|--|---|---|--|
| <b>Political / military outcome</b>                | Russia occupies large parts of Ukraine, possibly <b>toppling existing gov't</b> or at least <b>neutralising Ukraine</b> . Some military de-escalation possible in the best case of this 'base scenario' but <b>fights across country continue</b> for weeks/months; Western <b>sanctions remain in place for longer</b> , Russia energy supply partly disrupted.  | Russia prevails only after <b>prolonged and bloody fights</b> with heavy human losses on both sides. <b>Russia ramps up threats to escalate</b> the conflict towards other parts of Europe and/or civil/military nuclear concerns rise. Western sanctions and Russian retaliation materially extended.  | <b>Russia returns to diplomatic route</b> , securing <b>neutrality of Ukraine</b> (no NATO, EU membership) and <b>Russian control of Donbas region</b> ; Ukraine's accepts Russian Crimea annexation. This broad upside scenario has various shades, one of which includes the possibility of Putin losing local/oligarchic support and being replaced at the top. |
| <b>Sanctions</b>                                   | <b>Sanctions</b> already in place to be <b>maintained for long</b> and <b>extended to parts of Russian oil exports</b> and for individuals (SDN). Retaliation from Russia also disrupts commodity trade.  | <b>SWIFT restrictions possibly extended to entire banking sector</b> . Far reaching bans on Russian exports, incl. oil & gas, largely <b>cutting Russia off from western economies</b> . US broaden pain to Russia <b>via secondary sanctions</b> , forcing other countries to follow suit.   | <b>Ceasefire, potentially including very gradual unwinding of western sanctions</b> , even though public pressure in the West will persist to not quickly 'reward' Russian aggression.   |
| <b>Energy/commodity prices</b>                     | <b>Energy flow continues but at lower level</b> . NS2 not operational. <b>Oil to rise to \$130-150/b</b> for several weeks/months before receding very sluggishly (Iran may provide some relief, but not secured nor quick) <b>Commodity/Freight prices remain high</b> , esp. wheat on supply/transport disruptions. Palladium aluminium etc. prices stay high.  | <b>Severe disruptions</b> and sharply reduced supply of gas and oil by Russia raises <b>oil price to &gt;US\$ 170/b</b> (potentially spiking even significantly higher) <b>Sharply rising prices for agriculture</b> (wheat) and - to lesser extent - metals prices (esp. aluminium, palladium)   | <b>Normalisation of energy supply</b> , though war damages may still trigger <b>moderate disruptions in supply</b> also of agriculture, metals. <b>Drop of energy prices, even though</b> to levels somewhat above those prevailing before Russian escalation of the conflict (Brent ~US\$80-90pb)   |
| <b>Global / US/European growth &amp; inflation</b> | Protracted rise in energy / commodity prices & moderate supply disruptions <b>raise inflation mostly in 2022</b> ; recovery continues, but at a much slower pace, esp. in Europe, as inflation /political risks <b>dent confidence</b> and purchasing power. <b>CBs continue policy normalization</b> , even though more carefully/ <b>higher optionality</b> . ECB more cautious than Fed. Only one 2022 ECB hike, in Dec. | <b>Soaring energy prices, broader supply disruptions</b> (incl. metals, agriculture), <b>tighter fin. conditions and adverse confidence impact</b> (notably capex) bring the <b>global recovery to a halt /drive Europe into recession</b> ; inflation lastingly above target, <b>exacerbating CBs' policy dilemma</b> ECB maintains QE (even though lets PEPP expire), rate hike in question, though inflation gets even higher; <b>Fed embarks on less ambitious rate hikes</b> . | <b>Continued global recovery; inflation pressures still elevated</b> though, notably in US amid hot labour & property market; Fed to hike rates in consecutive meetings, ECB ends QE in summer to prepare the ground for rates lift-off in Sep., followed by a second hike in Dec.   |
| <b>Russia risk</b>                                 | Deep recession, GDP drawdown much worse than 1998 (-5.5%). Distressed, high risk of default esp. for foreign investors  | <b>Sov. default</b> , mainly on risk of missed interest payments on technical / market access grounds   | <b>Easing default strains</b> with Russia gradually regaining market access, normalising commodity exports   |

| Annual GDP growth (in %) | central scenario |      | risk scenario |      | upside scenario |      |
|--------------------------|------------------|------|---------------|------|-----------------|------|
|                          | 2022             | 2023 | 2022          | 2023 | 2022            | 2023 |
| US                       | 2.7              | 2.1  | 2.0           | 1.8  | 3.0             | 2.5  |
| Euro area                | 2.2              | 1.6  | 1.0           | 0.5  | 3.0             | 2.0  |
| China                    | 5.0              | 5.1  | 4.0           | 4.1  | 5.5             | 5.7  |
| RoW                      | 2.8              | 3.6  | 3.2           | 2.6  | 3.9             | 3.6  |
| World                    | 3.1              | 3.3  | 2.9           | 2.5  | 4.0             | 3.6  |

| Annual Inflation (in %) | central scenario |      | risk scenario |      | upside scenario |      |
|-------------------------|------------------|------|---------------|------|-----------------|------|
|                         | 2022             | 2023 | 2022          | 2023 | 2022            | 2023 |
| US                      | 7.3              | 2.2  | 7.7           | 1.9  | 7.0             | 2.3  |
| Euro area               | 6.2              | 2.5  | 7.0           | 1.8  | 5.3             | 2.2  |
| China                   | 2.5              | 2.1  | 3.0           | 2.3  | 2.1             | 2.0  |
| RoW                     | 6.8              | 4.2  | 7.2           | 3.8  | 6.3             | 4.1  |
| World                   | 6.0              | 3.3  | 6.5           | 3.0  | 5.5             | 3.2  |

| CB key rates | central scenario |      | risk scenario |      | upside scenario |      |
|--------------|------------------|------|---------------|------|-----------------|------|
|              | 2022             | 2023 | 2022          | 2023 | 2022            | 2023 |
| US           | 1.38             | 1.88 | 0.88          | 0.88 | 1.88            | 2.38 |
| Euro area    | -0.25            | 0.25 | -0.5          | -0.5 | 0.00            | 0.75 |
| China        | 3.50             | 3.60 | 3.40          | 3.40 | 3.70            | 3.70 |

|                                     |                              | Central scenario |      | risk scenario |      | upside scenario |      |
|-------------------------------------|------------------------------|------------------|------|---------------|------|-----------------|------|
|                                     |                              | 3M               | 12M  | 3M            | 12M  | 3M              | 12M  |
| <b>Fixed Income</b> <sup>1)</sup>   | <b>Current</b> <sup>*)</sup> |                  |      |               |      |                 |      |
| 10y Bunds                           | 0.10                         | 0.30             | 0.50 | -0.20         | 0.00 | 0.55            | 1.00 |
| 10y US Treasuries                   | 1.86                         | 2.00             | 2.25 | 1.60          | 1.75 | 2.20            | 2.50 |
| 10y Italian BTPs                    | 1.62                         | 1.90             | 2.20 | 2.00          | 2.20 | 2.20            | 2.60 |
| <b>EUR Corporates</b> <sup>2)</sup> |                              |                  |      |               |      |                 |      |
| Corp. IG non-fin.                   | 156                          | 150              | 130  | 225           | 175  | 115             | 110  |
| Corp. IG financials                 | 167                          | 165              | 145  | 250           | 190  | 115             | 110  |
| Corp. High Yield                    | 487                          | 500              | 450  | 750           | 600  | 375             | 375  |
| <b>Equities</b> <sup>3)</sup>       |                              |                  |      |               |      |                 |      |
| MSCI EMU                            | 128.2                        | -1%              | 7%   | -21%          | -10% | 15%             | 15%  |
| S&P 500                             | 4217                         | 0%               | 5%   | -17%          | -7%  | 10%             | 10%  |
| <b>FX</b>                           |                              |                  |      |               |      |                 |      |
| EURUSD                              | 1.09                         | 1.09             | 1.12 | 1.02          | 1.05 | 1.12            | 1.17 |

\*) as of 9/3/2022, 1) Fixed Income: in % p.a., 2) option-adj. spreads in bps, BofAML, 3) current value of equities: price index; scenario numbers are % changes based on total return

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