GEOPOLITICAL RISKS 2022: PUTIN-XI STAGFLATION RISKS

"Unprecedented events occur with some regularity, so be prepared." Seth Klarman

China and Russia are expanding their collaboration. Their new Eastern Axis is uniting against NATO. Ukraine could become the flashpoint. Western sanctions on Russia could spike inflation and lead to a recession across Europe. China could undermine Western sanctions and build an alternative Eastern payments system. This could accelerate its decoupling and make Russian and Chinese markets non-investable. Moreover, risks for Taiwan could rise substantially.

Investors are urgently deliberating on three questions:

A. How would heavy sanctions on Russia impact investments across Europe?

B. How would an energy crisis be resolved in Europe?

C. How would China support Russia and at what cost?

Geopolitics could create stagflation if Russia invades Ukraine. That dangerous path now appears more and more likely. The optimists still hope that Russia only wants to achieve respect and could settle on a more favorable Minsk Agreement. But the realists recognize that Russia cannot be appeased and may already have decided to invade Ukraine. Prelude diplomacy may only be used to create friction across Europe and to extract initial concessions from the West. If the sad realist perspective becomes highly likely, then only a few days remain to address the questions above.

A. The Western consensus appears to be that sanctions in this case could start with most severe options. Oligarchs and Putin loyalists could be hit hard. Many companies could face restrictions. Both Nordstream pipelines could be shut down: Germany may cancel Nordstream-2 and Russia could stop gas exports to most of Europe through Nordstream-1. And we could see the mother of all sanctions, namely cutting Russia off from the SWIFT payments system, which had previously been imposed on Iran.

Investors have already heavily unloaded investments in Russia and the Ruble has weakened substantially. EM Leaders has had zero exposure to Russia this year. But pain could be felt across Europe as Europe-Russia trade could largely collapse. Chart 1 illustrates respective trade weights and reveals that Germany would pay a high price. Exports could decline by $30bn and GDP growth could drop by 2% and cause a recession, even before second-level impacts from energy shortages are considered.

B. Europe is already facing an energy crisis even prior to the Russian aggression. Reserves are at very low levels and supply from alternative sources is increasing very slowly. Qatar and other Middle Eastern exporters could increase shipments and redirect LNG exports towards Europe. And the United States could corral its Western Hemisphere partners and accelerate LNG exports to Europe. But peak winter demand in Europe would most likely still face severe supply shortfalls which would create stagflation: a recession combined with much higher energy prices, as oil is projected to exceed $120 per barrel, while supply chains could be further disrupted.

Investors are considering potential impacts across Europe and are now taking a more defensive approach. On the other hand, a massive boom and opportunities are arising in energy and materials across the Middle East and Africa, which are the best performing markets so far this year, where EM Leaders has also added exposure. But the most important piece of the puzzle would be the response from China.

C. China is already a major energy importer from Iran and has repeatedly undermined Western sanctions. China has been working hard to develop alternative payment systems and has made progress on the digital Renminbi. China would now be uniquely positioned to collaborate with Russia in establishing a new Eastern payments system beyond SWIFT. Banks operating in China would be faced with lose-lose pressures to either tow the Chinese line or to implement Western sanctions.

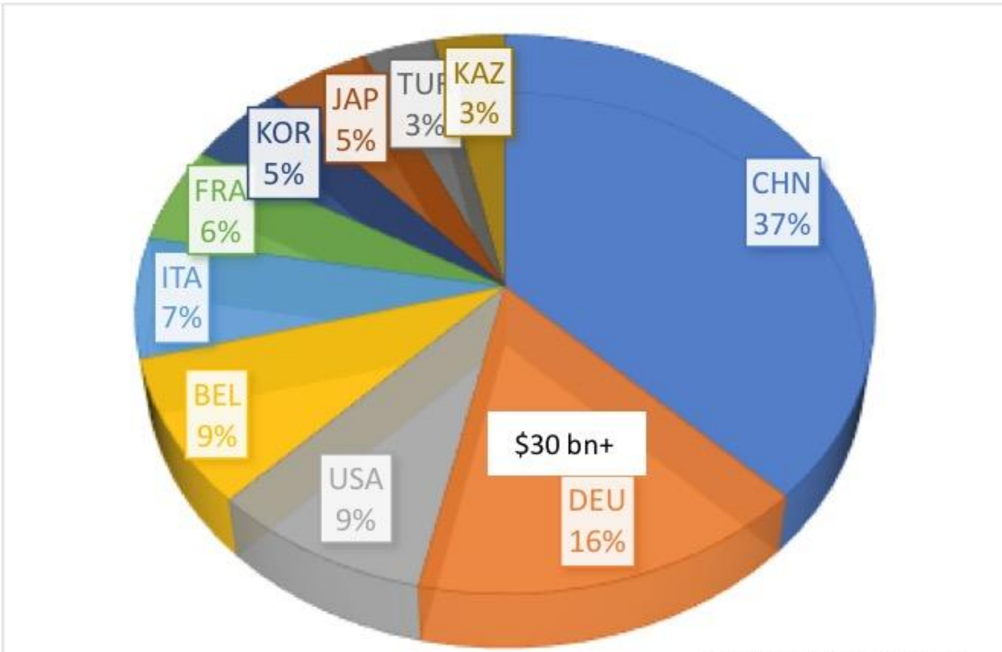
Chinese equities, especially US-listed ADRs, have performed poorly over the past year. Regulatory pressures and political sanctions have been detrimental. Just this week, a large Chinese biotech firm was added to the US non-verified red-flag list and its stock price dropped precipitously. Investors anticipate that many Chinese firms will be forced to de-list their ADRs. US and European policy makers are keen to re-shore chip production from China and to diversify supply chains beyond China. Trade tariffs imposed under the previous US administration remain in full effect. What kind of sanctions could now be added if China were to undermine Western sanctions?

Investors have already suggested to exclude China from the emerging markets benchmark. Chart 2 illustrates how the share of Chinese equity markets has risen to 32% while the Russian share has remained below 5%. This initiative was modeled on the Asia-ex-Japan split in 2001. But it could now become more pressing if Russian and parts of Chinese markets become non-investable. Anyone still following passive index investing may suffer a nightmare awakening with these “unprecedented events”.

Ukraine could indeed become a humanitarian and political tragedy. But implications could reach far beyond the region. The China-Russia axis could shake up geopolitics. Investors may quickly need to focus on capital preservation. And the next big question would be how the China-Russia axis could endanger Taiwan.

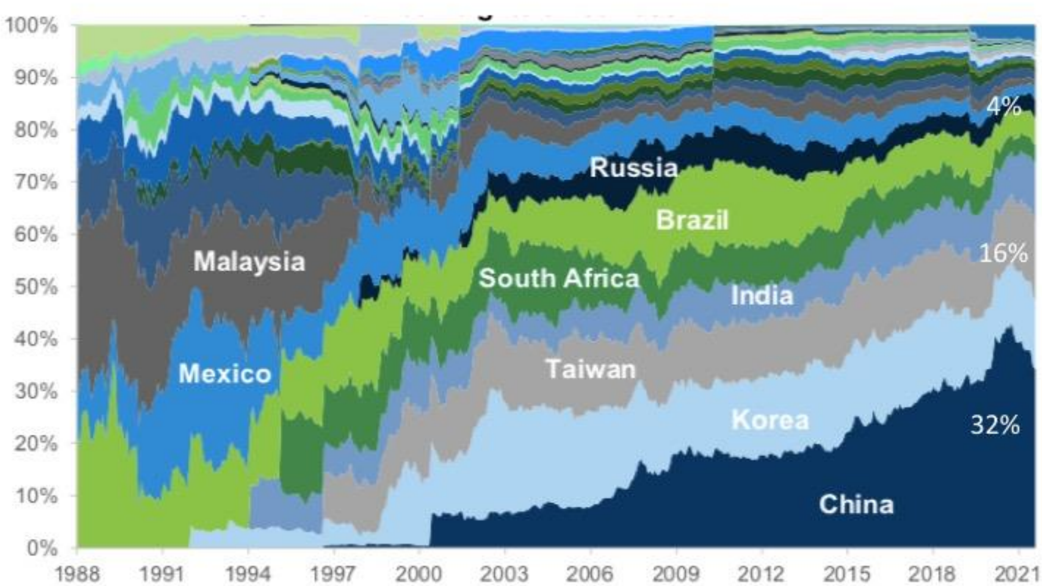
http://www.emleaders.com/pdf/eml-stagflation-2022.pdf

Russian Imports 2021 | Chart 1



Source: EM Leaders (2021)

EM Equities Universe | Chart 2



Source: MSCI, FactSet (2021)