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Market Update - January 2022: What is the market so worried about?

Stand-Off #1: The US Federal Reserve versus Inflation

Markets have certainly seen some renewed volatility in recent weeks as several factors weighed on sentiment. Firstly the rate of inflation has proved somewhat stickier and so far at least, intransigent; secondly, the rate at which the Federal Reserve might increase base rates to control that inflation; and thirdly, the situation on the borders between Russia / Belarus and Ukraine.

Turning firstly to the inflation question: recent measures have seen US inflation running at around 7% which is too high in the Fed's opinion. Since inflation became elevated in 2021, Fed members repeatedly stated that most of the inflationary pressures were likely transitory and based on booming demand from consumers and businesses as the reopening from Covid lockdowns progressed, and an inability by supply chains broken or disrupted by the Covid pandemic to meet that booming demand. Stories abound of workers isolating, semiconductor shortages, shipping containers in the wrong places, ports closed, ships unable to dock or in endless queues, millions of workers furloughed, car plants shutting due to parts shortages, shortages of building materials slowing construction projects, and so it goes on. All if not most of these shortages were a result of the pandemic and they resulted in disrupted manufacturing and logistics processes worldwide, although a fire in a silicon chip factory and a mega container ship wedged in the Suez Canal for a prolonged period didn't help either.

Fed Chair Jerome Powell late in 2021 declared that perhaps some of these inflationary pressures were not so transitory and might therefore be more systemic rather than cyclical in nature, and this has unnerved markets. The Federal Reserve in late '21 indicated it was preparing to raise interest rates by announcing a 'tapering' of the Quantitative Easing program wherein the Fed purchased a combined $120bn worth of US Treasury Bills and Mortgage-Backed-Securities monthly. The Fed then accelerated that program in November / December in order to terminate QE by end the end of March instead of June '22, and then started to talk about 'running off' the existing stockpile of $8.8 trillion in debt sitting on the Fed's balance sheet, $4.8 trillion of which was added during the covid era, so 2020-21 effectively.

None of this should have been a surprise to markets, although they have reacted badly to the uncertainty created by this, and admittedly the Fed could have calmed nerves by being clearer about their overall intentions. So, a case of miscommunication to a degree. For some years the Fed has maintained very low rates within a highly supportive monetary policy designed to shore up the economy, firstly through the Great Financial Crisis and latterly through the covid pandemic. This era of ultra-loose monetary policy is now ending, undoubtedly, and the market fears that the Federal Reserve might be inclined to act too aggressively in fighting the perceived inflationary threat, thus ramming on the monetary brakes too hard and in turn derailing the current – *very strong* – recovery in the US.

Markets and investors are right to fear this, given it is always within the ability and scope of an overactive and over-motivated central bank to act too hastily and destroy an otherwise robust economic expansion, replacing it instead with recession. The US Economy grew in GDP terms by 6.7% annualised in Q4 of 2021, making a real-terms GDP gain of +5.7% for 2021 as whole, more than offsetting the covid-bestowed GDP decline of 3.4% in 2021, and meaning the US economy is now $21 trillion nominal in size, and in late 2021 regained its pre-covid level. US growth in 2022 is not likely to match that of 2021 in any event as it moves further from the immediate post-covid lows and the recovery from these, but is still expected to reach +5% for the full year. The US economy is currently (on Q4 2021 figures) growing at roughly three times its longer term or 'trend' growth rate, available jobs are plentiful, employment is high, corporate earnings have grown at around 20+% in 2021 and will likely grow at circa 9% in 2022. Consumers meanwhile have the best balance sheets seen in many years, while the prospects for the economy remain broadly positive.

In short, the US economy is *easily* strong enough to no longer require the types of ultra-loose monetary policy that was required to steer it through the pandemic, and we must remember that the latest round of QE and the ultra-low base rates were the direct result of that pandemic. In any event, markets and especially equity markets typically perform quite well in interest rate upcycles. In the last rate upcycle starting from late 2015 and running through summer 2019, the S&P500 Index in the US rose 46% during that time, and the S&P Information Technology Index rose 96% over the same period. Similarly, if the Fed believes that its increasing rates potentially threatens the recovery, then they will pause the process. Thus in 2016 during the last rate upcycle, the markets expected three rate rises, and got just one as the Fed played the prudence card to keep the economy on a growth track. As is (too) often the case, markets have majorly overreacted to something that simply never warranted so much angst, and this may be due this time to many market participants never having seen a significant cyclical uptick in rates in their careers so far.

It is instructive to note at this point how the bond markets themselves perceive the inflation threat, and the best measure of this is the short to long term rates chart, the so-called 'yield curve'; at this point on 31 January, Treasury-Bill rates are as follows: 2-year debt yields 1.18%, 5-year debt yields 1.61%, 10-year debt yields 1.78%, and 30-year debt yields 2.11%. These yields, while off their recent all-time lows, are nevertheless still remarkably low when compared with any long-term backward comparison of US Treasury yields. The 5-year T-Bill is important as much commercial lending is priced off that yield, while the 30-year bond is especially important to consumers as US mortgages are priced off it - the current 30-year mortgage in the States carries a yield or rate of about 3.51% - one can imagine most UK home buyers being rather eager to lock in long term mortgages at that rate!

What this means is that the bond markets are not telling us that we have any sort of runaway inflation problem, and as the bond markets are several times the size of the equity markets, it behoves us to always listen to what the bond markets are saying. So, it seems the bond (and equity) markets are not so concerned with the inflation numbers per se, even though the current numbers

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are indeed elevated, it seems they are more concerned with an over-reaction (possibly dramatic) to those elevated numbers by the Federal Reserve. Such an over-reaction by the Fed could constitute what the markets term a 'policy-error', and yes, such an error if large enough could easily derail the current recovery.

Therefore, markets somewhat rashly seemed to have decided that all of these tightening activities by the Fed are going to happen almost immediately and for the most part simultaneously, which was never likely to be the case. The Fed has repeatedly stressed that base rates can only rise *after* the taper of QE has been completed, and that the balance sheet runoff will only likely start sometime after that and be a gradual process – the Fed is hardly likely to try and flood bond markets with $ Trillions of Treasury Bills, which would be totally counter-productive. We do not believe the Fed will do anything to dramatically over-correct the economy and it has repeatedly stated it will be mindful of the incoming data and act judiciously based on that data.

It seemed to us that Chair Powell has repeatedly stressed that his Fed will act judiciously and carefully when tightening monetary policy. In terms of the statement and press conference the Fed held January 26th, it did admittedly miss a key opportunity to spell out in somewhat clearer terms how it views its policy options in response to the perceived inflationary threat – that was an opportunity clearly neglected by the Fed, with the result that markets continued to sell off when there was no fundamental reason for them to do so.

In terms of the data itself, inflation is clearly a current problem but is in fact based on past events, inflation largely reflecting price pressures that have already manifested in the economy, thus inflation can therefore be regarded somewhat as a backward-looking projection or economic indicator. Many data sets concerning leading economic indicators and projections, whilst they might be proved inaccurate in future, do, we believe, point to an already slowing US economy in 2022 and a concomitant easing of inflationary pressures. Current and projected indicators concerning the housing market, retail sales, inventories, inflation, corporate spending intentions, consumer confidence, and durable goods orders (to name but a few) would suggest to us that the economy is already cooling, this being borne out by several PMI or Purchasing Managers' indices also turning lower this month – the PMI's are especially important as they indicate how and if corporates are to spend capital and invest. These distinctly forward-looking economic indicators suggest that the need for *substantially higher base rates will not exist* this year.

On Thursday 27 January, Apple Inc announced its all-time record quarter in terms of sales and revenues, and although the company does not expect its growth in 2022 to match its stellar growth of 2021, it also stated that it is now seeing an easing in the supply constraints and logistics bottlenecks affecting its business going into 2022, which will further allay inflationary fears. This statement on the supply chain contributed to a 5% rise in the stock on the day. Microsoft meanwhile has announced the $67.7 billion acquisition of leading digital gaming company Activision Blizzard, which must serve as an expression of confidence in current and anticipated economic conditions.

Fed Chair Powell mirrored this belief in the press conference following the Fed meeting on Wednesday 26 January, stating that the Fed's base-case expectation remains that the inflationary pressures will ease naturally during 2022 as the covid crisis eases and its resulting supply chain disruptions fade. Additionally, the overly generous fiscal policies of the US government over the covid era and the extraordinarily accommodative monetary policies from the Fed itself will not be there either, so this triumvirate of factors should argue strongly for lowering inflation expectations going forward into 2022. Undoubtedly there will be lingering inflationary concerns, such as how many of the current 'absent' 4.2 million workers from US payrolls are the late 50's or 60-somethings who have decided to retire early and will not be returning to their previous or any other jobs. Thus we do not believe that inflation is headed back down to the 2% or even lower levels of recent years, just that it will substantially moderate from its current elevated levels, perhaps back to a range of 2.5-4.0%.

As the economy cools and supply chains get closer to normality, thus more closely matching available supply with demand, so inflationary pressures will ease further, and the Fed will simply not have to do as much in terms of raising base rates to battle inflation as parts of the market currently expect or fear. The Fed's own forward predictions for inflation for 2022 are 2.6%, falling to 2.3% in 2023, and 2.1% in 2024, all of which figures would we suspect be well within the Fed's comfort zone on inflation. The data from the respected University of Michigan survey meanwhile, suggest the 5-year inflation projection at just 3.1%.

What we did not see from Wednesday's statement or press conference is a Fed that is bent on applying the economic brakes hard – the humility which Powell repeatedly stated they would operate with suggests to us a cool approach and not acting like a bull in a China shop when it comes to tightening monetary policy; the nimble approach he suggested could apply in equal measure to the Fed putting rates up or down, as economic conditions demand. As for the running down of the Fed's balance sheet, Powell explicitly stated that the Board of Governors is merely highlighting that the run-off will commence at some point soon, meanwhile he also stated they have 'not yet had the discussion' about when exactly to start the runoff. Our belief is it will start around July 2022, and at a mild initial rate of circa $50-$100billion per month.

Thus we see little likelihood of any significant policy error on the part of the Fed going forward, but until such time as inflation is seen to start easing or 'rolling over' from its current elevated level, markets will likely remain jittery and in 'risk-off' mode. Granted, Powell did not rule out the possibility of 50 basis-point rate hikes or rate increases in lockstep with every Fed meeting going forward, but then it's not his job as a central banker to rule such things out, or in for that matter; he has to maintain all options at the Fed's disposal, and not tie policy-maker's hands behind their backs.

Interestingly, data just in on Friday 28 January shows that wage growth has cooled materially in Q4, with the US Employment Cost Wages Index for Q4 2021 being almost 27% lower than that for Q3.

Similarly, the US Employment Cost Benefits Index for the same quarter was flat over Q3 but was notably 10% lower than forecast. The overall US Employment Cost Index for Q4 meanwhile was some 23% lower than for Q3. The biggest number just out however was the US PCE or Personal Consumption Expenditure Index which showed the effective cost of what Americans consumed in goods and services declined a rather large 33% in Q4 2021 over Q3, to an annualised read of 4.8% versus the previous quarter's annualised read of 7.2%. The equivalent year-on-year PCE figure barely rose from its former 5.7% to a new read of 5.8% for the year ending 31 December 2021, indicating that the inflation numbers are peaking or have peaked. The PCE inflation metric is one of the Fed's favoured inflation measures and will carry weight with the voting members of the Federal Open Markets Committee, the US equivalent of the UK's Monetary Policy Committee.

Meanwhile the Markit PMI or Purchasing Managers' Indices and the Durable Goods Orders indices have both turned somewhat lower in January, and this indicates that the economy is 'coming off the boil', which slowing in economic tempo should manifest in reduced inflationary pressures - and a more relaxed Fed.

As ever, one swallow or in this case 'a few swallows do not a summer make', and we must be careful not to extrapolate too much from a single month's figures. Nevertheless, these are metrics that the Fed pays careful attention to, they carry significant gravitas and are clearly showing that several areas of inflationary concern to the Fed are now showing that the Fed should be becoming less concerned about them. The Fed will be additionally aware of course that the onset of Omicron from November last year will have had a significantly detrimental effect on public and business confidence, and hence on the wider economy and the drivers of inflation, in which case the Fed also needs to ensure that it doesn't overplay its hand and talk the markets into an increased state of uncertainty.

The Fed will be similarly aware that the US housing market may have 'pulled forward' some future demand for housing as would-be home buyers rushed to acquire mortgages whilst rates were still at historically low levels, and that this rate of demand for mortgages will probably not be sustained. Thus the Pending Home Sales year-on-year figure for December 2021 came in at -6.9% versus the -0.3% decline forecast, whilst the month-on-month figures for Pending Home Sales to December came in at -3.8% versus the -0.1% forecast. All this of course indicates that demand in certain key areas of the market is starting to wane from previous peak levels, and we note that housing costs are one of the key drivers of inflation, together with wage costs.

And all the while the supply response is gathering pace; the Baker Hughes Rig Count, which monitors all operational oil rigs across the US and Canada, to give one key example, shows a week-on-week rise in the number of active rigs of +1% to week ending 28 January; now 1% doesn't sound much, but annualised that's an increase rate of 52%. As of February 2021, there were circa 295 rigs operational in the US, today there are 495, an increase of around +68% within a year, this neatly illustrating how the post-covid supply response will continue augmenting oil supply, hence lower prices and drive inflation lower.

So we are in a stand-off situation where elements of the investment markets believe the Federal Reserve has got it all wrong and is way behind the inflation curve, thus requiring rapid rate increases to choke off inflation and which will probably cause a recession; and the Fed itself which feels that inflation is set to subside naturally without the need for rapid and repeated rate rises. So far the data appears to support the Fed being right, although the markets will most likely need to see additional data sets supporting this thesis before they can rally meaningfully.

We see the prospect of either individual 50-basis point rate hikes or lock-step rate increases as highly unlikely based on current data. The so-called 'dot-plots' of the individual Federal Reserve Board voting members indicate the majority of them see just three, individual quarter-point rate rises in calendar year 2022, which gets the rate to just 0.90% at year-end. And Jerome Powell is correct to state that there is 'plenty of room' to raise base rates – standing at just 0.15% effectively at present, there is really only one direction for rates to go from here, and that's up. But even in the highly unlikely event that we see four rate rises this calendar year, that would still see US base rate at just 1.15%, which is hardly a calamity. And we must remember that many US mortgagees have already locked-in those ultra-low long term mortgage rates, while many US corporates have already realigned their medium- and longer-term borrowings based on the extraordinarily low rates available to them, and will consequently remain largely unaffected by rising base rates.

The Fed is also acutely aware that the tapering to zero of the Quantitative Easing program by March, coupled with a summer start to running off the Fed's own balance sheet assets will be highly significant tightening measures in their own right, and that base rate increases would be yet a third leg to the tightening operations. Thus, it may well be that the Fed does not need to increase base rate by four or even three rises this year. Yet some elements of the market still perceive that the Fed will derail the economic recovery by over-fighting a not so serious inflation menace. Time will tell, but we think Powell and his team at the Fed will get it broadly right, and the markets will recover to reflect this fact.

Stand-Off #2: Moscow versus Kiev, and NATO

Another major concern overhanging markets right now is the situation along Ukraine's borders with both Russia and Belarus. But if Vladimir Putin is intent on attacking Ukraine, he is going about it in an extremely strange fashion. Normally attacks on neighbouring or any other territories need to carry an element of tactical surprise in order to achieve some intended strategic gain. Far from being secretive, the Russians are telegraphing their (apparent) invasion intensions to the entire world, and more specifically of course to the USA and NATO.

So this smacks more of sabre-rattling than any real intent for a full-scale invasion of Ukraine. In any event, Ukraine is the second largest land mass in Europe behind Russia itself – it is about twice the size of Poland and almost the size of Texas, to place this in perspective, so will not be easily occupied. It contains around 43 million citizens, the vast majority of whom have no desire or intent to be (re)occupied by Russia, so the 100,000 troops massed on the Eastern border with Ukraine will be not nearly enough to occupy and ultimately pacify Ukraine. Additionally, Ukrainians have enjoyed 31 years of democracy, yes a flawed democracy but name one that isn't, and will have no desire to return to subjugation by Russia. This more or less entrenched Ukrainian democracy is part of the problem for not only Putin but his Belarusian stooge Alexander Lukashenko. Both dictators with extremely shaky legitimacies for ruling, both fear the flourishing democracy that has taken root in Ukraine, and fear that its continued existence, resilience, and success may serve as a beacon to the oppressed citizenries of not only Russia and Belarus, but across the entire Russian Federation, so fundamentally Putin fears civil uprisings above all else – and he probably has bad memories of Chechnya.

RUSI or Royal United Services Institute (a UK defence and security think-tank) analysts stated Jan 31st that what Russia has amassed on Ukraine's border does not amount to an invasion force, not yet anyway. But Putin having failed to get his way recently is once again upping the ante by moving more critical assets such as air defence systems, fuel supplies, essential personnel to man equipment, and other force multipliers to the region as a second step in his build-up of an invasion force. Russia has very publicly built up its forces on the Ukrainian border and continues to move assets very visibly, including contingents of its Baltic Fleet to the Black Sea, a move designed for maximum publicity as the fleet sails past a host of NATO nations.

Arguably it is solely intended as a public relations exercise, as it is unlikely the assets moved will play much of a role in any incursions into Ukraine: Russian naval forces have never in their history mounted let alone won an opposed seaborne invasion of a foreign territory, and they probably do not wish to chance such a move now. What Moscow does want is for the West and NATO to watch as each time Putin turns the screw and builds up his forces ever closer to something that could conceivably invade Ukraine, the intention being to keep the West guessing and in the hope that western leaders – probably in Germany or France – will crack and demand that the US and NATO make key concessions to Putin's demands in order to ultimately defuse the situation.

So the strategy is clear, keep mounting pressure and threatening to invade with an ever increasing and invasion-capable force, until someone in the West blinks and sues for peace. Putin then extracts his key *written* guarantees from NATO, declares victory over his arch nemesis, and states he has saved the world. In the meantime, he portrays himself as the saviour of the Russian people against an aggressor, a la Stalin, and puts himself forward as the strong leader they need to protect them from the evil intentions of the USA and NATO.

Putin has likely been emboldened by the Biden Administration's climb-down from stopping the Nordstream 2 gas pipeline from being completed in September 2021, which coupled with the shambolic military withdrawal from Afghanistan has encouraged him to believe he can win this high stakes political poker game. Putin respects only strength and perceives of Biden as a vacillating and weak old man, despite his undoubted foreign policy experience.

The West in the meantime responds with threats of dire sanctions and crippling blows to the Russian economy, Bob Menendez (Chair, US Senate Committee on Foreign Relations) stating on Sunday 30 January that his Committee is already devising the 'mother of all sanctions' to deter Moscow, and Liz Truss in the UK promising legislation that will attack Russian oligarchs, Putin's inner circle, and Russia's energy industry in the event of an invasion.

Putin almost certainly does not want to risk all in a shooting war with Ukraine - recent surveys in Ukraine have indicated that around a third of all citizens are willing to take up some form of armed or active resistance against a Russian invasion, while a further fifth or so are willing to engage in protests, civil disobedience and the like, so any Russian invasion force could have around 22+ million citizens actively engaged against them. And if one wants to know what many Ukrainians really think of subjugation by Russia, recall events of 80 years ago where many of them openly sided with Nazi Germany against Stalin in a case of 'my enemy's enemy is my friend'… Russia has still not pacified the Donbas region of Eastern Ukraine, where around 7% of Ukrainian territory is in Russian hands, after years of conflict and stand-off. Be mindful that this is essentially a conflict between Russia and Ukraine and not as the Russians try to portray it as a civil war. Certainly there are elements of the Ukrainian population supporting the Russians, but most of the forces operating in the Donbas are Russian.

Then there are the Western sanctions - Putin desires leverage over Western Europe and particularly Germany via the Nordstream 2 pipeline which is close to becoming operational, but if that shooting match does start, then Nordstream 2 is dead in the water. Putin is also a realist, and he must recognise this amongst other key facts, and he most likely does not wish to vaporise the political and monetary capital he has invested in Nordsteam 2 before he has been able to extract any significant political leverage from it.

While he likes to think of Russia as a superpower which in terms of its military capabilities it is, he needs to accept that Russia is hardly an economic superpower like the US, and the USSR ultimately fell apart for economic reasons, not because of any military defeat. It is the world's 11th largest economy, but again we need to create some perspective: the Russian economy in nominal Dollar terms is about 1/15th the size of the US, 1/10th that of China, half that of India, slightly smaller than South Korea, about the same size as Brazil, and a little larger than Australia. Perhaps most tellingly, Russian nominal GDP is less than half that of California's. Yet it punches above its weight due to its extraordinarily high military expenditure, which at circa 4.5% of annual GDP is well over double what China spends on its military in GDP percent terms, and again about double what most NATO nations are supposed to spend on defence – and most of them spend a lot less than that. This overspend on the military will earn Russia a relatively small return on its national capital deployed, keep the citizenry much poorer than they might otherwise be, and may contain the seeds of its own ultimate destruction as with the USSR before it, but that's another matter.

Putin's endgame is supposedly to create a security zone around Russia, by stopping NATO expansion into the states of the former Warsaw Pact, including Ukraine. Putin alleges that NATO is 'encircling' Russia, which is a bit rich given that NATO nations border just 6% of Russia's boundaries. He aims to continue pressuring Ukraine and the West until someone cracks, and he believes that will be the West.

So far the West is holding its nerve, beefing up its defensive posture in Europe, sending critical military technologies and assets such as advanced anti-armour weapons to Ukraine and other threatened ex-Warsaw Pact states, and pledging meaningful sanctions on Russia if an invasion goes ahead. Putin might have stated his 'red lines 'in Ukraine, but the West also has red lines, and capitulating to Putin's demand that NATO ceases any form of expansion eastwards goes deeply contrary to the bloc's 'Open Door 'policy towards future memberships, and Ukraine has already attained a mild form of associate status in any event. This is quite clearly a 'Chamberlain Moment' in Europe's history – appeasing Putin now effectively grants him free access to bully, threaten, and cajole all ex-Soviet bloc European states – and potentially others as well – into a renewed form of overall Russian hegemony, effectively a partial recreation of the Cold War status quo in Eastern Europe. This would clearly have huge consequences for the financial and investment markets.

Such an event would also serve to inform Beijing that the West is indeed a toothless tiger, and that China's goal of re-attaining control over Taiwan by any means necessary could effectively proceed unopposed by the West, and it is quite possibly this truism that is informing and directing the current robust NATO response to Putin's demands.

The West is thus far doing exactly the right thing in bolstering Eastern Europe's and particularly Ukraine's defensive posture by making it clear to Putin that any Russian invasion will prove very costly both in men and materials, together with economic consequences - the idea being to make him think thrice before making any bold moves. Certainly material sanctions would follow: Russia would be kicked out of the SWIFT international payments system, Russian banks would be severely sanctioned and cut-off, access to western capital and know how would be denied to its oil and gas industry, and Nordstream 2 would be consigned to history before it shipped a single therm of gas. Nordstream 2 is already part of the plot – besides being designed to ship greater quantities of gas more directly to Western Europe and thereby create for Moscow considerable political and social leverage over it, and at the same time drive a wedge between the transatlantic allies, it would also serve the additional Russian purpose of replacing the existing pipelines that happen to run through

Ukraine - and from which Ukraine extracts considerable revenues which it then uses to support its own military efforts against Russia in Eastern Ukraine – a Faustian bargain indeed.

So far Putin is not getting his way. The US and NATO responses were delivered separately to the Russians Jan 26th, with all of Russia's key demands being rebuffed. But Putin remains intent on making a grand show and to re-establish what he sees as some imperial glory in this, the 100th anniversary year of the formation of the USSR. He also needs some success to show to his populace as his approval ratings fall. But again he needs to be careful – Putin constantly expounds how the Russian and Ukrainian people are one and the same, and indeed Kiev is the home of the mother Church of Russian Orthodoxy, so it is extremely doubtful that the Russian people would countenance any form of serious shooting war with their Ukrainian brethren, especially once the body bags start to come home.

Similarly in Belarus, President Alexander Lukashenko is playing a dangerous game. Having originally set himself up as supposed honest broker between Moscow and Kiev over the Crimean and Donbas incursions, Lukashenko has since openly sided with Russia after the West imposed sanctions following the farcically rigged elections in Minsk of August 2020. But would the Belarusians who have recently been quite pro-Ukraine wish to engage their neighbour and former soviet ally in open warfare? It has to be doubtful, and Lukashenko is not just unpopular in Belarus, he is despised for the despot he is, and any form of shooting war with Ukraine in order to prop up Putin could prove the last straw for the oppressed Belarusians, who may now have acquired a taste for mass uprisings.

Add in the Western military assistance already rendered and the more that would follow any Russian incursions, and the possibility exists for the Russian forces to get a bloody nose. Putin calling up his army reservists would mean stripping the Russian economy of many workers and potentially destabilising economic output; meanwhile Russia has never meaningfully diversified its economy away from oil and gas exports and is critically revenue dependent on them, thus taking actions that entail a stopping of those energy exports would hardly constitute a wise move.

Putin knows all this, hence the conclusion for the time being at least that this is an exercise in sabre rattling, and for the reasons above it is not likely to work. He will not back down however, he will keep both pressure and demands up to see if Europe or the Alliance eventually cracks, but he will likely not call up his citizenry to fight their neighbours, he will likely leave that to smaller numbers of more elite full time troops who can be trusted to obey orders.

So some sort of minor incursions west of Crimea might be possible, or he could take more territory in the eastern Donbas region and consolidate his hold on Ukrainian territory there, such that the 7% of Ukrainian territory under effective Russian occupation already might just become 15 or 17%, and that would likely take on an air of permanence, such that we might end up with a UN-style 'Blue Line' separating the two opposing forces. Belarusian troops in the North and Russian naval assets in the Black Sea could act as a diversionary force to stretch Ukrainian forces thinner and allow invading forces to the East and South to achieve their objectives. Thus Putin gains more territory which he can hail as a victory to his people and claim that he has established a Russian-controlled buffer zone between the two countries - and NATO. The start of any small scale conflicts would likely be based on some form of concocted military attacks claimed by Russia as having been carried out by Ukrainian forces on the apparently peace-loving Russian and / or Belarusian forces, or a claimed attempt to protect ethnic Russians, much as the Third Reich concocted an excuse to take the Sudetenland in 1938, and indeed more recently provided Moscow with some of its justification for the 2014 annexation of Crimea.

Such minor incursions blamed by Moscow on alleged Ukrainian provocation might just avoid the turning on of Western sanctions, but would still render European and US public opinion decidedly worse against Russia and specifically against Nordstream 2, which already faces massive resistance from most of Europe and the US, such that it cannot currently be certified for operations even though it is complete from an engineering standpoint. Ironically a big winner from this might be the USA itself, where the shale oil fields in the Permian and Bakken Basins can produce vast quantities of natural gas as a by-product of oil production. Converted to LNG this could then be shipped in large volumes to Europe.

How the two opposing sets of diametrically opposed red lines are resolved is as yet unclear, but the US and NATO approach is so far to refuse Russia’s basic demands (which are in any event unacceptable) and instead to engage the Russians in dialogue aimed at arms limitation, and it is via this route that the West may offer some concessions based on removing certain forces and / or military assets from ex-Warsaw Pact states in return for a de-escalation of the current tensions, and guarantees that Russia will respect the territorial integrity of Ukraine, and possibly others. This would still constitute some measure of climbdown by the West, but the precedent for such an outcome was the Cuban Missile Crisis of 1962, where a humiliated USSR removed its missiles from Cuba, but so did the West when as part of the deal the US removed its theatre nuclear weapons from Turkey and Italy - so Kruschev was a winner here too, as well as JFK. This may be the means via which the current ‘crisis’ could be resolved. In the meantime its effect on investment markets will probably remain limited, unless Putin restricts gas exports, but that would be a form of economic suicide in any event.

So we do not anticipate this cold war getting seriously hot any time soon, rather it is likely to prove a steady and gradual ratcheting up of tensions over time, and the possibility exists that as the inflation concerns ebb from the markets in the coming weeks and months, so they will be replaced by these heightening tensions on the Russia-Ukraine border. In the event of a real shooting war breaking out of course, markets would tank initially and then take stock of the situation. All this will keep markets guessing for some time, but the end outcome will likely be a continuation of the current low-level conflict in Eastern Ukraine for some time, possibly a very long time.

In terms of the effect on the markets so far, probably around 90% of the recent volatility has been due to markets believing that the Federal Reserve in the US is going to massively overreact to inflation and in the process derail the economy and trash the recovery, with only the remaining

10% being attributable to the Russia – Ukraine situation. That could change of course, and in the meantime the markets must hope that the above analysis proves correct and that a full-on shooting war does not ensue.

In a nutshell, we believe that in relation to Stand-off 1 between Markets and the Federal Reserve, it is most likely a case of much ado about nothing, the inflation problem will fade and is already fading, meaning the Fed only needs to tighten policy to a lesser degree than currently feared by the markets.

In Stand-off 2 between Russia and Ukraine, the issue will prove more intractable than the inflation problem and could remain as a festering stand-off for some while. However Putin might opt for a quicker resolution to be reached by the anniversary date of the founding of the USSR 100 years ago on 30 December 1922, and the tit-for-tat negotiation route suggested above may just be the route by which this can be achieved.

With Kind Regards

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