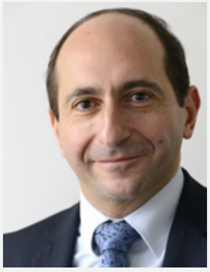

Didier BOROWSKI,
Head of Global Views

Foreword

The war in Ukraine at a turning point

By calling the war in Ukraine a «tectonic shift in European history», European leaders are giving an indication of the regime changes this war could lead to in the medium term.

In the short term, the economic consequences of the war will depend on how long and how intense the conflict is. A few elements allow us to make an initial assessment after one month of war:

- **Russian forces are bogged down on the ground,** experiencing serious logistical problems (lack of fuel, rations and perhaps even ammunition) and are suffering initial military setbacks.
- **The resistance and fighting spirit of the Ukrainians, supplied with weapons by at least 28 countries, is proving effective.** The fight is more intense and longer than Russian military strategists had anticipated. The human and material cost for the Russians is considerable. Ukrainian officials estimate that some 17,000 Russian soldiers have been killed, which is more than during the war in Afghanistan (15,000 dead in 10 years).
- **President Zelensky has established himself as a warlord both within his country and globally.** His high-profile appearances before the parliaments of Western democracies have made him a heroic figure who embodies and galvanises the resistance.
- **On the diplomatic front, talks resumed in Turkey between the Ukrainians and Russians after a three-week break.** Russians announced a change of strategy and promised de-escalation but there has been no significant breakthrough. The focus is on the conditions for a ceasefire. The status of the occupied territories (Donbass and Crimea) is not on the agenda, but it is clear that this will be at the heart of the upcoming negotiations. President Zelensky would accept Ukraine's neutrality subject to guarantees for his country's security (with a guarantee close to that of NATO's Article 5) and approval by referendum.
- **The EU has decided to gradually reduce its energy dependence on Russia with the support of the G7 countries.** The hydrocarbon sector is still relatively untouched by the Europeans, but pressure has been stepped up; Germany is already aiming to: (i) halve its Russian oil imports by the summer, (ii) stop importing Russian coal by the autumn; and (iii) stop importing Russian natural gas by mid-2024.

In short, Vladimir Putin is already facing deep economic and political challenges. And on the military front, the setbacks are mounting. From our point of view, the events of March increase the probability of a "short" war with a cease-fire and full-fledged negotiations in the coming months. China's bargaining power has *de facto* increased considerably and we continue to believe China will play a key role in ending the crisis. In the short term, the risk of a "vertical escalation" - with the use of unconventional weapons: chemical, biological or even tactical nuclear weapons - has been reduced. However, the negotiations will take a long time and it seems to us that it would be a mistake to consider that the risks of an escalation or even a widening of the conflict have disappeared. Uncertainty is elevated and it remains necessary to consider alternative scenarios.

In any case, this war will mark a turning point in international relations and military doctrine in Europe, and lead to a new form of globalisation. This conflict challenges doctrines that have been well established for decades, in particular the paradigm that economic integration is a bulwark against war. This crisis exacerbates the need to diversify supply chains and to relocate some production for strategic and/or resilience purposes. Economic links with Russia are definitely weakened.

Finally, from an economic point of view, the war in Ukraine aggravates the dilemma of the main central banks because, on the one hand, it will push inflation even higher (with spillover effects into all prices), and on the other hand, it increases the risks of a slowdown in growth. This dilemma is all the more pronounced as central banks underestimated the inflationary consequences of the fiscal and monetary measures taken during the Covid crisis. This is particularly true in the US. One lesson from the late 1970s and early 1980s is that late action can lead to inflation taking root, requiring more aggressive tightening and causing longer-term pain. But the other lesson is that soft landings are difficult to achieve, and that the risks of recession increase when financial conditions tighten too quickly.

It is between these two pitfalls that central banks – and investors – will have to navigate. In this document, we seek to provide some guidance to investors in this very uncertain and shifting world.

Finalised on 30 March 2022

Ukraine Crisis Tree

[A] Russia has partially invaded Ukraine, but is facing resistance and unprecedented economic sanctions. High level talks have started but no resolution - Russia nuclear forces are placed on high alert

[B] Short-term resolution with limited military escalation				[C] Prolonged military conflict and global military escalation	
B1] Sanctions deterrent effects and diplomatic talks end the conflict with an acceptable way out for V. Putin	**B2] Russia wins the war with contained casualties and no Kiev siege, then creates a "subdued" government in Ukraine**	**B3] Russia wins after war with a siege in Kiev, high number of casualties and risk of military escalation**	**B4] Unrest or military putsch ends Putin's regime**	**C1] Low intensity conflict with limited supply chain disruptions (evolution of B2)**	**C2] High intensity conflict (evolution of B3]**
Partitioning and/or demilitarisation of Ukraine moving to "neutral" status i.e not joining NATO		Full sanctions against Russia which enters an economic and financial crisis	Russia economic and financial crisis	Global stagflation	Worst case scenario, we can be expected including West and Russia military confrontation and Ukraine becomes a battlefield
Markets relief: limited repricing of global relative risk premia, limited global spillover but profit recession in EU still a tangible risk	Worse growth than our central scenario with EU GDP contractions and growth [0%-2%], Inflation towards 8%-10%	Spillover into Eastern Europe		GDP and inflation close to our central scenario	Global GDP contraction comparable with GFC or Covid-19
Better growth prospects than our central scenario and CBs back to normalisation	Energy prices to remain high as sanctions remain and rationing of energy coming from Russia and limited substitution capabilities		High uncertainty on Russian political new situation	Oil decelerating towards 75-80 by Q1 23 or even 60-65 in case of partial diversification (horizon 12-18months)	EU GDP down -4.5% to -2% with rationing of energy supply and economies to support the war efforts
Energy prices remain temporarily high before supply diversification materializes (e.g., Saudi or Iran) and the search to diversify suppliers makes further progress	Market instability starting to price in Russia crossing new red lines in Europe	Worse growth than our central scenario with EU GDP contractions and growth [0%-2%], Inflation towards 8%-10%	Energy prices to remain high and unstable	GDP for EA at 2.2%-2.4% (annual average growth), inflation in the 5.5%/6% (average)	Inflation skyrockets to double digit on severe shortages of commodities, even higher energy prices, food emergency
	Profit recession in Europe				
			GDP contractions and growth [0%- 2%], Inflation towards 8%-10%		
			CBs back to normalisation		
• Positive: European and Chinese equities, EM credit • Negative: Gov Bonds, commodities and energy and gold	• Positive : safe havens (USD), Oil prices stays close to 100-120 • Negative : liquid assets, and EUR	• Equity markets capitulation with US outperf. • Bond yields collapse • Oil prices high and volatile • Stronger USD and gold	• Yield curves flatten • Euro weakens, EM FX turmoil • Oil prices high and volatile • Equities high dividends and quality • Within EM favour Latam and China	• Negative real rates favour real assets gold commodities, EM debt • Equity value, quality and defensive • Short duration	• Markets capitulation • Favour UST and secured real assets • Bond yields collapse • Stronger USD weaker EUR and strong gold • Negative EM

Source Amundi Institute

Éric MIJOT,
Head of Developed Markets Strategy Research

Combining value with quality and secure dividends

1] What in your view are the most resilient areas on global equity markets?

The current market phase corresponds to a certain maturity of the US cycle. While the equity market has been facing the acceleration of the Fed's tightening of monetary policy since the beginning of the year, commodity prices continue to rise. This situation has been exacerbated since February by the Russian invasion of Ukraine, especially in Europe. The markets therefore have to cope with rising rates, rising commodity prices, and a probable slowdown in earnings growth.

In terms of style, it is prudent to diversify. The **Value style** takes into account a further rise in interest rates and has historically held up well in a stagflationary environment. **Quality stocks** (low leverage) and those with **high and secure dividends**, which are more defensive, also have their place.

Regionally, the US market has not failed to live up to its reputation for resilience during the market sell-off early this year. Nevertheless, it remains more expensive than the others. We should therefore **take advantage of its depth to look for quality value stocks**, as growth stocks are still under pressure from rising interest rates for the moment. Otherwise, **rising commodity prices are benefiting Canada, Australia, Norway and Mexico,** for example; these are good complements to consider. **The UK market can be used to play the transitional phase** between the commodity price rise and the economic slowdown. Energy stocks are heavily represented there, contrary to industrial stocks. At the same time, it has one of the highest dividend yields of any equity market. Finally, **the Swiss market provides a further step in the cycle** should the economic downturn eventually cause commodity prices to fall. It acts as a proxy for health stocks versus energy stocks.

In the end, we should not forget that any prospect of a resolution to the conflict in Ukraine would be conducive to a sharp equity rebound, which would instead benefit the segments that have suffered the most in the downturn, such as the Eurozone, financials and consumer discretionary stocks. Being heavily underweight, these segments would then be a source of underperformance during the rebound.

Finalised on 25 March 2022

Lorenzo PORTELLI,
Head of Cross Asset Research

2] Is there more upside for commodities?

Commodities are always driven by four sets of factors – fundamental, geopolitical, structural and cyclical. Today all four factors are supportive and are underpinning commodities price and in particular those of base metals and energy.

Recent commodity markets rallies have closed the undervaluation gap relative to nominal growth (i.e., the cyclical factor). Therefore, sustainable upside in commodities cannot be based solely on the recovery narrative.

The **geopolitical factor** is obviously **critical** these days. Natural gas will be under pressure from undersupply issues related to the recent tragic events in Ukraine. Sanctions and closed activities in Ukraine ports are creating a generalised shortage in a wide spectrum of commodities, from grain to steel. As a reminder, Russia and Ukraine combined account for 30% of global wheat exports.

Our structural constructive view on commodities is related to the **green transition** and a potential long-lasting **demand-supply mismatch** in crucial base metals. Inventories are at historic lows, and there are no signs of improvement there. If we adjust the main commodities valuations for growth and inventories, they look cheap, despite the recent rally, and are among the cheapest of asset classes.

Given this backdrop, **we reiterate our constructive view for commodities,** despite the recent rally, with logical repercussions on inflation.

Finalised on 29 March 2022

Alessia BERARDI,
Head of Emerging Macro and Strategy Research

3] How to evaluate emerging markets exposure to the Russia-Ukraine conflict?

In order to assess the impact of the most recent geopolitical events on the EM universe, we have been focusing on a few possible **channels of transmission,** one being the risk of **supply shock and the consequences on the commodities universe,** the second being the **decrease in demand from the areas/countries in proximity to the conflict.**

While **proximity** to the conflict zone could be easily assessed through **geographical distance (in which an important role is played by the flow of migrants),** there are other, more global aspects to consider when we refer to proximity, including **commercial/investment interlinks and tourism flows, as well as remittances.** In this sense, **Eastern Europe (either emerging or frontier economies) is expected to take most of the direct hit** from exposure to Russia and Ukraine, as well as the indirect hit coming from a more subdued demand from core European countries. That said, across neighbouring frontier countries that are able to maintain a certain degree of neutrality and not incurring a secondary type of sanctions, **proximity can open up opportunities, such as benefitting from business relocation and rerouting of trade and financial flows from Russia or exporting agro products in place of Ukraine.**

When we look at the **commodity channel**, first of all, due to the type of countries involved, we need to look at the **broader universe including energy, agro** and even **metals** where short-term shocks are adding to more structural pushes from net-zero transition ambitions. Second, it's fair to say that an increase in commodity prices will have more complex ramifications than drawing a net preference line between exporters and importers to identify winners and losers. While we started by considering the external position of these countries vis-a-vis commodities trade, the relative weight of these items in their inflation baskets as well as the fiscal cost to limit inflation spikes are certainly factors worth considering, too. **Energy and net food importers will experience an external and a fiscal deterioration indiscriminately.** Imports bills are skyrocketing and several governments are in a hurry to limit the pain to households by drafting **fiscal initiatives, such as higher subsidies, price caps, cash hand-outs, excise taxes cuts, resulting in higher fiscal cost.** Of course, the economies already reporting heavy twin deficits (fiscal and external), along with a more fragile debt position are likely to suffer the most and more likely to incur rating revisions or default. The Russia-Ukraine conflict has certainly accelerated the Sri Lanka discussion with the IMF (after long hesitation) where high oil prices and decline of touristic revenues have further limited the country's ability to service its external debt.

Higher commodity prices are good for net exporters but watch out for high inflation and higher fiscal costs to contain it

Conversely, commodity exporters should be the relative beneficiaries of the consequences of the recent geopolitical events. Indeed, Latin America countries are not only physically distant from the conflict zone and, trade-wise, relatively less connected (more so if we consider the Eurozone as a whole), but also those that are most positively correlated to the commodities cycle, either via oil, agro or metals, with Mexico representing the most important exception among the main countries in the region. **However, higher input costs are further weighing on inflation profiles that are already very stretched (Latam, but not only, being an example), possibly prolonging the tighter stance of their central banks (negative on growth). Moreover, the sense of urgency to contain further inflation spikes is calling for larger fiscal support, yet diverting fiscal resources or deteriorating fragile fiscal positions.** Indeed, it looks like high oil prices are not benefitting a country like Nigeria, where the government would use its fiscal revenues to finance fuel subsidies. The issue is even bigger in countries in need of ensure food security and where inflation is biting (e.g., in Africa). On the brighter side, if not immediately spent on public capex, the increase in oil revenues will allow Gulf Cooperation Council (GCC) countries to replenish oil fund reserves depleted during the pandemic crisis.

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