UBS

Global risk radar

What do geopolitical tensions in Eastern Europe mean for global markets?

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This publication series helps investors identify and assess global financial market risks and their investment implications.

At a glance

- Tensions around Ukraine have escalated in recent weeks. Our base case is for a continuation of diplomatic efforts leading to a stabilization and an eventual easing of these tensions. This may take several months, during which flare-ups remain possible, for example as a result of actions taken by the separatists in Ukraine, Russian special forces, or cyberattacks. All of these could trigger countermeasures by Western countries. In this scenario, we see any aggression staying below the threshold at which it would trigger the full range of threatened sanctions, with a thin margin of overstepping thresholds from either side.
- A full-scale invasion of Ukraine by Russian forces is a tail risk event, in our view. Should it occur, it would trigger risk-off sentiment among investors and tough sanctions against Russia. Energy flows, commodity prices, and the ability to execute cross-border transactions would be in focus. Energy supply disruption, whether as a result of sanctions, a Russian decision, or accidents, could have a longer-lasting impact. However, both parties seem keen to avoid such an outcome, in our view.
- We believe the current global rout in risk asset prices is not related to the tensions around Ukraine. In case of an escalation, investors therefore need to brace for more downside. Past market drawdowns driven by similar events have been short-lived, however.
- Investors with diversified portfolios and a long-term investment plan are best prepared for an eventual relaxation of tensions, as in our base case, but also to withstand setbacks caused by geopolitical events, as in our downside case. Exposure to commodities, especially energy, and cybersecurity should benefit in both the base and negative risk case, in our view.

Source: iStock

This report focuses on the market implications of escalating tensions around Ukraine. Our thinking is structured around four scenarios and, where possible, insights from previous geopolitical events. The scenarios we look at are:

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1. A **base case scenario** where diplomatic and political efforts ultimately lead to a dialing down of tensions. This may take several months during which the possibility of flare-ups remains elevated. Risk sentiment is likely to be negative, albeit likely only for some weeks, whenever these occur.
2. An **upside risk case** where a diplomatic solution is found quickly. Global assets show little reaction, as the risk premium priced in for an escalation currently is relatively low, in our view. Russian assets recover rapidly.
3. A **risk case scenario** where we see a military escalation of the conflict and the imposition of new sanctions against Russia, stopping short though of disrupting energy flows. We assume a quick cessation of fighting once it occurs. Experience suggests that market drawdowns driven by geopolitical stress events are typically short-lived. Russian assets would sell off further, and later recover only partially.
4. A **severe risk case** where we see prolonged fighting and a prolonged interruption of Russian energy exports. Broad equity markets would suffer, as would most other cyclical assets, and no quick recovery would ensue.

What is driving the geopolitical tensions around Ukraine?
Tensions in Eastern Europe have escalated in recent weeks. Russian troop movements near its border with Ukraine and statements by various Western leaders that a Russian invasion of Ukraine is both likely and imminent have led to fears of a military conflict.

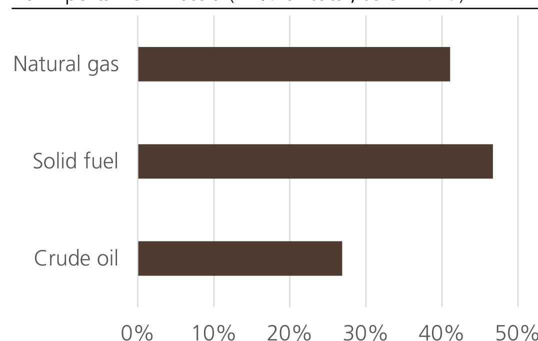
In an attempt to redraw the European security architecture, Russia has signaled to the West that it sees the eastward expansion of NATO over the past years, as well as the potential future accession of further states in the region, as a red line for its own national security. The West has underlined its commitment to the self-determination of sovereign states and the security of Ukraine, and has threatened a wide range of sanctions on Russia. Given that the positions of two parties are far apart, diplomatic efforts have so far not led to a relaxation of tensions.

The recent publication of intelligence information in Western media has been criticized by Russian authorities as a campaign against the country by the West and NATO. Russian Deputy Foreign Minister Alexander Grushko has described it as "demonizing" Moscow and an attempt to justify NATO's eastern expansion.

The situation remains fluid and is complicated by the involvement and interests of various countries. Much attention has been given to US President Biden's statement "My guess is he [Putin] will move in" at his 19 January press conference, which underlines the urgency behind the White House's thinking. At the same press conference, Biden emphasized the importance of a unified Western position and the significant response Russian aggression would entail. Currently, the US Congress is considering two packages of substantial sanctions against Russia. On the EU side, shaping a unified position means balancing the interests of its 27 member states first. Decisions on sanctions require unanimity in the European Council.

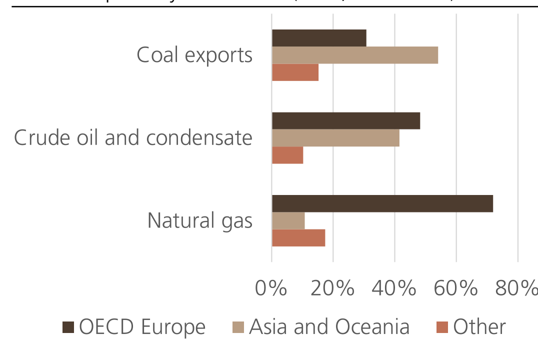
Notwithstanding the difficulties, diplomatic and political efforts are continuing, as US Secretary of State Antony Blinken's meeting with Russia's Foreign Minister Sergey Lavrov on 21 January shows.

Fig. 1: Europe depends on Russian energy supplies…
EU imports from Russia (in % of total, as of 2019)



Source: Eurostat, UBS, 24 January 2022

Fig. 2: … and Russia depends on Europe as a customer
Russian exports by destination (in %, as of 2020)



Source: EIA, UBS, 24 January 2022

Key risks for global markets
Should the crisis worsen, Europe's energy security would represent a key risk to markets in our view. The threat or reality of supply disruption of hydrocarbon flows could lead to their prices to rocket. Global energy markets are already tight, making near- to medium-term substitution near impossible. That said, energy continued flowing from Russia to Europe even at the height of the Cold War.

The West's threat to disrupt financial transactions with specific Russian counterparts or even the Russian economy as a whole would lead to significant disruption in cross-border business and difficulties settling Russian external debt. Such sanctions could also interrupt energy flows, as they may de-facto prevent payment flows for received fuel deliveries. For Russia, a tightening of the sanctions regime would likely reduce its long-term growth potential further, with negative consequences for the living standards of the population and the return outlook for Russian assets.

Scenario 1: Base case

Our base case is for a continuation of diplomatic and political efforts leading to a stabilization and an eventual relaxation of tensions. However, this may take several months during which the possibility of flare-ups of local conflicts remains elevated. Action by separatists in Ukraine or Russian special forces to further the division of the separatist regions from Ukraine, additional large-scale troop movements and military exercises, or cyberspace attacks could all trigger Western countermeasures. Yet any aggression in this scenario would not trigger the full range of threatened sanctions. We acknowledge the considerable risk of miscalculation, but believe that eventually the best interest of all parties involved is served by finding a diplomatic offramp.

We base our assessment on the following considerations:

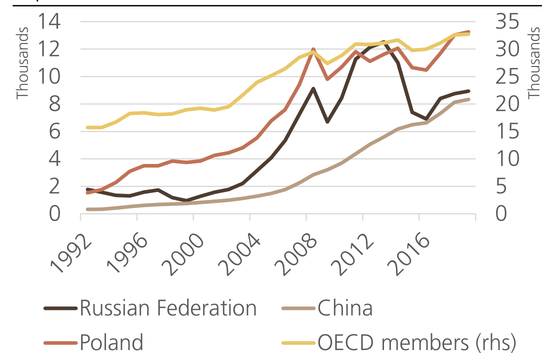
- A military escalation would impose human and economic costs on all parties involved. The integration of Russia and Ukraine in world energy and agricultural markets, as well as their cross-border business dealings, mean that significant sanctions against Russia would also lead to repercussions for Western companies, sectors, and even economic growth and inflation dynamics. According to Eurostat, 41% of the EU's natural gas imports, 27% of crude oil imports, and 47% of solid fuel imports originated from Russia in 2019. The EU conducted close to 5% of its goods trade with Russia in 2020, while that share stood at 37% for Russia, according to the European Commission. Gazprom, Russia's top gas producer, sold roughly 40% of its output to Europe (including Turkey) in 2020. The Russian energy sector comprised close to 20% of Russian GDP and 40% of fiscal revenues in 2019. Russia is also an important metals producer; for example, the country provides close to 40% of global palladium production and non-negligible amounts of metals needed for a successful energy transition. In sum, all parties have much to lose from a further deterioration in their relationship.

- A tightening of the sanctions regime would likely reduce Russia's long-term growth potential further, with negative consequences for the living standards of the population. Two years ahead of the next presidential elections in Russia, and against a backdrop of protests in Belarus in 2020, in Russia in early 2021, and in Kazakhstan this year, we think that further economic pressure on the local population, together with potential casualties, risks domestic resentment. The Russian government is likely to considers this scenario in its calculations, in our view. That said, previous sanctions against Russia have led not to a change in behavior, but rather a shift from West to East (China), and focus on reducing dependency on foreign funding and building up buffers.

- US President Joe Biden is facing midterm elections later this year. The president's disapproval ratings are currently high, and in our view he will want to signal a tough stance on Russia to voters and Congress. Similarly, European politicians may find it easier to talk tough publicly on Russia to the average voter than to justify higher energy costs and less employment opportunities. The same may apply to UK Prime Minister Boris Johnson. Not every statement needs to signal true intent—grandstanding

Fig. 3: Russian incomes left behind

Adjusted net national income per capita (GNI minus consumption of fixed capital and natural resources depletion; in current USD)



Source: World Bank, UBS, 24 January 2022

is part of politics. But public messaging is also important for Russian politicians as a sign of control and strength to the local population.

- Maximalist demands and unwavering positions are unlikely to be dropped early on in the negotiations, as both sides are waiting for concessions from the other side. In addition, the public display of positions may not fully reflect more nuanced discussions held behind closed doors. In this context, however, the unusual amount of intelligence information appearing currently in Western media might make it increasingly difficult to find a diplomatic solution to the conflict. History suggests a diplomatic offramp needs to reduce the political costs for it to work. We highlight that local media in Russia, the West, and even Ukraine portray the conflict very differently. The transition to a diplomatic resolution might therefore be easier to be achieved.

- By moving to a scenario of military escalation, the involved actors risk a loss of control by upending the value of the optionality inherent in the respective threats of a military escalation and harsh sanctions.

One potential resolution could involve an understanding of the chances of Ukraine's NATO membership in the foreseeable future that can be accepted by all involved parties. Here, official communication and behind-the-scenes dialogue may differ. Security guarantees, even if not in an ironclad, binding format, can be exchanged at the highest political levels. Signposts for an improvement in the tensions could stem from a stronger focus on what is possible, rather than impossible, engaging more strongly on areas of shared interest in parallel to the areas of opposing views, and the emergence of a framework of conducting talks than the ad-hoc meetings currently being called. Similarly, a bigger Restraint in official statements and media announcements could indicate that the focus is shifting toward an easing of tensions.

Scenario 2: Upside risk case

Diplomatic and political efforts are ongoing, and an off-ramp to the tensions may be in the making behind the scenes. This scenario is unlikely to materialize in the near term, in our view. A more stable relationship between the West and Russia could have benefits in the medium to longer-term for arms control, conflict resolution, and the energy transition.

Scenario 3: Downside risk case

A military escalation is a tail risk, in our view. While the likelihood of such escalation has risen in recent weeks, we think that the worst-case outcome of a large-scale conflict, pitting Russia openly against Western states and NATO, will be avoided in light of the above-outlined costs (see scenario 4 for more on this). We believe that Russia is not willing to be involved in an ongoing military conflict involving a possible occupation of large parts of Ukrainian territory. The invasion of a small part of Ukraine, long-range warfare, or targeted strikes against military installations appear much more feasible for Russia than a larger invasion. We think a military escalation would likely focus minds on ceasing fighting rapidly, moving back to the diplomatic sphere, and limiting the conflict to a regional one. That said, the escalation will likely have created new circumstances for negotiations, with new facts on the ground and new sanctions.

What could an escalation look like?

Based on media and analyst reports, as well as our discussions with experts, the Russian military would likely be able to defeat the Ukrainian military in a conventional war, especially given its airspace superiority and long-range missile capabilities. Still, in close combat, Ukrainian forces would likely be able to impose losses on an occupying force. Accordingly, we assign a very low probability to a large-scale invasion and occupation of territory, in part because areas that are home to a large Russian-speaking population, for example the Donbass region, may be of higher strategic relevance for Russia than parts of Ukraine further west. Rather, in this scenario targeted strikes against Ukrainian military positions could degrade offensive capabilities and facilitate a limited incursion with clear strategic goals. This may include stationing Russian troops in the separatist republics in the Donbass and providing the military capabilities to counter unmanned drones. There may be a limited expansion of territorial gains for either Russia or the separatist regions, for example, to create a buffer zone to the prior line of demarcation. Additionally, cyberattacks on Ukrainian government facilities, command and control centers and on Western institutions as well as disinformation campaigns would be expected.

Draft legislation being discussed in the US Congress considers potential sanctions against senior Russian officials and individuals in the business sphere, financial institutions, sovereign debt, providers of SWIFT-type services, the Nord Stream 2 (NS2) natural gas pipeline, and Russian extractive entities. This list is non-conclusive and may expand or be trimmed in the legislative process. The EU has not taken a clear position yet on what sanctions might be expected. In a military escalation as described in this scenario, we would expect the West to react with harsh sanctions. New Russian debt would likely be in scope. Sanctions targeted at Russian politicians close to and including President Vladimir Putin, as well as parts of the business elite, seem likely as well; this could have important market implications for the companies the latter own. Targeted obstacles to clearing transactions via sanctions on certain banks and corporates, as well as significant export restrictions to suppress technology transfers and to hurt future exploration of the extractive industries are also possible. But excluding Russia from SWIFT and a complete stoppage of energy flows is highly unlikely in our view. The latter is particularly doubtful from the European side, given the significant collateral damage it would incur. The exact sanction package would likely be unclear in the early hours of a military escalation, and given the uncertainty, the initial market reaction would likely be more negative than what markets would price after getting clarity on the West’s response.

This is only one potential negative risk case and is meant as an illustration. Should an escalation occur, it may be more or less severe than outlined here.

US bills discussed in the Senate

US Democrat and Republican members of Congress have developed two bills with sanctions against Russia. One of the key differences between the two is the timing of sanctions introduction: The bill drafted by the Republicans envisages sanctions imposed shortly after it is enacted (i.e., without any external triggers); the bill drafted by the Democrats envisions sanctions imposed once the US president determines that Russia is engaged in "a significant escalation of hostilities" against Ukraine. The bill drafted by the Democrats include sanctions targeting, among others, Russia's senior officials, three or more banks out of a list of 12 banks, new sovereign debt, providers of SWIFT-type services, NS2, and Russian extractive entities. The bill drafted by the Republicans include sanctions targeting, among others, Russia's senior officials and individuals of the business elite, new sovereign debt, providers of SWIFT-type services, NS2, state development corporations, and designation of Russia and Russia-supported armed forces in Donbass as a state sponsor of terrorism. We are monitoring the passage of this legislation.

What effect could such an escalation have on global financial markets?

At this point, we think that global markets are not pricing in a large risk premium linked to the crisis. While Russian assets have accelerated their sell-off since last week, global markets only seem to be starting to take note of the crisis recently, as the greatest focus remains on global yield moves. Oil prices are not trading out of line with market fundamentals at this point, in our view – despite potential large spikes should a military escalation take place (see also scenario 4 below).

An escalation of the situation could trigger risk-off sentiment among investors. However, experience suggests that market drawdowns driven by geopolitical stress events are typically short-lived and often provide opportunities for investors to increase market exposure. Please see also the figures further below, illustrating the market impact of the Crimea crisis in 2014 and of Iraq's invasion in Kuwait in 1990.

During a risk-off period, we would expect global equities to move down, but only slightly. As Europe is the region most dependent on Russian gas imports, we would expect EMU equities to suffer more than global equities. In fixed income, emerging market credit would be impacted the most, led by Russia, which makes up 3.2% of the EMBI Global Diversified and 4.4% of the CEMBI Diversified.

The main beneficiaries from a market sell-off would likely be traditional safe-haven assets such as the CHF, the JPY and US Treasury bonds. The gold price typically rises during geopolitical events, and it would likely additionally benefit from potentially higher inflation expectations on the back of rising energy costs in Europe. Inflationary pressure may stem as well from rising food prices should grain supplies from Russia and Ukraine, two large exporters, be disrupted. Food prices are already at their highest levels since 2011. The effect would be greater on lower-income countries.

How should investors position themselves?

While the geopolitical tensions around Ukraine could weigh on markets, we highlight that investors with diversified portfolios and a long-term investment plan are best prepared for an eventual relaxation, as in our base case, and also to withstand setbacks, as in our risk case.

While some of our tactical recommendations, like our preference for Eurozone stocks, may suffer when negative headlines surface, our preference for energy stocks should soften the blow. Allocations to

commodities and energy stocks can be an option for investors to position for a benign fundamental outlook independent of the situation around Ukraine, with the extra benefit of adding some safety to their portfolio in case of an escalation.

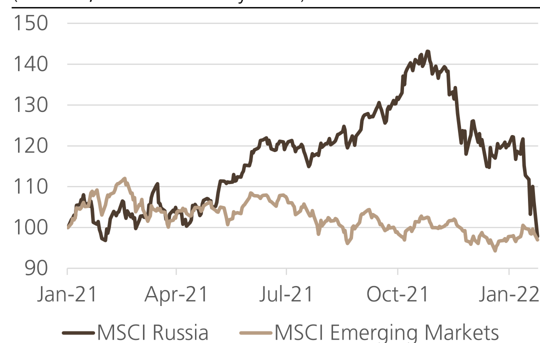
We also recommend considering investments in cybersecurity. The threat from cybercrime is rising, along with the need for investment to defend against it. Frequent reports about breaches in the cyberspace of corporates and individuals underscore the urgency of this risk. Cyberattacks have also been a prominent topic between state actors over recent years. This is why cybersecurity is part of the "ABCs of tech" theme, which also includes artificial intelligence and big data.

Russian assets in the spotlight

When it comes to Russian assets, investors who are concerned about a further escalation can consider establishing hedges via short positions in the Russian ruble. The currency would likely see sharp downside in case of a meaningful escalation, with USDRUB levels between 80–90 within reach. However, we note the risk premium incorporated in the ruble has risen to a significant extent already, and it is trading at cheap levels compared to its fundamentals. Together with the elevated carry, such a hedge would come at potentially high costs. In our base case of a relaxation of tensions—even if this takes a considerable amount of time—we expect the ruble to appreciate again as the geopolitical risk premium is priced out and investors focus more on the benefits of high hydrocarbon prices for Russia's external balance and its hawkish monetary policy. USDRUB traded below the 70 mark as recently as late October, and we forecast the ruble to trade in the lower 70s over the course of the year. For investors not shying away from the geopolitical risks and those aware of potentially significant losses, we retain a long RUB, short USD recommendation in our EM FX strategy.

Fig. 4: Russian equities under pressure…

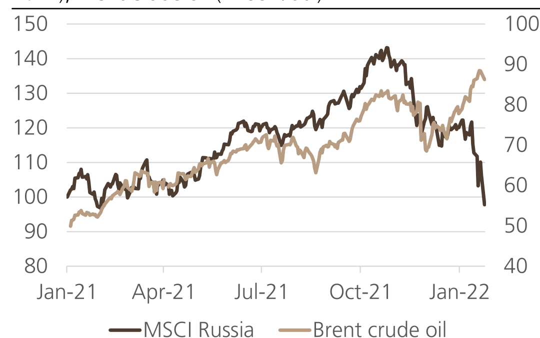
Performance of MSCI Russia and MSCI Emerging Markets (indexed, 100 = 1 January 2021)



Source: Bloomberg, UBS, 25 January 2022

Fig. 5: … and losing touch with oil prices

Performance of MSCI Russia (indexed, 100 = 1 January 2021), Brent crude oil (in USD/bbl)



Source: Bloomberg, UBS, 25 January 2022

We maintain a neutral tactical allocation to Russian equities and hard currency credit, given the ongoing geopolitical uncertainty. Russian sovereign and corporate credit spreads have widened by 110bps and 66bps, respectively, year-to-date, underperforming similarly rated peers. While we can't rule out further volatility in the Russian credit space, we remain comfortable with Eurobonds of Russian issuers under CIO coverage. The fundamentals of Russian sovereign and corporates under CIO coverage remain sound, in our view, supported by sizable gains in energy prices over the past year as well as the global and domestic economic recovery. The technical backdrop is less supportive, however, given the sizable share of foreign investors across key Russian assets. For example, 52.3% of Russian sovereign Eurobonds (or USD 20.5bn) were held by foreign investors as of end-3Q21, according to the Central Bank of Russia. This compares to a low of 29.4% in 1Q17. Still, under our base case, and especially our positive risk case, Russian credit should recover some of the relative underperformance. But given the opacity of the situation and the potential for further aggressive steps, we think that at this point the risk-reward of Russian credit is not favorable compared to other emerging market (EM) issuers.

Russian equities have been under pressure since November, after significantly outperforming EM peers in the previous quarters. Russian equities' sell-off is especially pronounced against the rise in oil prices since mid-December. Overweight positioning in Russian equity markets likely contributed to the sharp sell-off trigged by the geopolitical tensions. The 12-month-forward dividend yield for MSCI Russia now exceeds 10%, the highest level in recent years, and its 12-month

forward P/E has dropped to below 5x, which is closer to the crisis levels when oil prices were at a trough in March/April 2020. Once the geopolitical tensions abate, as per our base case, we think Russian stocks will rebound to trade more in line with their supportive fundamentals. In light of current elevated uncertainties, however, we abstain from recommending investors to gain exposure or add to existing positions in Russian equities for now.

Scenario 4: Severe downside risk case

An escalation of the conflict that disrupts the flow of energy supply would carry negative consequences for the global economic outlook. This may occur due to unintentional outage, a political decision by Moscow, or US and international sanctions targeting the Russian energy sector. The latter two options would likely occur only after a large-scale invasion of Ukraine by Russia or persistent fighting. In such a scenario, broad equity markets would suffer, as would most other cyclical assets.

Explainer: How energy markets could be impacted

- Russia is the world's third-largest producer of oil and second-largest producer of natural gas, with a global market share of 12% and nearly 17% in 2020, respectively, according to the BP Statistical Review of World Energy. Europe is Russia's main overseas market for both commodities; in 2020, European OECD nations took in 48% of Russia's crude and condensate shipments and 72% of its natural gas exports. Around 70% of Russian crude is transported out of four ports (Primorsk, Nakhodka, Kozmino Bay, and Ust-Luga). The majority of its natural gas exports travel by pipeline. Russia also has a few terminals for deliveries of liquified natural gas (LNG).

- Our base case is that oil demand will reach a record high this year. We forecast Brent crude to trade at USD 80–90/bbl, with the risks biased to the upside. With OPEC and its allies (OPEC+) unwinding their production cuts and benefiting from higher demand, spare capacity should fall to multiyear lows this summer. OECD commercial oil inventories are also at their lowest levels since late 2014. Given this backdrop, the oil market will be sensitive to news of supply disruptions. While our base case expects no disruption to Russian energy exports, we see three ways Russian production and exports could fall: by unintentional outage (e.g., damage to pipelines), a political decision by Moscow, or US and international sanctions targeting the Russian energy sector. That said, with the exception of the Nord Stream 2 pipeline, Washington has indicated that it may exempt energy from the punitive measures it is currently considering, given the potential impact such measures could have on energy prices. Energy has been flowing from Russia to Europe even at the heights of the Cold War.

- Nonetheless, in a severe scenario, we assume that 10–20% of Russian oil production and exports are disrupted, lifting Brent prices to USD/bbl 125 or higher. Elevated prices temper oil demand, keeping the market from overtightening. The magnitude of the price reaction would depend on when the disruption occurs. OPEC+ still has some spare capacity, so the group could increase production and compensate for the disruption at this time. This buffer, however, is likely to diminish

this summer, with only Saudi Arabia and the UAE having spare capacity. A post-summer disruption would result in a greater price reaction, which would then trigger a fall in demand and support production in short-cycle supply such as US shale oil. The exact level at which demand falls off is difficult to calculate. It also depends on the US dollar exchange rate (since most oil is consumed by countries with other currencies) and the energy subsidies and economic growth in emerging Asia, which has been the engine of oil demand growth in recent years. A simple way to estimate at which point oil prices will start to pinch is to use global oil spending as a percentage of global GDP. In 2011–13, it was around 4.5%; currently, it is around 3%. A price level of USD 125/bbl would raise global oil spending to around 5% of GDP—a level at which we expect demand growth to correct and trigger a vigorous supply response from US shale.

Economic impact: A sharp rise in the oil price could have two material consequences at the macro level. The first would be a hit to global GDP growth due to lower consumption as households and businesses allocate a greater share of their wallets to energy and fuel. The second would be inflation, with consumer price indexes rising even further in the short term, but falling even faster thereafter.

In a scenario of oil prices rising to USD 150/bbl in the first half of this year, we would expect world GDP to undershoot our current estimate by around 40–50 basis points. Of course, not all countries will be hit evenly: Given its greater dependence on oil, for example, the US will likely feel a slightly larger impact than Europe, China, or Japan. Our GDP impairment estimate might not seem large, but we believe it is reasonable as we expect a surge in oil prices would be met with a few mitigating factors. The first is policy response. We think central banks will dial down their recently hawkish tone and slow the pace at which they are planning to tighten monetary policy. On the fiscal side, governments may ease the burden on businesses and households either by reducing taxes or through direct support payments. The second is an adjustment in market behavior; we could see an effect similar to that experienced in the aftermath of Japan's Fukushima disaster, where a shock provokes a stronger demand reaction than a gradual increase in prices. Third, higher oil prices will hurt the spending power of US lower-income households, who also have the lowest levels of savings. Middle- and higher-income groups will likely be less affected given their remaining savings accrued during the pandemic. European consumers also have a savings cushion that is more or less intact.

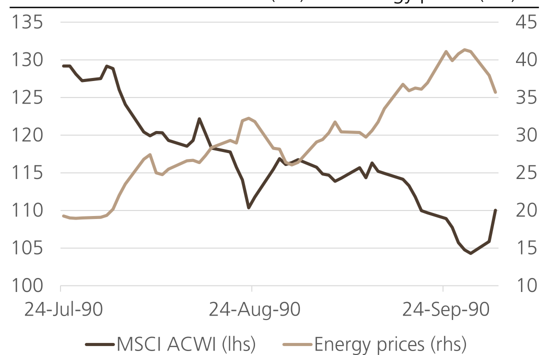
Financial markets' historical performance…

Supply-driven energy price shocks based on geopolitical tensions are not an uncommon phenomenon to global financial markets. In past episodes*, global equities have fallen 15–18% on average, but recovered within six months. Countries more reliant on imported oil tended to suffer more, as is the case for Europe, which imports around 90% of the crude oil it consumes. High grade bonds have offered some protection in the past, but less so than during other periods of market stress without energy-induced inflation worries. In credit, high yield and emerging market bonds suffered the most, but recovered within three months. The US dollar was initially seen to appreciate as investors sought a safe haven; however, this move reversed later due to higher oil prices. Safe-haven currencies such as the Swiss franc and the Japanese yen appreciated due to increased geopolitical risk premium.

*For the historical performance around supply driven energy price shocks, we look at the following episodes: Iran-Iraq war (1979), Gulf War (1990-1991), Venezuelan general strike (2002-2003), Libyan civil war (2011).

Fig. 6: Global stocks and energy price reaction during Kuwait invasion in 1990: Global equities hurt

Performance of MSCI ACWI (lhs) and Energy prices (rhs)



Source: Bloomberg, UBS, 24 January 2022

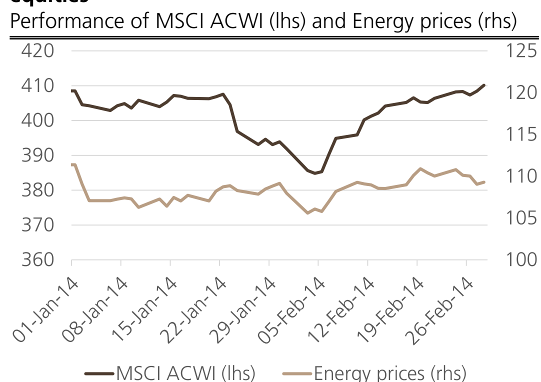
…and expected performance under the outlined severe risk case

We would expect global equities to fall 13–15%, mainly driven by a multiple contraction on higher inflation and falling leading indicators. Global earnings would be less impacted than European ones as margins are less sensitive to rising energy costs. Consumer staples, utilities, healthcare, and energy would be the less impacted, while cyclicals and small-caps would be particularly under pressure.

In fixed income, we would expect long-term government bonds to rally as yields decline and markets readjust their expectations on when central banks will hike rates. The breakeven inflation curve would most likely invert as higher energy prices feed into near-term inflation, while the long end would reprice lower due to higher risk premiums. This would then entail lower real yields. On the credit side, high-beta names and segments would suffer the most due to lower growth and hence earnings prospects. Emerging market credit spreads would be most vulnerable, particularly for issuers that are dependent on energy imports or have links to Russia and Western economic sanctions.

Fig. 7: Global stocks and energy price reaction during the Crimea crisis in 2014: Quick recovery of global equities

Performance of MSCI ACWI (lhs) and Energy prices (rhs)



Source: Bloomberg, UBS, as of 24 January 2022

A severe downside scenario as outlined above would add to existing stagflation fears. As laid out in the Global Risk Radar "Stagflation: How would markets react?" (2 December 2021), we think only a few traditional asset classes would deliver positive returns. Investors would have to turn to hedge funds, commodities, volatility-linked products, and more granular asset class strategies to protect their portfolios.

In the severe risk case, Russian assets would come under severe additional pressure. The ruble, as the main shock absorber for the Russian economy, could breach 100 per USD, as a large part of Russia's external trade would be impeded, and amid further portfolio outflows from Russia. The Russian central bank would likely not defend the ruble at a specific level, but let it find a new equilibrium and possibly only try to attenuate the largest swings. An escalation scenario that curtails the free flow of energy will likely also involve sanctions on specific Russian banks, companies, and (parts of) the sovereign complex—Russian credit, local bonds, and equities would likely face the additional headwind of Western investors selling the securities of the entities in scope, and further reducing their overall exposure to Russia.

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