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Things to watch for in 2023 (3): Will next year's game changer be Ukraine again?

- US mid-term elections might have been a turning point

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Things to watch for in 2023 (2): Shifts in two major drivers of yen depreciation

US mid-term elections might have been a turning point

Russia began its invasion of Ukraine on 24 February. The war was initially expected to come to a speedy conclusion. However, with Ukraine having received substantial military support from the US and Europe, Russia has found itself in a deadlock, with its military action dragging out longer than expected.

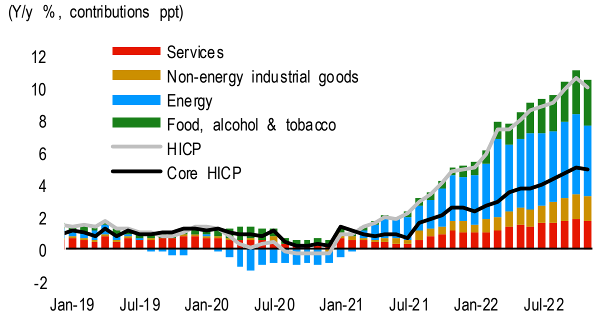
In his testimony at the House of Representatives on 2 March, Fed Chair Jerome Powell viewed the Russian invasion of Ukraine as a "game changer." Then, the Fed started to raise interest rates at the March FOMC meeting, clearly mentioning in its statement that the invasion of Ukraine by Russia was likely to create additional upward pressure on inflation and weigh on economic activity. As everyone knows, with the Fed having subsequently worked towards monetary tightening at an unprecedented pace, a wave of rate hikes is spreading around the globe.

Europe, where the war is taking place, is sustaining more extensive negative impact from the situation with Russia and Ukraine than the US. As a retaliatory measure for sanctions against Russia in response to the Ukraine issue, Russia started to gradually reduce natural gas supplies to Europe in June. Supplies via the Nord Stream 1, a major pipeline, have been stopped since September. With natural gas shortages and soaring prices dealing a blow to the economy, the outlook for Europe now depends on gas.

In addition to natural gas supplies from Russia being stopped and distribution of Ukrainian grain reduced, Europe saw record-setting heat waves in summer, leading to a surge in food and energy prices. Inflation in the eurozone is more than 10%, with food and energy accounting for more than 70% of that (Chart 1 on next page). With regard to economic conditions, negative growth has been avoided thus far due to a resumption of economic activity while living with COVID-19 and seeing a recovery of inbound demand. However, according to projections by the European Commission announced on 11 November, the growth rate is expected to decline q/q in Oct-Dec 2022 and Jan-Mar 2023. Negative growth for two consecutive quarters, i.e., a technical recession, is expected, meaning that stagflation in the eurozone is imminent.

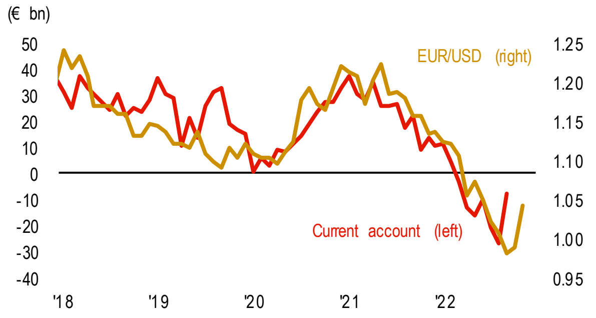
With no clear end to the Ukraine issue in sight, energy prices will remain high in 2023. This is likely what most market participants, including myself, see as the main scenario. However, if Russia and Ukraine were to reach an agreement on a ceasefire or a peace deal, that would have an extremely big impact, because no one expects that. If the Ukraine issue were resolved, energy prices would plunge and European economic/price projections would improve considerably.

Chart 1: Eurozone HICP



Source: Eurostat; compiled by Daiwa Securities.

Chart 2: Eurozone Current Account, EUR/USD



Source: ECB, Bloomberg; compiled by Daiwa Securities.

The US mid-term elections might have been a turning point with regard to the Ukraine issue. One of the many reasons for Ukraine putting up a good fight is the provision of a massive amount of support from the US. Ukraine would face a severe situation if it were to lose support from the US. Some in the Republic Party are cautious about continuing large-scale support for Ukraine. On 29 November, House Majority Leader Kevin McCarthy, the House GOP leader, said that Republicans would not write a "blank check" for Ukraine. Some are also calling for budgets for supporting Ukraine to be reallocated to domestic economic measures and measures for responding to long-term competition with China.

In fact, since around the time of the mid-term elections, we have seen more media reports hinting at a shift towards a path for peace negotiations by the US. According to news in the Wall Street Journal on 13 November, President Biden's national security advisor Jacob Sullivan visited Kyiv on 4 November and recommended that President Zelensky's team start thinking about realistic demands and priorities for negotiations, including reconsidering its stated aim of Ukraine regaining Crimea.

At a joint press conference after a meeting with the French President on 1 December, US President Joe Biden mentioned the possibility of negotiating with Russian President Vladimir Putin, stating that he was prepared to meet with Putin if he indicated that he was interested in ending his country's war with Ukraine. If the Biden administration is steering towards a path for a peace deal, the Russia/Ukraine war is likely to move towards an end in 2023, which may be another "game changer."

If food and energy prices fell due to an end to the war in Ukraine, it is highly likely that European inflation would subside rapidly. Once inflation subsided, the economy would shift from stagflation to recession. In a recession, the ECB should conduct rate cuts, not rate hikes, and buying bonds is recommended in a recession trade. Even in a scenario in which the war in Ukraine continues, we forecast that investment returns from European bonds, particularly French government bonds, would be greater than those from US Treasuries. This would be even more so the case if the war were to come to an end.

In the forex market, as well, the euro is expected to be preferred. With the energy shock leading to deterioration in the terms of trade in the eurozone, the current account (seasonally adjusted value) in the eurozone shifted to a deficit in March 2022 for the first time since February 2012, which was about a decade ago. This was greatly influenced by a surge in imports reflecting higher oil and gas prices. Once energy prices plunge, buying pressure on the euro is likely to strengthen in line with improvement in the current account (Chart 2). The rise in yields and dollar appreciation, both of which have been driven by the Fed's hawkish stance, is clearly peaking out. If, in addition to these US factors, the energy crisis were to stop worsening, it would make the euro easier to buy.

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