EMBARGOED UNTIL: 11.30AM THURSDAY 10 MARCH 2022

THE FORWARD VIEW – GLOBAL

MARCH 2022

National Australia Bank

Russian invasion triggers uncertainty & volatility in global markets

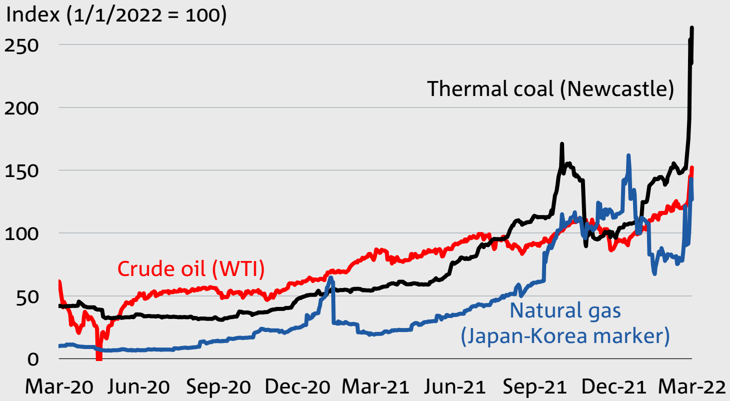
- The conflict between Russia and Ukraine has caused a significant spike in energy prices – reflecting the importance of Russia in the production and export of oil, natural gas and coal, and limited additional supply elsewhere. In addition, the conflict triggered a broad decline in equity markets, along with increased volatility in financial markets more generally, with expectations around global monetary policy decisions also shifting lower since mid-February.
- The duration of the conflict, and the resulting impact on energy prices, is highly uncertain – however it is clear that energy prices will remain elevated in the near term. Of the world's five largest oil consumers, three of them (Japan, India and China) are highly dependent on imports for supply, making them more vulnerable to energy price shocks. More generally, the conflict could further impact already disrupted global supply chains.
- It is important to note that the COVID-19 pandemic continues, and remains a major risk to economic activity – particularly in emerging markets (where vaccine protection is generally weaker). As highlighted by the rapid emergence and spread of the Omicron variant, additional highly infectious variants of COVID-19 can not be ruled out.
- We have substantially cut our global forecasts this month – largely reflecting the impact of the Russia-Ukraine conflict – down to 3.7% in 2022 (previously 4.2%) and 3.5% in 2023 (previously 3.6%). The main contributor to this downturn is Russia – which is likely to suffer a deep recession as a consequence of sanctions. In addition, we have lowered our growth forecasts for the Euro-zone, UK and Japan, and, to a lesser extent, for India, China and the US, largely reflecting the impact of higher energy prices. The forecasts are based on an oil price of around $US110/barrel (through to Q2) but, at times, the price has moved well above this in recent days, signalling downside risk to our projections.

Global Growth Forecasts

(% change)

	2019	2020	2021	2022	2023
US	2.3	-3.4	5.7	3.4	2.2
Euro-zone	1.6	-6.5	5.2	3.2	2.4
Japan	-0.2	-4.5	1.7	2.1	1.9
UK	1.7	-9.4	7.5	3.5	1.4
Canada	1.9	-5.2	4.6	3.5	3.1
China	6.0	2.3	8.1	5.0	5.5
India	4.8	-7.0	8.2	7.2	6.1
Latin America	0.1	-6.9	6.1	1.7	1.6
Other East Asia	3.5	-2.9	4.3	4.6	4.6
Australia	2.0	-2.2	4.7	3.9	2.6
NZ	2.8	-1.9	5.6	3.5	1.9
Global	**2.8**	**-3.2**	**5.9**	**3.7**	**3.5**

Russia-Ukraine conflict drives global energy prices higher, in part reflecting tight supplies



CONTENTS

CONTACT

Alan Oster, Group Chief Economist
+61 (0)414 444 652

Gerard Burg, Senior Economist – International, +61 (0)477 723 768

Tony Kelly, Senior Economist
+61 (0)477 746 237

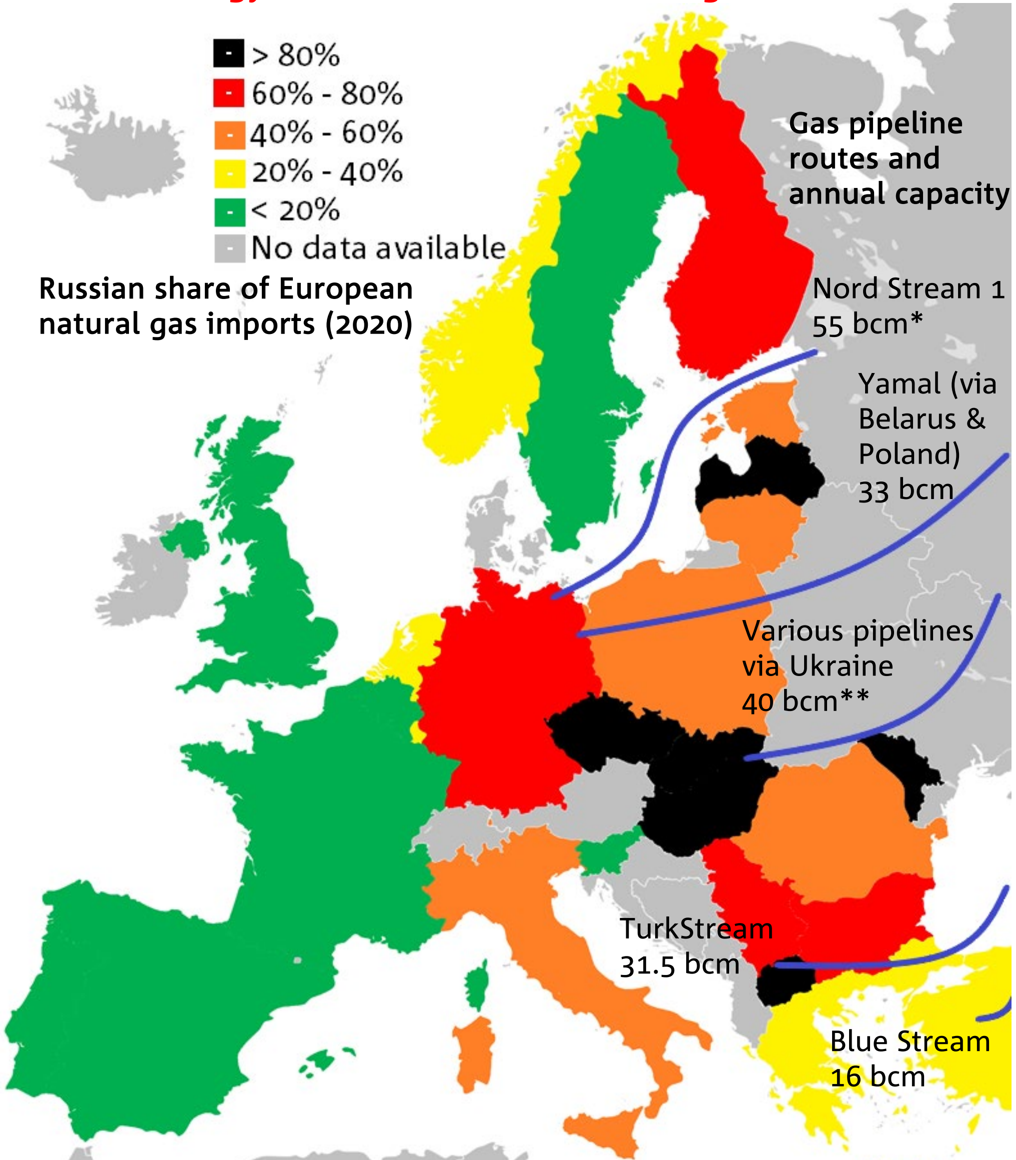
AUTHORS

Gerard Burg & Tony Kelly

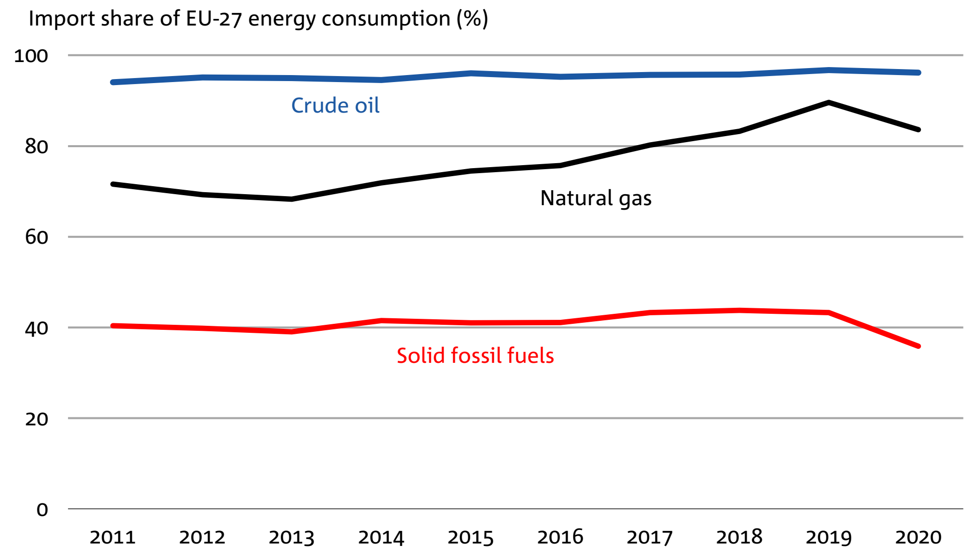
CHARTS OF THE MONTH

Energy (and to a lesser extent metals) trade presents the primary risk around Russia-Ukraine conflict for most economies – other trade and financial linkages more limited, presenting a smaller risk

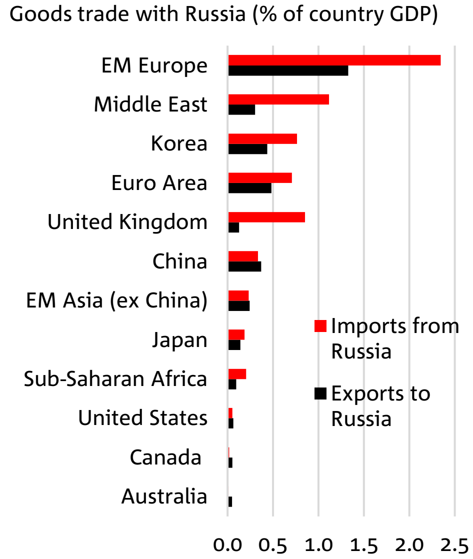
Europe has a high degree of energy import dependency – particularly for oil and gas. Natural gas supplied around 25% of the EU's energy needs in 2020 and the region sourced almost 40% of this gas from Russia

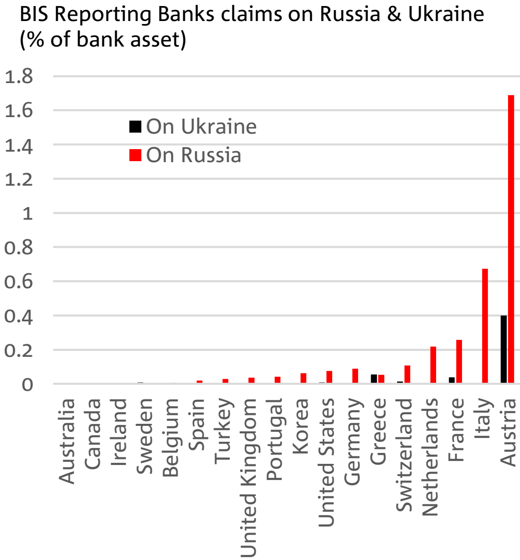


* Construction on Nord Stream 2 (also 55 bcm) has been halted due to current crisis
** Actual flow in 2021 rather than capacity



Outside energy & metals, Russia's other trade and financial linkages to most economies present smaller risks





Sources: Eurostat, Economist Intelligence Unit, Refinitiv, BIS, NAB Economics

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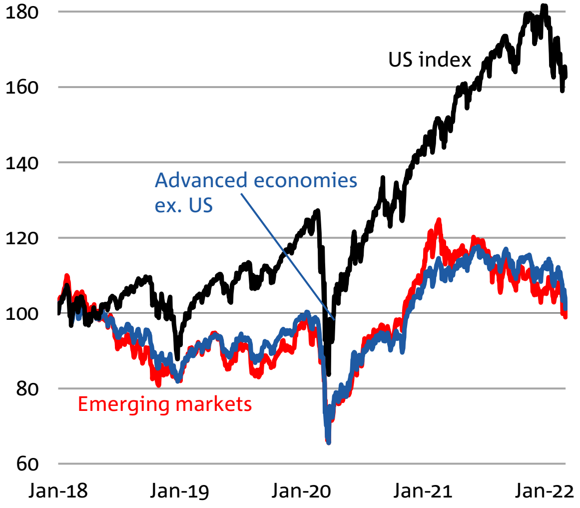
FINANCIAL AND COMMODITY MARKETS

Russia-Ukraine conflict drives volatility in financial markets and energy prices higher

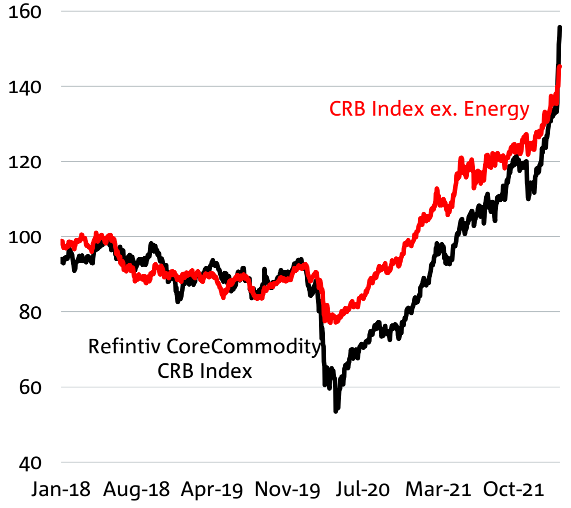
Ukraine invasion adds further downward pressure on equities

MSCI Equity Indices (1 Jan 18=100)



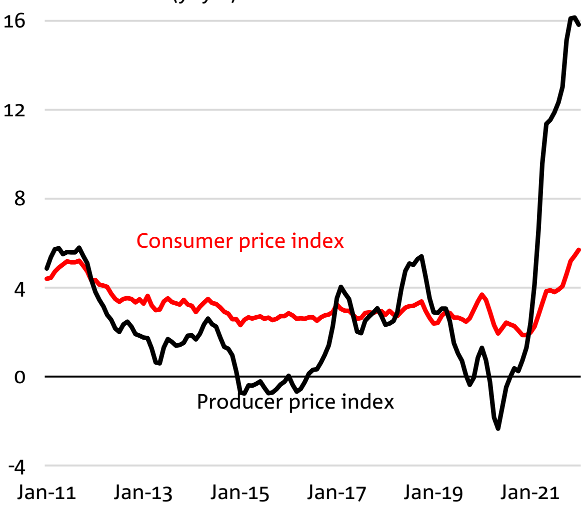
Commodities higher as sanctions appear likely to impact supply

Commodity indices (23 May 18 =100)



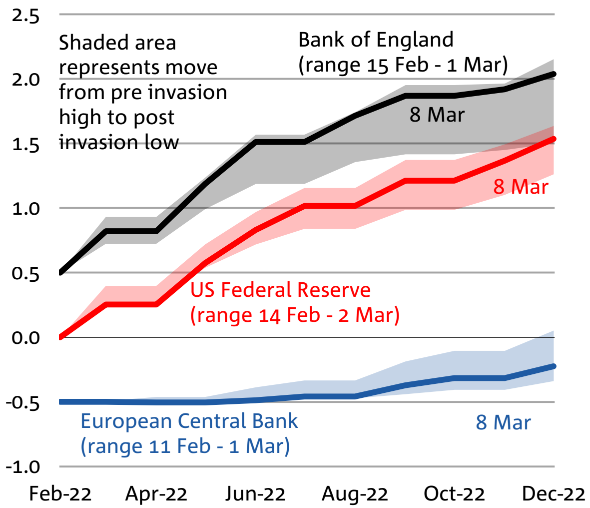
Higher energy prices will add to existing inflationary pressures

Global inflation (yoy%)



Geopolitical uncertainty drives volatility in rate expectations

Market implied policy rates (%)



 Sources: Refinitiv, NAB Economics

- Financial markets were significantly impacted by Russia's invasion of Ukraine – highlighting the fact that the risk of open conflict had not been fully priced ahead of the event.
- The response in equity markets – which had already retreated in January on expectations of tightening monetary policy – varied somewhat, with non-US advanced economies (led by Europe) and emerging markets plunging around 5%. In contrast, US market responses were relatively muted, although volatility (as measured by the VIX index) increased significantly. Similarly, government bond markets have also been volatile, with yields off recent peaks.
- In contrast, commodity prices have trended substantially higher, with the Refinitiv CoreCommodity CRB Index rising in March to its highest level since September 2011. Since the start of the Russia-Ukraine conflict, energy prices have risen rapidly, with WTI oil prices moving above US$120 a barrel (at the time of writing) – from around US$90 in early February. Russia is a major supplier of crude oil, coal and natural gas – particularly into Europe – but also a range of metals. Sanctions on Russian firms and restrictions on access to finance for Russian banks is likely to constrain the supply of these commodities for at least the duration of the conflict (if not longer) – with insufficient spare capacity to replace Russian volumes –given an estimated global supply shortfall of around 1 million barrels a day prior to the conflict (IEA).
- Constraints on Russian exports will add additional inflationary pressure to the global economy. The broad range of influences that have contributed to price pressure persist – including the impact of various COVID-19 outbreaks, a preference for goods consumption over services in many countries, shortages of labour, raw materials and key inputs and disruptions to global shipping. While energy prices are stripped away from the core consumer price measures that most inflation targeting central banks monitor, higher energy prices will flow through production costs and in the distribution of goods and services.
- Volatility has also been evident in monetary policy expectations – which had ramped up considerably in early 2022 due to inflationary pressure. Market expectations for the US Fed, Bank of England and European Central Bank were pared back considerably at the start of March in response to the Russia-Ukraine conflict. At the time of writing, expectations for both the Fed and BoE have largely retraced, however expectations for the ECB now represent one typical rate hike by the end of 2022 (compared with two prior to the Russia-Ukraine conflict).

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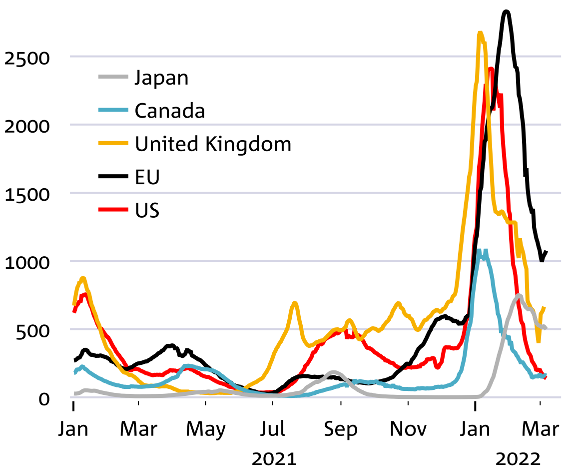
ADVANCED ECONOMIES

Major AEs looked to be strengthening as Omicron wanes, but Ukraine/Russia will hold growth back

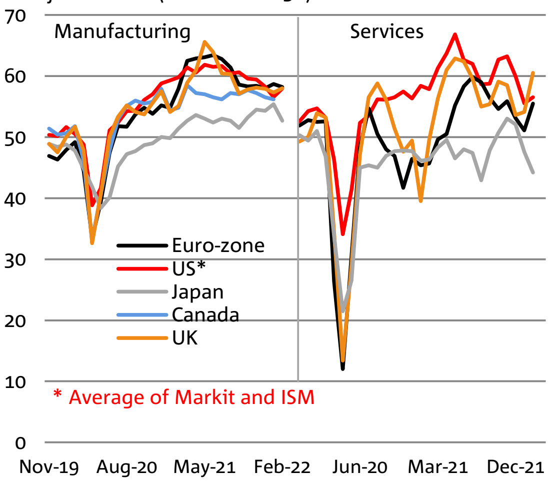
Receding of COVID wave will lift activity

New covid cases (per million people, 7 day ma)



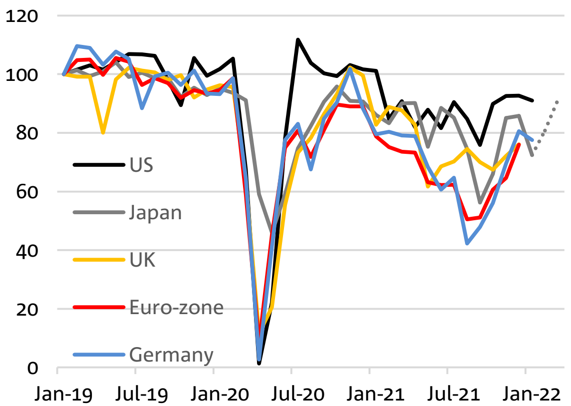
Reflected in rebound in services PMIs in Feb. (ex Japan)

Major AE PMIs (Breakeven = 50)



Supply still a constraint…signs car prodn rebound stalled in Jan.

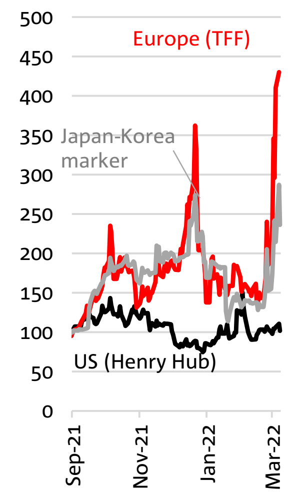
Motor vehicle/transport production (Jan 19 =100)*



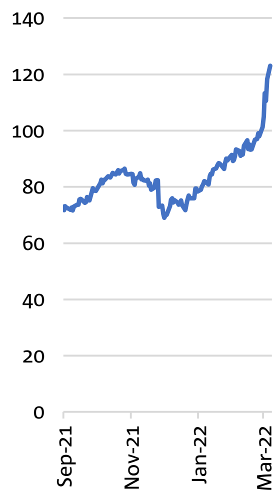
* Motor veh. other than Japan (transport equip.). Japan Feb/Mar data are producer expectations

Russia/Ukraine – energy a key but also other impacts

Natural gas prices, 1/9/22= 100



Oil prices (Brent, $/barrel)



Sources: Refinitiv, Macrobond, US EIA, NAB Economic

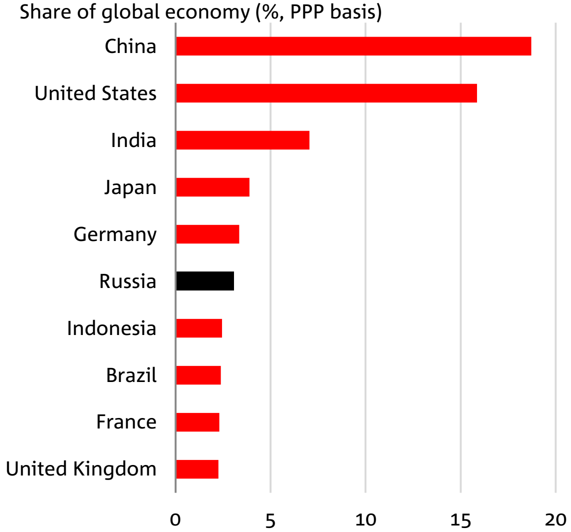
- After strong growth in Q4 – outside of the Euro-area – data for Q1 have been consistent with our expectation that major advanced economy (AE) growth would slow substantially in Q1. However, with the latest COVID-19 wave fading, Q2 GDP growth should rebound. At this stage we expect this to remain the case despite Russia's invasion of the Ukraine, although there is significant uncertainty how the conflict (and the international response) will unfold from here.
- The number of new COVID-19 cases has fallen substantially in most of the major AEs. This has allowed restrictions on activity to be eased and high frequency data (such as Google Mobility indicators) has moved higher in response. Less people falling ill should also ease the pressure on already tight labour markets. The pick-up in service sector PMIs in February also suggests that a rebound began last month. As a result, while Q1 growth will be soft, the rebound in COVID-19 affected services suggests that most AEs will still see positive growth in Q1 with an even stronger Q2 in prospect.
- Japan is an exception, as its COVID-19 wave started later and has only just recently peaked. Moreover, while the quasi-state of emergency has been lifted for some prefectures it was recently extended to 21 March for others (including Tokyo). Industrial production also declined in January and we now expect to see GDP fall in Japan in Q1.
- More broadly supply issues remain a factor. While business survey indicators, such as supplier deliveries, have shown some improvement, they continue to indicate supply chains are under pressure. The pick-up in major AE auto production we have been tracking for several months appeared to stall in January.

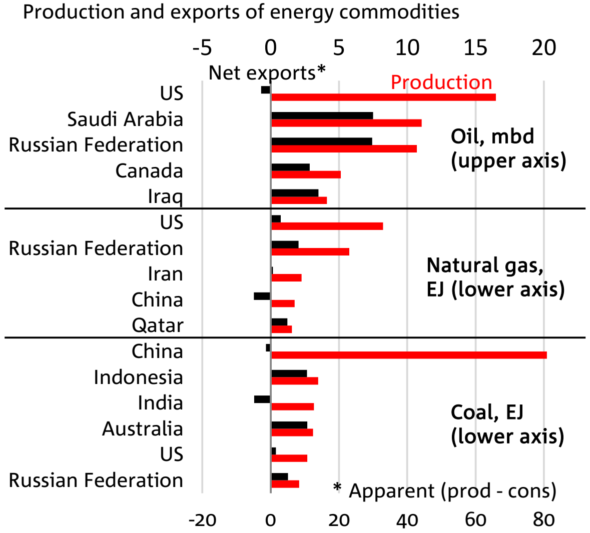
The Russian invasion of Ukraine, and the international reaction, adds a significant degree of uncertainty to the forecasts. While higher energy costs (oil and, outside the US, natural gas) are an obvious channel which will slow growth, sanctions and companies own decisions to cease interacting with Russia, and the resulting trade and financial market disruptions, will also act as a drag. Apart from energy, Russia (and Ukraine's) major role in other markets (e.g. palladium, neon, aluminium) risks exacerbating existing supply bottlenecks. Euro car makers have announced factory closures due to a shortage of parts that had been sourced from Ukraine. Possible risk aversion by consumers and businesses along with wealth impacts from falling equity markets may also hit activity. As a result, we have marked down our forecasts for Europe and Japan (a net energy importer).

EMERGING MARKET ECONOMIES

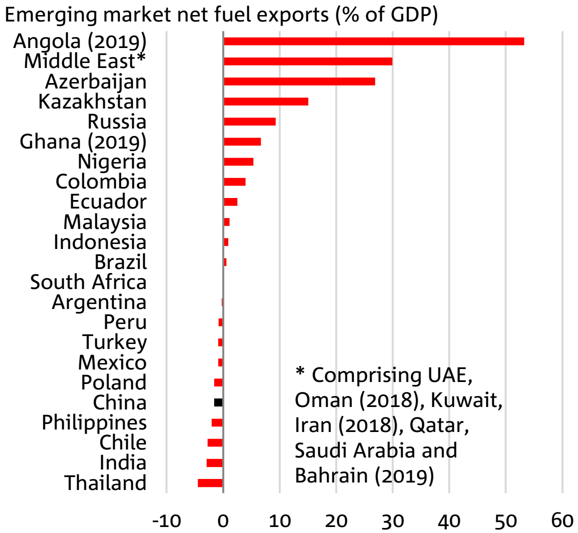
Energy importing EMs exposed to Russia-Ukraine fallout, while COVID-19 risks persist

Russia is a major economy – the sixth largest overall – and has a major role in global energy markets

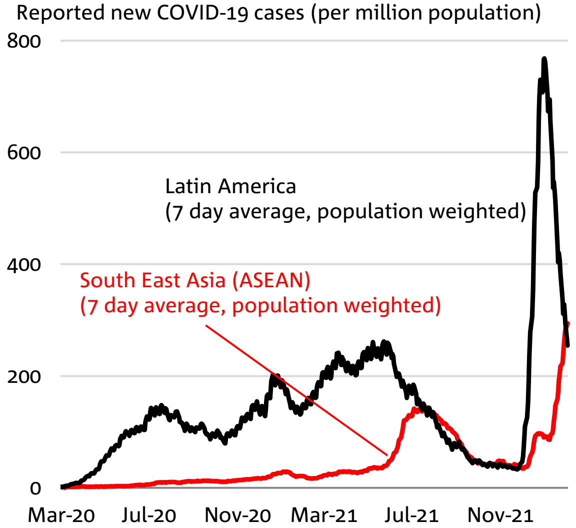




Higher energy prices have a mixed impact on EMs



COVID-19 remains a larger risk for EMs than advanced economies



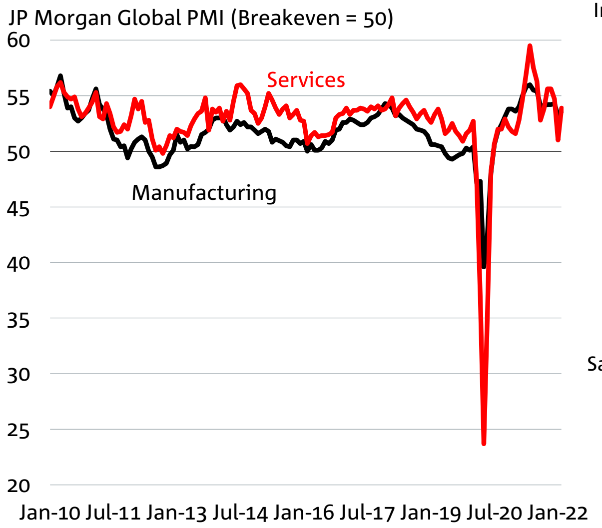
- Russia's invasion of Ukraine came too late in the month (24 February) to be evident in February's monthly data. Overall, the EM composite PMI was a little stronger in February – up to 51.3 points (from 50.8 points in January) – with an uptick in manufacturing the key driver, driven primarily by China, while Russia's manufacturing PMI was weaker.
- In contrast, the EM services PMI was marginally softer in February, down to 51.5 points (from 51.6 points previously). China's services PMI eased from positive to neutral territory in February, in part reflecting measures to control Omicron outbreaks.
- Russia is the world's sixth largest economy (on a purchasing power parity basis), accounting for around 3% of global GDP. The energy sector has an outsized share of Russia's economy – reflecting Russia's status as the third largest oil producer in 2020, the second largest natural gas producer and sixth largest coal producer. Sanctions that constrain the capacity of Russia to sell its energy resources in global markets will significantly impact its economy, as well as driving up global prices for these commodities.
- Sanctions are also impacting the functioning of Russia's financial sector, with the value of the Ruble plummeting (with one of the largest falls on record), the Central Bank of Russia more than doubling its policy rate (from 9.5% to 20%), the stock market crashing (and subsequently closing for trade) and domestic financial institutions suffering a bank-run. Ratings agencies have cut Russia's sovereign credit rating to junk bond levels, highlighting the risk of default.
- Higher energy prices will have a mixed impact on emerging market economic growth – depending largely on whether countries are net exporters or importers of energy. Net exporters in the Middle East and parts of western Asia and Africa are likely to benefit from higher oil prices, while India and China are among the EMs negatively impacted.
- With global focus increasingly concentrated on the Russia-Ukraine conflict, it is important to highlight that COVID-19 remains a key risk in emerging markets. The Omicron wave appears to be receding in some EMs (such as in Latin America) but is yet to decline in Asia. With generally lower vaccination rates, and in many countries, less effective vaccines deployed, emerging markets remain more exposed to the negative activity impacts of COVID-19 than advanced economies.

Sources: IMF, BP Statistical Review of World Energy, Refinitiv, NAB Economics

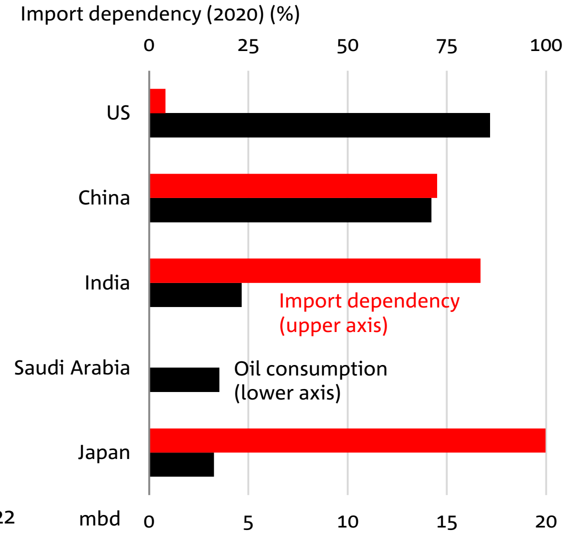
GLOBAL FORECASTS, POLICIES AND RISKS

Russia-Ukraine conflict drives down growth prospects for 2022

PMIs stronger in February on improved AE services



Some major oil consumers are highly import dependent



Russia's economy to suffer as a result of sanctions

China forecast to miss growth target in 2022

- The JP Morgan global composite PMI was considerably stronger in February – rising to 53.4 points (from 51.1 points in January) – reflecting stronger readings for services among the advanced economies (for which this aggregate measure is more heavily weighted towards). It is important to note that this outcome came ahead of the Russia-Ukraine conflict and surge in energy prices.
- The duration of the conflict, and the resulting impact on energy prices, is highly uncertain – however it is clear that they will remain elevated in the near term. Of the world's five largest oil consumers, three of them (Japan, India and China) are highly dependent on imports for supply, making them more vulnerable to energy price shocks. More generally, the conflict could further impact already disrupted global supply chains.
- European countries are likely to re-evaluate their energy policies and reduce their dependency on Russia for fuel sources. A draft white paper from Germany's government outlines plans to rapidly increase investment in renewables – to provide 100% of its electricity needs by 2035.
- In early March, China unveiled its annual growth target – 5.5% in 2022 – at the National People's Congress. Last month we cut our forecast for China's growth to 5.1%, reflecting the weakness in the country's property sector, softer momentum heading into 2022 and likely severe policy responses to COVID-19 outbreaks. Due to the energy price impacts of the Russia-Ukraine conflict, we have trimmed it further to 5.0% this month.
- Reflecting the importance of oil to its economic growth, we have also revised India's forecast lower – to 7.2% (from 7.5% previously).
- While the risk focus has shifted towards geopolitical conflicts, it is important to note that the COVID-19 pandemic continues, and remains a major risk to economic activity – particularly in emerging markets (where vaccine protection is generally weaker). As highlighted by the rapid emergence and spread of the Omicron variant, additional highly infectious variants of COVID-19 can not be ruled out.
- Overall we have substantially cut our global forecasts this month – largely reflecting the impact of the Russia-Ukraine conflict – down to 3.7% in 2022 (previously 4.2%) and 3.5% in 2023 (previously 3.6%). The main contributor to this downturn is Russia – which is likely to suffer a deep recession as a consequence of sanctions imposed by a wide range of countries. It is worth noting that there is a high degree of uncertainty around this forecast, given that the duration, and ultimate extent, of the conflict and sanctions is unknown.

Sources: Refinitiv, IHS Markit, BP Statistical Review of World Energy, NAB Economics

National Australia Bank

Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Jacqui Brand
Personal Assistant
+(61 0) 477 716 540

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

Australian Economics and Commodities

Gareth Spence
Senior Economist – Australia
+(61 0) 436 606 175

Brody Viney
Senior Economist
+(61 0) 452 673 400

Phin Ziebell
Economist – Agribusiness
+(61 0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

International Economics

Tony Kelly
Senior Economist
+61 (0) 477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

Global Markets Research

Ivan Colhoun
Global Head of Research
+61 2 9293 7168