AXA Investment Managers

Mind Games

129 – 28 March 2022

Note to readers: Macrocast is taking a break on 4 April. Next issue on 11 April.

Key points

- The IFO survey's forward-looking components in manufacturing are now below the levels seen during the "mini recession" of 2012-2013.
- The European Union (EU) wants to wean itself off Russian gas entirely by 2030. It's thus in Moscow's interest to try to maximize its profits there "while it can".

Last week's dataflow has confirmed that the economic fallout from the war in Ukraine is already tangible in the Euro area, especially in Germany where the IFO survey's forward-looking components in manufacturing are now below the levels seen during the "mini recession" of 2012-2013. Awareness of the magnitude of the shock is clearly high in policy circles in Berlin, and a top-up to the fiscal package supporting consumers has been swiftly announced. On the European front however, the Council meeting concluded on Friday without producing any breakthrough. Key decisions – on defence spending an energy in particular – won't come before the Commission provides detailed propositions first "by the end of May".

There is one area though where some progress has been made: joint purchases of gas across member states to secure better prices will be possible, and gas storage will be better supervised to improve the EU's energy security. The elephant in the room however is that to secure large enough gas inventories for next winter, the EU will have to accelerate imports significantly, and for now this means accepting significant Russian supply. President Biden's offer lift exports of United States liquefied natural gas (US LNG) to the EU would cover only the equivalent of 10% of Russian natural gas. Still, the message to Moscow is that at the latest by 2030 the EU wants to wean itself entirely off Russian gas. Russia is incentivized to maximize its profits "while it can", i.e. as long as the EU does not have a clear alternative supply sources. So, it's in Moscow's interest to try to lift gas prices as much as possible without switching supply off. This may be what is behind V. Putin's demand last week that EU gas imports from Russia are paid in rubles. Drawing attention again on the gas supply issue pushed prices up at the end of last week.

Still, the cost to Russia of the war in Ukraine is piling up rapidly even beyond the economic realm. Support from China may be more hesitant, as Sinopec's reported decision to suspend an investment project in Russia suggests. Militarily, although Russia seems to be scaling down its ambitions in Ukraine to focus on Donbass, the need to divert troops to this war may already be reducing the influence of Russia in other key areas on its borders. Last Friday Russia has accused Azerbaijan of having sent troops to an area of Nagorno-Karabakh controlled by the Russian army. While the market may react positively to this weakening of Russia, we continue to think that we need to brace ourselves for more flare-ups ahead.

German manufacturing is nosediving

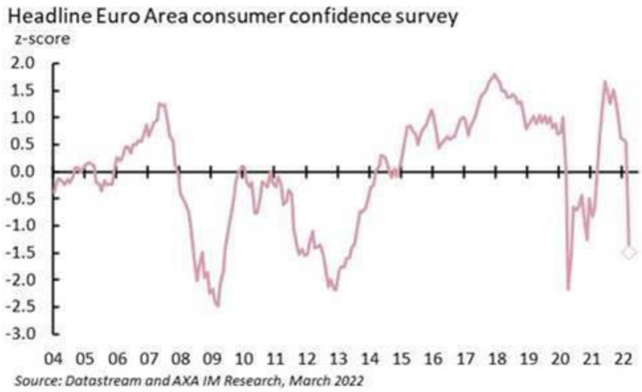
For our previous issue of Macrocast we had only the preliminary results of the March Institut National de la Statistique et des Etudes Economiques (INSEE) survey for a first foray into the economic impact of the war in Ukraine on the European economy. Last week dataflow came with a puzzle. The Purchasing Managers Index (PMI) for the Euro area came out below its February level, but still more than one standard deviation above the long-term average. The comments from Markit – the producer of the index – attributed this above expectation resilience to the lingering tailwind from the reopening of our economies. The PMI is often the “indicator of first intention” when trying to detect inflexions in the cycle (its direct comparability across countries and regions also explains a lot of its popularity). Yet, this time it seems that national surveys are reacting faster. As we expected, the news from Germany are particularly concerning. The headline manufacturing IFO index fell abruptly below its long-term average, and its forward-looking components corrected even more, with 6-month ahead expectations now standing at 2 standard deviations below the long-term average (see Exhibits 1 and 2). This is worse than during the “mini recession” which hit the German economy in 2012-2013.

Exhibit 1 – Bad IFO

Exhibit 2 – German manufacturing blues

Policymaking can be slow in Germany, but the awareness of the depth of the potential shock is clearly high this time. Berlin announced last week a significant EUR 15bn top up to the fiscal package supporting households against the impact of higher energy prices, with a three month EUR 0.3 per litre cut by in the tax on petrol (EUR 0.14 for diesel), together with one-off payment to taxpayers of EUR 300, plus EUR 100 in additional child support. Combined with the first measures announced earlier, this amounts to roughly 1% of GDP, the same quantum as in France.

Exhibit 3 – Europeans are worried



For now, it’s likely that the main transmission channel of the Ukraine war to business confidence is through higher input prices and more disruption on supply lines (e.g. for the electric cables which the German car industry sources in Ukraine). European governments are trying to prevent a more pervasive impact on business confidence in the months ahead via the erosion of purchasing power. While cash injections will certainly help, they may not suffice to deal with a deterioration in households’ willingness to spend. We mentioned last week in Macrocast the possibility to see a rise in precautionary savings. The European Commission has released a "flash version" of its consumer survey for March last week. The deterioration in consumer confidence is massive (see Exhibit 3), at 1.5 standard deviation below the long-term average. Unfortunately, details by country and component is not yet available.

Slow like filling a gas tank

While national initiatives are piling up in the fiscal space, progress on a joint-EU response continues to be very slow. We had hoped that the new "re-armament race" in the strategic realm would find quickly a natural complement in the budgetary realm in the form of more mutualized spending on defence, if only because some of the most fiscally challenged member states are also quite far from the North Atlantic Treaty Organization (NATO) objective of military spending reaching 2% of GDP. We will probably have to wait until May to see anything substantial on the matter. The European Council meeting which concluded on Friday night merely replicated the stance expressed at the summit in Versailles: "*The European Council looks forward to an analysis to be developed by the Commission by mid-May, in coordination with the European Defence Agency, of the defence investment gaps and to the proposals for any further initiative necessary to strengthen the European defence industrial and technological base*." The conclusions then mention the possibility to release the "*full potential"* of several *existing* initiatives, such as the European Defence Fund (EDF), but is often codeword for accelerating disbursements without expanding the overall envelope. (the EDF's budget stands at only EUR 8bn for 2021-2027).

Discussions in Brussels have seemingly focused on the energy issue. No decision was made on any boycott of Russian oil or gas, despite the push in this direction from some member states. It may well be that the speed of the deterioration in the dataflow is adding to Berlin's resolve to stall on this issue. If the economy is already taking a very visible hit at the current energy price levels, the impact in a "sudden stop" in supply would probably be extremely high given Germany's reliance of Russian gas. A lot of preparatory work is focusing instead on gradually reducing this reliance (over several years) as well as planning in case Russia decides to "switch off" access (in line with the conclusions of the summit in Versailles, the European Commission has been tasked with submitting a plan "*by the end of May*" as well.

Yet, beyond this planning, **the formation of energy prices in Europe should be tackled with some urgency, in light of the deterioration in consumer confidence. There was no breakthrough of this either at the European Council.** There was more on what Brussels would allow member states to do individually – e.g. with the relaxation of the state aid regime – rather than on what EU countries could do together. Several items in the "toolbox" were mentioned – including windfall taxes on some energy providers – but it looked more like a general menu from which capitals could choose from rather than as a consistent plan. True, the Council called "*on the Commission to submit proposals that effectively address the problem of excessive electricity prices while preserving the integrity of the Single Market, maintaining incentives for the green transition, preserving the security of supply and avoiding disproportionate budgetary costs".* Yet, press reports suggest that the opposition persists between those (France, Spain) who before the Ukraine war were vocal in their criticism of how the European auction system for electricity comes with an in-built "over-sensitivity" to gas prices and others (e.g. Germany) who remain wary of intervening in the price formation mechanism.

Securing gas supply and storage has however emerged as an area of concrete cooperation between member states. Joint purchases could help obtain better price conditions and, more immediately, the Council endorsed the European Commission's proposal for introducing a gas storage level obligation of 90% on 1st November every year, transitorily lowered to 80% for November 2022, with intermediary targets at various stages of the year. Maybe more fundamentally, the Commission's proposed legislation would introduce a new mandatory certification of all storage operators *"to ensure that the influence over storage system operators does not put at risk the security of energy supply or any other essential security interest in the Union or any Member States"*. Critically, it would require "*any person or persons that it considers may put at risk the security of energy supply or the essential security interest of any Member State or the Union to dispose of the shareholding or rights they have over the storage system operator and to set a time limit*". **This would in effect make it impossible for non-European operators to manipulate gas inventories in the EU.** They would have to act on the supply itself.

The elephant in the room is obviously that to secure large enough inventories for next winter, the EU must accelerate imports significantly, and for now this means accepting significant Russian supply. For those of our readers who like to look at data themselves, it's possible to follow storage in the EU (split across individual countries) in near real-time here. **As of 25 March 2022, the utilization rate of gas storage capacity stood at 25.8% which is low but not an outlier: it's in line with the levels seen in 2021, 2018 and 2017 at this time of the year** (see Exhibit 5). The pattern of inventory formation is regular: storage reaches a minimum at the end of the winter, then builds up quickly from the spring onward to hit a peak generally in November. Distributors' strategy probably explains the bulk of the year-on-year variations. It's likely that the steep rise in gas prices last autumn as the contribution from renewable energy was low because of weather conditions, and several nuclear plants had closed for maintenance, incentivized them to keep the inventory build-up to a minimum ahead of winter. November 2021 was the first year in our sample when the Commission's 90% target would have been missed by a significant margin. Note however in 2017 and 2018, hitting 90% in November of the previous year had not resulted in a higher level of inventories by the end of the winter than in 2022 (see Exhibit 5). The variables in the energy equation are largely uncertain. Demand for gas ultimately depends on the weather, the intensity of economic activity and the availability and prices of the other energy sources.

Exhibit 4 – Gas inventories "normally depleted"

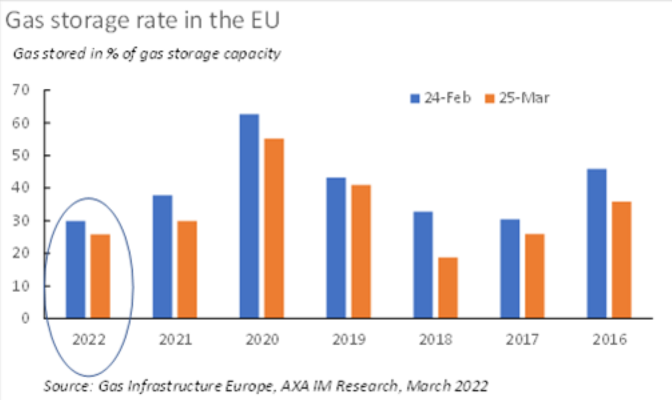
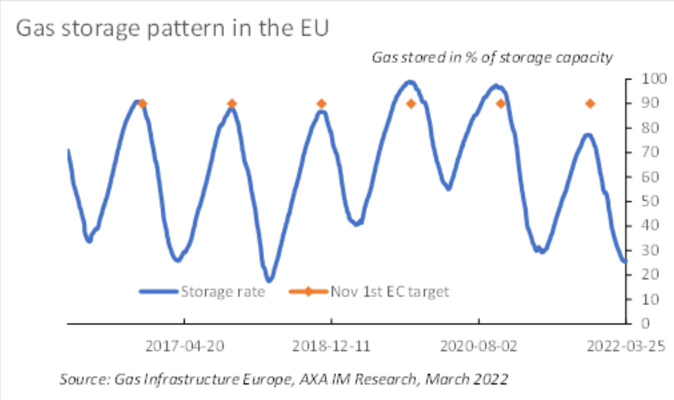


Exhibit 5 – The seasonal gas storage pattern



Since the beginning of Russia's attack on Ukraine, EU gas inventories have diminished further (the rate stood at 29.9% on 24 February), despite an acceleration in imports, as consumption was high. The "inventory replenishment campaign" is starting now. **President Biden's offer to coordinate efforts to step up exports of US LNG to the EU would cover only the equivalent of 10% of Russian natural gas** (he pledged an additional 15 billion of cubic meters of LNG this year, while the EU imported 150 billion of cubic meters of Russian gas in 2021).

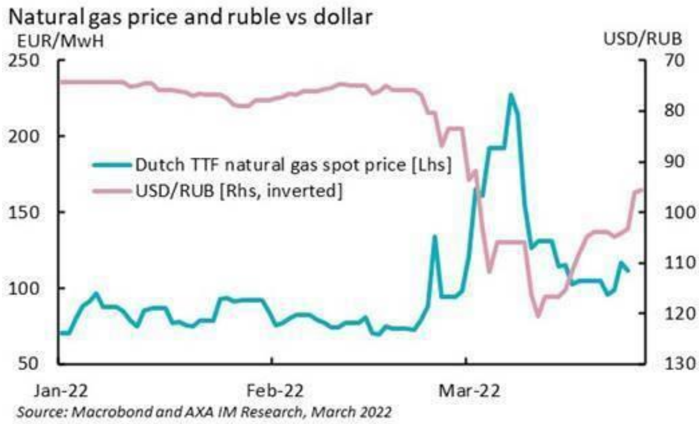
Gas is a cumbersome weapon

Given those constraints and the so far incapacity/unwillingness of EU members to reach an agreement on any full or partial boycott, the Russian side is probably confident that it can continue to sell its energy to its biggest market (for gas) this year. Yet, the unambiguous message Moscow is getting from Brussels is that at some point – and at the latest in 2030 – the EU will wean itself entirely off Russian gas. This strategic objective could well survive the end of the sanctions if a peace agreement were to be reached in Ukraine. This creates an interesting situation from a "game theory" point of view. Russia is incentivized to maximise its profits "while it can", i.e. as long as the EU does not have a clear alternative supply sources. So, it's in Moscow's interest to try to lift gas prices as much as possible without switching supply off. This is possibly what is behind Vladimir Putin's demand last week that EU gas imports from Russia should be paid in rubles.

True, the immediate economic justification of such a move could be to counter the depreciation of the Russian currency now that the central bank can no longer access the bulk of its hard currency. Indeed, EU distributors, to pay for their gas, would have to sell hard currency to holders of rubles – mostly Russian entities. Politically, this could incentivize the EU to loosen some of the sanctions to be able to transact with more Russian entities in their quest for rubles. From a practical point of view, what matters for Russia is to be able to continue to buy goods from the rest of the world, for which it needs foreign currency. Since 28 February, Russian entities have been forced to sell on the domestic market 80% of their hard currency intake. V. Putin's demand would then not change much technically. In the current configuration, EU buyers pay in euros and dollars, which are then forcibly sold back into rubles on the Russian market. If the EU were to comply with Putin's demand, EU buyers of gas would have to buy rubles with hard currency, which would then be sold back into rubles. Hard currency would thus still enter Russia and could be used to purchase goods from the rest of the world. A difference though might be that in the current system, it might be easier for Russian entities being paid in euros and dollars to keep this hard currency outside Russia and dodge the obligation to sell them back domestically. In any case, the ruble has rebounded after Putin's statement (see Exhibit 6) although we have to be careful not to read too much given into stated parities given the lack of volume on the Russian foreign exchange market since the beginning of the war and the sanctions.

In our view, however, shoring up the ruble is a second order objective for Moscow with this move. The first one is to re-create concerns over the continuation of the gas supply to lift market prices. So far in this war the stakeholders have operated under an "implicit deal" where the European governments would not contemplate boycotting Russian gas – despite public opinion pressure – and Russians would not contemplate switching off EU's access to supply. Putin's request for a redenomination of the contracts forces member states to make decisions, whether to comply or not, and take the risk of losing access. Gas prices rose again after Putin's announcement, even if they remain significantly below the peak of 2 weeks ago.

Exhibit 6 – Ruble and gas up after Putin spoke



All this might be a clever tactical move by Moscow, but ultimately Russia is faced with the same dilemma as before. One after the other, EU heads of state and governments have been signalling their opposition to a currency redenomination of the gas contracts. If this position persists – which we think is likely - the ball would then be in Moscow's camp again, and Vladimir Putin would have to decide whether to switch off access or not. We have repeatedly held the view that this would probably determine whether the EU embarks onto a proper recession in 2022 or not, but the consequences for an already fragilized Russian economy would be much more devastating.

In this context, the report by Reuters last week that the Chinese oil company Sinopec has suspended its involvement in a joint investment project in Russia matters. We have already explored in Macrocast why Russia could not rapidly fully offset the end of its exports of fossil fuel to Europe with an intensification of its trade with China, but if on top of the technical constraints, Beijing itself is showing signs of *political* hesitations, then the economic equation would become quickly untenable for Moscow. So far, the report has neither been denied nor confirmed by the Chinese government.

The cost to Russia of the war in Ukraine is piling up rapidly even beyond the economic realm. Even if progress on the EU's internal response to the economic fallout of the crisis is slow, NATO unity has undeniably improved and renewed its attraction to Finland and Sweden. Support from China may be more hesitant than what Putin had hoped after his meeting with Xi at the beginning of February. Militarily, although Russia seems to be scaling down its ambitions in Ukraine to focus on Donbass, the need to divert troops to this war may already be reducing the influence of Russia in other key areas on its borders. Last Friday Russia has accused Azerbaijan of having sent troops to an area of Nagorno-Karabakh controlled by the Russian army as a result of the peace deal with Armenia signed in 2020.

The market may react positively this week to a sense that Russia's position may be weakening, reducing the possibility of escalation, and possibly expecting some progress from the new talks in Turkey between Russia and Ukraine. The main event for the market next week may well be the US labour market data for March next Friday. Strong readings are likely and would fuel the Federal Reserve (Fed)'s current hawkishness. Yet we continue to think that investors may collectively understate the difficulty to bring the Ukraine war to a proper resolution swiftly and the potential for more flare-ups on the energy front ahead. Oil prices remain high, eroding purchasing power everywhere, including in countries such as the US where the economy is for now roaring.

We also need to continue monitoring the sanitary situation in China. Government policy seems to continue "oscillating" there between a continuation of the "zero Covid" policy and the realization that its economic cost may be too high. The approach being developed in Shanghai - with a 5-day lockdown hitting one half of the city at a time – could be seen as an attempt at a compromise. While all eyes are on Ukraine, supply-side disruptions have only slightly eased in the world economy (see Exhibit 7). For all the rhetoric about "deglobalisation" and the need for the west to focus more on shortening its supply chains, smooth production in China continues to be essential to the global economy.

With a still hazy resolution in Ukraine and more concerns about China, the EU should not waste too much time before implementing another step in economic policy integration. European governments may also keep in mind that the room for manoeuvre of the US President may be severely curtailed if the Republicans win the mid-term elections in November. Even if for now there seems to be a decent level of Atlanticism across the political spectrum in Washington DC, isolationism is still a powerful force in the Republican party.

Exhibit 7 – Only tentative improvement in global supply constraints

Country/Region	What we focused on last week	What we will focus on in next weeks
	• President Biden attends NATO meeting in Europe, announces plans to provide gas to Europe • Fed members discuss openness to 50bps hike if necessary, markets increasingly see this in May • New home sales (Feb) -2.0%, following existing (-7.2%) with mortgage apps also falling • Jobless claims fall to 187k, setting lows not seen since late 1960s, showing labour market still tight • Durable goods orders (Feb) fall 2.2% after strong gains in the past 3-months	• Ukraine developments as US warns frustrated Putin will resort to escalation • Payrolls (Mar) – last before May FOMC – expect solid jobs growth, unemployment to fall further and earnings to rise from Feb. • PCE inflation (Feb), expect rise in both headline and 'core' • Income and spending (Feb), monitor income change, particularly in real terms • ISM index (Mar) gauge any early war impact
	• Euro area consumer confidence has dropped sharply in March. Headline business confidence resilience hides underlying weakness • EU Council meeting concluded without a breakthrough	• Member states and euro area March flash HICP inflation • Business and consumer surveys for March (EC and PMIs) and April (German GfK) • Germany March unemployment rate • March car registrations
	• Spring Statement delivered only modest relief to cost of living squeeze. Margins suggest more possible in Autumn • CPI inflation (Feb) set new 30-yr high at 6.2% • Retail sales (Feb) fell 0.7% ex-fuel, consumer confidence (Mar) fell to near pandemic lows Retail sales (Feb) fell amid a shift to services	• Final GDP for Q4 2021, provisional figures suggest 1% rise, little revision expected • BoE household lending data (Feb) expected to continue trend of expansion • Nationwide House price index (Mar) • BoE's Gov Bailey and Broadbent to speak
	• Mfg Flash PMIs (Mar) has been more robust than expected (53.2 +0.5pt) even if supply delivery lengthens and export orders fell. Svcs improved but remains in contraction territory • CPI Tokyo (Mar) rose to 1.3%yoy (+0.3pp)	• Tankan surveys (Q1) are expected to decline after a quarter under Covid restrictions and pressure on energy prices. Worth to watch any heterogeneity between sectors/size • Final PMIs to account for delayed answers
	• Banks cut mortgage rates despite LPR holds steady • Beijing fine-tunes COVID policy to mitigate impact on growth	• PMIs to confirm a substantial shock to the economy from the latest Omicron wave
	• CB: Mexico hiked +50 bps to 6.5%, Hungary +100 bps to 4.4% & South Africa +25 bps to 4.25%. Philippines (2.0%) stood on hold • Feb CPI (yoy%) was unchanged from Jan in South Africa (5.7%). It picked up in Singapore (4.3%) and moderated in Malaysia (2.2%) • Korea's first 20-day exports slowed further in March to 10.1%yoy	• CB: Chile is expected to hike +150 bps to 7.0%, Colombia +150 bps to 5.5% & Czech Republic +50 bps to 5.0%. Thailand (0.5%) to stay on hold • March CPI (yoy%) to accelerate in Indonesia (2.5%) & Poland (9.8%) • Industrial production numbers for Brazil, Chile & Korea

Upcoming events		
	US :	Mon: Adv trade (Feb); Tue: Case-Shiller & FHFA HPI (Jan), JOLTS Job Openings (Feb), Conf Board cons conf (Mar); Wed: ADP survey (Mar), GDP (Q4); Thu: jobless claims (26 Mar), PCE inflation (Feb), Personal income & spending (Feb), Chicago PMI (Mar); Fri: Employment report (Mar), Mfg PMI (Mar, f), ISM mfg indx (Mar)
	Euro Area:	Tue: Fr Insee cons conf (Mar); Wed: EU19 Bus conf (Mar), Ge & Sp HICP (Mar,p); Thu: EU19 & It Unemp (Feb), Ge Unemp (Mar), Fr & It HICP (Mar,p), Fri: EU19, Ge, Fr, It, & Sp Mfg PMI (Mar,f), EU19 CPI (Mar, p)
	UK:	Tue: BoE Lending (Feb), M4 (Feb); Wed: BRC Shop price indx (Mar); Thu: GDP (Q4), Business investment (Q4), Current account (Q4); Fri: Mfg PMI (Mar),
	Japan:	Thu: Industrial production (Feb,p); Fri: Tankan large mfg indx (Q1)
	China:	Sun: Industrial profits (Feb); Thu: PMI (Mar); Fri: Caixin mfg PMI (Mar)

Our Research is available on line: http://www.axa-im.com/en/insights

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