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Holger Schmieding, Chief economist | holger.schmieding@berenberg.com | +44 7771 920377

NOTES ON THE MARKET SELLOFF IN EUROPE

Berenberg Macro View

Putin's probably futile attempt to establish by brute force a new Russian empire on the basis of a crumbling petro-economy poses the most serious threat to global security since the Cuban missile crisis of October 1962. As Putin wages war on Ukraine, surging prices for energy, foodstuffs and raw materials are driving inflation to the highest levels in 40 years in Europe and beyond. Prices for these items may not have peaked yet. European industry may face further shortages of some key inputs. Amid grave uncertainty, European risk markets have every reason to sell off.

Or do they? One of the lessons I learned in 30 years in markets is simple: in the thick of a selloff, lean back and look at the big picture. It helped in the post-Lehman turmoil, it helped when much of the world – weirdly – considered the euro to be doomed in 2011, and it did so again when the Covid-19 pandemic struck with full force in March 2020.

In geopolitical terms, the world will not be the same again – see our summary of [potential political consequences](#). Energy policy will change for good. The costs of transition will be significant until the benefits of a greener and more diversified energy mix can be felt. But short of extreme and – hopefully – highly unrealistic tail risk scenarios, it seems unlikely that Putin's war will permanently depress the value of the productive capital of the European private economy, as expressed in equity prices, by almost 20% in dollar terms relative to what we considered fair value late last year.

To assess the economic and financial outlook for Europe, consider these arguments:

- (1) The war is terrible and looks set to get worse in coming days and weeks. However, one way or the other, we will likely have more clarity by late April or May, be it with a de facto frozen conflict at some new "line of contact", a costly and ultimately unsustainable Russian occupation of (most of) Ukraine, or a crumbling of the Russian attack as Ukraine keeps up the fight while discontent with Putin's brutal aggression and its impact on Russia itself grows in the Russian elite.
- (2) Over time, many people get used even to very sad circumstances. The initial sharp blow to consumer and business confidence in Europe will likely fade somewhat if and when the outlook becomes clearer.
- (3) For most of Europe, the war and the firm Western reaction are a huge external shock, mainly coming from a big one-off spike in import costs. Eurozone inflation looks set surge to c7% or more soon. But inflation will almost certainly recede significantly again thereafter. Unlike the US, the Eurozone does not exhibit any home-grown inflationary dynamic.
- (4) The terms-of-trade shock transfers purchasing power from the users to the producers of such scarce inputs, at least to those producers who can still sell them. But even under very pessimistic assumptions about the future prices and availability of such inputs, this transfer should not reduce the value of Europe's productive capacity by 5%, let alone by almost 20%, in my view.
- (5) Near-term, the Eurozone will likely remain in the near-stagflation into which it had fallen with the Delta wave of Covid-19 infections in November 2021 as the impact of the war offsets the post-Omicron rebound in services. A recession looks unlikely. Of course, as we do not know the extent of the surge in prices and the



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reaction of consumers to it, we cannot rule out a temporary decline in real GDP for two quarters in a row. However, the Eurozone does not suffer from excess demand, excess capacities or financial excesses that, after being laid bare by an external shock, would require a cleansing recession for domestic reasons.

(6) The inflation shock to real disposable incomes hits many households at a time when they are sitting on huge excess savings which they had built up during the pandemic. Also, employment has risen to new records, or looks set to do so shortly, on both sides of the Atlantic. By and large, household finances are – on average – in unusually good shape. Even after paying much more for energy and food, many households still have more spending power than usual. The same holds for most companies. Once the initial shock has run its course, these fundamentals will likely reassert themselves.

(7) A prolonged interruption of Russian natural gas supplies to Europe seems unlikely. Neither Europe nor Russia seem to want that. The severe European sanctions on Russia include a carve-out for the most crucial energy supplies. Partial import bans on Russian oil and other measures will likely hit Russia hard. But one way or another, some Russian energy and raw material supplies will continue to find their way to the world market eventually. Over time, high prices will lead to more supply from other sources. Users will adjust, reduce their need for such scarce inputs and turn to less expensive alternatives. The shock will lessen, prices will partly normalise again. In the meantime, poorer emerging markets that need to import expensive commodities will likely face much bigger problems than the richer European countries.

(8) A genuine [*financial crisis seems unlikely*](#) in the advanced world. Instead, the uncertainty and the resulting need for a cautious step-by-step approach may reduce the tail risk that the US Fed may inadvertently tighten its policy too much.

(9) In geopolitical terms, Ukraine's courageous fight for freedom and the encouragingly strong and united response of the free world may make it even more unlikely that China would dare to invade Taiwan in the foreseeable future.

As a big-picture economist, I am not in the business of calling a bottom for markets. For a while, markets can take on a self-sustaining dynamic of their own. Fear can beget fear. But as in the case of previous severe shocks, markets should eventually look through the dramatic [*near-term event risks*](#). I would expect European equity indices and the euro to be less depressed in three to six months from now. Of course, we may first need a better idea of how the situation will evolve and how far energy, food and raw material prices may surge before risk markets can turn up again for good.

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