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Assessing the key event risks for economies and markets

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Economics

Event risks in 2022

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Potential event risks fall into three categories: geopolitics, politics and economic/financial upsets

Top geopolitical risks

- Russia invades Ukraine: a clear and present danger (pages 4-6)
- China attacks Taiwan: the worst geopolitical risk (pages 7-8)

Political risks in the advanced world

- French elections: the Le Pen risk (10-11)
- UK politics: Johnson out? (12-13)
- US mid-term elections: a worsening stalemate? (14-15)

Economic and financial risks

- Monetary policy error – overtightening or too loose for too long? (17-19)
- Tightening tantrum (20-21)
- Equity market correction (22-23)
- New shock to global energy supplies (24-25)

Geopolitical risks

Russia invades Ukraine: clear and present danger (1)

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A Russian invasion could unsettle markets and cause a temporary setback for the European economy

Risk – having amassed troops on Ukraine's borders, Russia may try to invade and occupy

- Russian President Vladimir Putin's objective still seems unclear = invasion risk hard to judge
- Ukraine is not part of NATO. Some NATO members support Ukraine with defensive weapons.
- A Russian invasion could be the worst war in Europe since 1945, a crisis similar to Cuba 1962.
- The West would likely react with punitive sanctions against Russia and more arms for Ukraine.
- China will watch the Western reaction closely. Could it affect Beijing's stance towards Taiwan?

Potential timeline – a serious imminent risk as Russian troops seem combat-ready

Economic impact in Europe – temporary shock, but low risk of recession

- Serious temporary blow to business and consumer confidence. Spike in energy prices would add to inflation
- In a worst case scenario, a prolonged interruption in the flow of oil and gas could cause temporary energy shortages in parts of Europe.
- Russia is no major market for advanced economies. Long-term economic impact very small, except for Russia and Ukraine

Market impact

- Temporary sell-off in risk assets and higher demand for safe havens – followed by rebound

Russia invades Ukraine (2): a look at previous crises

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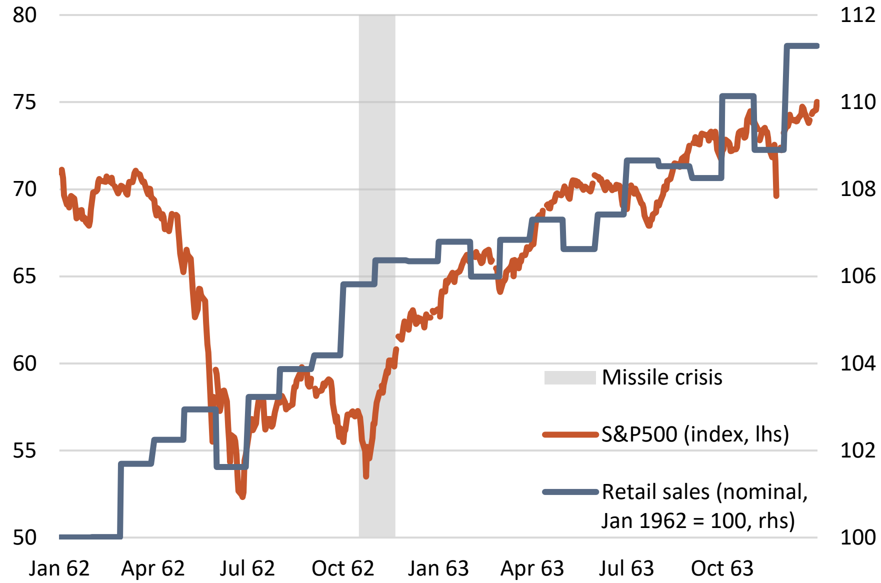
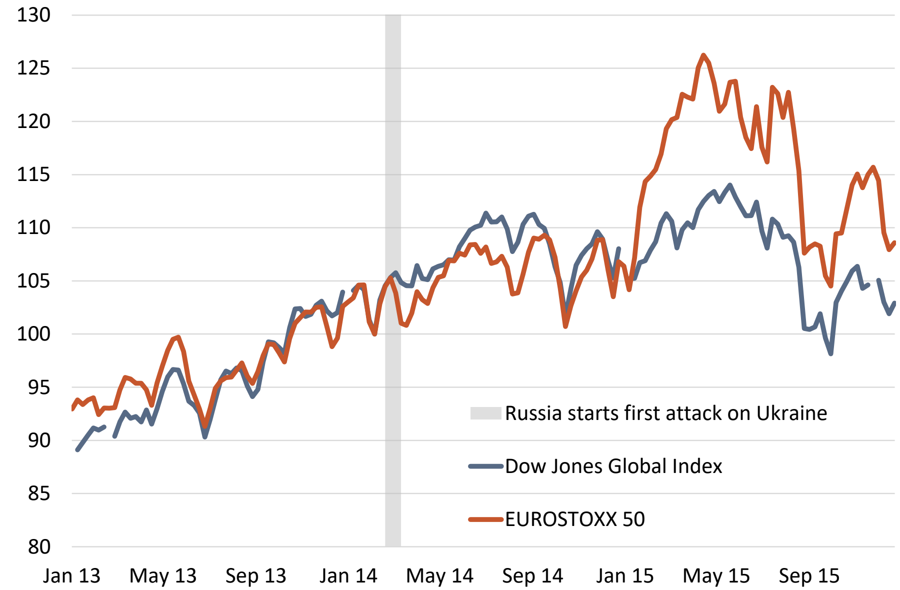
Cuban missile crisis: S&P500 and US retail sales



Retail sales: seasonally adjusted. Sources: S&P, Census Bureau

US and European stock indices during Russia's first attack



Grey bar highlighted military operation by Russia from mid-February 2014 to late March 2014. Weekly data. 100 = w/c 7 February. Source: Dow Jones, Eurostoxx

- A Russian invasion of Ukraine could be the worst war in Europe since 1945 and the worst geopolitical crisis since Cuba 1962.
- Cuban missile crisis timeline: early Oct 1962: CIA identifies missiles on Cuba (equities start to fall); 22 Oct: US imposes naval "quarantine" on Cuba to interdict further missile shipments; 23 Oct: trough in stocks although tensions remain high, 28 Oct US-Soviet agreement (while stocks were already recovering); 20 Nov: end of US naval "quarantine" of Cuba.
- Cuban missile crisis impact: temporary setback for equities; very limited economic impact.
- Russia's 2014 attack (annexation of Crimea, Donbass intervention): very little impact on European economy and markets. But that was a much smaller war than a potential frontal Russian attack on Ukraine.

Russia invades Ukraine (3): economic risks for Europe?

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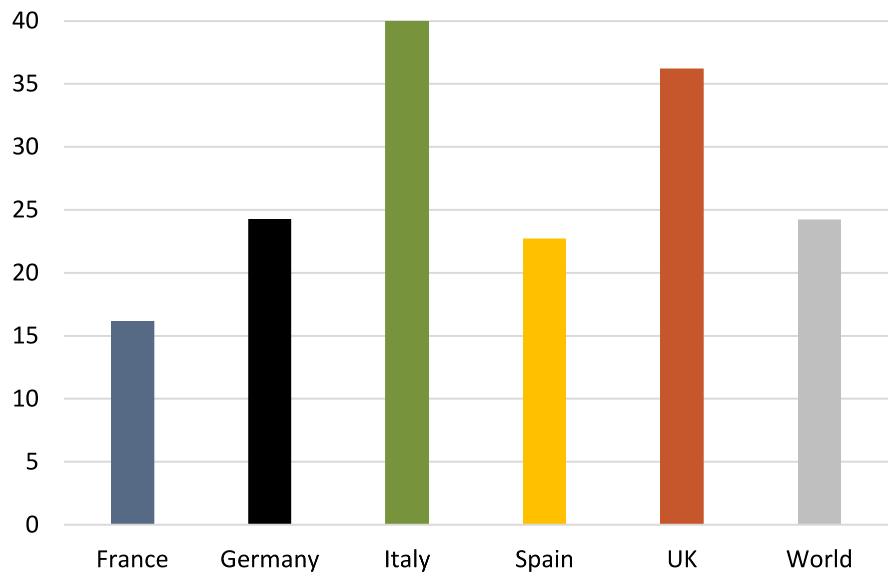
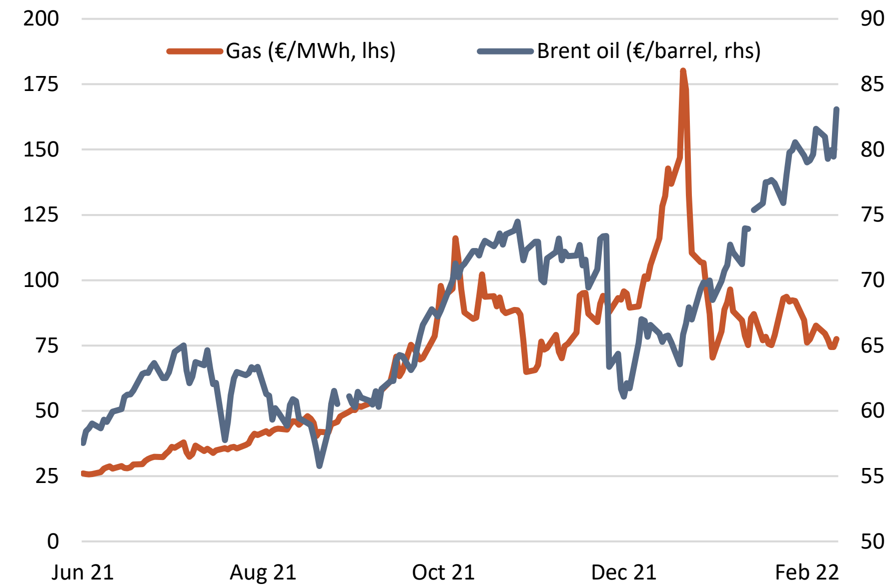
Share of primary energy from gas (%)



In 2019. Source: Our World in Data based on BP Statistical Review of World Energy (2020)

European oil and gas prices



Gas: Dutch TTF gas base load futures. Sources: FT, ICE, Berenberg

- Russia's mismanaged economy is no big market for advanced economies, e.g., only 1.9% of Germany's goods exports go to Russia.
- But Russia is a major supplier of energy and some raw materials. It supplies c40% of the EU's consumption of natural gas.
- Gas prices spiked in 2021 as Russia restricted its deliveries to those covered by long-term contracts and European storage ran low.
- Energy mix differs between countries in Europe: 40% of primary energy comes from natural gas in Italy, but only 16% in France.
- A shortfall in Russian gas deliveries could be expensive for Europe. But with the cold season due to end shortly, the costs would likely be bearable. Expect governments to offer further subsidies to the worst affected households if need be.

China attacks Taiwan: the worst geopolitical risk (1)

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China versus US: could China turn the great power competition into a war?

Risk: China tries to subjugate Taiwan by force

- Taiwan is a US ally – US may respond with force to a Chinese attack on Taiwan
- Potential for large-scale destruction
- Heightened risk of broader conflict, potentially engulfing other parts of East-Asia

Potential timeline – unclear

- If Russia invades Ukraine – would Chinese perceptions of the US reaction change Beijing's assessment of the risks it would incur if it attacks Taiwan?
- At its 20th Party Congress in Autumn 2022 the China's Communist Party will likely re-elect President Xi Jinping as general secretary. Xi has long stated his intention to bring Taiwan under Chinese rule.

Economic impact – direct confrontation China versus US would imply serious risk of global recession

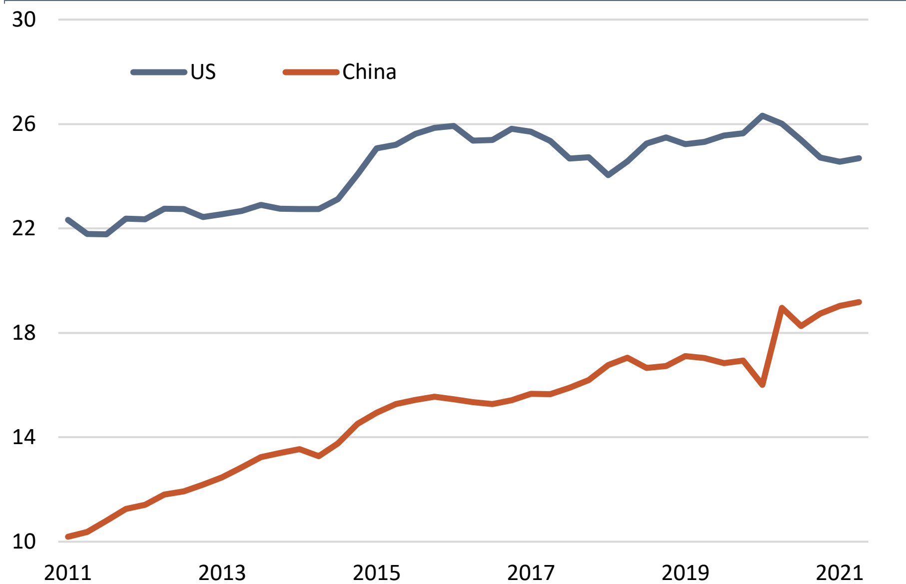
- Major disruption to global trade (directly due to military operations in the South China Sea and indirectly due to sanctions)
- Global trade shock would worsen supply troubles and add to inflation.
- Fear of broader conflict plus higher inflation would hit confidence and thus spending and investment.

Market impact

- Global sell-off in risk assets and likely bear market in equities – positive for safe haven currencies
- Dash for safe havens such as US Treasuries, Eurozone bonds, Japanese bonds and UK gilts

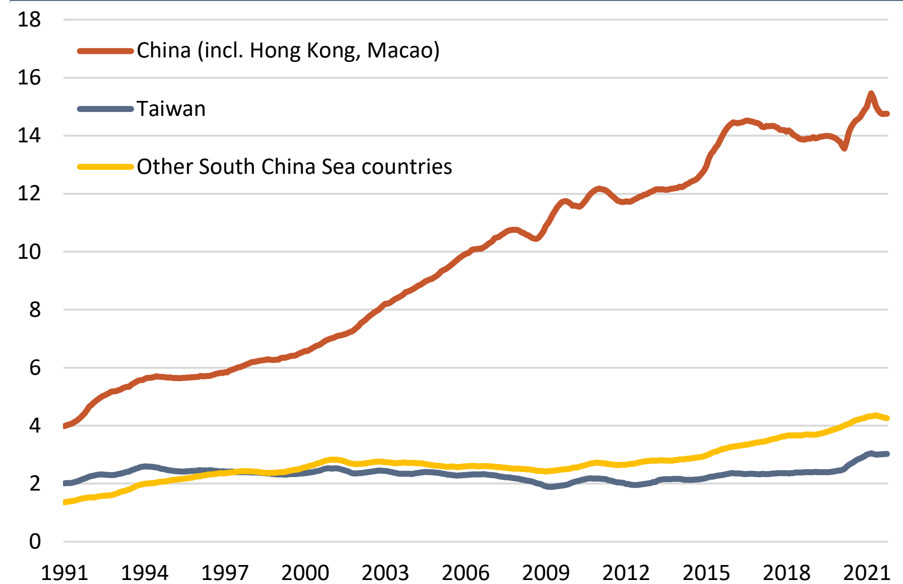
China attacks Taiwan: the worst geopolitical risk (2)

Share of world nominal GDP (%)



% shares of seasonally adjusted nominal GDP in USD; world: sum of advanced and emerging economies; quarterly data. Sources: BEA, China National Bureau of Statistics, Haver

Share of world exports (%)



12-month moving averages, based on data series for world merchandise imports in USD coming from specified countries; aggregates include imports that mainland China, Hong Kong and Macao receive from each other; other South China Sea countries: Brunei, Malaysia, Philippines, Vietnam; monthly data. Source: IMF

- In its ‘Taiwan Relations Act’, the US has stated its intention to support to Taiwan in case it is attacked.
- It remains unclear exactly what measures the US would take in case China attacked Taiwan. But it is not unthinkable that such an event could turn into a hot conflict between the two global superpowers.
- The US and China contribute around almost 45% to global GDP. In addition, countries bordering the South China Sea make up nearly a fifth of world trade.
- A Chinese attack on Taiwan would likely spell big trouble for the global economy – the recession risk would be very high.

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Political risks

French elections: tail-risk Le Pen (1)

A right-wing President of France could halt the European integration process

Risk: a radical right-winger becomes President of France

- France is the second largest Eurozone economy.
- Right-wing candidates reached the second round of the elections in 2002 and 2017, losing with 17.8% and 33.9% of the votes, respectively.

Potential timeline: first round of presidential election on 10 April, runoff round on 24 April 2022

Berenberg probabilities: 10% risk that right-wing Marine Le Pen wins, 5% risk for ultra-right Eric Zemmour

Economic impact: modest damage to French trend growth

- *Frexit* (French exit from EU or euro) ***unlikely***
- No further economic integration within the Eurozone during the 5-year term of a right-wing president
- Reform reversals and increased public spending in defiance of European rules hurt business confidence
- Tough immigration laws and expulsions may spark violent confrontations, curbing consumer confidence

Market impact: yields rise in France and Eurozone periphery, Eurozone equities wobble

- Increased demand for safe haven bonds such as US Treasuries or German Bunds
- Modest negative impact on French and – to an even smaller extent - European equities

Tail risk: major French debt sell-off spills over to Southern Europe amid rise in global yields – ECB has to step in to prevent a second sovereign debt crisis

French elections: tail-risk Le Pen (2)

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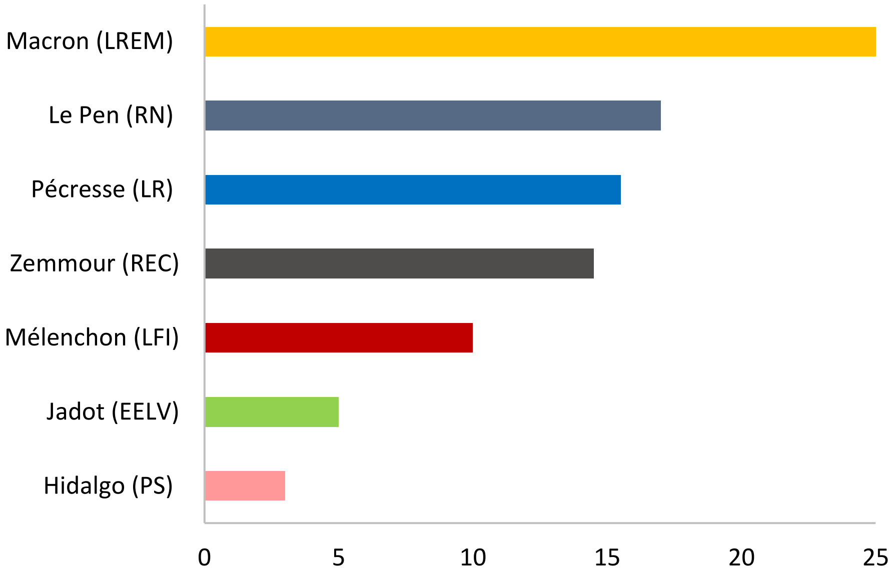
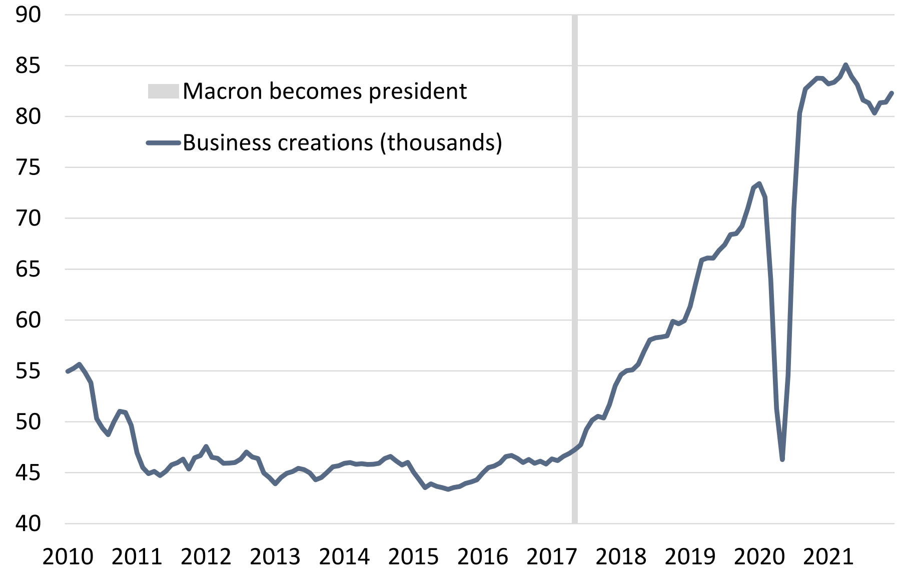
Voting intentions for the first round (%)



RN: radical right, REC: new radical right, LREM: centrist, LR: centre-right, FI: radical left, PS: Socialist. Source: average 8-11 February OpinionWay and Ifop polls

France under Macron: a better place to start a business



Number of new enterprises, all sectors, seasonally and working day adjusted, monthly data. Source: INSEE

- If no candidate gets more than 50% of votes in the first round on 10 April, the top two candidates advance to the runoff.
- Radical right-wing Marine Le Pen is, according to opinion polls, the most likely challenger of incumbent President Emmanuel Macron in the second round. Surveys suggest that Macron would defeat her by a 56% to 44% margin.
- Right-wing Eric Zemmour is currently fourth in the polls. His radical views on immigration might spark confrontations and weigh on consumer confidence. Surveys suggest that Macron would defeat him with 62% versus 38% in a potential runoff.
- Under Macron, the economy of France has improved. In 2021 the monthly average number of new firms surpassed 80k, up from 45k in 2015. Increased deficit spending under Le Pen could potentially crowd out private investment and harm the economy.

UK general election – risk of a shift to the left (1)

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If the Conservatives replace Boris Johnson as PM, a general election could follow soon thereafter

Risk – UK general election follows Conservative leadership contest

- The Conservative Party could replace its leader and prime minister Boris Johnson within weeks following a series of scandals and a major slide in the polls.
- New Conservative leaders often call an election soon after taking the reins in order to secure a new mandate – Theresa May did so in 2017 and Boris Johnson in 2019.
- Power could shift to the left-wing Labour Party - which has not yet fully shaken off the far-left economic policy tilt adopted under its previous leader Jeremy Corbyn .

Potential timeline – any time in 2022, election probably within three months of a new prime minister

Economic impact – limited outside the UK

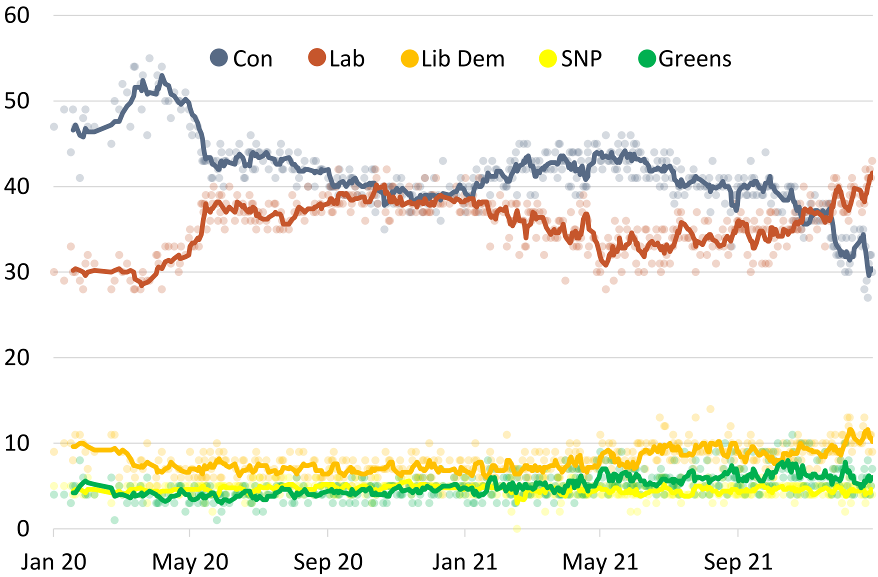
- If Labour wins, rising taxes and increased regulation could damage UK growth potential – hurting business investment and productivity.
- Labour may need to promise the Scottish National Party a second referendum on Scottish independence as part of a possible coalition deal.

Market impact

- Replacing Johnson with a more predictable Conservative PM would benefit UK markets.
- However, a leftward shift under Labour would be negative for UK equities but positive for sterling – pro-EU Labour would soften on Brexit-related matters.

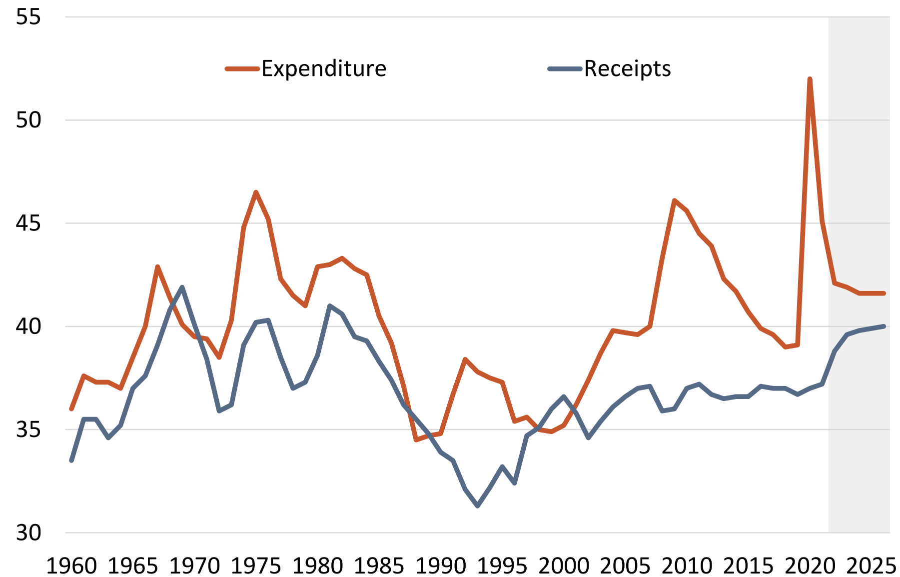
UK general election – risk of a shift to the left (2)

UK opinion polls – next general election



Voting intentions at the next general election (% support12 December 2019 UK results: Conservatives – 43.6%, Labour – 32.2%, Liberal Democrats – 11.6%, Scottish National Party (SNP) – 3.9%, Green Party – 2.7%. Chart lines show five poll moving average. Dots indicate individual polling results. Both UK and GB surveys included. Sources: UK and GB opinion polls.

Revenues and expenditure (% of GDP)



Shaded area shows OBR projections. Annual data. Source: OBR

- If Labour remains ahead in the polls, a new Conservative leader probably would not risk a snap election – this contains the risk of a further leftward shift in UK economic policy until at least the next general election, scheduled for 2 May 2024.
- However, if a new PM enjoys a honeymoon period and a bounce in the polls, they could be tempted to call an early election in order to secure a new mandate. This would be risky. Boris Johnson won just 340k more votes in 2019 (13.97m) than Theresa May in 2017 (13.64m). However, due to the distribution of votes in the UK's first-past-the-post system, Johnson ended up with 365 out of 650 seats in the House of Commons – versus 317 for May. UK elections are often unpredictable.
- A win for Labour would increase the risk of Scottish independence and probably lead to an even greater planned rise in public spending and taxes as a % of GDP - which could damage UK growth potential.

US mid-term elections: a worsening stalemate? (1)

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Likelihood of a Republican wave in the 2022 mid-term will constrain Biden's economic agenda

Risk – a worsening stalemate in Washington could weigh on risk markets

- Mid-term elections to Congress often result in a swing against the incumbent president
- Biden's low approval rating (which at this stage is lower than any other post-war president apart from his predecessor Donald Trump) suggests that the 8 November 2022 mid-terms may be no different
- Possible red wave – if the Republicans gain control of the Senate and win the House from the Democrats they could block Biden's economic policies in 2023 and 2024
- Democrats currently have a slim majority in both houses of Congress. But they already struggle to agree among themselves on major fiscal initiatives – a divided Congress – or a Republican majority in both houses unable to overrule a presidential veto, would exacerbate the current semi-gridlock

Potential timeline – 8 November mid-term elections to the US Congress

Economic impact – limited, almost no impact for Europe or Asia

- Biden has passed three big stimulus packages, higher public spending already in the pipeline
- Amid strong demand momentum, legislative gridlock should not hamper demand growth much.
- Congress unlikely to pass any trade liberalisation initiative – modest negative for global trade

Market impact

- Assuming the mid-terms produce the outcome markets expect, the impact should be modest
- The perceived impact on potential fiscal and regulatory policies would shape market reaction

US mid-term elections: a worsening stalemate? (2)

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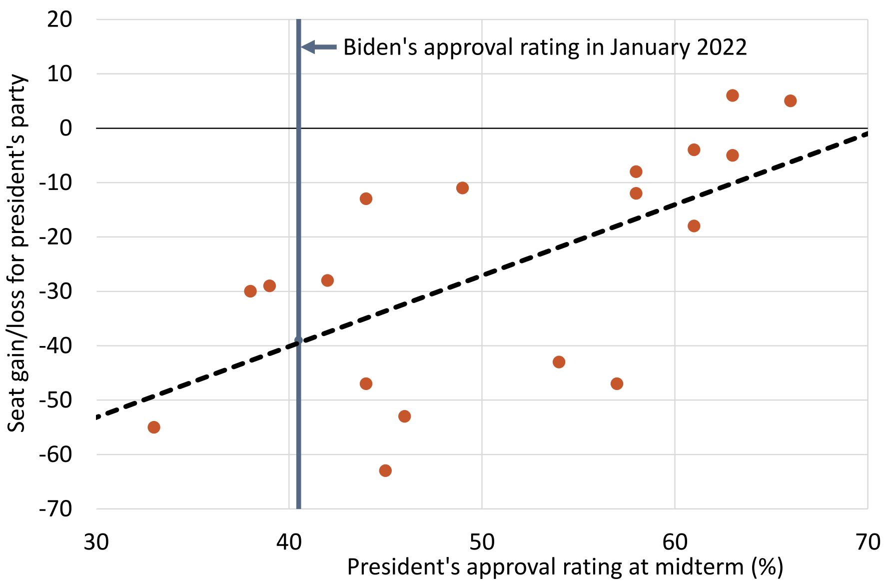
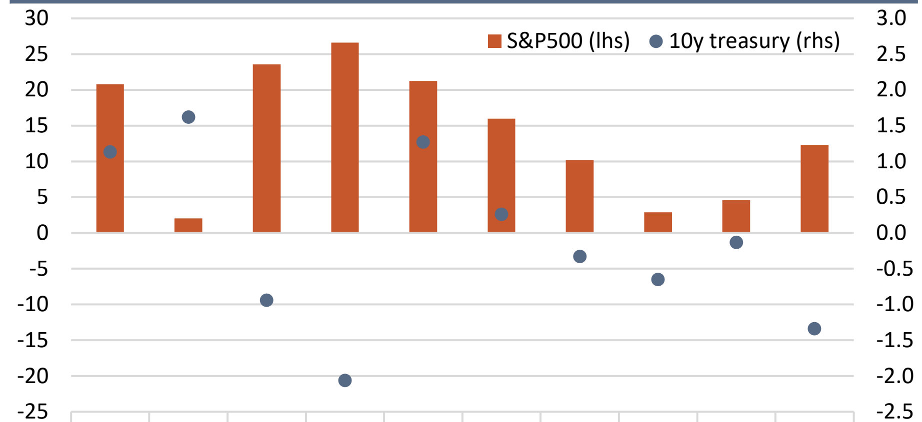
Mid-term House result vs president's approval rating



The president's average net approval rating on election day by the net number of House seats his party gained/lost in midterm elections; since 1946. Source: FiveThirtyEight

Stock prices and treasury yields after midterm elections



1982	1986	1990	1994	1998	2002	2006	2010	2014	2018
Senate: R hold	Senate: D win	Senate: D hold	Senate: R win	Senate: R hold	Senate: R win	Senate: D win	Senate: D hold	Senate: R win	Senate: R hold
House: D hold	House: D hold	House: D hold	House: R win	House: R hold	House: R hold	House: D win	House: R win	House: R hold	House: D win

Change over one year after elections, S&P500 stock price index: change in %, 10year treasury yield: change in ppt. Rep: Republican, Dem: Democrat, hold: party retains of chamber after election, win: party wins control of the chamber (including with the help of "independents"). Sources: S&P, Federal Reserve

- The president's party usually loses seats in mid-term elections – the size of losses often correlates with President's approval rating.
- Treasury yields: no clear response pattern to mid-term election results. Mixed response of stock prices to mid-term results.
- Divided Congress – or a majority in both houses of Congress against the President's party can produce gridlock. That adds to noise and complicates policy making significantly.
- But a divided Congress need not hold back the economy unless major legislative changes are required.

Economic and financial risks

Monetary policy error (1)

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Central banks are treading a narrow path as they normalise monetary policy

Risk – faced with an uncertain inflation outlook, central banks grapple with two-sided risks as they normalise monetary policy after a period of unusual accommodation.

- **Overreaction risk:** On the one hand, central banks – most notably the Fed and the BoE, less so the ECB – could raise policy rates and reverse QE faster and by more than is needed.
- **Underreaction risk:** On the other hand, central banks – possibly the Fed and the ECB, less so the BoE – may also tighten too slowly to curtail inflation before it takes a firm hold in expectations and wages.

Potential timeline – 2022 and 2023

Economic impact – risk of boom-bust

- If central banks overreact, they could turn the solid upswing of 2021 and 2022 into a modest and short recession in 2023 – but policymakers could quickly reverse course if need be.
- If central banks underreact, the upswing could turn so hot in 2023 and early 2024 that policymakers are forced to slam on the brakes hard – triggering a painful policy-induced recession that lasts until inflation returns to 2% or below on a sustained basis.

Market impact

- Overreaction – equity market correction, surge in demand for government bonds
- Underreaction – bull market first, sustained bear market in equities thereafter

Monetary policy error – overtightening (2)

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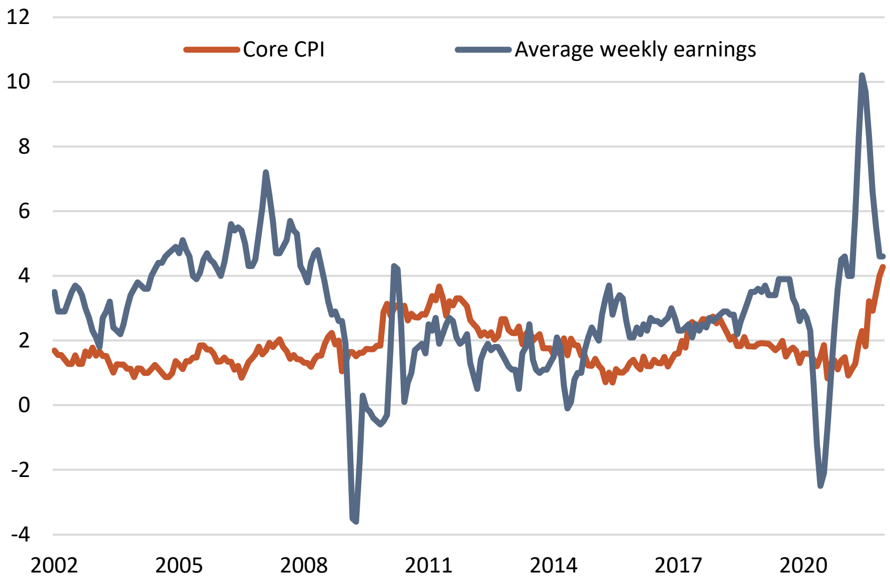
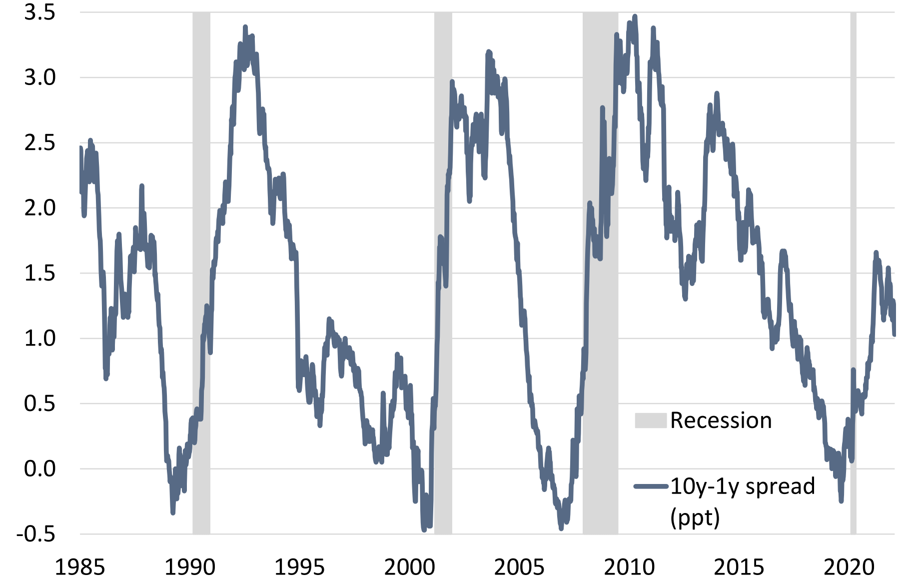
UK consumer price inflation and weekly earnings (% yoy)



Core CPI: consumer price index, all Items ex energy, food, alcoholic beverages, and tobacco, not seasonally adjusted; average weekly earnings: private sector, total pay, 3m moving average, seasonally adjusted; monthly data. Source: ONS

US yield curve flattening – a potential recession harbinger



Yield spread between government bonds with 10 and 1 years of remaining maturity; weekly data. Source: Federal Reserve Board

- Futures markets expect the US Fed to hike at least six times in 2022 – in line with our own call. Expectations have shifted sharply higher since late 2021 when markets expected just two hikes (based on 1 December futures curve). In the UK, markets now look for the bank rate to hit 2% by end-2022, versus 1% on 1 December (we project 1% for end-2022).
- Inflation surprised to the upside a lot in 2021 and early 2022. Base effects and temporary supply chain disruptions remain key drivers of high yoy rates, in the Eurozone and the UK much more so than in the US. These factors should moderate later this year.
- Employment costs and longer-run inflation expectations do not yet point to inflation dynamics that cannot be contained with a gradual policy normalisation. But further inflation surprises may panic the Fed and the BoE into hiking excessively – which could stall or even reverse instead of moderating the upswing. The recent flattening of the US yield curve highlights this potential risk.

Monetary policy error – too loose for too long? (3)

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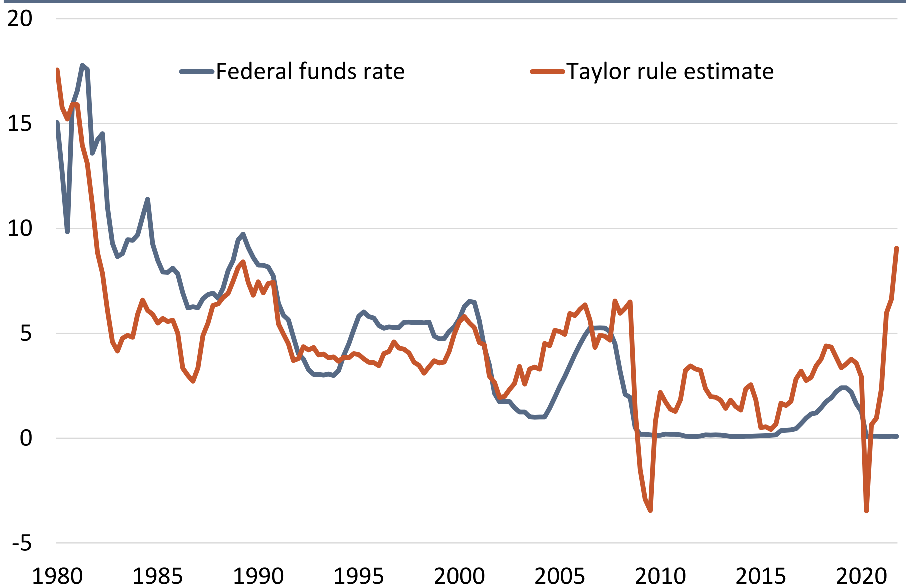
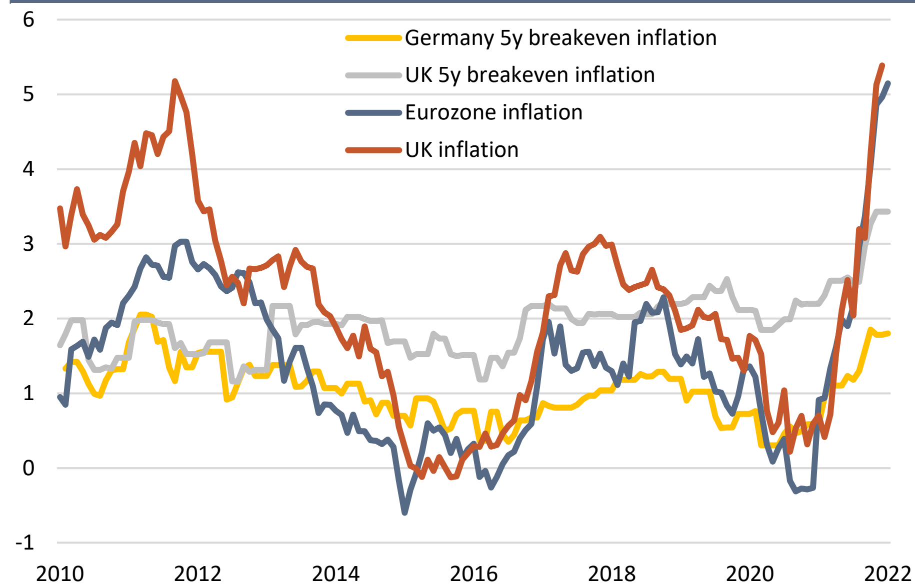
Fed funds rate versus policy rule



Interest rates in %; median Taylor rule using r=2%. Quarterly data. Source: Federal Reserve Board.*

Eurozone and UK: inflation and inflation expectations (% yoy)



Inflation: all items HICP (Eurozone) and CPI (UK); 5year breakeven inflation based on bond yields, UK: adjusted down by 0.9 ppt to account for difference between RPI and CPI; monthly data. Sources: Bundesbank, BoE, Eurostat, ONS, Haver

- Financial markets wonder if the Fed, the BoE and the ECB could make a policy error in the coming years. But a major mistake may already have happened. Arguably, at least the Fed stimulated too much in 2020 and 2021 amid an unprecedented loosening of US fiscal policy. After stimulating demand too much, a soft landing for inflation is now more difficult to achieve.
- In the US, the gap between the Fed funds rate and a policy rule such as the Taylor rule has risen to nearly 9ppt – by far the biggest gap in the post-1980s era of declining inflation.
- In the Eurozone, fiscal policy stabilized real incomes and supported employment during the pandemic but did not get overly aggressive. As a result, Eurozone inflation is not driven by excess demand (yet).

Tightening tantrum (1)

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Bond yields are set to rise as central banks normalise their monetary policy – but how far should they go?

Risk – bond markets overestimate the future pace of tightening, causing yields to spike

- Sovereign bond yields provide benchmarks used to price credit and discount future cash flows – a sudden outsized rise in yields could disrupt lending to the real economy and jar risk markets such as equities.
- Markets worry that the US Fed is behind the curve and will have to raise rates very rapidly in 2022.
- If markets fear that the Fed will aggressively sell its holdings of Treasuries on top of rapid rate hikes, bond yields may surge significantly further.

Potential timeline – near-term risk, which may start to dissipate once inflation rolls over and markets believe that the Fed will not slam on the brakes too harshly

Economic impact – temporary, but severe, setback in global economic momentum

- A sudden spike in benchmark yields could hurt the global upswing for a quarter or two. Nominal momentum – wages and inflation – would likely moderate.
- But central banks could compensate by committing to a slower pace of policy tightening thereafter.

Market impact

- Acute bout of market panic with losses for both bonds and equities. Bruised investors may seek refuge in relatively safe dollar-denominated assets.

Tightening tantrum (2)

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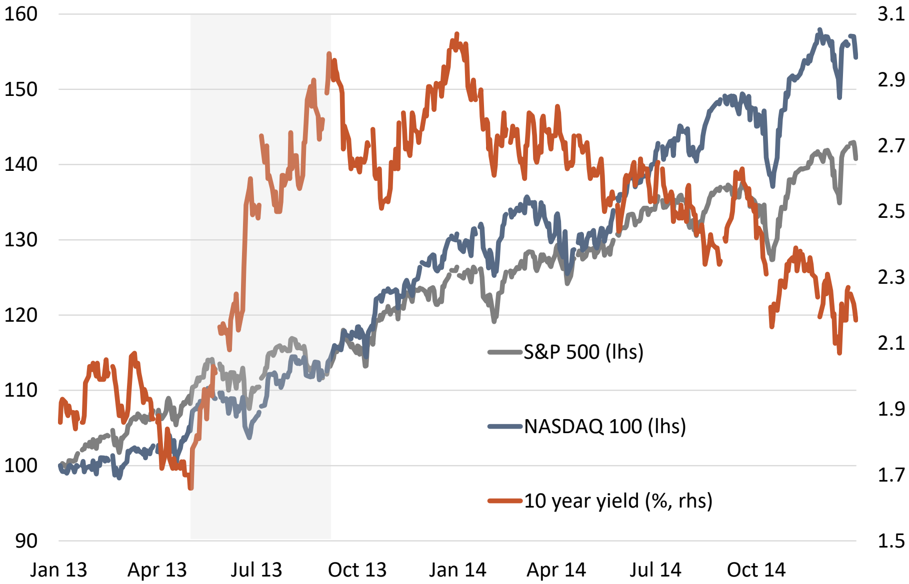
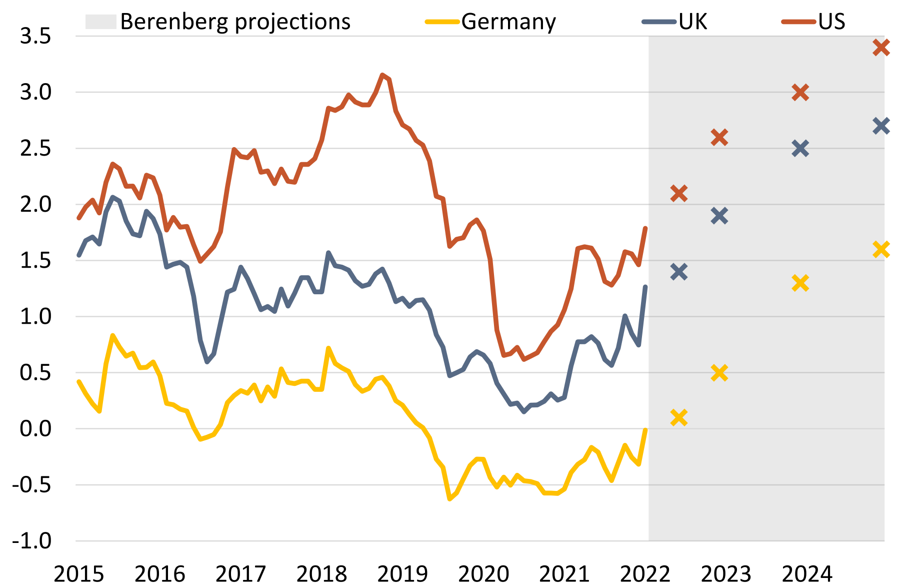
Taper tantrum (US treasury yield vs stock market indeces)



Shaded area highlights period of rising yields during US taper tantrum; stock indices: 2 Jan 2013 = 100; daily data. Sources: US Treasury, S&P, WSJ

Expect a rebound in benchmark yields



10-year benchmark yields in %, Berenberg forecasts from mid-2022 onwards. Source: Bloomberg, Berenberg projections

- Excess demand in the US and strong demand in Europe, combined with persistent global supply chain disruptions and labour shortages, have caused inflation to surge across the advanced world. Central banks are reacting by reducing the degree of monetary accommodation.
- Bond yields are likely to rise towards more normal levels as part and parcel of a more normal business cycle. However, further inflation surprises or a steeper-than-expected path for policy rates could trigger a disruptive sudden spike in benchmark rates.
- Potential impact? Remember the 2013 Fed taper tantrum? A big problem for bond markets with no lasting impact on equites and the real economy.

Equity market correction (1)

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After two years of unusually large gains, could global markets correct in 2022?

Risk – Equities suffer a major correction or go into a sustained bear market

- Two key drivers of equity market gains since the Great Financial Crisis are going into reverse – bond yields are rising and key central banks are starting to reverse asset purchases.
- Equity markets, especially in the US, remain close to all time highs according to key valuation metrics such as price-earnings ratios.
- In a world of elevated uncertainty, the risk of a correction or bear market seems to have risen.

Potential timeline – elevated near-term risks due to Russia-Ukraine and rising inflation

Economic impact – modest to severe, depending on the scale of the correction

- Markets are volatile by their nature – occasional losses for cash investors are par for the course. A garden variety correction in equity markets need not impact the real economy much.
- In the – still unlikely – case of a large correction or sustained bear market, the potential economic impact could be more severe.
- By sapping confidence, tightening financing conditions and reducing financial wealth, a major sustained drop in equity prices could hold back the business cycle.

Market impact

- Flight to safety: positive for government bonds, US dollar and gold

Equity market correction (2)

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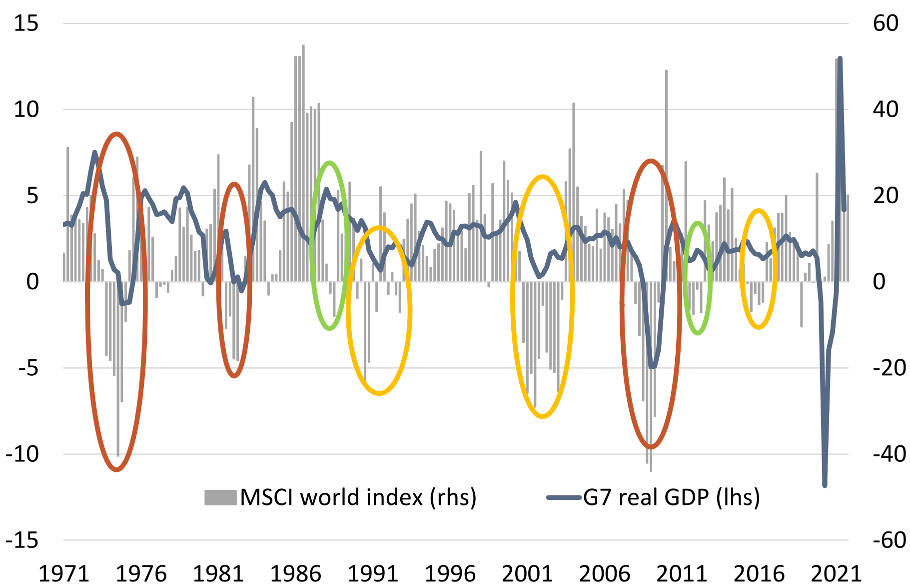
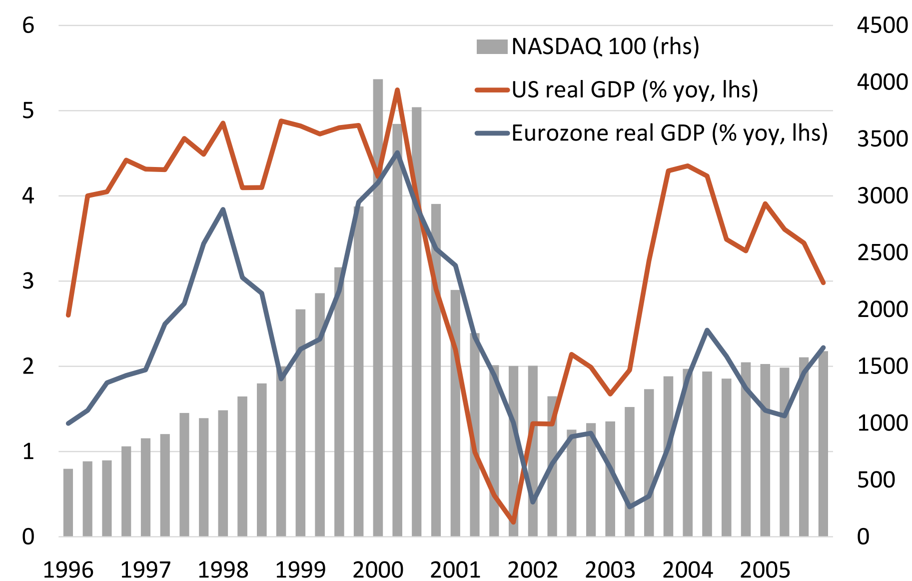
Equity market corrections = recession? Not usually



Change in % yoy; red circle: recession, yellow: economic slow-down, green: no negative economic impact; quarterly data. Source: OECD, MSCI.

The big slowdown – Dot.com boom-bust hurt GDP growth



Quarterly data. Source: WSJ, BEA, Eurostat.

- Sometimes, equity markets can get ahead of economic fundamentals. When that happens, they often correct once enough market participants realise that stock prices exceed the value of the underlying assets. Since 1970, global equity markets have generally overpredicted downturns for advanced economies.
- Due to the nature of animal spirts and the proclivity of investors to exhibit herd behaviour, corrections need not occur as a result of any material change in the outlook for the real economy.
- While selloffs in the mid-1970s, the early 1980s and the late 2000s coincided with steep drops in economic output, other major corrections – such as when the Dot-Com bubble burst in the early 2000s – coincided with only a slowdown in real GDP growth.

New shock to global energy supplies (1)

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A Russia-Ukraine conflict threatens to further squeeze global energy supplies

Risk – shocks such as a Russian invasion of Ukraine, punitive Western sanctions or other geopolitical risks could disrupt global oil and gas markets, further adding to inflation in Europe and (by less) in the US.

- Global producers have struggled to raise supplies of key commodities such oil and gas to match surging demand during the recovery from COVID-19 – in turn, prices have risen sharply.
- Russia accounts for 12% of global output of crude oil (including natural gas liquids) and 17% of global output of natural gas.
- Disruptions to Russian exports could further widen the gap between global demand and supply for energy.
- For net energy importers such as Europe, rising energy costs are a negative terms-of-trade shock which hurts business margins and household real incomes.

Potential timeline – near-term risks elevated amid possible Russian invasion of Ukraine

Economic impact – slowdown in real economic momentum in affected regions

- A negative energy supply shock would hurt energy consumers and lower real wages
- But the impact would fade over time as other oil and gas exporters react to rising prices and raise production to fill the gap caused by any shortfall .

Market impact

- Surge in oil and gas prices, flight to safety of government bonds despite extra inflation hit

New shock to global energy supplies (2)

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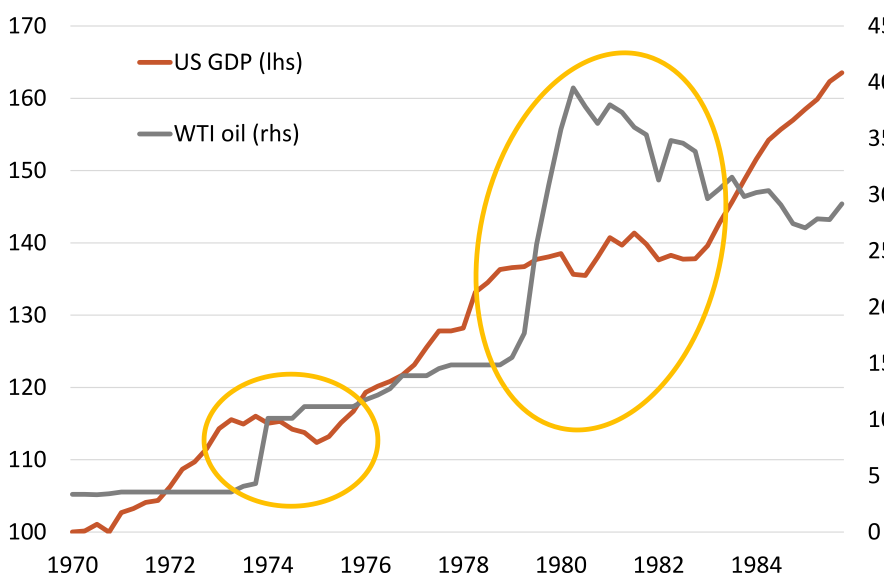
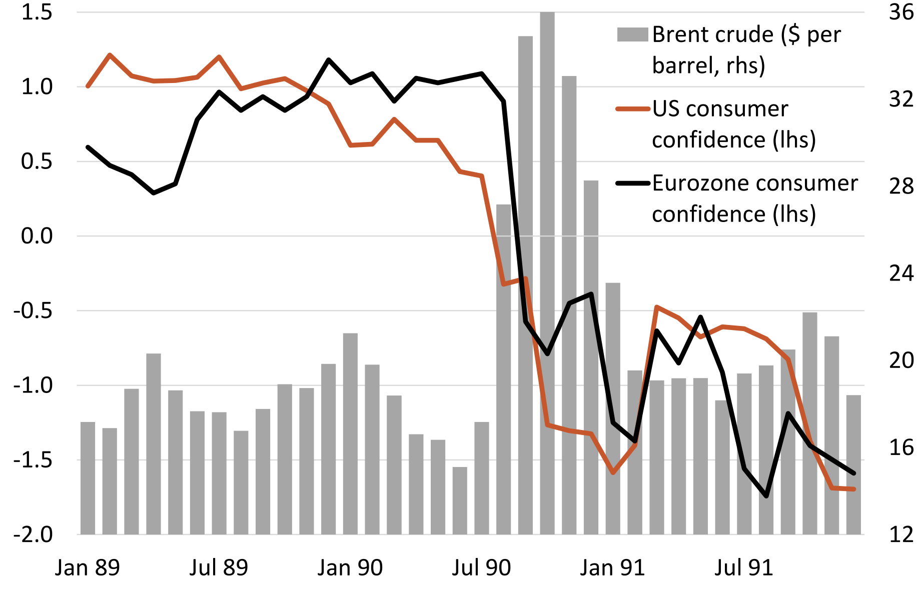
US real GDP versus oil price



Quarterly data. Real GDP 1970 Q1 =100. WTI oil in $ per barrel. Source: WSJ, BEA.

1990's oil price shock vs US and Euro consumer confidence



Monthly data. Consumer confidence data shown as standard deviations from mean. Source: EIA, CB, EC.

- If Russia invades Ukraine, disruptions to global energy markets threaten to hurt global supply at a time when oil and gas prices are already surging due to short supply relative to demand. The potential risk looks similar to previous energy supply shocks that occurred during geopolitical crises.
- In 1973, an OPEC oil embargo against nations that had supported Israel during the Yom Kippur War (including the US and UK) caused the oil price to triple, pushing much of the western world into recession. In 1979, the west suffered again when global oil production dropped in the wake of the Iranian revolution – the price of oil doubled.
- In 1990, the oil price doubled in response to the Iraqi invasion of Kuwait. While the supply shock was less severe than the 1970s episodes, it nonetheless contributed to the early 1990s recession in the US and Europe.

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