

February 14, 2022

## **Ukraine: Key Questions**

For the past two months, Russia has been mobilizing around Ukraine, leading to fears that Moscow is planning to invade. The U.S. has warned Russia against such action, lining out extensive sanctions and other potential responses.

Given the fluid nature of the situation in Ukraine, it is difficult to create a report detailing current events. After all, they are changing so rapidly that this element is best left to the media. Instead, we want to give some context to the current situation formatted in a series of questions with responses from both of us, Bill and Patrick. As always, we will close with market ramifications.

### **Question #1: Why is Russia so interested in its “near abroad”?**

**Bill:** All nations have key geopolitical needs, conditions they must create to ensure their survival. Russia is the largest nation in the world by area. Most of it is flat; there are few physical barriers to outside invaders. Historically, Russia protected itself by expanding the territory it controls. Russia/USSR overcame invasions by France (Napoleon) and Germany (Hitler), in part, by forcing invaders to traverse long distances, extending invader supply lines and eventually relying on the Russian winter to win the day. However, this stance is problematic; it is costly to subjugate peoples and nations in Russia's periphery. In Russia's history, the empire has expanded and contracted. The collapse of the Soviet

Union was similar to other periods where the Russian empire was forced to consolidate. Over time, the desire to expand returns; President Putin's actions in Georgia, Belarus, Ukraine, Armenia, and Kazakhstan are all elements of this desire to expand. The desire to control Russia's near abroad is part of the “muscle memory” of Moscow.

Ukraine is very important to Russia's goals as an empire. Zbigniew Brzezinski noted that [“without Ukraine, Russia ceases to be an empire, but with Ukraine suborned and then subordinated, Russia automatically becomes an empire.”](#) Russia's coveting of Ukraine is consistent with the historical treatment of its near abroad.

**Patrick:** Indeed, the desire for “buffer” countries along Russia's borders to enhance the country's military security isn't the only reason Russian leaders have traditionally sought to build an empire. Russian leaders have also sought to benefit from the industrial capacity, natural resources, and human capital available in neighboring countries. Despite Russia's extensive geographic reach, the country's economic and technological development have often lagged that of the nations further west, making it tempting to take control of neighboring countries with developed industries, natural resources, or better development potential. Throughout much of the 20<sup>th</sup> century, for example, Ukraine provided the Soviet Union with highly productive agricultural areas (especially for wheat farming), extensive mineral deposits (including big coal fields), and some of the USSR's top manufacturing facilities. In sum, Russian leaders like President Putin

have long looked to the “near abroad” for military security and economic resources, not to mention the overall geopolitical power that comes with large geographic size and a big population.

**Question #2: Isn't one of the tactics of war the element of surprise? Why is Russia so open about its mobilization?**

**Bill:** The element of surprise is an important tactic in warfare. At the same time, major military operations require some degree of mobilization. A cascade of mobilizations set the stage for WWI; as each of the participants geared up for war, it sent a message to other nations to do the same.<sup>1</sup> The other element of mobilization is that militaries can't be kept on a war footing indefinitely. At some point, these forces either go to war or stand down.

Mobilizing forces does signal to Russia's adversaries that it is serious about Ukraine. So, there is a value to that even if no invasion occurs. The mobilization has caused the West to react and take Russia's concerns seriously. But the mobilization carries costs as well, beyond the fiscal expenditures. The West can react in ways unhelpful to Russia.

Another element of mobilization and the loss of surprise is that if the parties are perceived as unequal, the element of surprise is less important to the stronger power. The U.S. took its time preparing to invade Iraq in 2003, for example. The lack of surprise didn't harm the war effort. Russia may believe that its military is superior to Ukraine's and thus feels the element of surprise isn't important.

**Patrick:** Russia's apparent lack of concern for showing its cards could also have elements of a feint about it. Since the Russian “way of war” remains focused on heavy ground forces, it can't easily hide its mobilization efforts, and in this case, mobilizing its forces so publicly and menacingly is an effective way to create a sense of threat that Moscow hopes will work in its favor. However, forcing the U.S. and NATO to focus on Russia's ground-force mobilization could also be meant to draw attention from Russian preparatory activity in other military or non-military domains. For instance, the deployment of Russian forces in Belarus for “joint exercises” could merely aim to draw Ukrainian forces further west and away from a planned invasion route in the east. [Moscow might also be more focused on “grey zone” attacks geared toward destabilizing the Ukrainian government, as some Ukrainian officials have argued.](#) In other words, the Russian leadership's big ground-force mobilization could end up being a ruse that allows them to launch a surprise cyberattack or coup attempt.

**Question #3: What other goals does Russia have besides controlling Ukraine?**

**Bill:** This question touches on the first one. Russia wants to extend its influence as far as possible around its periphery. Although that might mean invasion and control, this goal can also be accomplished by economic coercion and diplomatic efforts. Key to expanding Russia's influence into Western Europe is to undermine NATO. On this front, Putin's accomplishments are mixed. He is clearly undermining Germany's commitment to NATO. Germany is heavily dependent on Russian natural gas, with [Moscow supplying about half of Germany's requirements.](#) The Nord Stream 2 pipeline, which is essentially completed but lacks approval from German regulators, would

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<sup>1</sup> A good analysis of this process can be found in: Tuchman, Barbara. (1962). *The Guns of August: The Outbreak of World War I*. The Macmillan Publishing Company.

double Germany's capacity to import gas from Russia. Germany's decision to phase out nuclear power has made it increasingly dependent on Russian gas, making Berlin reluctant to take a hard line against Moscow. Within Germany's ruling coalition there is a clear difference between the SPD, which tends to take a conciliatory stance with Russia, and the Greens, which are more open to sanctions. The U.S. has proposed sanctions that very well could make it difficult for Europe to buy Russian gas, effectively leaving Germany with the unappealing choice of either severely damaging its economy by adopting the sanctions or dividing NATO by opposing the proposed sanctions. So, on this front, Putin has made inroads into weakening NATO.

On the other hand, Russia's actions have led Finland and Sweden to openly consider joining NATO. Finland's deliberation is especially notable. During the Cold War, Finland was openly neutral; the term "Finlandization" described a condition where a nation deliberately acquiesced to Soviet pressure to avoid threatening Moscow. The fact that Finland is even thinking about joining NATO poses a serious threat to Russia. Sweden's decision not to join NATO during the Cold War sent similar signals. Russia's actions have clearly caught the attention of these Nordic nations; even if they don't join NATO officially, we expect them to lift their defense spending and oppose Russia's threats. Eastern European attitudes have hardened as well. Poland has been supportive of hosting NATO troops. Given Eastern Europe's experience during the Cold War, these nations will likely oppose Russia's actions.

**Patrick:** While Putin's aim to weaken NATO has yielded mixed results so far, you

could probably say the same about his domestic goals. The next presidential election isn't until 2024, and the next parliamentary elections aren't until 2026, but it wouldn't be a surprise if Putin is looking for an international crisis to get his citizens rallying around the flag. It wouldn't be the first time a leader has used war threats to bolster his political support. If so, however, Putin may be finding the situation a bit more complicated. The Russian population may be taking a more skeptical approach to the crisis than the Russian leaders expected. Our read of domestic press accounts suggests the government is taking pains to justify the Russian troop deployments as a necessary drill to test mobilization capacity. That may mean Putin is concerned that entering a discretionary war would generate domestic political opposition rather than renewed patriotism and support for the government.

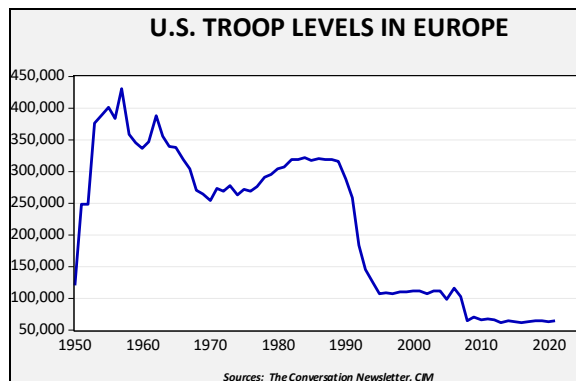
#### **Question #4: What impact will the crisis have on U.S. interests?**

**Bill:** Our contention is that the U.S. has failed to create a hegemonic policy that is compatible with America's domestic political environment. During the Cold War, opposing communism was powerful enough to allow the U.S. to maintain a massive overseas presence consistent with hegemony and simultaneously garner domestic political support. Hegemony requires sacrifices; providing the reserve currency leads to persistent trade deficits (which adversely affect labor markets), and the defense cost of stabilizing the world and protecting sea lanes is enormous.

The U.S. maintained peace (yes, there were wars, but WWII didn't occur) by freezing three conflict zones—Europe, the Far East, and the Middle East. By taking over the defense of Germany, the U.S. solved the "German problem" in Europe. In Asia, the

U.S. defended Japan, ensuring that Japan's neighbors no longer had to fear that island nation. Japan had been expansionary to ensure the supply of raw materials which it lacked; by demilitarizing Japan, the region could focus on economic recovery. And in the Middle East, the U.S. stabilized borders and protected the flow of oil from the region. The cost of the model was huge, and when the Soviet Union devolved, some elements in the U.S. political system wanted to dispense with the model.

U.S. troop strength in Europe has fallen precipitously.



There is no consensus on how the U.S. should manage its hegemonic role; in fact, some of the deep divisions in U.S. domestic politics suggest at least a significant minority would prefer to end American hegemony. If the U.S. is going to back away from this role, other nations will likely fill the void, at least as regional hegemony. In Europe, the U.S. would likely prefer Germany take this role; however, Russia's actions suggest that Putin might want that position.

It is not clear to us that the U.S. wants, or can afford, to return to the Cold War hegemonic model. If restoration is going to occur, it will require sacrifices likely skewed to upper-end households. At this juncture, we don't see a political consensus supporting such an outcome. Therefore,

although recent measures to oppose Russia's actions in Ukraine have been impressive, they likely fall short of what would be necessary to fully contain Russian aspirations.

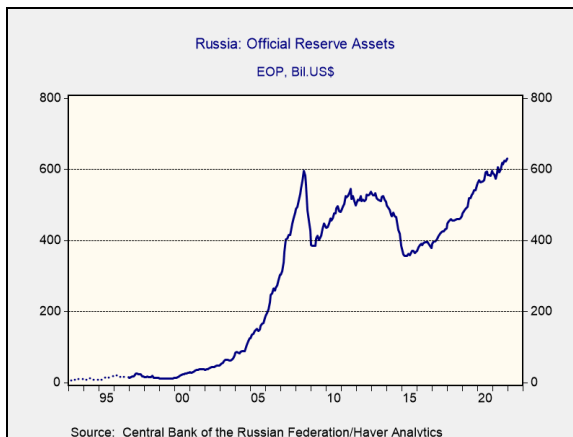
**Patrick:** All the same, it can't be totally ruled out that U.S. voters might unexpectedly swing behind a reinvigorated American commitment to Europe in response to Russia's aggression. For U.S. soldiers deployed to the welcoming, well-developed military infrastructure in Europe, the hardships will be vastly less onerous than for those sent to places like Iraq and Afghanistan over the last two decades. If the deployment successfully heads off a shooting war, America's warrior class could conceivably regain some of their faith in U.S. leaders and their involvement overseas. It's also possible that U.S. voters will find it more palatable to come to the aid of their cultural brothers and sisters in Europe, especially given that the economic costs of U.S. hegemony these days seem to be pinned more on Asian countries like China than on the U.S.'s rich, high-cost peers in Europe.

#### **Question #5: What happens if there is an invasion?**

**Bill:** This is difficult to answer because there are various outcomes short of a full takeover of Ukraine. We could see a partial invasion, for example. But any invasion will likely trigger U.S. sanctions; if all those laid out by the Biden administration are enacted, it would be difficult for Russia to sell oil abroad, at least to the West. That outcome would likely lead to energy shortages in Europe and perhaps an economic downturn. Thus, we may see a phased rollout to ensure that gas supplies are not completely ruptured until spring.

There has been talk of a broader European war if Russia takes this action. Although this is possible, we doubt it would occur. European militaries are not up to the task of a large war and we doubt the U.S. would be willing to “go to the mattresses” over Ukraine. An invasion without a significant response would undermine NATO, but such a response might not require a major military component.

Russia does have some ability to weather sanctions. China would likely ignore Western sanctions and thus continue to buy Russian energy. Additionally, Russia has built up its foreign reserves, which could allow it to maintain imports.



Russian reserves represent almost two years of goods imports; although Russia has reduced its reserves in dollars to about 20% of its foreign exchange reserves, euros represent 30% and thus may not protect Moscow from sanctions.

**Patrick:** U.S. officials continue to highlight their threat to impose economic sanctions against Russia [and key Russian officials](#) in the event of an invasion. They maintain assurances that the U.S. will not be sending troops to fight on Ukrainian soil. However, there is more of a military threat here than meets the eye. Importantly, the Biden administration has stressed that if Russia

invades Ukraine, the U.S. and NATO will boost their military infrastructure and deployments in Eastern Europe, close to Russian borders, and bolster their military aid to Ukraine as well. In this sense, it's not entirely accurate to say that the U.S. and NATO have vowed to limit their response to economic sanctions.

### Ramifications

Any Russian invasion of Ukraine would be bullish for crude oil, natural gas, wheat, the dollar, and Treasuries. Although the proposed U.S. sanctions may not be fully implemented, fears that they could eventually be triggered will likely lead to a decline in Russian supplies. A potential spike in crude oil could be mitigated by Strategic Petroleum Reserve releases. But there is no such relief available for natural gas. In the event of an invasion, European buyers would be scrambling to acquire supplies. The U.S. is attempting to increase non-Russian gas to the EU; it has had talks with Qatar, for example. [However, the ability to move flows to Europe will be limited.](#) Complicating matters is that natural gas demand is highly sensitive to temperature; a cold snap in the U.S. will reduce potential LNG flows to Europe.

Russia is a leading exporter of wheat; in 2020, [Russia supplied nearly 18% of global wheat exports. Ukraine ranked fifth, supplying 8%.](#) Essentially, a conflict that would likely disrupt wheat exports would reduce global supplies by 25%. Higher wheat prices would not only lift global inflation, but it would also pressure vulnerable countries. [Egypt is the world's largest wheat importer, followed by Indonesia and Turkey.](#) It should be noted that the Arab Spring was caused, in part, by rising food prices.

The dollar, and to a lesser extent, the Swiss franc and the Japanese yen, could benefit. These are considered flight-to-safety assets and often rally during periods of geopolitical stress. Treasuries are also in this category and would likely benefit. Gold may also rally, although its record during periods of turmoil is mixed. Crypto might benefit as such currencies are often used to skirt sanctions, but given the short history of these products, there is no historical record of how they behave in crises.

Risk assets would likely suffer the most. Equities, both domestic and developed

markets, high-yield bonds, and emerging market assets would all be negatively impacted. Of course, Russian equities and debt would likely suffer as well.

In the case where a conflict is avoided, oil and gas prices would likely decline, as would wheat. For the most risk-tolerant investors, Russian equities would be attractive.

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*This report was prepared by Patrick Fearon-Hernandez and Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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