

September 12, 2022

The Ukraine War at Six Months: Some Reflections

On February 24, Russian forces entered Ukraine. Despite warnings from U.S. intelligence about an invasion, the general consensus was that Moscow was merely threatening to act. Thus, when Russia invaded, Europe was mostly caught by surprise. Much of what followed was also unexpected.

As we reach the six-month mark of the conflict, we believe it's worth taking some time to discuss what has surprised us about the war so far, some of the key risks going forward, and the most likely outcome of the conflict. We will also touch on the lasting changes this war will cause and one important narrative that will likely lose its power. We will close with our usual look at market ramifications.

Surprises So Far

Outside of U.S. intelligence, the invasion was generally unexpected. The fact that American intelligence agencies correctly signaled Russia's actions is notable, and perhaps suggests deep penetration of Russia's military. Why was there such a high level of skepticism over the invasion? This was mostly because the risk calculus seemed to suggest war was a bad idea. Even assuming a rapid and successful invasion, controlling a country as large as Ukraine would be difficult. U.S. intelligence agencies correctly noted the buildup of forces and argued that it was not a bluff, but this evidence was mostly ignored.

The performance of Russia's military was profoundly inept. Before the invasion, the consensus was that Russia's military forces would make quick work of the Ukrainian military. After all, Russia had spent years reforming its military. However, the combination of risky strategies poorly executed coupled with an underestimation of Ukrainian resistance thwarted Russia's plans to decapitate the Ukrainian government and quickly take control of the country.

The Western industrialized nations rapidly coalesced to engineer an unexpectedly unified and strong response. Part of the reason for Russia's ambitious plans was it didn't seem to expect a strong response from the West. There is good reason for this position. Russia's incursion into Georgia in 2008 didn't engender a reaction. The annexation of Crimea only led to modest sanctions. Russia's geopolitics is historically focused on creating buffer zones around Moscow; the goal is to force an invader to move a long way across indifferent or hostile territory. In the wake of the Cold War and the expansion of NATO, Moscow has felt vulnerable, and its goal is to rebuild that buffer. The Kremlin expected the West to allow Russia to meet its geopolitical goals. Instead, there was widespread support for Ukraine and the West implemented strong sanctions that have effectively isolated Russia from much of the OECD.

The Short-Run Known Unknowns

Although there were other surprises, those mentioned were the three most obvious. As the weeks have passed, concern has shifted to what will happen over the next few months. Here are some key questions:

Will Russia cut off oil and/or natural gas to Europe? Already, Russia has reduced flows of natural gas well below normal levels in what looked like a bid to keep the EU undersupplied going into winter. However, demand reduction and new supplies coming from other parts of the world have allowed inventories to rise at a normal pace, and we expect supplies will be ample heading into winter. Nevertheless, a very cold winter will still lead to supply issues, but if temperatures are normal or warm, Europe will likely make it through in reasonably good shape. On the other hand, cutting oil and natural gas production also raises risks for Russia. Russia doesn't have a lot of storage capacity. Once storage is filled, if Russia wants to continue to squeeze supply, it will be forced to shut-in production, which may lead to a permanent loss of production capacity.

Will European political resolve to support Ukraine hold? Europe's economy is suffering under the weight of higher energy prices. The Italians will hold elections on September 25, and it currently looks like a coalition of right-wing parties will gain power. Some of the parties that will almost certainly be in the government are sympathetic to Russia. That doesn't necessarily mean the new Italian government will break with sanctions, but the odds of such an outcome will likely be elevated. As economic pain increases, it will be a challenge for EU governments to maintain support for Ukraine.

Will a divided government in the U.S. maintain support for Ukraine? The U.S. has been [remarkably generous](#) in supporting the Ukrainian war effort. But with the midterm elections looming, history would suggest that at least one house of the U.S. legislature will swing to the GOP. There are isolationist wings in both parties, but the Republican "America First" movement may

be less accommodating to Ukraine support. It should also be noted that the Biden administration is reluctant to fully support Europe in its energy crisis. The [energy secretary has warned against U.S. refiners increasing product exports](#), likely fearful of the political fallout from higher domestic gasoline and diesel prices. If the Freeport LNG export facility had not suffered a fire earlier this year, it is likely that U.S. natural gas prices would have been higher. The bottom line is that there are limits to U.S. and European support for Ukraine.

Will Russia escalate this war to take on NATO nations in Central Europe? So far, both sides have cautiously avoided involving regions outside Ukraine. NATO has been reluctant to provide weapons to Ukraine that could strike Russia,¹ and Russia has not attacked areas in Poland or other nations that are providing support for Ukraine. At the same time, Russia has made threats to use its nuclear arsenal if the war escalates. One possible trigger could be if NATO troops become directly involved in supporting Ukraine. Another would be if unrest rises in Russia and the Kremlin believes it is being supported or sponsored by the West. In a non-nuclear war with NATO, Russia would almost certainly lose; however, since the Cold War, nuclear armed nations have tended to avoid direct confrontation.

The War's Outcome

The advent of nuclear weapons has changed how wars are fought. Although a non-nuclear power can face defeat, nuclear powers with extensive delivery capabilities generally cannot suffer unconditional surrenders. Russia is a nuclear power, while

¹ Interestingly enough, Ukrainian forces did strike targets in Crimea, which Russia claims it has annexed. Moscow, at least so far, has not viewed this as an attack on Russia itself.

Ukraine is not. If Russia does prevail over Ukraine, it is unlikely that NATO would respond to the defeat with nuclear weapons. The same cannot be said for Russia. Although the history of the Cold War suggests that a nuclear power can lose a war with a non-nuclear rival, that outcome depends on how important the loss is perceived to be. Afghanistan for the Soviets and Vietnam for the Americans were not enough to trigger a nuclear exchange. However, it is not clear how Russia would react to being ousted from Ukraine. In the case of Vietnam and Afghanistan, neither nation was considered a core interest of the U.S. or U.S.S.R., respectively. Ukraine, though, might be seen as a core interest to Moscow.

At this point, it isn't certain if Ukraine can win this conflict, and we don't think Russia can win without a larger involvement of forces. Both sides have suffered serious losses. Russian casualties [may be as high as 80k](#), with [25k fatalities](#). Ukrainian forces have seen an [estimated 9k killed](#). So far, Russia hasn't declared war (the action in Ukraine is officially a "special military operation") and so a general mobilization has not been executed. [Russia is trying to expand its forces](#), although it isn't clear if this goal can be accomplished without a draft. Russian President Putin is clearly reluctant to declare a war and mass mobilization. We suspect this is because he fears such action will not be popular and would undermine his power, but so would losing a war to Ukraine. At this point, [it doesn't appear that Russia has enough troops in theater to take control of Ukraine](#), and we are not seeing indications that Russia is mustering enough resources to make that commitment.

At the same time, we also have doubts that Ukraine can win this war outright. The war has been devastating to the Ukrainian

economy and its war effort depends on NATO arms supplies. Moreover, there are likely limits to how much support NATO will offer Ukraine.

Between support fatigue and production bottlenecks, NATO is struggling to keep Ukraine supplied with enough material to conduct the war. All the same, NATO and the West do not want to see this conflict escalate. Although Ukrainian President Zelensky has vowed to remove Russian troops from his country, it isn't obvious to us that NATO will provide enough support to meet that goal. Instead, the path forward, at least for now, is a continued conflict and stalemate. A stalled outcome, similar to the end of the Korean War, is perhaps the most likely outcome.

That said, [tying Russia down in this war serves at least America's interests](#). An unending conflict is a drain on Russia's economy and will undermine efforts to expand its influence elsewhere. That isn't necessarily the case with Europe, however. The loss of Russian energy has been a nasty blow to the EU economy, creating conditions of stagflation. Although the [adjustment of energy flows will eventually improve Europe's supply situation](#), it's also true that it will probably never enjoy energy prices as low as they were before the war.

What Persists

The U.S. decision to freeze Russian foreign reserves remains one of the major events of this war. Although the U.S. did something similar to Iran, it had never taken that action with a G-8 country. By doing this, it removes a key pillar to global trade. Now nations know if they diverge from U.S. interests, they are at risk of being denied access to the dollar-based financial system and the global reserve asset. If a nation is comfortably within the U.S. orbit, being removed from the dollar-system isn't likely.

On the other hand, China could find itself excluded at some point and its \$980 billion of Treasuries could become impossible to sell. In the wake of this action, no nation can be sure its reserves held in dollars are completely safe.

For Europe, even if the war ends soon and sanctions are lifted, Russia will be an unreliable source of energy and other commodities. Europe will never be able to “unsee” the damage wrought by Russia. Russia will need to reorient its energy flows to more friendly nations and Europe will need to find alternative energy sources.

Although trade regionalization has been developing for some time, the Ukraine invasion has accelerated that trend. During the period of unilateral American hegemony, trade relations mostly focused on efficiency. Going forward, other concerns will be vital, such as security and geopolitical relationships. This environment will lead to less efficiency but greater safety.

One Idea That Ends

The Ukraine war will likely end some trends, a key one being the following narrative.

Narratives are how humans make sense of their world. Although it isn't the only way we learn, stories are unusually powerful. Jesus didn't expound on theology, but instead he told stories to explain what he was trying to do. One characteristic that makes stories powerful is simplicity. The world is messy and complicated, but narratives make it simple.

Germany had a policy called “Wandel durch Handel” or, change through trade. This idea is a pillar of the Social Democratic Party created by Willy Brandt, who was the

German chancellor during 1969-74. The concept was that increasing trade would lead adversaries to change. In Germany, this policy was considered to be [one of the reasons for the end of the Cold War](#). *The Ukraine war has severely undermined this policy and, to some extent, leaves Social Democratic foreign policy adrift.* It is not obvious what will replace it.

Ramifications

There are two ramifications from the Ukraine war that will likely affect markets indefinitely. First, [inflation will become a more persistent issue](#). Globalization led to a flat aggregate supply curve, and factors that increased demand, such as expansionary fiscal and monetary policies, increasing population, etc., tended to have only modest effects on inflation. But as globalization as practiced from 1990 to 2020 unwinds, the aggregate supply curve will steepen. This change will likely lead to persistently higher and more volatile inflation.

Second, trade will tend to become more of a tool of international relations and less of an economic tool. In other words, instead of sourcing imports or foreign investment in the most efficient manner, concerns such as security or “buying” support for foreign policy goals will become more important. That outcome will lead to greater security of supply but at higher prices.

Third, the war has revealed the fragility of supply chains for critical commodities, such as oil, natural gas, grains, fertilizer, and key metals. There will be an incentive to stockpile these critical goods, which will tend to lift their prices.

Bill O'Grady
September 12, 2022

This report was prepared by 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.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.