

A misty, atmospheric photograph of a dense evergreen forest. The trees are dark green and silhouetted against a light, hazy background, creating a sense of depth and mystery. The mist is thick, partially obscuring the trees in the distance.

RUSSIA-UKRAINE:

# The Beginning of the End?

WRITTEN BY

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**Two years into Russia's full-scale war in Ukraine, we now think a *de facto conclusion* to the war is possible within 12–18 months in a manner likely to favor Moscow at Kyiv's expense.**

However, we think a swift conclusion is contingent on the speed and degree to which Kyiv and its Western backers resign themselves to the grim strategic and economic realities at play. Ultimately the war's end, however unpalatable the terms might be, would likely reverse the adverse growth and inflation shocks the conflict delivered to the global economy and markets—over a period of years, not months.

## Strategic Dynamics

### **RUSSIA HAS REGAINED THE STRATEGIC INITIATIVE IN UKRAINE.**

Kyiv's failed counteroffensive in 2023 put Moscow back in the driver's seat. The Kremlin's reescalation of aerial attacks on major Ukrainian cities, coupled with its selective offensive operations on the ground, stand in contrast to a handful of attention-grabbing but ultimately insufficient Ukrainian drone and other strikes from Crimea to Moscow.

### **MOSCOW RETAINS THE KEY TERRITORIES WE FLAGGED AS THE LIKELY OBJECTIVE BACK IN MARCH 2022.**

Despite months of horrific violence that likely produced well over 100,000 military casualties alone,<sup>i</sup> the front lines remain largely unchanged from the early months of the war. Russia's focus on the south and the east remains consistent with our initial assessment of Kremlin strategy. In our opinion, it is no accident that the areas of greatest strategic and economic value are home to the greatest concentration of Russian speakers in Ukraine; the Donbas and southern agricultural belt were some of the most economically productive regions of the Tsarist and Soviet empires going back to the 1840s, attracting economic migrants from the Russian-speaking core. Without this territory Ukraine is all but landlocked and denuded of its key industrial heartland and outlet to global markets.

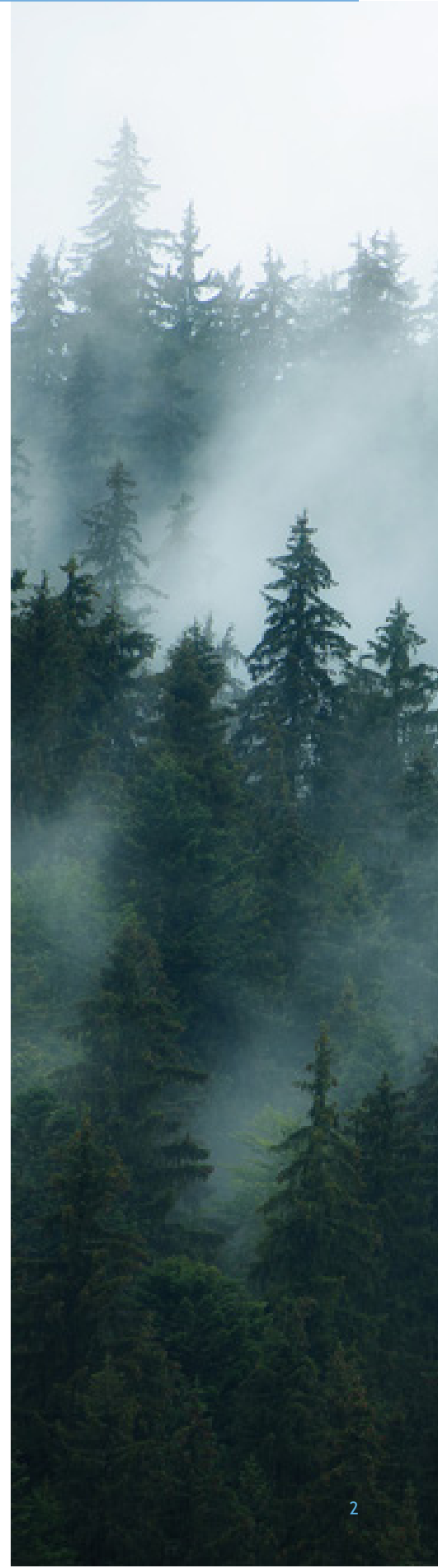
### **THE STATUS QUO OVERWHELMINGLY FAVORS RUSSIA AT THE EXPENSE OF UKRAINE.**

The war is being fought on Ukrainian land, disproportionately destroying Ukrainian homes, businesses and infrastructure, with a disproportionately high toll on Ukrainian civilians. While both sides remain opaque about the extent of military casualties, Ukraine's population is smaller than Russia's by 100 million.<sup>ii</sup> Adding to the demographic disadvantage is the consideration that nearly a third of Ukraine's population is displaced, with nearly half of this group living as refugees abroad, magnifying the economic and humanitarian pressures.<sup>iii</sup> Ukraine's agriculture and service sector exports have been important silver linings to the gloom, but in our view, they are fragile and contingent.

<sup>i</sup> <https://www.theguardian.com/world/2023/aug/18/ukraine-russia-war-battlefield-deaths-rise>

<sup>ii</sup> UN Data from 2022: [https://data.worldbank.org/indicator/SP.POP.TOTL:name\\_desc=false](https://data.worldbank.org/indicator/SP.POP.TOTL:name_desc=false)

<sup>iii</sup> <https://ukraine.iom.int/news/millions-assisted-millions-more-still-need-two-years-ukraine-war-says-iom>





## Relative Economic Strength

### WESTERN AID IS NECESSARY FOR UKRAINE BUT MAY NOT BE SUFFICIENT.

That Ukraine has not suffered an economic collapse already is almost entirely due to Western aid. GDP contracted by nearly a third in the first year of the war, as did industrial production, and the recovery has been slow from a low base, driven heavily by wartime activity underwritten by Western aid.<sup>iv</sup> The fiscal deficit—again, despite myriad Western subsidies—stands at nearly 20% of GDP.<sup>v</sup> That inflation has not skyrocketed reflects Western financial backing. Absent Western support, we would likely see military expenditures rise, the primary balance widen, and debt service costs explode. Without any appreciable untapped revenue streams to replace the infusion of Western funds, we believe the only alternative would be to monetize the deficit, with potentially disastrous consequences for inflation and debt sustainability; growth is already fragile, while the fiscal balance, debt stock, and cost of debt would likely be uncontrollable.

#### UKRAINIAN MACROECONOMIC DATA & CONSENSUS FORECASTS

Actual Bloomberg Consensus Forecast	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
<b>Real GDP (YoY%)</b>	2.5	3.4	3.2	-4.0	3.4	-29.1	4.9	4.0	5.4	5.1
<b>CPI (YoY%)</b>	14.5	11.0	7.9	2.7	9.3	20.1	13.4	7.2	7.3	6.3
<b>Unemployment (%)</b>	9.5	8.8	8.2	9.5	9.8	24.5	19.6	16.0	13.8	11.0
<b>Current account balance (% of GDP)</b>	-1.1	-1.7	-2.3	3.5	-1.9	5.0	-4.5	-5.5	-7.0	
<b>Budget (% of GDP)</b>	-2.7	-2.1	-2.1	-5.9	-4.0	-15.7	-19.7	-17.8	-10.4	-8.1
<b>Policy rate (%)</b>	14.50	18.00	13.50	6.00	9.00	25.00	15.00	13.25	11.15	
<b>Exchange rate (USDUAH)</b>	28.10	27.72	23.81	28.34	27.29	36.92	38.13	39.00	42.00	

Source: Bloomberg and International Monetary Fund data, as of 3 April 2024.

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**Past market experience is no guarantee of future results.**

In our view, the picture only gets bleaker when considering the external accounts, which feed into the sustainability of public finances. Ukraine's high-single-digit current account deficit is currently at levels that would be considered high in a conventional EM context. However, we believe the problem is starker when considering that foreign aid transfers are included in this line item. Absent the aid, and in a scenario where Ukraine has to pay for weapons at market rates, the current account deficit would likely balloon.

<sup>iv</sup> Source: Bloomberg, data accessed 3 April 2024.

<sup>v</sup> Source: Bloomberg, data accessed 3 April 2024.



## IN STARK CONTRAST, RUSSIA'S ECONOMY HAS BEEN RESILIENT RELATIVE TO UKRAINE—AND RUSSIA'S OWN PAST.

Beyond the obvious point that the warzone is outside Russia itself, the Russian economy has repeatedly defied predictions of a sharp contraction. While Russian GDP did contract in 2022, it was a minor 1.2% fall versus the double-digit decline the consensus expected at the time.<sup>vi</sup> Since then, forecasters—most recently the International Monetary Fund—have repeatedly upgraded their Russian economic forecasts. The record-low unemployment rate seemingly underscores the degree to which life in wartime not only goes on, but has even improved for significant swaths of the Russian population, if not for many of the ethnic and religious minorities who represent a disproportionately high share of Russian forces and casualties.

### RUSSIAN MACROECONOMIC DATA & CONSENSUS FORECASTS

Actual Bloomberg Consensus Forecast	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Real GDP (YoY%)	1.8	2.8	2.2	-2.7	5.9	-1.2	3.6	2.0	1.1	1.3
CPI (YoY%)	3.7	2.9	4.5	3.4	6.7	13.8	6.0	6.7	5.0	4.1
Unemployment (%)	5.2	4.8	4.6	5.8	4.8	3.9	3.2	3.1	3.2	3.5
Current account balance (% of GDP)	2.0	7.0	3.9	2.4	6.7	10.5	3.3	2.5	2.2	2.7
Budget (% of GDP)	-1.5	2.6	1.8	-3.8	0.4	-2.1	-2.3	-1.9	-1.2	-1.3
Policy rate (%)	7.75	7.75	6.25	4.25	8.50	7.50	16.00	12.70	8.55	
Exchange rate (USDRUB)	57.69	69.35	61.95	74.04	75.17	74.19	89.47	96.90	108.00	

Source: Bloomberg and International Monetary Fund data, as of 3 April 2024.

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Observable real-life phenomena are consistent with the data. Russians continue to travel abroad, and there is ample evidence of booming consumption domestically. In any case, we don't agree with the argument that a slowing economy and/or military defeat in Crimea would signal the death knell for Putin's regime. Military missteps and economic dislocations have been long-running themes in Russian history. Moreover, we think it is striking that wartime developments remain favorable to Russia with little apparent cost to the person in the street. To the average 40-year-old Russian who has in their lifetime witnessed empty store shelves and seen their family's life savings wiped out on numerous occasions including 1991 and 1998, we imagine the current situation pales in comparison to those of the past.

<sup>vi</sup> Source: Bloomberg, data accessed 3 April 2024.



Regardless of the outcome of the 2024 US election, we think the prospects for continued Western support of Ukraine remain in question.

## (The Absence of) Domestic Politics

### **RUSSIAN OPPOSITION LEADER ALEXEI NAVALNY'S DEATH WAS TRAGIC— IN PART BECAUSE IT IS UNLIKELY TO CATALYZE IMMINENT MATERIAL CHANGE.**

In our view, Navalny's fame abroad did not translate into political change at home. While known for his brilliant wit and use of social media to mount trenchant critiques of Putin's regime, and considered a brave man to willingly return to Russia on his own accord, Navalny ultimately failed to change Putin's policies or indeed drive him out of power.

### **NAVALNY'S SAGA HIGHLIGHTS RUSSIA'S RELATIVE ADVANTAGE IN DOMESTIC POLITICS.**

Viable opponents to Putin are not currently in evidence in Russia, and the fates of Navalny and Wagner Group head Prigozhin were chilling warnings to any potential pretenders to the throne. By contrast, after an initial period of remarkable national unity, domestic fissures are evident in Ukraine, not only in the visible rupture between Zelensky and former Commander-in-Chief Zaluzhny, but in what seems to be a greater willingness of Ukrainian politicians to start questioning government policy publically.

## Western Limits

### **WE VIEW WESTERN SANCTIONS AS LARGELY TOOTHLESS.**

February saw the thirteenth round of EU sanctions, as well as sanctions from the UK and US. The measures, which center on an increasingly obscure set of individuals and organizations, are likely to have little impact on Russian actions. The West has mostly avoided sustaining more serious sanctions, including on key commodities like aluminum, fearing economic blowback in our view.

### **WE THINK THE EROSION OF WESTERN RESOLVE OVERALL IS A DECISIVE PROBLEM.**

While many focus on former President Donald Trump's influence on congressional debates over Ukrainian aid, we believe the drivers of waning Western support go well beyond his sphere of influence. Western publics are seemingly bristling at the costs – witness European farmer protests over Ukrainian imports—wondering about the wisdom of Western policy in the wake of the failed 2023 counteroffensive, or simply losing focus in the context of other conflicts, notably in Israel/Palestine. Regardless of the outcome of the 2024 US election, we think the prospects for continued Western support of Ukraine remain in question.

## The Road Ahead Appears Bleak

### **“NEITHER WAR NOR PEACE” IS NOT A VIABLE STRATEGY IN OUR VIEW.**

We see important parallels between Kyiv’s current predicament and position and that of the newly arrived Bolshevik regime in Russia in 1918. Then as now, the government was losing an expensive war against an intractable foe, facing the uncomfortable prospect of unconditional surrender to end the fighting. At the time, Bolshevik leader and People’s Commissar for Foreign Affairs Leon Trotsky advocated a policy of “neither war nor peace.” The result was a disastrous acceleration of the German advance through the lands of the Russian empire culminating in the peace of Brest-Litovsk, which was in effect a Russian capitulation. If Western resolve collapses, which we now think likely to happen within 12-18 months, Zelensky will likely face a similar decision. The overall risk in our opinion is that he opts for a Trotsky-like stance that will ultimately result in a conclusion indistinguishable from unconditional surrender: the significant difference being the timeline and casualty count leading to a final settlement.

### **FOR MARKETS, AS FOR UKRAINE, THE DESTINATION LOOKS INCREASINGLY CLEAR; THE PATH REMAINS IN QUESTION.**

Whereas earlier, we argued that the conflict would persist for quarters if not years, we now think a de facto conclusion possible within the next 12-18 months. As in 2022, we think Russia remains focused on the effective partition of Ukraine in a manner that leaves a landlocked and notionally independent state with Kyiv as its capitol. We believe such a result—however unpalatable to many—is within Moscow’s grasp. In our view, the key question for markets and Ukraine itself is how quickly Kyiv and Zelensky in particular are willing to accept surrender. We believe swift capitulation could pave the way for some new arrangement between Russia and the West—perhaps not immediately, but history suggests over 4-5 years—which would help slowly reverse the adverse growth and inflation shocks the conflict generated in its early stages. A longer path punctuated by sporadic but futile escalatory steps would likely inflame the growth and inflation pressures on markets while likely leaving the ultimate destination the same, if more distant.



In our view, the key question for markets and Ukraine itself is how quickly Kyiv and Zelensky in particular are willing to accept surrender.



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## Disclosure

*Market conditions are extremely fluid and change frequently.*

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