Russian – Ukraine crisis and implications for Fed and ECB monetary policy

• **USD:** Russia strikes, global market reaction ripples (in the initial hours) – the immediate reaction to the sharp escalation in the Russia – Ukraine crisis, comes from commodity prices with a spike in European natural gas futures up more than 60%, Brent crude topping $105 and WTI rising above $95. The accompanying sharp downtick in risk assets (US and European equities - S&P 500 down more than 2.6%, Dow Jones declining 859 points, the European Stoxx 50 index and the DAX down 5.1%, the CAC by 5.0% and FTSE 100 down 3.3%), encourages safe haven flows into sovereign debt (UST and German Bund 10yr yields down 15bp lower at one stage with the former breaking below 1.85%) and into USD (DXY breaks through the 97.00 barrier), JPY and to a lesser extent CHF, especially from EMEA FX. Meanwhile, EUR (and GBP) also falls some 1.6% against JPY to around 128 and 1.3% against USD to around 1.1160 while Commodity FX (AUD, NZD, CAD) is down about a big figure from the Russian pre-announcement levels, taking their cue from the volatility – induced risk off session than gains in commodity prices. Gold also finds a solid bid, trading as high as as $1973 before reversing.

• **USD:** But these losses are short-lived, perhaps reinforcing the notion that a geopolitical crisis such as this rarely causes a full-blown recession and while asset market corrections can be sharp, they tend to be generally short-lived. And by day's end, oil prices are $7 off their highs, both the S&P 500 and Dow Jones index end up well in positive territory – 63 and 92 points up respectively, Nasdaq manages to erase its declines to close a massive 436 points higher and the UST 10Yr yield pares back its decline to just 3bp, rising back to a close at 1.97% (from 1.85%). In FX though, the reversal is not anywhere near as sharp with DXY still closing the session well bid above 97.00 though both JPY and CHF decline a big figure from their lows of 114.43 and 0.9170 respectively. Commodity FX (AUD, NZD, CAD) also fails to lift with the late reversal in risk sentiment.

• **USD:** Implications for the Fed and ECB - market sentiment remains bearish despite the later reversal in sentiment, but earnings are still strong, and labor markets are tight. Inverted spot interest rate curves are the best and most tradeable recession indicator, and we are not there by a long shot. But while the volatility in asset and commodity markets can be sharp but short-lived and much of the near-term implications from the escalation may be discounted, markets will still likely be concerned about high global inflation, lower growth and an absent policy put, all of which is exacerbated by the crisis-induced spike in energy prices.
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• USD: This greater uncertainty and vulnerability in financial markets may weigh on the timing and pace of Fed tightening steps despite an inflation rise that is likely to be higher than expected in the coming few months though this is also likely to limit Fed’s desire to turn outright dovish. But with fiscal support for US consumers no longer existing and the negative impact of inflation on wages weighing on spending, this leans towards a Fed 25bp hike in March than 50bp (markets are already re-pricing lower) and perhaps slowing the pace at which the Fed may hike rates later in the year. European growth rates will also be impacted as near-term energy supply problems will slow spending. Indeed, downside risks are already on the European radar with ECB chief economist Philip Lane noting this week that geopolitical tensions are currently a “very significant risk factor, particularly for Europe”. This would suggest the ECB is likely look through a spike in oil prices by not bringing forward the timing of its expected first move in policy rates until year-end, given the likely transitory nature of the supply-driven increase in energy prices. And in the unlikely event of a more sustained negative market reaction and an increase in systemic stress, the ECB is more likely to provide additional liquidity in the form of swap lines. Regardless of the likely higher inflation prints in coming months, higher uncertainty will likely require the ECB to retain some optionality with respect to its monetary policy stance (as also highlighted in comments by Bank of France Governor Villeroy this week) and therefore caution should prevail on expectations for any earlier-than-expected tapering in net asset purchases as the Russian – Ukraine crisis presents material downside for euro area GDP prints in 1Q-22 and 2Q-22 (perhaps lowering the 2022 GDP baseline by as much as 2pp to 2%). Such sentiment already sees ECB hikes for this year being increasingly priced out (20bps lower over the last two weeks) and more is likely following the ECB’s March meeting.

Singapore: Modest rise in core CPI supports April “slight” slope steepening

• SGD: Singapore’s January core CPI comes in slightly below consensus at 2.4% YoY but with momentum still strong – on a MoM basis, core CPI rises 0.4% (Previous: 0.5%) and on a 3M/3M basis, core CPI accelerates to 1% (Dec: 0.8%, Nov: 0.7%). Meanwhile, January headline CPI is unchanged but still elevated at 4.0% YoY (Dec: 4.0%, Nov: 3.8%). The MAS’s inflation outlook is marginally more hawkish than January 25th MPS, with inflation still seen reaching 3% by mid-2022 before easing, but with upside risks from pandemic related and geopolitical shocks in further disrupting global supply chains and a tighter labor market. Citi analysts also expect core CPI to climb further to 2.6-2.7% in February, reaching 3% in April, and averaging 2.8% in 2022.

• SGD: With 2022 core likely to average in the upper half of the 2-3% range, Citi analysts maintain their base case of a 100bps “slight” slope steepening in April (80% probability) – this would take the slope steepening so far (October 2021 meeting plus the January inter-meeting) to around 2.5% p.a. and be consistent with MAS’s preference for a sequence of calibrated tightening moves to further reduce monetary accommodation in real terms, along with an expected slightly positive output gap. But with core CPI likely to average >2% through 2024 on the recent Budget measures and other factors, a “neutral” policy band slope steeper than 2% p.a also seems possible. Should MAS choose to reduce monetary accommodation at a swifter pace, a more aggressive slope steepening of >1% (100bp) is possible (20% probability). Barring a further step up in February-March core CPI that leads to sharper hikes in MAS’s 2022 core forecasts, an upward re-centering is unlikely in April, though this remain an option in October 2022, especially if the slope has already been normalized to least 2% p.a.
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