Zeitenwende and Paradigm-Change: GeoPolitics rattles Goldilocks

"The darkest places in hell are reserved for those who maintain their neutrality in times of moral crisis." Dante Alighieri, Italian Poet and Moral Philosopher (1265-1321)

Does the current moral crisis change our political and economic paradigm?
Does geopolitics dominate economics and markets during times of crises?
Does morality gain more influence on our economic and financial decisions?

YES! Markets enjoyed a great run with goldilocks: stable growth and expanding trade, low inflation and cheap commodities, monetary stimulus and rising markets. Even the pandemic reinforced the goldilocks, until geopolitics is now turning the old paradigm upside-down: a tragic war is transforming politics, as massive sanctions are curtailing trade and cutting growth, and rising energy prices are stoking inflation and monetary tightening. GeoPolitics is emphasizing morality and national security at the expense of trade and efficiency, putting the goldilocks into reverse.

Germany's Zeitenwende has global implications

The German government announced three 180-degree-reversals last week: Germany delivers defensive weapons to Ukraine, Germany imposes drastic sanctions on Russia, and Germany adds €100 bn to its defense spending. "Wandel durch Handel" or "liberalization through trade" has failed miserably, both with Russia and with China. German trade will now be guided by morality and national security rather than purely business and economic interests, and its naïve partnership with Russia will be relegated to the history books. Western economies will address the corruption of oligarchs much more decisively. Neutrality during this moral crisis appears impossible for the United States, NATO, Europe, and its allies, despite high economic costs, as Dante, the Italian philosopher, observed when he initiated the humanist tradition.

Europe facing recession from war

Putin's war is inflicting tragic suffering on the Ukraine, with massive destruction and millions of refugees across Europe. Even the existing limited sanctions will likely cause a recession, as trade is collapsing, business exits are causing losses in the hundreds of billions, and record commodity prices are cutting production, employment, and profit margins. Even in an optimistic scenario, negative growth over the next quarters could reduce annual EU growth by two percentage points. Policy options are constrained on the monetary side with rising inflation as well as on the fiscal side with the reversal of the pandemic stimulus.

US stagflation from energy crisis

US inflation could rise into double digits by mid-2022 if energy prices remain elevated and risk premia rise further from tensions in the Middle East. Russian and Israeli opposition could prevent any deal with Iran, which could raise geo-political risks. Saudi Arabia could limit supply increases from OPEC, given its worsening relationship with the US. The UAE, Egypt, and Turkey could undermine Western sanctions as they maintain their relationships with Russia. Despite a fall in demand, energy prices could further increase as Russian exports to Asia are subsidized whereas Western exports of LNG into Europe are less efficient and more costly. Inflation expectations could accelerate further from a wage-price-cycle even as markets expect the FED to raise rates seven times this year and to reverse its balance sheet expansion.

China is the wildcard

Chinese policymakers are projecting much lower growth this year, given the ongoing pandemic restrictions and the collapse of the Chinese real estate market. Chinese developers' sales declined by 40% in January, while land sales dropped and asset sales to state firms increased. Massive lockdowns have been expanded into Shenzhen and Hong Kong, which are further clogging supply chains until China gets access to a more effective mRNA vaccine. Now China is facing a crucial decision on whether it will support Russia's war, which could trigger massive secondary sanctions from the US and from Europe. The Chinese support for Russia could be linked to Russian support for China over Taiwan, although that timeframe could be delayed by two years, while China further decouples and immunizes itself against anticipated Western sanctions.

Polarized emerging markets

BRICS have been the five largest emerging markets covering over 60% of this space. Russia has now been excluded from MSCI indices. China has publicly supported Russia. India remains torn and dependent on Russian military collaboration but could take the opposite strategic position to China and to Pakistan. Brazil and South Africa have tried to remain neutral, but are more likely to join the Western alliance, as could Mexico and South Korea. Asean countries might follow Singapore and oppose the Russian invasion, except for Myanmar and Laos. That could bring back a Sino-Russian-polarized world of the 1950s with backing from Pakistan and Saudi Arabia. The Chinese markets could soon be classified as stand-alone outside of EM indices. Emerging markets investments could become more polarized and quite political.

Deadlocked climate policies

China's current politics and the Western response could be decisive factors in advancing climate policies. The US has delayed additional sanctions on China under section 301 of its Trade Act but that window could close as NATO is finalizing its strategic concept for its Madrid summit in late June. Internal Chinese struggles between economic interests and the dominant military and political leadership could result in a new Sino-Russian coalition and rising alignment with commodity exporters. Such a coalition could doom global efforts to reinvigorate climate policies. Moreover, US Republicans are again advocating higher domestic fossil energy production, while Europe could be forced to increase fossil energy use, given its energy shortages from Russian sanctions, and declining public support for renewable energy during the crisis.

Fallacity of index investing

Russia's anticipated default on $150 bn of government and corporate bonds, on $170 bn of foreign-held equities (incl. ADR and GDR), and the announced expropriation of billions of assets of foreign companies which are suspending operations in Russia, could become a once-in-a-generation watershed moment in global financial markets. Institutional investors had intended to diversify through indices and quasi-index funds, which have been caught straight in the middle: equity index funds faced write-offs of 4% of its assets in February, as Russian equities were excluded and marked to zero in MSCI EM indices. Large equity mutual funds with quasi-index strategies performed even worse and lost an additional 2% in February as they failed to address geopolitical risks. Russian bonds account for 6% of global EM debt indices and could be excluded at the end of March, as defaults could lead to low recoveries in a polarized environment. The largest investment firms and major pension funds need to explain to members why they are losing billions of dollars in Russia and why they ignored geopolitics.

Outlook has further downside

Geopolitical risks do remain elevated: Putin's war already created a humanitarian tragedy but could be further escalated and lead to a full EU embargo on Russian energy exports. Potential conflict with Iran could further increase risk premia in energy markets. China's trouble with Covid lockdowns and real-estate-meltdowns could provoke political crises and lead to stronger Sino-Russian cooperation and an escalation in North Korea. The FED (and the ECB) remain (well) behind the curve on inflation and monetary tightening, and potential yield curve inversion could increase stagflationary (or recessionary) pressures. Meanwhile, commodity exporters and the healthcare sector as well as defense and industrial firms could see some upside. **Neutrality with index-investments may have worked well under the goldilocks regime but today, investment decisions must incorporate geopolitics, China's strategic realignment, as well as the deeply unbalanced Western monetary policy. This change of paradigm stipulates that investments cannot be neutral, they cannot be amoral, but they must be active and affirmative.**

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