Truist Advisory Services, Inc.

Economic commentary from the Investment Advisory Group

Quick take – Russia invasion a modest negative for U.S. economic growth

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What happened

Russia launched a military invasion into eastern Ukraine. A flight to safety pushed U.S. stock prices and bond yields sharply lower, while the U.S. dollar jumped to its highest level since July 2020, particularly against the euro.

Additionally, global energy prices surged in expectation of disrupted Russian energy exports and Ukrainian natural gas exports. U.S. crude oil crossed above $100 per barrel (West Texas Intermediate) for the first time since mid-2014, up about $10, or 11%, in the past 10 days. U.S. natural gas prices (Henry Hub) have increased more than 20% over the same span.

This week, in response to the Russian military actions, Germany stopped the certification process for the Nord Stream 2 pipeline, which would carry natural gas from Russia directly into Europe via Germany. European natural gas spiked more than 40% in several countries, including the Netherlands, Germany, and the United Kingdom (U.K.).

Western leaders — primarily the U.S., Europe, and the U.K. — are formulating sanctions against Russia. The most likely sanctions will be financial and export controls, but probably would exclude energy exports, which would cripple European economies.

The U.S. is likely to release some supply from the Strategic Petroleum Reserve (SPR), which would be mostly symbolic for the crude oil markets and unlikely to have a large impact on U.S. gasoline prices.

Our take

This move into Ukraine has been long planned and calculated by Russia, which will not be dissuaded by the current Western sanctions, making them ineffective. Now that military action has started, the maneuvering room for a possible diplomatic solution is very limited. Frankly, Russia now holds most of the cards, such as knowing that cutting off Russian energy exports hurts Europe economically more than itself. On the other hand, the notion that Russia would voluntarily slow or cut off energy exports to Europe is equally doubtful.

The biggest impact to the U.S. economy is that it aggravates inflationary pressures as supply chains are disrupted, even those not directly connected (for example, overordering and hording by companies). Moreover, Ukraine is a leading exporter of agricultural and key

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industrial commodities. For instance, Ukraine is the world's second largest exporter of barley, third largest of iron, eighth largest of wheat, and tenth largest of steel.

Global energy markets are pricing in prolonged disruptions. Ukraine is the 4th largest natural gas exporter, while Russia is among the largest crude oil exporters at over 7.5 million barrels per day. The direct impact of energy is significantly higher on Europe than on the U.S. and could push some European nations into recession. That would cool U.S. exports marginally and complicate European-based supply chains due to factors such as hampered production.

Conversely, if the Russian military action is prolonged in terms of weeks or months, it has the potential to restrain the extreme level of job-hopping seen by U.S. workers (i.e., preferring job stability in an uncertain time), thus easing some of the recent wage inflation. But that would take a while.

Higher inflation would ding already-sour consumer and business sentiment, which were both below their pandemic lows in most recent readings, **as well as U.S. consumer spending**. Yet, the latter is more complex insofar as higher energy prices benefit the U.S. economy since U.S. supplies are largely from domestic energy producers. Thus, the "lost" spending would largely shift to energy providers, such as gasoline stations and utilities companies. Moreover, sustained higher energy prices would likely spur additional energy investment in the U.S. (e.g., increased exploration and production, building additional energy infrastructure and export capacity, etc.). Hence, **higher inflation due to energy prices would be a modest net negative for U.S. economic growth.**

Ultimately, **we maintain our view that U.S. recession risks are low.** There are ample savings built up as a result of pandemic-assistance programs and we have seen strong wage and income growth. Average hourly earnings increased 5.7% from a year ago (through January), well above the 2019 average of 3.3% and double the 2.4% average for the decade before the pandemic (2009 through 2019). Thus, consumers clearly have the wherewithal to weather this issue, albeit with some pain.

The developments in the Russia-Ukraine conflict increase U.S. recession risk only very modestly in our view. Assuming a short invasion, the net effect is likely to cause a brief, slight cooling effect for the U.S. economy, likely mimicking a severe weather event. For a prolonged war (+6 months), the net economic effect is likely to be modestly negative due to the increased inflationary pressures, especially for commodities and energy prices.

Lastly, with respect to the Federal Reserve (Fed), this issue plays perfectly into the slower rate hike scenario we expected, meaning fewer rate hikes in '22 than the markets had been pricing. This would be supportive of avoiding a recession in the near term. Despite hotter inflation readings, the last thing the Fed would want to do is aggressively hike interest rates into a slowing U.S. economic environment.

Bottom line

The Russian invasion is a modest negative for U.S. economic growth. Obviously, a quick resolution or diplomatic solution would blunt much of the economic impact. We maintain our view that U.S. recession risks are low. Though there may be short-term pain for consumers with hotter inflation, much of the spillover effects from the Ukraine situation into the energy markets is likely to shift spending from discretionary consumption to the energy sector within the U.S. economy.

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