RBC Global Asset Management

What a Russian defeat would mean for financial markets

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Some eight months into Putin's invasion of Ukraine, what now seems clear is that Russia is losing the war.

If Putin's initial goals were to remove the government in Kyiv, impose his own regime therein, demilitarise the country and stop its Western orientation, then these goals have failed. Subsequently falling back on more limited, stated goals, such as securing Donbas and a southern land corridor to Crimea, Putin has appeared to try and cement gains on the ground by announcing the annexation of four partially occupied regions of Ukraine. However, recent military defeats in Kharkiv and around Kherson now raise doubts as to whether even these objectives can be sustained.

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Indeed, a total collapse of Russian forces in Ukraine now seems entirely possible. The war has proven to be a huge defeat for Putin and Russia, and the limits of Russian conventional military power have been exposed. The brutality of the Russian attack ensured seismic sanctions imposed not only on the Russian economy, but also the near pariah status for Putin himself with the likes President Xi of China and PM Modi of India now appearing to distance themselves from the leader. Within Russia, opposition and unease are also growing as the poor performance of the Russian military and the state throughout this conflict continues.

Ukraine, on the other hand, has united and mobilised against the Russian threat, now possessing a capable military force and arguably now a much greater threat to Russia than eight months ago. The West has also now united around the common purpose of standing up to Russian aggression.

Putin's limited options and how they will impact markets

From here on, Putin is faced with three limited options, each of which would impact markets.

1. Finding peace

Firstly, in my opinion, the wise thing for Putin to do would be to quickly sue for peace. Russia's attempts to force an energy crisis in Europe, the annexation of the four regions of Ukraine and threats of nuclear arms, were designed to force Ukraine and the West to the negotiating table and concede to peace on Putin's terms - Russia keeps what she occupied.

Yet, being on the front foot, Ukraine appears in no mood to negotiate until Russia is pushed back to its position as of February 23 at the very least which is seemingly the most likely outcome at present as Russian forces in Ukraine may collapse over the winter. But waiting for this eventuality would leave Putin vulnerable to domestic political fallout from what would then clearly be a devastating military defeat. An early withdrawal amid a peace process might enable Putin to save some face by limiting Russian casualties, and perhaps he could negotiate some sanctions of moderation on the Russian economy.

As for financial markets, a Ukraine win and early end to the war would obviously be well received. Risk assets would rally, and commodity prices would likely fall, helping counter the global cost of living crisis and potentially allowing the Fed to pivot in terms of interest rates. Much of this would be dependent on the remaining political set up in Russia – if Putin stays, relations with the West will remain strained and sanctions moderation limited. With markets waiting for the next flare up between Putin and the West, perhaps we would see a relatively short but still significant market rally.

2. Ukraine wins

Second, a much more optimistic scenario involves Ukraine winning and Putin losing power, most likely via an internal coup. A popular uprising would be less probable but could happen over time, especially if Putin tries to grind out a longer war. Obviously, there are concerns about who would follow Putin – I think the next person will be from within the inner Kremlin circle but with a desire to stabilise the relationship with the West. If this happens, and Putin leaves power, sanctions will be moderated, and markets are likely to rally hard on any such outcome as the prospect will open investment back into Russia.

3. Nuclear War

The third option, and obviously the worst-case scenario, is that Putin could carry out his threat of using tactical nuclear weapons to try and halt any Ukrainian offensives, forcing the Ukrainian side to the negotiating table. However, as military specialists have highlighted, the use of tactical nuclear warfare is difficult in practice – it might not bring clear cut military victory and risks contaminating Russia and occupied territory at huge political costs to Russia.

Any use of nuclear weapons by Putin would almost totally isolate him internationally, particularly from his key ally, China. It would risk military intervention by NATO, and the prospect that China and NATO might reach the same conclusions; that Putin needs to be removed. The global markets would likely be sent into a tailspin, with flight to quality assets, commodity prices would rise massively, global growth would crater, and risk assets would suffer. Risks would be of a global systemic risk event, adding to already elevated concerns around the global cost of living crisis, Fed tightening and existing war concerns. Ultimately, an outcome that involves nuclear war is unlikely but would spark a global security and economic crisis.

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