

Russia-Ukraine Crisis: Entering the third year

- Heading into its third year, the war has become bogged down
- Prospects for peace remain dim
- Russia's economy has not collapsed despite sanctions
- Ukraine's wartime economy is a surprising success
- EU energy and cost-of-living crises
- The global energy landscape has changed dramatically
- An escalation of the geopolitical conflict is a major upside risk to oil prices

The Russia-Ukraine war entered its third year

Thursday, 24 February 2022 was a turning point in European history. Overnight, Russia launched a brutal war of aggression on Ukraine, an independent European nation. Two years after the start of the war, its negative effects have been far-reaching. In addition to the harrowing human cost of the war, the economic impact has been devastating in Ukraine itself, but also substantial for the European Union and the world more widely.

Russia's invasion of Ukraine is among the most - if not the most - significant shocks to the global order since World War II. As we approached the second anniversary of Russia's all-out war against Ukraine, the time is right to take stock of the past year and look ahead to the third year of the war.

Russia's attack was the second, even more severe, stage in hostilities that had already begun in 2014, with Russia taking control of the Crimean Peninsula and supporting separatist forces controlling parts of Ukraine's Donetsk and Luhansk regions. The two regions were in the spotlight during the week leading up to the February 2022 attack, as Russian President Vladimir Putin decided to recognise them as independent entities, in violation of international law, and sign cooperation agreements with them. A few days later, in the early hours of 24 February 2022, President Putin addressed the Russian people in a televised speech, making his case for war, without using the word 'war', but instead referring to a 'special military operation' to demilitarise Ukraine and remove 'neonazis' (as he called the Ukrainian leadership) from power. Later the same morning, the Russian full-scale attack on Ukraine began.

Global leaders reacted swiftly by condemning the attack on the 'strongest possible terms' and demanding that Russia stopped its military campaign. Sanctions package was prepared with the aim of weakening the Russian economic base and limiting revenues generated by Russian energy sales to support its war effort. 12 tough sanction packages on Russia have been adopted, and according to some reports, a 13th package is in preparation as the war enters its third year.

Since its early days, the war has had a profound impact, not only on European security, but also on its economy and on the world economy as a whole. The world has grown more polarised during these two years of war, with many countries supporting Ukraine, some trying to maintain working relations with both sides, and some countries openly supporting Russia. These developments have disrupted supply chains and trade between Europe and Russia has fallen significantly largely due to sanctions.

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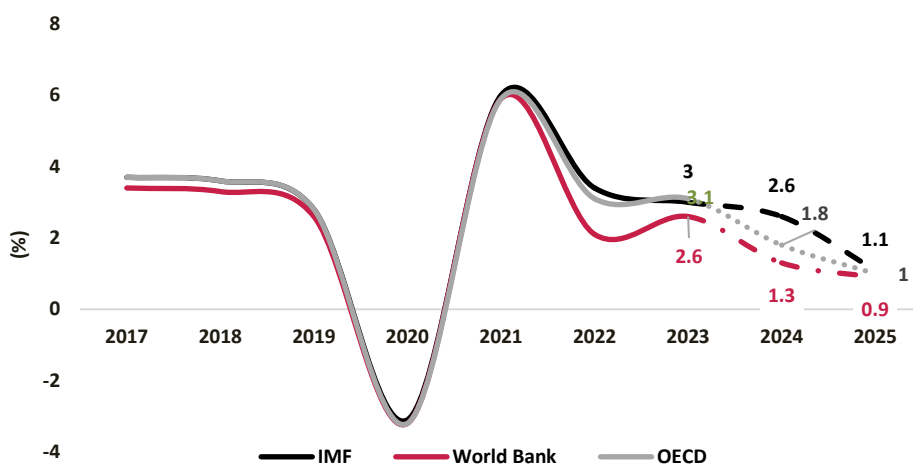
By all estimates, prospects for peace remain dim at the moment as the two sides remain at odds over the way forward. Kyiv wants Moscow to abandon all its territorial claims, withdraw its forces from Ukrainian territory and give financial compensation for the damage inflicted. Moscow, on the other hand, insists that Ukraine shelve a law banning talks with Russia and wants it to return to its neutral, non-aligned and non-nuclear status, as well as ensure the rights and freedoms of its Russian-speaking citizens. The world and Europe have changed, and even if Russia's war ended today, repairing broken trust and connections may take decades.

Russia’s economy has not collapsed despite sanctions

The sanctions on Russia targeted sectors such as financial, trade, energy, transport, technology and defence. The main goal of the sanctions has been to hinder the Russian war effort by targeting the Russian economic base through financial, economic and trade measures.

According to World Bank data, Russian GDP shrank by 2.1 % in 2022. However, according to a recent World Bank estimate, the country returned to positive growth in 2023, with GDP up 2.6 %. This development has given new momentum to the debate on the efficiency of sanctions. According to some reports, the initial predictions of poor Russian economic performance following the sanctions were not entirely correct – this was mainly due to high oil prices, narrow sanction regimes and aggressive Russian fiscal expansion. Furthermore, it was also reported that Russia used 2022 to adjust to the sanctions. The 2023 economic results were therefore related to these adjustment policies, including the development of new markets, especially in China and India, as well as increased military spending. This stronger-than-expected recovery was fueled by substantial fiscal support, including additional military spending. Oil production and exports contracted modestly, and the authorities announced end-2023 an extension of the export curbs of 300,000 barrels per day as well as a deepening by 200,000 barrels per day starting in January 2024. Growth in Russia is projected to slow to 1.3% in 2024, and then to 0.9% in 2025. Tightening monetary policy is expected to dampen domestic demand. Meanwhile, Russia’s economy has proven to be surprisingly resilient amid waves of Western sanctions in the nearly two years since it launched its full-scale invasion of Ukraine. As a result, in late January, the International Monetary Fund (IMF) more than doubled its forecast for the pace of the Russia’s economic growth this year, raising it from 1.1% in October to 2.6%. However, the IMF warned the Russian economy is still facing significant headwinds despite receiving a recent growth upgrade.

Chart 1: Russia GDP (% YoY)



Source: World Bank, IMF, OECD, Bloomberg, BIMB Securities

Ukraine's wartime economy is a surprising success

According to the World Bank, Ukraine's GDP has started to recover, with growth turning positive in 2Q 2023 for the first time since Russia's invasion due to strong public consumption demand and a modest supply recovery in sectors related to supporting the war economy. Growth expanded by an estimated 4.8% in 2023, following the preceding year's steep contraction. Nonetheless, output remained about 30 percent lower in 2023 than its preinvasion level. Growth was underpinned by improved electricity access, a better harvest, and additional government spending, albeit at the cost of increasing fiscal and current account deficits. While the unraveling of the Black Sea Grain Initiative in July 2023 continues to exert downward pressure on grain exports, Ukraine has successfully identified alternative routes for grain exports that have supported the sector. The outlook for Ukraine remains highly uncertain. Growth is projected to be 3.2% in 2024 and 6.5% in 2025. Active hostilities are expected to continue throughout 2024, with base effects and one-off factors including agricultural harvest which should fade. Despite the war, Ukraine's economic indicators are showing strength. Given the stronger than expected recovery, the IMF upgraded Ukraine's GDP growth to 4.5% in 2023, and it is expected to grow at 3-4% in 2024. However, the outlook remains exceptionally uncertain, with the war remaining the predominant risk.

Spillover effects of Russia-Ukraine conflict on Malaysia

The direct impact of the Russia-Ukraine conflict on Malaysia is limited given the less significant trade and financial relations between Malaysia and the two countries. For the whole of 2023, trade between Malaysia and Russia amounted to RM14.2bn (2022: RM12.3bn; 2021: RM8.8bn) and Ukraine RM0.5bn (2022: RM0.7bn; 2021: RM1.5bn). The Russia-Ukraine conflict has minimal direct repercussions to the Malaysia economy as both nations only accounted for less than 1% of total trades and Malaysia's financial exposure to Russia and Ukraine are limited. However, there are indirect implications in the form of higher commodity prices and global inflationary pressure given both Russia and Ukraine are major oil and natural gas producers. As Ukraine is a major producer and exporter of many key food supplies, notably wheat, maize and oilseeds, global food supply chains faced major disruption as a result of Russia's war on Ukraine. Prolonged war could push commodity prices higher and worsen the energy crisis.

EU energy and cost-of-living crises

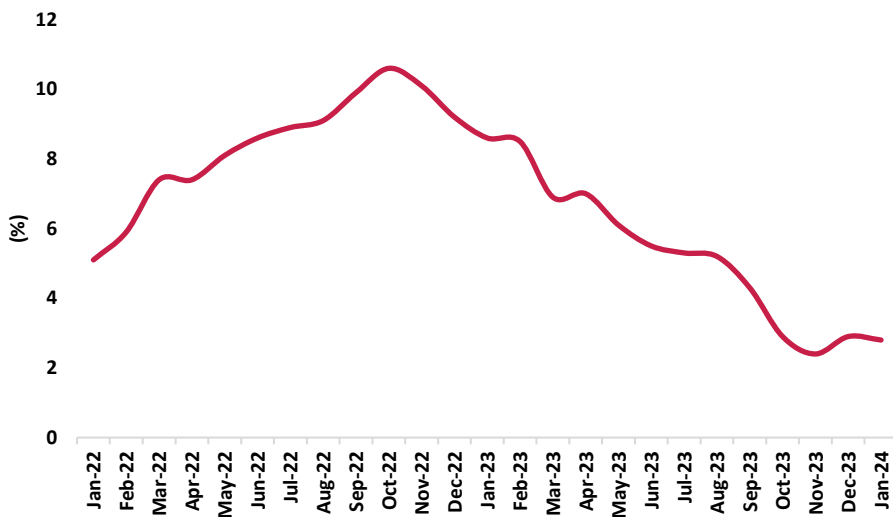
Before the war, Russia provided 24.4 % of the EU's gross available energy, which meant that Europe was heavily reliant on Russian energy and that Russia had the potential to use this situation to its advantage. With sanctions in place and work to diversify the energy supply ongoing, the share of energy imported from Russia started to decline – in some cases sharply – such for natural gas. However, several issues contributed to rising energy prices and generated an energy crisis in 2022. Increasing demand after COVID-19 lockdowns for example, as well as an exceptionally hot and dry summer 2022 both played a part. Consequently, annual energy inflation reached a record level and the price of energy rose sharply.

The war added heavily to the inflationary pressures building up in the euro area during the post-pandemic recovery and pushed up consumer prices, especially for energy and food. Headline inflation increased from 0.3% in 2020 to 2.6% in 2021 and then to 8.4% in 2022. Energy and food inflation accounted for more than two-thirds of this record-high inflation in 2022. As a response, the European Central Bank (ECB) began a series of interest rate increases. The 10 consecutive increases made gradually over a year, bringing key interest rates to record levels. The ECB, at its first meeting of this year, decided to keep the three key interest rates unchanged. Accordingly, the interest rate on the main refinancing operations, the interest rates on the marginal lending facility and the deposit facility remained at 4.50%, 4.75% and 4.00% respectively. Markets have expected rates to start

falling as early as April 2024. We expect the ECB to keep rates higher for longer, and if anything, begin lowering rates only in 2H24, though the risk is for the ECB to begin cutting rates earlier.

Even though inflation figures have since fallen and annual inflation stood at 2.8 % in January 2024, looming recession and slow growth, especially in the euro area, hinder economic prospects. GDP for the Eurozone remained unchanged in 4Q23, following a 0.1% contraction in 3Q23, meaning the bloc averted a technical recession. However, the economy has been in a state of stagnation, contracting or growing by a slight 0.1% since the beginning of 2023.

Chart 2: Eurozone Inflation (% YoY)



Source: Bloomberg, BIMB Securities

The global energy landscape has changed dramatically

The energy sector continues to feel the effects of Russia’s invasion of Ukraine, which in February 2022 sparked the first truly global energy crisis. Two years on, energy prices have pulled back from record highs, but trends vary widely among regions. In many parts of the world, prices are still elevated – holding back economic growth, straining the finances of households and businesses, and complicating efforts to improve access to electricity. Energy markets, faced with an unusually high degree of geopolitical uncertainty, remain on edge.

Meanwhile, the war continues to reshape the global energy system in profound ways. Trade patterns for oil and natural gas have shifted dramatically since Russia’s invasion as governments look to strengthen their energy security. At the same time, cleaner alternatives to fossil fuels are growing faster than ever. Due in part to policies unveiled by governments after February 2022, the world’s capacity to produce renewable power is expanding at a remarkable pace, while the popularity of clean technologies such as electric vehicles and heat pumps is surging. The biggest legacy of the global energy crisis triggered by Russia’s invasion of Ukraine may be that it accelerates the end of the fossil fuel era – with IEA projections now showing that under today’s policy settings, demand for oil, gas and coal is set to peak within the decade.

Several OPEC+ countries announce additional voluntary cuts

Several OPEC+ countries agreed to voluntarily cut oil production by a total of 2.2 million barrels per day in the first quarter of 2024. Saudi Arabia, the world's biggest exporter of crude oil, will lead the effort by extending a voluntary production cut of 1 million barrels per day of oil - previously intended to run till the end of December - by another three months. The kingdom's production will stay at around 9 million barrels a day until the end of March 2024. In addition to Saudi Arabia, the following voluntary barrel-per-day production cuts were announced: Russia by 500,000; Iraq by 223,000; the United Emirates by 163,000; Kuwait by 135,000; Kazakhstan by 82,000; Algeria by 51,000 and Oman by 42,000.

Table 1: OPEC crude oil production ('000 b/d)

	Iraq	Kuwait	Nigeria	Saudi Arabia	UAE	IR Iran	OPEC
Jan22	4,253	2,584	1,413	10,060	2,932	2,499	28,079
Feb22	4,298	2,614	1,378	10,208	2,960	2,539	28,500
Mar22	4,309	2,639	1,354	10,262	2,983	2,546	28,557
Apr22	4,433	2,660	1,285	10,364	3,015	2,565	28,678
May22	4,416	2,688	1,233	10,425	3,044	2,543	28,482
Jun22	4,434	2,718	1,238	10,585	3,083	2,574	28,716
Jul22	4,521	2,774	1,131	10,738	3,131	2,564	28,964
Aug22	4,546	2,811	1,057	10,909	3,168	2,571	29,621
Sep22	4,518	2,823	1,087	10,991	3,193	2,549	29,767
Oct22	4,593	2,806	1,066	10,861	3,187	2,548	29,558
Nov22-	4,484	2,684	1,175	10,474	3,047	2,565	28,879
Dec22	4,480	2,649	1,267	10,478	3,039	2,574	28,971
Jan23	4,410	2,692	1,308	10,295	3,046	2,554	28,798
Feb23	4,375	2,676	1,371	10,361	3,046	2,574	28,883
Mar23	4,358	2,678	1,354	10,405	3,038	2,567	28,797
Apr23	4,107	2,650	1,098	10,496	3,034	2,625	28,530
May23	4,127	2,555	1,277	9,976	2,895	2,698	28,099
Jun23	4,181	2,551	1,298	9,998	2,894	2,754	28,189
Jul23	4,271	2,552	1,163	9,050	2,896	2,872	27,358
Aug23	4,292	2,551	1,249	8,924	2,911	3,043	27,482
Sept23	4,307	2,576	1,390	9,006	2,924	3,058	27,755
Oct-23	4,355	2,552	1,388	8,987	2,918	3,121	27,895
Nov-23	4,270	2,567	1,319	8,942	2,907	3,165	26,615
Dec-23	4,292	2,543	1,422	8,940	2,896	3,168	26,692
Jan-24	4,194	2,434	1,419	8,965	2,927	3,163	26,342

Source: OPEC, BIMB Securities

Russia remains a top oil exporter, but its revenues have dropped

Despite harsh international sanctions following its invasion of Ukraine, Russia continues to play an outsized role in world oil markets. In 2023, it remained the third largest producer of oil behind the United States and Saudi Arabia, and the world's second largest oil exporter behind the United States, and the biggest net exporter globally.

Russian oil export volumes remained stable year-over-year in 2023 at 7.5 million barrels per day, with a slight loss in crude offset by an equivalent gain in oil products. While overall exports to the European Union, the United States, the United Kingdom and OECD Asia stood at negligible levels, dropping 4.3 million barrels per day below their pre-war average, shipments rose sharply to India, China, Türkiye and countries in the Middle East.

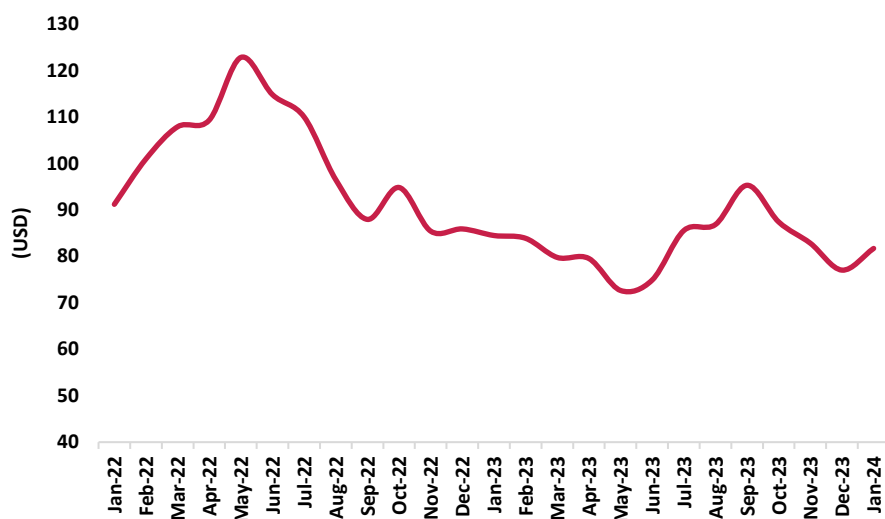
Even so, the monthly average of Russia's export revenues from commercial oil tumbled in 2023 by USD4.2bn year-over-year. This was the result of G7 price caps, increasing discounts for Russian crude and a broader decline in global oil prices.

Oil Outlook: buoyant but volatile

Brent crude oil prices were volatile last year, including in the wake of the conflict in the Middle East; they averaged USD82/bbl, down from USD85.9/bbl in 2022. Production cuts by OPEC+, which were deepened and extended in November 2023, have mostly been offset by robust output elsewhere, including in Iran and the United States. Currently, OPEC+ spare capacity stands at just over 5 mb/d. In EIA’s latest Short-term Energy Outlook (STEO) report (Dec 2023), it expects a net crude oil deficit in 1Q24 with world consumption slightly eclipsing production. EIA has forecasted a record-high demand for oil in 2024-2025, we think that the elevated crude oil price environment will be here to stay in the medium term. We maintain our Brent Oil assumption of USD85/bbl for 2024.

Elevated amidst volatility in 2024. We expect Brent oil prices to remain elevated in 2024 with much volatility in sight. We think that the oil markets will continue to face the energy tri-lemma in 2024, of: i) an improvement in demand (EIA forecasts record-high demand of 102.34mbpd); ii) supply tightness; and iii) potential geo-political risks/trade wars/embargoes. These factors, in our view, will continue to induce volatility in the oil markets. With the OPEC+ and its allies’ efforts to continue curtailing production in 2024, we expect oil supply to remain tight in the foreseeable future.

Chart 3: Brent Crude Oil

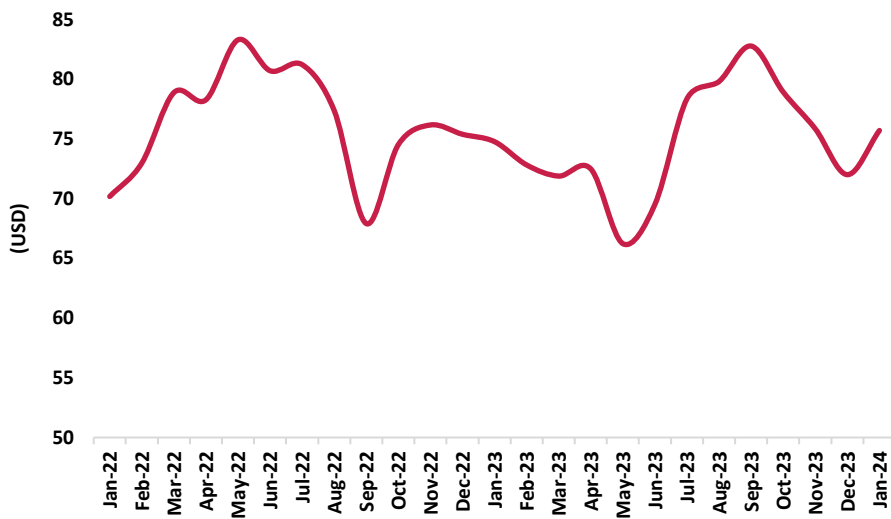


Source: Bloomberg, BIMB Securities

Conflict and geopolitical risks

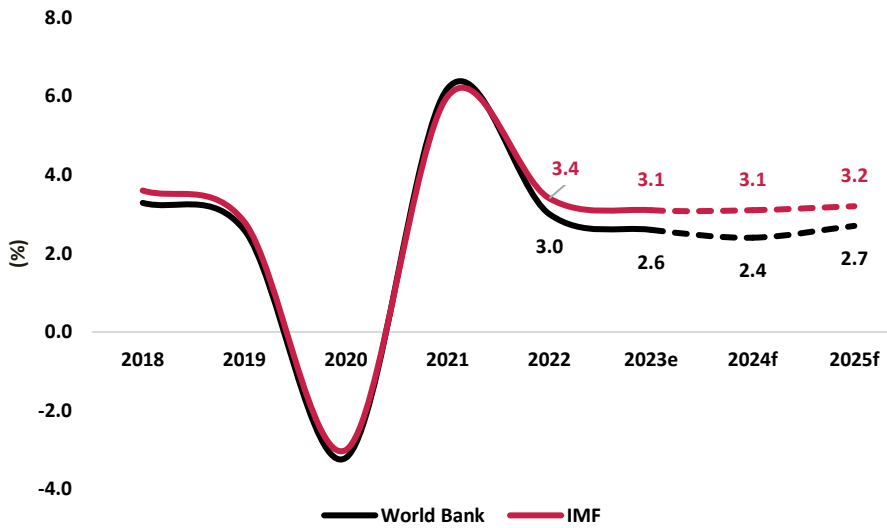
Geopolitical risks have increased sharply in the wake of the recent conflict in the Middle East, which comes on top of Russia’s invasion of Ukraine. Any escalation of these conflicts could have significant consequences in commodity markets and for economic activity. While the effects of the conflict in the Middle East on commodity prices have so far been muted, historical precedents suggest that an escalation could lead to significant oil supply disruptions and large spikes in commodity prices, especially if major oil producers became embroiled. At the global level, soaring energy prices could push up inflation, reduce business and consumer confidence, and lead to a tightening of financial conditions, dampening investment and overall activity.

Chart 4: WTI Oil Price



Source: Bloomberg, BIMB Securities

Chart 5: Global GDP (% YoY)



Source: World Bank, IMF, Bloomberg, BIMB Securities

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BIMB Securities uses the following rating system:

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BUY	Total return (price appreciation plus dividend yield) is expected to exceed 10% in the next 12 months.
TRADING BUY	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain.
HOLD	Share price may fall within the range of +/- 10% over the next 12 months
TAKE PROFIT	Target price has been attained. Fundamentals remain intact. Look to accumulate at lower levels.
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