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### In Short:

We see three broad scenarios pointing to an extended war or an uneasy peace –

1. Ukraine “wins”:  
Geopolitical risk moderates but geo-economic challenges persist
  2. Russia “wins”:  
Heightened risk of more conflict and geo-economic fragmentation
  3. Stalemate: No peace settlement. Frictions flare up into periodic regional conflicts
- We expect persistent geopolitical risks to boost national security-driven fiscal/regulatory activism in trade, investment, supply-chains, defence, energy/infrastructure, etc.
  - Investors should manage the resulting sovereign risks and seek returns by diversifying and selecting/sizing country exposures – not raise concentration risk or home bias.

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## I. The First Year of War

After a year of war, Ukraine is now in a brutal battle of attrition. Mere meters have been fiercely contested, yet there is no sign of de-escalation. If anything, hostilities are intensifying. Western support for Ukraine includes increasingly exquisite, expensive, effective kit and training. Restraint to avoid escalation has been shifting to structurally undercutting Russia’s military threat with large-scale offensive operations.

The Kremlin is doubling down, not backing down. Russia seems to be preparing a large-scale mobilization and renewed offensive, possibly within months. Sanctions are handicapping Russia’s high-tech military and civilian activity, but the economy is coping and adapting, even though the G7 Oil Price Cap seems to be reducing oil export/fiscal revenue, which suggests the war may drag on.

Yet markets seem focused on macro factors more than war. Global growth is reaccelerating as China reopens and inflation falls, if unevenly. Europe is coping surprisingly well. Energy subsidies/price controls, conservation, sourcing away from Russia and an unusually warm winter have prevented stagflation. Energy prices have fallen sharply. If the world economy has adjusted, shouldn’t investors move from geopolitics to valuations, fundamentals and upside?

We wish it were so simple. The energy shocks of 2022 may not repeat even if the war drags on. But if next winter is cold, or there is a Cold War 2.0, commodity prices may be structurally higher in Europe than in the Americas, Asia or Emerging Markets (EM). The “Global South” opposes the war but is not onside with West in isolating Russia – and not even in technological decoupling from China, and so may become a crucial arena of great-power rivalry for influence.

Thus, the global economy is segmenting in our view, as the war deepens a reconfiguration of the world order underway since the Global Financial Crisis and punctuated by Brexit, Trump’s trade wars, COVID and US-China frictions. Strategic portfolio asset allocation should evolve in response.

Figure I: Mapping possibilities

**1. Post-Soviet Borders 1992-2014**

US credibility deepened; somewhat bipolar somewhat multipolar world, and yet not so fragmented?

**2. Post-Crimea Annexation, 2014-21**

US credibility dented; Russia gains foothold and recognition of Crimea as Russian. World becomes increasingly multi-polar?

**3. Rump Ukraine Redrawn by War, 2022-?**

US credibility damaged; Russia gains land bridge to Crimea, more Ukrainian territory. World is at risk of greater fragmentation?

Source: Washington Post, Institute for the Study of War, Invesco. Conflict zones as of Feb. 3, 2023.

## II. War or Peace?

Most people did not expect war despite hostilities since the 2014 annexation of Crimea, Russia's late-2021 mobilisation or early-2022 US warnings. On Day 1 of the invasion, Russia was expected to win quickly. Around Day 365, Ukraine hopes to push Russia back.

War is unpredictable and defining victory or the war/peace distinction is harder than it seems. Accordingly, we consider three possibilities: 1, Ukraine Wins; 2, Russia Wins; 3, Stalemate. We conclude with market views and set out why we think Going Nuclear is unlikely in the appendix.

### Ukraine Wins:

Negotiations after a ceasefire/armistice culminate in a peace treaty largely on Ukraine's terms, perhaps a return to prewar borders, probably leaving Crimea as Russian territory. Significantly weakened, Russia could turn inward to repair itself, as after the 1991 Soviet collapse. Or it could become even more nationalist and turn eastward, under Putin himself or another hardline leader.

Ukraine/Europe/West/United States win big. NATO/US military kit, intelligence, diplomacy and coordination conclusively outgunned Russia's war machine – despite Western restrictions that require weapons to be used only for defense (at least so far), making for a harder-won victory. Pax Americana is boosted, especially in the West, perhaps reducing the risks of instability elsewhere.

Even in winning, Ukraine and the West face uncertainties. Would Ukraine join the EU or NATO and if so, when? If not or for the interim – likely a multi-year process subject to obstruction by any NATO member, and its accession to the EU, Ukraine might need to be armed to the teeth to deter further attacks. Plus, there is perennial risk of US disengagement, crystallized in the Trump era.

Whatever the specifics, there is no return to the ante-bellum status quo. Russia has resurrected the spectre of wars of conquest; economic disruption on a scale not seen since WWII; and perhaps the first of many challenges to Pax Americana in what could be a bipolar or multipolar world but is no longer unipolar, despite Russia's defeat.

**Russia Wins:**

A Pyrrhic victory, huge losses that outweigh gains on any conventional scale, cannot be ruled out. The Kremlin is clearly willing to bear enormous costs to restore control of part of the Soviet Union.

Russia has perhaps the largest natural resource endowment in the world on the largest territory with some 3x Ukraine's manpower. China and India buy its energy on the cheap, they and others buy its soft or hard commodities. Russia has few allies, but Iran and North Korea supply arms.

Russia could change the course of the war by outlasting Ukraine and the West with men, materiel and mettle, despite Ukraine's willingness to fight for survival and Western support. On a shorter horizon, a successful Russian offensive may drive the West to reconsider what is achievable and sustainable regarding long-term military support to Ukraine.

If Russia turns the tide and establishes durable control of part of Ukraine, "Rump Ukraine" would have to be stabilized and armed to the teeth in this scenario too. NATO would have to be even better fortified. Western Europe's impetus to decouple from Russia would be that much stronger. The risks of other major conflicts elsewhere could rise. National security considerations would become even more important in global economic policy, including in trade/investment barriers.

**Stalemate:**

Wars can end in negotiation and treaties or remain unresolved: Korea, Indo-Pak/Sino-Indian, Mid-East; "frozen conflicts" on Russia's doorstep—Georgia, Moldova

With existential risk perceived by Ukraine, Russia, Western Europe, the war drags on. Sanctions undercut Russia's military capabilities yet do not prevent it from sustaining a destructive, if ineffective war effort. Russia follows in the footsteps of Iran and North Korea, which have continued to develop nuclear weapons despite decades of military/economic sanctions. Russia is a far larger, more capable, resourceful, powerful adversary. Soviet Russia gave the West a strong run for its money in the 20th Century. Russia may be much weaker today, but it can still replace weaponry, mobilise more soldiers and redevelop military/industrial technologies.

Russia has strong motivation to maintain conflict or at least avoid a treaty. Peace would remove a key barrier to Ukrainian NATO membership. NATO cannot accept members involved in armed conflict because of its Article V collective-defense clause — an attack on any member state is an attack on all. In the case of Russia, this could be tantamount to nuclear war.

Furthermore, the traditional path into the West for former Soviet Republics and Warsaw-Pact satellite states was NATO membership, stepwise integration into the EU and ultimately Eurozone entry. Russia's long-running effort to influence, then destabilize, and now conquer Ukraine implies that the only ironclad guaranty of Ukraine's security is NATO membership, and that would pave the way for Ukraine's irreversible westernization.

**Figure II: Russia's territorial buffers have diminished over the last century**



Source: Statista, Invesco. 2022 borders.

And that is the heart of the matter: For Russia to be a great power straddling Eurasia, resuming a global role on par with China, the US, Europe or its own history it needs substitutes for China's economic heft and rising geopolitical power; for the US alliance system, the dominance of the dollar and influence on the global narrative; and Europe's soft/regulatory power.

Russia has been restoring influence in the Mid-East and Africa, where the US has been receding, but not in its near-abroad where the US, EU and China are making inroads. There is every reason to think that Russia will keep trying to fend off the West as long as it can – and equally to expect the US/UK/EU to shore up Ukraine and protect the Western system against these threats.

### III. War, Peace and Markets

This (in)famous advice has been interpreted literally and figuratively. The Rothschilds made outsized, contrarian returns, lending to sovereigns at war, buying in the carnage of market crashes, investing with an information edge, famously learning first who had won the Battle of Waterloo.

It clearly matters who wins, and what winning means from all angles – military or geopolitical; economic or financial – both in the theater of war and the wider world. Yet, whoever wins or in a stalemate, the world order is unlikely to return to the status quo ante.

Instead, we expect increasing state intervention for geopolitical, foreign-policy and national-security aims. The idea that economic interdependence would stop conflict by making war too costly has clearly not worked, so economic and financial globalization will very likely continue to morph.

The peace dividend, already disappearing, will likely be reversed in many ways. Guardrails are rising to manage the risks of great-power rivalry, friction and conflict. Expect larger budget deficits, greater regulation, more emphasis on tangible, high-intensity capex for resilience; redundancy and reliability of just-in-case supply chains; and much greater insurance in national security, including military hardware and capacity.

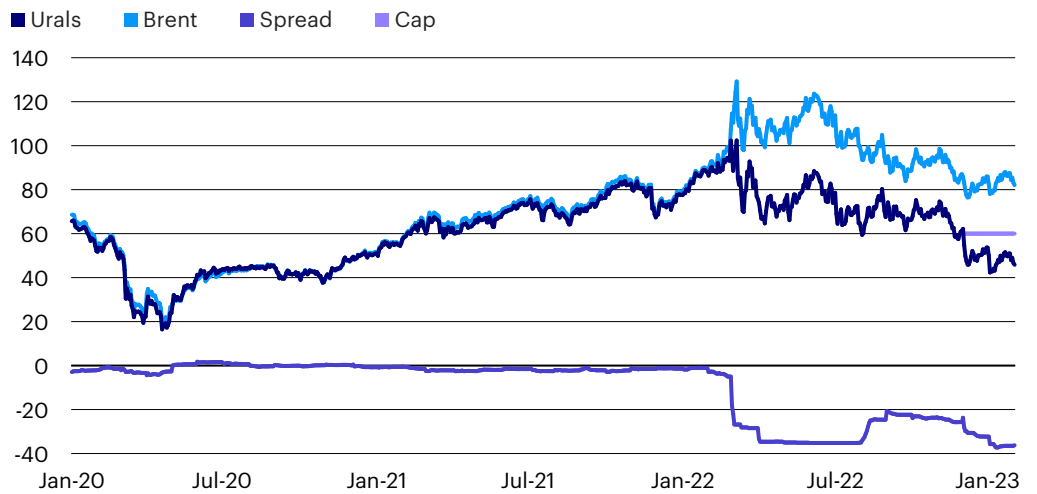
All this means less emphasis on the efficiency, productivity and the profit motive that have underpinned globalisation since the Soviet collapse. Yet, economic integration has progressed so far that decoupling for a Cold-War replay would be disruptive, costly and counterproductive. Isolationism is widely seen to have worsened the Great Depression and WWII.

### Geopolitical Stalemate and Financial Segmentation

We expect “re-globalization”, a reform/restructuring of globalization, not full “deglobalization”. This implies economic segmentation – not fragmentation – and means some sectors, regions, national economies would become more integrated even as others are partly disentangled.

Segmentation is already happening in markets and is already replacing the convergence that came with globalization. Consider oil prices and the direction of oil trade – here you have an example of differentiated pricing, driven by decoupling and reintegration in different parts of the world.

**Figure III – Geopolitical barriers point to segmented markets and call for diversification**



Note: Spread refers to the price spread between Brent and Urals, the Russian crude oil benchmark. Cap refers to the US\$60/bbl price cap imposed on Russian oil by the G7. Source: Bloomberg, Macrobond, Invesco. Data as at Feb. 3, 2023.

Russian Urals and Brent used to trade almost fully converged, with virtually no price spread. As the war started, Brent skyrocketed. But the spread collapsed and stabilized even as oil prices remained volatile; and after the G7 imposed a price cap on Russian oil, the spread trended down.

China and India are integrating with Russia in buying its crude as Europe decouples. Yet, Russian crude is reportedly being refined elsewhere and sold in Europe, despite embargoes by both.

Thus, deglobalization is limited by the profit motive. Yet, the price of the same commodity varies across the world. As a result, Emerging Asia gets a competitiveness boost while Europe faces greater competitive pressure to improve energy efficiency. We believe all this calls for greater regional and sectoral diversification, to capitalize on Asia’s competitiveness gains and the prospect of greater European energy efficiency.

This is opposite to the usual response to national-security trade/investment barriers – increasing home/region bias. Investors who increase regional concentration might benefit from say Asia’s improved energy balance. And they may overestimate the risk to European growth and corporate profits because of profit-driven limits to price divergence, given global profit maximization.

## Market Role Reversal in the Theater of War?

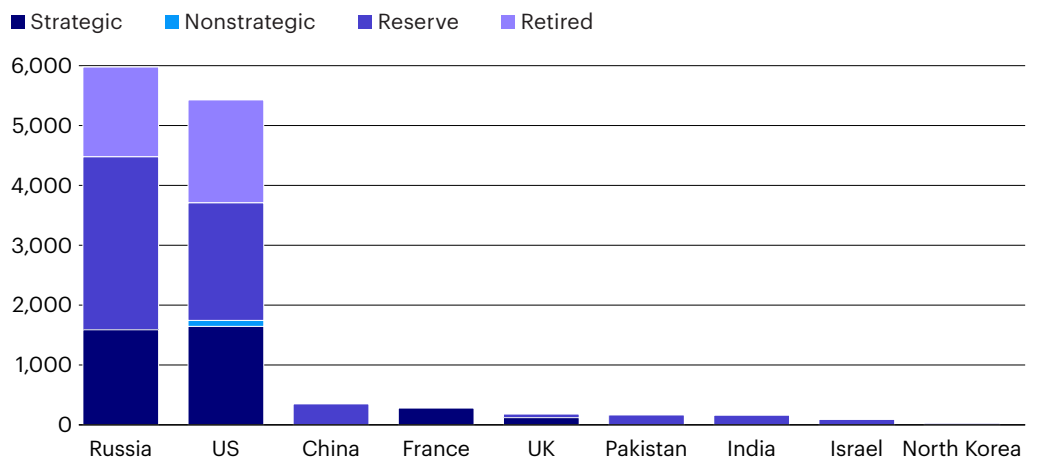
How to approach Ukraine or Russia depends much more closely on how the war unfolds, of course. If Ukraine somehow wins or even in an uneasy peace, its debt would be restructured, probably on favorable terms. The door would open to significant investment opportunities from reconstruction and reintegration into the West, as in South Korea. But Russia is unlikely to be rehabilitated in Western eyes anytime soon whether it wins or not.

This would be the reverse of the post-Soviet story. Back then Russia generated some of the highest returns in history, while Ukraine and several other post-Soviet Republics were market backwaters. For Russia to come back into focus for mainstream investors would probably require a dramatic, convincing and sustained transformation into a state focused on prosperity instead of power. That might happen after defeat in war, as in Germany or Japan, but seems unlikely in today's Russia.

## Appendix: Going Nuclear?

Despite these statements, we see a low risk of nuclear war, though neither nuclear war nor standoff/crisis can be ruled out. Russia's repeat nuclear saber-rattling will probably remain an effort to intimidate Ukraine and the West rather than a real threat, because both strategic and tactical battlefield nukes are likely to be more harmful than helpful to the war effort.

**Figure IV: Russia retains the world's largest nuclear weapons stockpile (# of warheads)**



Source: Federation of American Scientists, Invesco. 2022 estimates.

The use of strategic nuclear weapons seems pointless and unlikely. Strategic nukes are a deterrent and a bargaining chip, given "Mutually Assured Destruction" (aptly, "MAD"). Their use could cause human extinction for the nuclear powers have enough weapons to destroy the world many times over. Such excess capacity shows that a nuclear state has a sufficient arsenal to survive a first strike and retaliate and annihilate, rendering nuclear war unwinnable and hence irrational.

Furthermore, there is no direct conflict between Russia and any nuclear-weapon state – no effort is being spared to contain that risk. The battlefield is Ukraine itself.

Tactical nukes may be another matter, however. Russia is thought to have more than any other country. These low-yield weapons have a concentrated radius and could turn the tide in battle, without attacking another nuclear-capable state.

Using – or threatening tactical nukes fits the Kremlin's military doctrine of "escalate-to-de-escalate". There is no well-mapped playbook against tactical nuclear weapons that renders them unusable, unlike strategic nukes. If Russia were to use tactical nukes in Ukraine, the West could not retaliate with nukes without entering the war and risking Armageddon.

So what's to stop Russia from going nuclear tactically? Former top brass has hinted that the US would retaliate with a dramatic, direct, debilitating attack on Russia's conventional capabilities. Wholesale destruction of naval fleets, airpower, munitions or military factories could severely undercut Russia's capacity to wage war, defend itself or retaliate proportionately against the West.

True, such a response could trigger strategic nuclear retaliation by Russia,. Neither Russia nor the US operate a formal no-first use policy (unlike China and India). A debilitating conventional attack could meet Russia's well-established criteria for first use — an existential threat to the survival of the Russian Federation or state.

**However, we believe threats to destroy conventional capabilities are necessary and effective.**

- First, any use of tactical nukes must be prevented at almost any cost. Their use, if insufficiently costly, could trigger a widespread tactical-nuke arms race drastically increasing the risk of their use elsewhere — possibly Iran/Saudi Arabia/Israel? Korea? India/Pakistan/China?
- Second, threats to neuter Russia's conventional warfare capabilities should deter the use of tactical nukes. Russia would be left with strategic nuclear weapons for deterrence and dependent on conventional arms imports from North Korea or Iran. Domestic conventional capabilities would take time to rebuild and be even less effective because of sanctions on high-tech equipment and chips. And though its tactical nukes may still be usable, to continue the war and control territory, Russia needs deeper conventional resources now.
- Third, the Kremlin, political elites, potential successors, the state and military share a vested interest in retaining as much military capacity as possible and avoiding Armageddon with other countries. Russia's survivability as a state and great power requires both conventional and nuclear capabilities for deterrence and foreign policy goals in general — including its Ukraine war. Russia may not be winning with conventional forces, but is damaging Ukraine, depleting Western resources (as the west is depleting Russia's armoury) and may yet achieve some success. The Russian state is therefore likely to avoid the military consequence of using tactical nuclear weapons as a last resort. Indeed, the US/West may even expect resistance in the chain of command against the use of tactical nukes in order to increase the survivability and usability of Russia's conventional forces.

Stepping back, the argument is often made that President Putin is irrational, that in COVID isolation, he has lost sight of the hard calculus of geopolitics and the cost-benefit analysis. But it is at least as likely that he is a rational actor who miscalculated the extent of US/Western/Ukrainian resolve given the Afghanistan debacle. Putin himself would have to weigh up the use of tactical nukes, given the already significant damage and depletion of Russia's conventional military forces. His military and geopolitical ambitions have outstripped his military and economic capabilities and resources, and he has been refining military operations, battlefield leadership and strategy and so seems to be recalculating rather than gambling. All of this suggests that Putin himself would not run the risk going nuclear to a series of strategic and military miscalculations that would make matters worse for himself, for Russia and the world.

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**Investment risks**

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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All information as of Feb. 3, 2023, in USD, unless stated otherwise.

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