



Ukraine: Three Views

John Mauldin | March 3, 2014

All eyes are on Ukraine as the drama continues to unfold. Today, for an early *Outside the Box*, I'm going to offer three sources on Ukraine. The first is a note that I got from the head of emerging-market trading at one of the world's largest hedge funds. This is what he sent out last week, ahead of any real action:

My view, Putin is stuck now, cannot easily de-escalate. Further escalation is a possibility, with Ukraine cracking along the obvious ethnic fault lines and the West reacting with measures such as sanctions and visa restrictions. Tit-for-tat follows; gas supplies to the EU are disrupted. Russian capital outflows accelerate and the RUB [ruble] quickly gets to 40/\$, fuelling inflation and unnerving the Russian banking system, and also infecting the European banking system, in the manner that Chris Watling has envisaged. Meanwhile, the Chinese liabilities residing inside the European banking system are also in trouble, of course, and will continue to deteriorate. The CBR [Central Bank of Russia] hikes repeatedly with very little effect on slowing the RUB slide, further hurting GDP growth and economically sensitive segments of the market. The Russian RTX index revisits the GFC lows of 2008, Gazprom ADR's are already within shouting distance of their 2008 lows today. In such a scenario, there is an obvious risk of market contagion spreading throughout Eastern and Western Europe, and in fact the rest of the world. It is likely to resemble something on the order of the 1998 LTCM + RUB collapse + Asian financial crisis magnitude. In fact, a number of hedge funds will fail precisely because they have loaded up so heavily with European debt instruments which will unravel.

Meanwhile, politically, the US ends up looking weaker and weaker, and getting less and less respect internationally. The US-Russia confrontation is taking place under the critical gaze of the leaders of Israel, Saudi Arabia, Egypt, Iran, Syria, Turkey and Hizballah in Lebanon.

They are seeing the following:

- 1) President Obama is now seen backing off a commitment to US allies for the second time in eight months. They remember his U-turn last August on US military intervention for the removal of Syrian President Bashar Assad for using chemical weapons. They also see Washington shying off from Russia's clear and present use of military force and therefore concluding that Washington is not a reliable partner for safeguarding their national security.
- 2) The Middle East governments and groups which opted to cooperate recently with Vladimir Putin – Damascus, Tehran, Hizballah and Egypt – are ending up on the strong side of the regional equation. Others such as Turkey and Qatar are squirming.
- 3) American weakness on the global front has strengthened the Iranian-Syrian bloc and its ties with Hizballah. Assad is going nowhere.

- 4) Putin standing behind Iran is a serious obstacle to a negotiated and acceptable comprehensive agreement with Iran, just as the international EU- and US-led bid for a political resolution of the Syrian conflict foundered last month, and now is unlikely to ever be revisited.

Notice what he said about European banks. Their exposure to emerging-market corporate debt, Chinese debt, and Russian liabilities is going to weaken their balance sheets just as the European central bank stress test will be kicking off.

This is going to be a very interesting period of time and potentially quite dangerous. Very few people saw US market vulnerabilities in early 1998 coming from outside the US. As I said in my 2014 forecast, the United States should be all right until there is a shock to the system. We have to be aware of what can cause shocks. Ukraine in and of itself might not be enough, but notice that the Chinese are preparing to slow their economy down as part of the process of reducing their dependency on bank debt and foreign direct investment in construction and other projects. China has been one of the main engines of global growth, so a slowdown will have effects. It's all connected, as I wrote in the 2007 letter we reprinted this weekend.

I should note that other very savvy investors and managers think there will be no contagion from current events. That's what makes a market. It's why we need to pay attention to Ukraine.

In the second part of today's *Outside the Box* we visit a short essay on Ukraine by Anatole Kaletsky, which talks about timing investments during market crises:

Financial markets cannot afford to be so sentimental. While we should always recall at a time like this the famous advice from Nathan Rothschild to “buy at the sound of gunfire,” the drastically risk-off response to weekend events in Ukraine makes perfect sense because Russia's annexation of Crimea is the most dangerous geopolitical event of the post-Cold War era, and perhaps since the Cuban Missile crisis. It can result in only two possible outcomes, either of which will be damaging to European stability in the long-term.

Finally, I got a piece on Ukraine from my friend Ian Bremmer, who says, “[W]e are witnessing the most seismic geopolitical event since 9/11.” His analysis plus background data help us understand what is really going on in Ukraine.

Ian will be at my conference in San Diego, May 13-16, and you should be too. If you don't have a plan for dealing with what happens when the midterm forecasts begin knocking on the door, you won't know what to do when the time comes. Our conference offers a wonderful opportunity to bring your plans into focus and perhaps make a few new ones. [You can find out more here.](#)

I'm feeling a lot better today than I did this weekend. I am stuck in Miami due to the cancellation of my flight but hope to be able to get to Washington DC tomorrow morning to experience the East Coast version of the polar vortex. But, for the nonce, I guess I will be forced to sit outside at the pool or on the beach and continue my research, which is once again stacking up. You have to love iPads, which are for me great productivity enhancers. I did finish George Gilder's brilliant must-read book *Knowledge and Power* this weekend, and I highly recommend it. And I suppose I should research the gym facilities here later this afternoon. I have mastered the trick of reading on my iPad while walking on the treadmill. No excuses. Have a great week.

Your enjoying the Miami weather analyst,



John Mauldin, Editor
Outside the Box

Realpolitik In Ukraine **By Anatole Kaletsky, Gavekal**

Oscar Wilde described marriage as the triumph of imagination over intelligence and second marriage as the triumph of hope over experience. In finance and geopolitics, by contrast, experience must always prevail over hope and realism over wishful thinking. A grim case in point is the Russian incursion into Ukraine. What makes this confrontation so dangerous is that US and EU policy seems to be motivated entirely by hope and wishful thinking. Hope that Vladimir Putin will “see sense,” or at least be deterred by the threat of US and EU sanctions to Russia's economic interests and the personal wealth of his oligarch friends. Wishful thinking about “democracy and freedom” overcoming dictatorship and military bullying.

Financial markets cannot afford to be so sentimental. While we should always recall at a time like this the famous advice from Nathan Rothschild to “buy at the sound of gunfire,” the drastically risk-off response to weekend events in Ukraine makes perfect sense because Russia's annexation of Crimea is the most dangerous geopolitical event of the post- Cold War era, and perhaps since the Cuban Missile crisis. It can result in only two possible outcomes, either of which will be damaging to European stability in the long-term. Either Russia will quickly prevail and thereby win the right to redraw borders and exercise veto powers over the governments of its neighbouring countries. Or the Western-backed Ukrainian government will fight back and Europe's second-largest country by area will descend into a Yugoslav-style civil war that will ultimately draw in Poland, NATO and therefore the US.

No other outcome is possible because it is literally inconceivable that Putin will ever withdraw from Crimea. To give up Crimea now would mean the end of Putin's presidency, since the Russian public, not to mention the military and security apparatus, believe almost unanimously that Crimea still belongs to Russia, since it was only administratively transferred to Ukraine, almost by accident, in 1954. In fact, many Russians believe, rightly or wrongly, that most of Ukraine “belongs” to them. (The very name of the country in Russian means “at the border” and certainly not “beyond the border”). Under these circumstances, the idea that Putin would respond to Western diplomatic or economic sanctions, no matter how stringent, by giving up his newly gained territory is pure wishful thinking. Putin's decision to back himself into this corner has been derided by the Western media as a strategic blunder but it is actually a textbook example of *realpolitik*. Putin has created a situation where the West's only alternative to acquiescing in the Russian takeover of Crimea is all-out war.

And since a NATO military attack on Russian forces is even more inconceivable than Putin's withdrawal, it seems that Russia has won this round of the confrontation. The only question now is whether the new Ukrainian government will accept the loss of Crimea quietly or try to retaliate against Russian speakers in Ukraine—offering Putin a pretext for invasion, and thereby precipitating an all-out civil war.

That is the key question investors must consider in deciding whether the Ukraine crisis is a Rothschild-style buying opportunity, or a last chance to bail out of risk-assets before it is too late. The balance of probabilities in such situations is usually tilted towards a peaceful solution—in this case, Western acquiescence in the Russian annexation of Crimea and the creation of a new national unity government in Kiev acceptable to Putin. The trouble is that the alternative of a full-scale war, while far less probable, would have much greater impact—on the European and global economies, on energy prices and on the prices of equities and other risk-assets that are already quite highly valued. At present, therefore, it makes sense to stand back and prepare for either outcome by maintaining balanced portfolios of the kind recommended by Charles, with equal weightings of equities and very long-duration US bonds.

Looking back through history at comparable episodes of severe geopolitical confrontation, investors have usually done well to wait for the confrontation to reach some kind of climax before putting on more risk. In the 1962 Cuban Missile Crisis, the S&P 500 fell -6.5% between October 16, when the confrontation started, and October 23, the worst day of the crisis, when President Kennedy issued his nuclear ultimatum to Nikita Khrushchev. The market steadied then, but did not rebound in earnest until four days later, when it became clear that Khrushchev would back down; it went on to gain 30% in the next six months. Similarly in the 1991 Gulf War, it was not until the bombing of Baghdad actually started and a quick US victory looked certain, that equities bounced back, gaining 25% by the summer. Thus investors did well to buy at the sound of gunfire, but lost nothing by waiting six months after Saddam Hussein's initial invasion of Kuwait in August, 1990. Even in the worst-case scenario to which the invasion of Crimea has been compared over the weekend—the German annexation of Sudetenland in June 1938—Wall Street only rebounded in earnest, gaining 24% within one month, on September 29, 1938. That was the day before Neville Chamberlain returned from Munich, brandishing his infamous note from Hitler and declaring “peace in our time”. The ultimate triumph of hope over experience.

Special Eurasia Group Update – Ukraine

By Ian Bremmer, Eurasia Group

dear john,

russia is conducting direct military intervention in ukraine, following condemnation and threats of sanction/serious consequence from the united states and europe. we're witnessing the most seismic geopolitical events since 9/11.

a little background from the week. russian president vladimir putin provided safety to now ousted ukrainian president viktor yanukovich. the ukrainian government came together with broadly pro-european sentiment...and with few if any representatives of other viewpoints. the west welcomed the developments and prepared to send an imf mission, which would lift the immediate economic challenge. and then, predictably...the russians changed the conversation.

the west – the us and europe – supported the ukrainian opposition as soon as president yanukovych fled the country. that also effectively breached the accord that had been signed by the european foreign ministers, opposition and president yanukovych (a russian special envoy attended but did not add his name). the immediate american perspective was to take the changed developments on the ground as a win. but a "win" was never on offer in ukraine, where russian interests are dramatically, even exponentially, greater than those of the americans or europeans. for its part, the new ukrainian government lost no time in antagonizing the russians – dissolving the ukrainian special forces, declaring the former president a criminal, and removing russian as a second official language. the immediate russian response was military exercises and work to keep crimea. president vladimir putin kept mum on any details.

let's focus on crimea for a moment. it's majority ethnic russian, and ukrainians living there are overwhelmingly russian speaking (there's a significant minority population of muslim crimean tatars, formerly forcibly resettled under stalin – relevant from a humanitarian perspective, but they'll have no impact on the practical political outcome). crimea is a firmly russian oriented territory. crimea has a russian military base (with a long term lease agreement) and strong, well organized russian and cossack groups – which they've supplemented with significant numbers of additional troops, as well as military ships sent to the area. russia has said they will respect ukrainian territorial integrity...and i'm sure they'll have an interpretation of their action which does precisely that. moscow will argue that the ouster of president yanukovych was illegal, that he's calling for russian assistance, that the new government wasn't legally formed, and that citizens of crimea – governed by an illegal government – are requesting russia's help and protection. all of which is technically true. to be sure, there are plenty of things the russians have already done that involve a breach, including clear and surely provable, given sufficient investigation, direct russian involvement in taking over the parliament and two airports in crimea. but that's not the issue. it's just that if you want to argue over the finer points, the west doesn't have much of a legal case here and couldn't enforce one if it did.

and the finer points aren't what we're going to be arguing about for some time. president obama's response was to strongly condemn reported russian moves, and to imply it was an invasion of sovereignty...promising unspecified consequences to russia should they breach ukrainian sovereignty. if that was meant to warn the russians, who have vastly greater stakes in ukraine (and particularly crimea) than the americans and the europeans, it was a serious miscalculation, as putin already controlled crimea, it was only a question of how quickly and clearly he wanted to formalize that fact. there's literally zero chance of american military response, with the pentagon quickly clarifying that it had no contingencies for dealing with moscow on the issue – that's surely not true, they have contingencies for everything. but secretary of defense chuck hagel just wanted to ensure nobody thought the president meant that all options were on the table. instead, we're seeing discussions of president obama not attending the g8 summit in sochi and targeted sanctions against russia.

putin has since acted swiftly, requesting a vote from the russian upper house to approve military intervention in ukraine. it was approved, unanimously, within hours. it's a near-certainty that the russians now persist in direct intervention. the remaining related question is whether russian intervention is limited to crimea – putin's request included defense of russia's military base in sevastopol (on the crimean peninsula) and to defend the rights of ethnic russians in ukraine...which extends far beyond crimea. putin's words may have been intended to deter the west, or he may intend to go into eastern ukraine, at least securing military assets there. given that pro-russian demonstrations were hastily organized earlier in the day in three major southeast ukrainian cities, it seems possible the russians are intending a broader incursion. if that happens, we're in an extremely escalatory environment. if it doesn't, it's still possible (though very difficult) that the west could come in financially and stabilize the kyiv government.

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before we get into implications, it's worth taking a step back, as we've seen this before. in 2008, turmoil developed in georgia under nationalist president mikheil saakashvili, a charismatic figure, fluent english speaker, and husband to a european (from the netherlands). he made it very clear he wanted to join nato and the european union (the latter being a pretty fantastic claim). the russian government was doing its best to make georgia's president miserable – cutting off energy and economic ties and directly supporting restive russian-speaking republics within georgia. for his part, saakashvili delighted in directly antagonizing putin – showing up late for a kremlin meeting (while he was busy swimming), insulting him personally, etc.

saakashvili was a favorite of the west, the us congress particularly feted him. the messages from the united states were positive, making it sound like america had his back. internally, there was a strong debate – vice president dick cheney led the calls to free himself from russia's grip as fast and as loudly as possible, secretary of state condoleezza rice thought saakashvili unpredictable and dangerous, and wanted to urge him to back off (as did former secretary colin powell, who lent his view to the white house as well). the cheney view prevailed, georgian president already had a habit of hearing what he wanted to out of mixed messages, and he proceeded. on 8 august, the russian tanks rolled into georgia and then the united states was left with a conundrum – what to do to defend america's "ally" georgia.

as it turned out, nothing. national security advisor steve hadley chaired a private meeting with president bush and all relevant advisors, most of whom said the united states had to take action. bush was sympathetic. hadley stopped the meeting and asked if anyone was personally prepared to commit military forces to what would be direct confrontation with russia. he went around the room individually and asked if there was a commitment – which would be publicly required of the group afterwards (and uniformly) if they were to recommend that the president take action. there was not – not a single one. and then the meeting quickly moved to how to position diplomacy, since there wasn't any action to take.

that's precisely where we are on ukraine – but with much higher stakes (and with a united states in a generally weaker diplomatic position), since ukraine is more important economically and geopolitically (and to europe specifically on both).

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the good news is that russia doesn't matter as much as it used to on the global stage. indeed, a big part of the problem is that russia is a declining power, and the west's response on ukraine was to make the west's perception of that reality abundantly clear to putin. which, in putin's mind, required a decisive response. but this has the potential to undermine american relationships more broadly. to say the us-russia relationship is broken presently is an understatement – the upper house also voted to recall the russian ambassador to washington (america's ambassador to moscow had just this past week ended his term – the decision was unrelated to the crisis).

what will be much more interesting is 1) the significance of the west's direct response; 2) whether the russians will cause trouble on a broader array of fronts for the west; and 3) whether a strongly-intentioned russia can shift the geopolitical balance against the united states.

taking each of these in order.

1) the west's direct response. we won't see much, although there will certainly be some very significant finger-pointing. president obama will cancel his trip to sochi for the upcoming g-8 summit and it's possible that enough of the other leaders will join him that the meeting is cancelled. it's conceivable the g7 nations would vote to remove russia from the club. the us would also suspend talks to improve commercial ties with the united states. it's possible we see an emergency united nations security council session to denounce the intervention – which the russians veto (very interesting to see if the chinese join them, and who abstains...). hard to see significant european powers actually breaking relations with russia at this point, but an action-reaction cycle could spiral. also, nato will have to fashion some response, possibly by sending ships into the black sea. shots won't be fired, but markets will get fired up.

2) international complications from russia. this will significantly complicate all areas of us-russian ties. russia doesn't want an iranian nuclear weapon, but they'll be somewhat less cooperative with the americans and europeans around iranian negotiations...possibly making them more likely to offer a "third way" down the road that undermines the american deal. on syria, an intransigent russia will become very intransigent, making it more difficult to implement the chemical weapons agreement and providing greater direct financial and military support for bashar assad's regime.

on energy issues, a russian invasion of eastern ukraine would put in play the integrity of major pipelines. moscow and kyiv would share strong incentives to keep gas and oil flowing, but in the worst case we could see disruptions. ukraine has gas reserves for a while, but then the situation could become dire. russia could divert some european-bound gas through the nord stream line, but volume to europe would drop. this is all in extremis, but out there.

3) geopolitical shift. russia will see its key opportunity as closing ranks more tightly with china. while we may see symbolic coordination from beijing, particularly if there's a security council vote (where the chinese are reasonably likely to vote with the russians), the chinese are trying hard to maintain a balanced relationship with the united states...and accordingly won't directly support russian actions that could undermine that relationship. leaving aside china, russia's ability to get other third party states on board with their ukrainian engagement is largely limited to the "near abroad" – armenia, belarus, tajikistan – which is not a group the west is particularly concerned with.

but it is, more broadly, a significant hit to american foreign policy credibility. coming only days after secretary of state kerry took strong exception to "asinine", "isolationist" views in congress that acted as if the united states was a "poor country," a direct admonition by the united states and its key allies is willfully and immediately ignored by the russian president. that will send a message of weakness and bring concerns about american commitment to allies around the world. g-zero indeed.

* * *

we'll be watching this very closely over coming days. i'm flying to seoul for a conference on monday, where i'm meeting up with president george w bush. should prove interesting on russia, no question. i'm back on wednesday, but will be available by phone/email throughout, so feel free to get in touch.

yours truly,
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