

## Predicting the Unpredictable

As the markets awoke at the beginning of the week to news of a US air strike on Iraq, one aspect of the risk off trade that had been ensuing became clearer. Those who had been selling equities from the week earlier were doing so because of events in Russia, and definitely not what was leading up to US action in the Middle East. Without a doubt if events were to intensify or the degree of US involvement were to increase in the region, that might lead to a different story, but oil prices trading at a thirteen month low is one other example of how financial markets are exhibiting a lack of concern over the region.

As the attention of investors has clearly been with equities, the key question to how a broader set of sanctions impact the Russia economy is what now, if any effect will they have on companies with economic or financial ties to Russia. Furthermore, what impact would broadening sanctions do to the global economy? Sanctions now go beyond targeting specific individuals or their firms and encompass entire sectors. As Mohammad El-Erian points out in the [Financial Times](#), this has direct implications to both supply chains and costs companies face, and then of course impacts to consumer demand.

Another threat is that if either country continues to strengthen their sanctions. Although motivation is to put pressure on Vladimir Putin, the sanctions ultimately only punish the Russian citizenry. Furthermore, it gives Putin the out that any hardship is the result of imposed disruptions by the West, and thus allows him to utilize the West as the scapegoat. As the Western European economies are the ones with much stronger economic ties to Russia, it's the leadership of German Chancellor Angela Merkel and company that have a much larger dog in the fight, and thus need to be where a solution is

fostered. It has long been clear that the US has given up their role as the global policeman and looks to play a limiting role in how this plays out.

The politics can be disguised in the near term to mask the real damage being done to the Russia economy. This might not last for much longer. The EU accompanied by the US and other smaller western nations have now sanctioned much of Russia's financial system by limiting their banks access to parts of western capital markets. This hurts every single foreign investor with capital in Russia. And we can yet again introduce another risk, as their financial sector remains burdened with external debt close to half their foreign exchange reserves.

Since the end of June the Ruble has declined close to 7 per cent against the dollar, and measuring since right before Russia annexed Crimea, their central bank has had to raise interest rates from 5.5 per cent to 8 per cent in order to slow the rate at which capital attempts to flee the country. A diminishing ruble weakens the Russian economy. And to further exacerbate the weakening ruble, Russia's ban on EU food imports only further weakens the currency as Russian consumers face an enforced inflationary environment paying higher food prices.

Russia's growth in the last two and a half decades was a result of their economy opening up to the rest of the world and removing the centrally planned level of government. The steps Russia is taking are reminiscent of times past and the Cold War era. The potential for greater geopolitical risk that could result from tensions escalating is one important factor that is maintaining the bid in the gold market. The proven unpredictability of Vladimir Putin seems to suggest that gold is acting as the appropriate hedge.

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