Key Developments to Watch in the Russia-Ukraine Crisis

The impact of sanctions and rising commodity prices are in focus.

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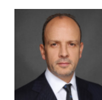

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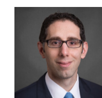

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KEY INSIGHTS

- Sanctions have severely limited the Bank of Russia's ability to defend the ruble; we think additional sanctions on Russian banks and sovereign debt are likely.
- Ukraine would likely receive tremendous financial support from Western countries, but it could still default on its sovereign debt.
- The Russian invasion is intensifying the inflationary pressures that major global central banks are monitoring as they prepare to tighten monetary policy.

First and foremost, we express our dismay at the humanitarian tragedy unfolding from the Russian invasion of Ukraine, and our thoughts are with anyone in Ukraine or with family or friends in the country.

Markets have generally responded logically to the crisis, with the largest movements focused on securities impacted by the current regime of sanctions. Russian equities and the ruble have sold off sharply. Overall, technology and banks have underperformed, while prices of commodities, especially oil, have climbed.

We believe global markets will likely remain risk averse and volatile until there is more clarity on the extent and likely duration of the invasion and the risks to oil prices, economies, the banking sector, and supply chains are more fully understood.

We are closely watching developments in three areas: sanctions and their economic impact, Ukrainian and Russian securities, and commodity prices and the implications for importers and inflation.

Impact of Existing and Potential Sanctions

What are the existing sanctions that Western countries have imposed on Russia?

The U.S. and Europe have significantly strengthened their initial set of sanctions and measures taken to isolate Russia's economy and financial system. On a scale of 1 to 10 in terms of severity, **the sanctions have moved from an initial two or three to a seven or eight**.

We estimate that the sanctions could reduce Russian gross domestic product (GDP) per capita by 30% over time. In comparison, sanctions against Iran reduced its GDP per capita by about 70% after SWIFT sanctions were imposed in 2012. We believe Russia's downside will be less severe because it has a more

diversified economy, and the country has already been living with sanctions since the Crimea incursion.

The new measures ban a significant portion of the Russian banking system from transactions using SWIFT, which is a messaging system used by financial organizations such as banks to arrange and settle large transactions. Also, the Russian central bank can no longer access its U.S. dollar and euro reserves in foreign central banks.

This has **severely limited the Bank of Russia's ability to defend the ruble** through buying rubles in exchange for dollars or euros. The ruble plunged by around 30% on February 28, even after the central bank raised its benchmark short-term lending rate to 20% from 9.5% and the country implemented some capital controls in an effort to stop the decline.

All foreign transactions in local Russian markets have been halted. Global Depositary Receipts (GDRs), which represent shares of a foreign company, for Russian equities are no longer trading in London because no brokers are prepared to take on the settlement risk involved with the trades. Trading in American Depositary Receipts (ADRs) for Russian stocks was temporarily halted in late February for an indefinite period.

Could Western countries impose even more punitive sanctions?

The fact that Russian firms can still access SWIFT for some transactions reflects the reality that much of the world still needs to access Russian energy. With **around one-third of the natural gas consumed in Europe coming from Russia**, it is very difficult to sanction the country's energy sector.

The partial SWIFT ban and barring the Bank of Russia from accessing foreign reserves are already extracting a severe toll on the country's currency. This could prompt an unpredictable response from Russia. A prolonged war, or a move to divide Ukraine into two countries or to push for regional "self-determination" leading to a federal state or confederation, could also trigger additional sanctions, potentially including a ban on all SWIFT access.

Measures such as cutting off central bank reserve access or SWIFT transactions can be adjusted relatively quickly and are generally not designed to be kept in place for the long term. In contrast, **trade sanctions have often been maintained for extended periods**—nearly 40 years in the case of sanctions imposed on the the former Soviet Union in the mid-1970s and extended to Russia.

Possible Implications for Russian and Ukrainian Securities Across Asset Classes

Are Russian stocks a significant part of emerging market indexes?

Russia accounts for a small part of broad emerging market indexes. As of early March, Russia was only 1.5% of the MSCI Emerging Markets Index, a commonly used benchmark.

MSCI, which maintains emerging market stock indexes, will remove Russian equities from its benchmarks as of March 9 primarily because of the market's accessibility. This won't create any immediate further pressure on Russian equities because trading is halted. We are assessing any longer-term implications. Any decision to reclassify Russia again in the future will be based on resolution of the conflict and any unwinding of capital controls.

How could the situation impact Russian and Ukrainian equities and bonds going forward?

While it is currently not possible for foreigners to trade Russian stocks, a **dividend payment moratorium for foreign holders of Russian stocks is likely to stay in place for much longer**, even if trading resumes. Many emerging market investors have been drawn to the Russian market for its

> Wars are inflationary in general.

relatively large dividend payouts, so we anticipate that the payment halt will meaningfully dampen sentiment toward Russian equities going forward. In addition, some institutional investors may be forced by their end investors to divest Russian stocks, pressuring the local market lower.

There is **potential for Russian banks to become insolvent**. Russian banks have significantly reduced their foreign lending—Sberbank, the largest bank in Russia, has only 12% of its outstanding loans in U.S. dollars—and the Bank of Russia has been doing all it can to support the country's banks, but sanctions are putting meaningful pressure on the banks. If the West imposes more sanctions and Russia's commodities exports are disrupted, the Russian banking system would be in significant danger.

Ukrainian and Russian bonds could face selling from passive investors if emerging market bond index provider J.P. Morgan removes them from its benchmarks.

Another area of focus is whether Ukraine or Russia could default on its sovereign debt. Ukraine has committed to paying its debt obligations and is likely to receive tremendous financial support from Western countries. However, much depends on the eventual territorial integrity of the country and its government's dedication to improving long-term growth and debt payment capacity, so a default is possible. Russia is likely to have problems paying coupons on its sovereign debt and probably some corporate bonds because of sanctions, so we anticipate some defaults.

Impact of Rising Commodities Prices on Interest Rates and the Global Economy

Do you think that the conflict will affect the tightening plans of major global central banks?

Wars are inflationary in general. This is particularly true coming out of a pandemic when both countries involved are major producers of energy and agricultural commodities—about 20% of global wheat production is from Russia and Ukraine. Russia also accounts for a large proportion of global industrial commodities supply, including 38% of palladium and over 10% of battery-grade nickel, and its disruption could have very significant price impacts.

In terms of global interest rates, this could create a "push and pull" situation where we have **higher inflation but weaker financial conditions**, which, hopefully, can offset each other to some degree. This is not likely to change the tightening plans of major global central banks over the next few months, although in the longer run it could affect how high central banks ultimately raise rates.

How do you see the situation impacting the global economy?

Taking an optimistic view, the positive momentum of the Chinese economy as it emerges from a major fiscal tightening cycle and the strength of the U.S. labor market coming out of the pandemic should keep the global economy from entering recession.

Looking Forward

What are you looking for as signals that the conflict may be de-escalating and the investment environment improving?

The signposts for an improving environment for equities include Ukraine becoming "neutral and nonaligned" between Russia and the West. On the other hand, Russia's reported targeting of civilian areas as opposed to military facilities is further worsening the humanitarian situation as well as the investment environment. **Russia could potentially bring Ukraine's shale gas production areas under its control** and withdraw its forces from the rest of the country, which would be a better outcome from all points of view than a prolonged war.

The unprovoked invasion of a country is certainly unusual in recent history, as well as tragic, and these types of sanctions have never been applied to a country the size of Russia. Nevertheless, we can draw on our decades of experience investing in emerging markets across asset classes, including during times of volatility sparked by sanctions. The lens of history can be informative.

We are closely monitoring the price of the Russian ruble against other major currencies as an indicator of how sanctions are affecting the country's economy. Further weakening in the ruble could force the Bank of Russia to further raise interest rates and impose even tighter capital controls with the aim of ensuring financials sector stability.

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