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INSIGHTS WEBINAR SUMMARY

Russia-Ukraine Crisis—Investment Implications

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Current State of Affairs

- At the onset of the discussion, Chief Investment Officer and Head of International Fixed Income Arif Husain acknowledged that the Russia-Ukraine crisis is a highly fluid, fast-evolving situation. Building on that point, Emerging Markets (EM) Credit Analyst Peter Botoucharov noted that the EM research team began evaluating the probability of several potential escalation scenarios in Eastern Europe and Ukraine during the last few months of 2021.
- The team's downside risk scenarios began materializing as Russia amassed troops on the border followed by the recognition of two separatist republics, Donetsk and Luhansk.
- Mr. Botoucharov shared two key points: First, Russian President Vladimir Putin's final goal remains unclear. Putin does not want to occupy Ukraine, and he is also mindful of protecting the lives of Russian soldiers.
- The second point focused on sanctions. Using the Crimean crisis in 2014–2015, Mr. Botoucharov stated that sanctions can go through various stages over time but can also escalate very quickly, as evidenced by the removal of select Russian banks from the SWIFT payment network. The current sanction imposed on the Central Bank of Russia, which prevents it from transacting with other nations' central banks, has materially impacted the Russian economy and financial system and could be even further tightened as conditions evolve.
- On Monday, February 28, the Central Bank of Russia more than doubled its benchmark interest rate to 20% and introduced foreign exchange controls to prevent further decline in the ruble.

Evaluating the Impact on Equity Markets

- Emerging Europe Equity Strategy portfolio manager Ulle Adamson reminded participants that as of Monday, February 28, foreign investors were barred from transacting in local Russian equities. Trading was also halted for American Depositary Receipts (ADRs), but markets trading in Global Depositary Receipts (GDRs) remain operational.
- MSCI, a leading market data and index provider, is currently considering excluding Russia from its set of indices, but that process would not be immediate.
- According to Ms. Adamson, Russian equities have historically possessed some of the highest dividend yields globally, and a moratorium on dividends from Russian state-owned entities seems likely.

- Despite the sanctions imposed on the Russian banking system, Ms. Adamson does not expect a major solvency issue as Russia's central bank is going to great lengths to support systemically important financial institutions.

Evaluating the Impact on Bond Markets

- Samy Muaddi, Emerging Markets Bond Strategy portfolio manager, also acknowledged great uncertainty. However, he reminded participants that history often provides guideposts for EM investors. There are tools and pattern recognition that we can use both in dealing with conflict zones, but also dealing with the ramifications of sanctions.

- On capital controls, Mr. Muaddi noted that these could introduce repayment issues for investors scheduled to receive sovereign and corporate coupons, potentially triggering a series of defaults. Western markets have not yet imposed forced divestment or halted secondary trading, but if those provisions were imposed, prices would likely fall further.

- Mr. Muaddi encouraged investors to avoid using a "broad-brush stroke" when evaluating capital controls. History guides us that capital controls are often highly specific.

- Should Russian debt securities become benchmark-ineligible, passive selling would drive prices down further.

What Contagion Risks Might Occur?

- War is inherently inflationary, so Mr. Muaddi has taken preemptive action by reducing exposure to markets with higher inflation, such as Egypt.

- On interest rates, the push-pull balance of higher rates coexisting alongside weaker financial conditions should not change short-term Fed policy. Over the long term, policymakers will need to evaluate those competing conditions, which could impact the level of terminal rates.

- It is critical whether or not Russian commodity exports will continue, specifically whether Russia will cut off its energy exports. Ms. Adamson shared that Russia accounts for over 10% of total global oil production and nearly 20% of global natural gas production.

- Russia's natural gas exports are key for Europe, according to Ms. Adamson, as its natural gas supply accounts for 35% of Europe's total use, and there are not enough other sources to offset that loss.

- Nearly 70% of Russia's oil product is exported globally, and OPEC+ doesn't have the spare capacity to make up the balance should an embargo be imposed.

- Longer term, Ms. Adamson believes these concerns could help accelerate an energy transition in Europe away from fossil fuels and toward renewable energy.

Are We Through With Western Sanctions?

- Mr. Botoucharov believes that the Western world can do more. He believes that further and more stringent banking sanctions could go into effect, citing specifically that neither sovereign debt nor the ADR and GDR markets are fully sanctioned at present. They could also extend SWIFT restrictions.

- However, the next set of sanctions depends on how geopolitical scenarios develop, with downside appearing more likely as conditions progress.

- Mr. Muaddi added that Western nations need to leave room for adjustment when crafting sanctions, as much to protect their own nations from an escalatory spiral as to avoid inflicting harm on Russia. Having never used "tools"—such as causing a banking crisis—before in a country as resourced as Russia, the West is crossing into uncertain and unfamiliar territory.

What Are Conditions Like in Russia?

- For the average Russian, the combination of a weak ruble and capital controls meaningfully impacts their financial position.

- A large decrease in GDP per capita is possible—Mr. Muaddi believes a worst case could be a near 30% decrease—due to the capital controls imposed.

- Effectively, there is a shift toward autarchy forcing an increased reliance on self-sufficiency; the combination is both inflationary and impacts living conditions.
- Ms. Adamson reminded participants that Russia has been operating under some combination of sanctions since 2014 and that efforts for import substitution and toward greater self-reliance have existed for quite some time. She noted that Russia is specifically trying to diversify away from Western technology. However, despite operating under similar conditions for an extended period, she acknowledged that this bout is unprecedented, and that there will be long-lasting impacts.
- Adding to that, Mr. Botoucharov shared that sanctions are typically long term in nature. He believes the trade and financial sanctions will last for many years. He is hopeful, however, if there is a resolution that the central bank and SWIFT sanctions can potentially be lifted sooner, enabling some level of trade.

Can These Conditions Drive Long-Term Change in Russia?

- Russians are very united behind their leader, making it hard for other political parties and elements of democracy to break through. Mr. Botoucharov remains hopeful that these conditions can drive structural change in the country, but he acknowledges that it is an issue of educating people on—and promoting—democracy.
- Mr. Muaddi recognizes that there is a bottom swell of support for this in Russia, but the avenues to implement these changes are nascent.
- Ms. Adamson cited that there is broad-based Russian support for a limited incursion into Ukraine but not an invasion. Despite some anti-war protests there remains support for President Putin, so the chances of regime change are low.

What Are the Prospects of a Global Recession?

- If Russia decides to respond through a commodity war and cease oil and gas exports, there would undoubtedly be a substantial inflationary shock globally. Emerging markets would likely bear the brunt of this, given that consumer price index weights in these markets are inherently skewed toward core products, like food and energy.
- Mr. Botoucharov thinks it is unlikely, however, for Russia to cease energy exports, given the mechanical challenge in slowing oil and gas production from its current high levels. Additionally, the lost income from these exports would hurt its economy meaningfully, thus it is not a surprise that energy sanctions have not been enacted yet.
- Mr. Muaddi struck a more positive note. He highlighted that China and the United States are the two largest contributors to global growth, and China has just finished one of its largest ever tightening cycles, while the United States continues to emerge strongly from Omicron, with labor markets and consumption trending positive. Thus, Mr. Muaddi maintains a more positive outlook on global growth.

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