



Understanding the Potential for Defaults in Russian Bonds

The latest developments add to Russia's negative economic outlook.

March 2022

What Has Happened?

After a significant amount of speculation and consternation over a possible default, Russia has initiated its coupon payments on two of its dollar bonds. This was a relief to markets, and the price of the bonds rallied on news of the payments. However, it should not be taken as a firm indication of what might happen to the rest of Russia's foreign currency bonds, which total over approximately USD 40 billion.

The ongoing war in Ukraine has caused Russia's external government bonds to decline rapidly to levels that imply a default is highly likely. Even so, a default on sovereign debt is an extremely rare event and, if it is declared, this will be the first time it has happened in Russia since 1998. Over the past few weeks, all the major rating agencies have downgraded Russian debt from investment grade to "junk."

Since Russia's invasion of Ukraine in late February, Western governments have placed severe economic sanctions on the country, including freezing roughly half of the central bank's assets. This has effectively led to economic isolation for Russia and put significant pressure on its financial markets and the ruble, which has sunk to record-low levels.

What Are the Implications for Markets?

For Russia's external bonds, the events are likely to have little impact because—as mentioned—these bonds have been trading at extremely depressed levels that indicate a high probability of default. The developments could turn some attention toward Ukraine, where the authorities insist that they will continue to service external debt for now. However, we believe that, eventually, some type of debt restructuring will likely be needed for Ukraine.

More broadly, emerging markets (EM) are likely to remain volatile for the time being. EM bond spreads¹ have widened recently, with investor sentiment knocked by both the Ukraine crisis and the prospect of monetary tightening from major central banks such as the U.S. Federal Reserve. As a result, EM bonds have been hit by outflows, a trend we expect may continue in the near term.

During times of volatility, we believe it is vital to stick to our investment process, which is centered on fundamental research and takes a long-term investment perspective. With that in mind, our view is that the recent spread widening has helped to improve valuations elsewhere in EM debt, and we therefore remain constructive on the asset



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¹ Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

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class. We are approaching yield and spread levels that make EM debt attractive relative to other areas of fixed income.

Are There Broader Macroeconomic Implications?

The latest developments with Russia's bonds add to the already poor condition of the Russian economy. The sanctions on Russia are the most significant placed on any large economy in a generation and are likely to cause a major contraction in the Russian economy.

We believe there are two primary channels for the situation in Ukraine to spill over into emerging markets more broadly: commodity prices and financial flows. For commodity importers, such as India, rising commodity prices are a negative in terms of trade shock, which will probably drain income from the economy and generate inflation, leading to activity slowing. For commodity exporters, such as Brazil, rising commodity prices are a positive in terms of trade shock, which will likely drive economic activity and credit improvement. Inflationary pressures may lead to EM central banks hiking more and holding rates higher for longer. So far, this has led to only modest repricing in EM local rates given that aggressive hiking paths were already priced in to a certain extent.

As mentioned above, there have been outflows from EM debt because of the crisis. We are assessing what the potential impact of J.P. Morgan's decision to remove Russia from its EM benchmarks on March 31 may be on other emerging markets. In EM external debt, the redistribution of Russia will be evenly spread across a range of countries; in EM local debt it will be more concentrated, with Brazil, Thailand, and Malaysia as the market share gainers.

Are There Direct Impacts on T. Rowe Price Portfolios From the Latest Developments Regarding Russia's External Debt?

At the beginning of the year, with the exception of a U.S. mutual fund,

the Emerging Europe Equity Fund, T. Rowe Price funds had very little exposure to Russian and Ukrainian securities. Across our EM debt suite, we were broadly underweight Russia. The vast majority of our funds across T. Rowe Price had zero exposure.

T. Rowe Price is actively monitoring our approach to managing and valuing these holdings. Due to the escalating events in Ukraine and Russia, and the rapidly changing market environment, reported holdings and country exposure information as of the last public reporting period of February 28, 2022, may now be different.

T. Rowe Price has also been actively monitoring the recent Russian sanctions developments. We are in compliance with the requirements of Executive Order 14024 (Executive Order) and related directives as well as UK and EU sanctions issued against Russia. We have put controls into our pre-trade compliance systems to ensure that no investments or divestments are made in violation of the Executive Order or other applicable sanctions programs.

What Are We Monitoring Next?

For the affected bonds, there is a 30-day grace period before a default may be declared. With coupon and maturity bond payments due on other Russian external debt over the coming weeks, we anticipate further announcements and headlines on this topic.

More broadly, we continue to monitor the situation in Ukraine closely. Our base case is that the war is protracted, but discussions between Ukraine and Russia are ongoing and things could change quickly. Sentiment may shift if either tail risk (low-probability event) materializes—either there are signs of a resolution to the conflict, which improves sentiment, or the situation worsens, which depresses sentiment further.

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