Russian Risks Rising

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Russian assets have been under pressure for several months due to the country's involvement in the Ukrainian crisis and the consequent imposition of sanctions by the US and the EU. The rapid fall in oil prices has accentuated the pressure, given the country's dependence on oil and gas exports. The Russian ruble has lost close to half of its value against the dollar since the beginning of 2014. Russian external sovereign and corporate bonds have also performed very badly in the markets and the sell-off has spread to the local bond market as well. The Central Bank of Russia has reacted to the ruble's weakness with an emergency 650 basis point rate hike, followed by additional measure to support the foreign exchange market.

While we continue to believe that Russia's credit quality is essentially sound and that both the ruble and the country's bonds have overshot their fundamental value, it is important to recognize that the risks have increased substantially in recent weeks.

Growth expectations continue to come down with lower oil prices and the Russian economy is likely to go into recession in 2015. We had been expecting growth to be just above zero. The depth of the recession will depend on oil prices and on the effect of the recent emergency rate hikes on domestic consumption, as well as the ongoing impact of sanctions.

Russia's current account will be substantially weakened by lower revenues from oil and gas exports. Imports are also likely to fall due to the recession and sanctions (both those imposed by the US and the EU and the counter-sanctions on agricultural products imposed by Putin). There is a risk that the current account surplus turns into a deficit, depending on how these two factors offset each other. Russia's capital account will remain weak as long as sanctions remain in place, as Russian corporates are repaying their existing loans without access to new financing. Capital flight — a feature of the Russian economy for the last several years — is expected to continue. These factors will continue to place pressure on foreign exchange reserves, which stood at US$416 billion at last reporting, although we estimate that only $200 billion is readily available to support the currency.

As long as the ruble's depreciation continues to outpace the fall in oil prices, Russia's fiscal accounts should benefit, given that a high proportion of the government's revenues is linked to the US dollar while expenditures are largely in rubles. Non-oil revenues will be hurt by slower growth, however.

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The combination of sanctions and the central bank's emergency rate hike to 17% is increasing stress on the Russian banking system and on Russian corporates. Non-performing loans in the banking system are likely to increase while corporates are facing a financing squeeze and will likely see their revenues hurt by lower domestic demand. There is a risk of downgrades to corporate credit ratings, although we believe that most large Russian corporates continue to have sound balance sheets and would be likely to receive government support if necessary, given their strategic importance. Smaller corporates are more vulnerable and some could default on their debts.

The central bank followed up its emergency rate hike — which the market found insufficient — with a series of measures to support the currency. These measures include not just the sale of US dollars from reserves but also an increase in the size and frequency of foreign currency repo auctions, the provision of foreign exchange loans and a suspension of mark-to-market requirements for Russian banks. The market reacted very favorably to these measures, reversing close to half of the previous week's currency depreciation. It remains to be seen, however, if these measures will provide more than a temporary respite. Liquidity in the ruble remains very low and bid — ask spreads are extremely high.

There is a risk that the central bank will resort to capital controls to support the currency. We do not expect this to happen and top Russian officials have denied any intention of doing so. If capital controls were to be imposed, however, we would expect them to come first in the form of forced repatriation of US dollars from Russian exporters. We think it is very unlikely that the Russian government would take measures that would prevent Russian borrowers from repaying their foreign obligations or any other measure that would further isolate Russia from the global financial markets.

We do not expect Russia to default on its sovereign or quasi-sovereign bonds. There is no reason for the country to default as payments are relatively small compared to the size of the country's foreign exchange reserves. The risk of a downgrade to Russia's sovereign rating has increased, however, given the deteriorating growth outlook and the stress in the financial markets. Russia is currently rated one level above junk by S&P and two levels above by Moody's and Fitch. While we do not expect the country to lose its investment grade rating, we acknowledge that this is a possibility.

The restoration of confidence in the ruble and in Russian assets more generally depends on continued aggressive action by the central bank but also on external factors. The first of these is oil prices. We believe that for oil to stabilize the market needs to see a reduction in supply from either North American shale producers or OPEC. This may take several months to materialize and would likely lead only to a return to the US$60-70 per barrel range. This level ought to be supportive of the ruble at the current level but would not be sufficient to lead to a meaningful rebound in the currency. The second key factor would be a disengagement of Russia from Ukraine, which would lead to the removal of sanctions. We do not consider this likely and in fact the risk remains that Russia instead becomes more directly involved in the Ukrainian crisis.

Given the risks outlined above, our view on Russia has become more negative. Markets have, however, largely priced in a negative scenario while liquidity has dried up. We are, therefore, remaining neutral in our positioning in both US dollar and local currency, while continuing to monitor the situation very closely.

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