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EMERGING MARKET FIXED INCOME - UPDATE

THE FALLOUT FROM THE WAR IN UKRAINE

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SUMMARY

› Although Western sanctions imposed on Russia following its invasion of Ukraine on 24 February limit the ability of the sanctioned firms to service their debts, it is the harsh capital controls imposed by the Central Bank of Russia (CBR) that have significantly increased the prospects of Russia defaulting on its sovereign debt and of Russian companies following suit.

› Regarding Russian sovereign debt in rubles, the decree baring coupon payments to non-residents came into effect on 2 March, when only Russian residents have been receiving coupon payments.

› The widespread freeze on CBR's external assets imposed by the western powers is likely to significantly impair Russia's ability to service its external debt. In January, Russian hard-currency corporate bonds outstanding amounted to USD98 bn, larger than the USD39 bn of external government debt.

› Investors are left wondering if Russian companies will be able to meet their coupons and debt repayment obligations in hard currency. The Russian government is allowing them to repay debts to foreign creditors of "hostile" nations only in rubles, unless they obtain a permit to do so in hard-currency. Unless there are fallback mechanisms in place for their hard-currency corporate bond issues, Russian companies are likely to be in technical default if they service hard-currency debts in rubles.

› Russian bonds had a relatively large weighting in emerging-market (EM) fixed-income indices widely used as benchmarks by asset managers. This helps explain why the EM corporate bond index (the JP Morgan CEMBI Broad Diversified) posted a negative total return performance of 8.9% year-to-date (on 10 March), and spreads over US Treasuries have risen to 426 bps. The EM local currency sovereign bonds index (the JP Morgan GBI-EM Global Diversified) has posted a total return of -8.2% year-to-date (on 10 March), with the sell-off in Russian government bonds leading to a sharp rise in the index yield to 6.2%.

An overview of Western sanctions on Russia and Russia's reaction

Western countries have imposed wide-ranging sanctions on Russia following its invasion of Ukraine on 24 February. Fixed-income markets have been impacted directly by the following sanctions imposed by US, the UK and the EU:

1. There is a ban on primary and secondary trading of new Russia sovereign bonds.
2. Sanctions, asset freezes and a ban on financial market access cover a number of Russian banks as well as state-owned enterprises and firms.
3. A number of Russian banks have been removed from the SWIFT global payments messaging system.

4. Measures have been introduced that prevent the Russian Central Bank (CBR) from deploying its international reserves.

These sanctions are likely to remain in place at least until there is a de-escalation in the conflict between Russia and Ukraine. And the experience of Iran, North Korea and Cuba show that sanctions can remain in place for a long time, even after de-escalation.

Although Western sanctions and asset freezes limit the ability of Russian firms to pay their coupons and reimburse their debt, it is the harsh capital controls imposed by Russia that have significantly increased the prospects of Russia defaulting on its sovereign debt and of Russian companies following suit.

The main capital-control measures implemented so far by Russia are as follows:

1. Coupon payments to non-residents holding ruble-denominated Russian sovereign bonds (OFZs) are banned.

2. Russian residents are prohibited from making foreign-currency transfers abroad since 1 March.

3. Export companies have been ordered to convert 80% of their foreign-currency revenues into rubles.

4. Foreigners are banned from selling Russian securities.

5. Russian companies and individuals are allowed to repay debts to foreign creditors in "hostile" nations only in rubles, or with a permit in hard-currency.

6. Private purchases of foreign currency have been suspended until 9 September and bank customers are allowed to withdraw no more than USD10,000 from foreign-currency accounts.

Are the Russian government and companies likely to default?

The situation is very fluid. Between Western sanctions and the capital controls put in place by the Russian government, **investors are left wondering whether Russian companies will be able to meet their coupons and debt repayment obligations in hard currency. The decree that bars making coupon payments to non-residents on ruble-denominated sovereign debt is being applied.** On 2 March, only Russian residents received due coupon payments.

The CBR has close to USD620 bn of foreign reserves but the asset freeze by the US, UK, EU and Japan affects a large part of these reserves. The High Representative of the EU for Foreign Affairs Josep Borrell has confirmed that more than 50% of the CBR's external assets is affected by the measures announced. According to its own publications, the CBR holds USD132 bn of gold reserves onshore. In addition, at end-June 2021, Russia held 13% of its reserves in Chinese renminbi assets. These could still be at its disposal.

The move to prevent the Russian central bank from using its international reserves is likely to significantly impair Russia's ability to service its external debt. However, some of its US dollar sovereign bonds issued after 2014 contain fallback mechanisms that could enable repayments in euro, sterling, Swiss francs and rubles without triggering a technical default. The next coupon payment for US dollar-denominated sovereign bonds without a fallback mechanism is due on 16 March (on two bonds for a total of USD117 mn). There is a 30-day grace period for these bonds, after which a non-payment or a payment in rubles is likely to be considered as a default. The next coupon payment on USD-denominated Russian sovereign bonds with a fallback mechanism is due on 21 March. Payment in rubles on these bonds is unlikely to be considered a default.

Overall, however, **the risk that coupon payments are not honoured or are not honoured in foreign currencies has triggered sharp rating downgrades. All three of the main ratings agencies (Moody's, S&P 500 and Fitch) now consider the Russian government is likely to default on both its local and foreign currency long-term debt.** S&P has assigned a CCC- rating with a negative credit watch, Fitch a C-rating and Moody's a Ca-rating with a negative outlook. These ratings are consistent with an expected recovery rate of between 35% and 65%, which is above the price at which most Russian hard-currency sovereign bonds were trading on 10 March. Further downgrades could be on the cards if Russia officially defaults and the expected recovery rate falls close to zero. Russia already defaulted in 1998. In 2000, it exchanged the defaulted bonds with a face-value cut of 36%, giving them an estimated recovery value of 38%.

Approximately USD17 bn of hard-currency debt issued by Russian corporates is due to be repaid during the remainder of 2022, and an additional USD4 bn in coupon payments. **Not only are Western sanctions** (in particular the exclusion of Russian banks from SWIFT and the freezes on Russian assets) **making payment deadlines more difficult to respect**, **but the Russian governments is also allowing Russian companies and individuals to repay debts to foreign creditors of "hostile" nations** (which include the US, EU, Australia, UK, Canada, Monaco, South Korea, Switzerland and Japan) **exclusively in rubles, unless they obtain a permit from the government.** A special bank account in rubles needs to be opened in a Russian bank to send payments to a foreign creditor at the daily exchange rate set by the CBR. This measure is being applied to payments above RUB10 mn per month (USD65,000).

However, unless Russian hard-currency corporate bonds have fallback mechanisms similar to those covering Russian government bonds, payments in rubles are likely to be considered as representing a default once the 30-days grace period expires. At the time of writing (10 March) despite the executive order of 5 March allowing payments only in rubles, principals and coupons were still being paid in hard currency.

How might a Russian default impact foreign investors?

Although the Russian fixed-income universe is relatively large (approximately USD237 bn of Russian government bonds in rubles and in hard currency and USD98 bn of hard-currency corporate bonds), **foreigners' holdings are relatively low, according to our estimates**. Foreigners held 19% (USD38 bn) of ruble-denominated Russian sovereign bonds in January 2022 and 50% of Russian sovereign bonds in hard currency (equivalent to approximately USD20 bn). While the data is less clear, JP Morgan estimates that institutional foreign investors held around 22% (or USD21 bn) of Russian hard-currency corporate bonds at end-January.

Russian bonds have constituted a relatively large share of emerging market (EM) fixed-income indices widely used as benchmarks by asset managers. However, due to

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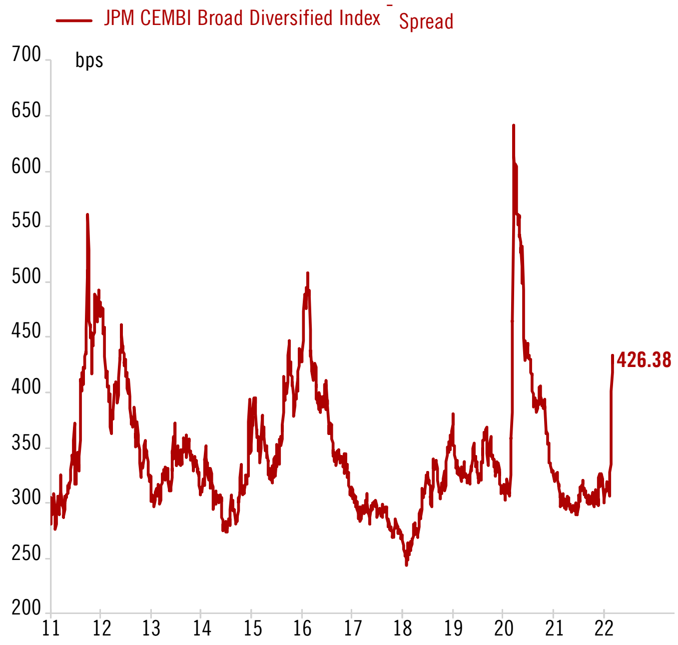
the Western sanctions and the introduction of stringent capital controls in Russia, JP Morgan has decided to exclude Russian bonds from all its indices after 31 March.

In February, Russian companies accounted for 3.95% of the market value of the JP Morgan CEMBI Broad Diversified Index, which represents a basket of EM hard-currency corporate bonds, but this figure has since fallen to 1.36% due to the huge decline in the price of Russian bonds. The market dislocation is staggering, with most Russian corporate bond curves trading at distressed levels of USD10-30 cents on the bid side. **This has led EM corporate bonds to post a total return of -8.9% year-to-date** (on 10 March), **and the spread on the JP Morgan CEMBI Broad Diversified Index over US Treasuries has risen to 426 bps** (*see chart 1*).

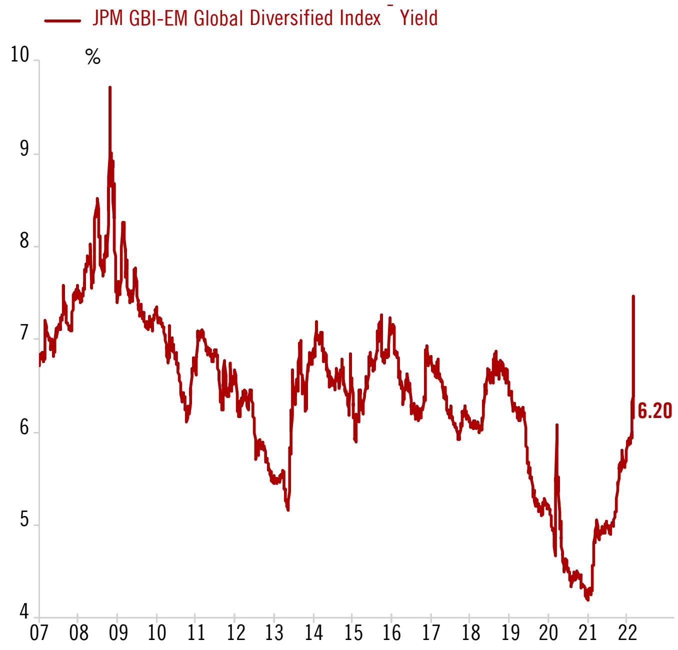
In February, Russian debt represented 6.84% of the JP Morgan GBI-EM Global Diversified Index, used as a benchmark for EM local currency sovereign bonds. This had fallen to 1.84% in March. By 10 March, EM local currency sovereign debt had posted **a total year-to-date performance of -8.2%** (-8.5% in USD terms and -5.5% in euros). **Unsurprisingly, the sell-off in Russian government bonds has led to a sharp rise in the JP Morgan GBI-EM index yield to 6.2% on 10 March, with a spike as high as 7.5%** (*see chart 2*).

CHART 1: EM HARD CURRENCY CORPORATE BOND SPREAD



Source: PWM - AA&MR Factset, 10.03.2022

CHART 2: EM LOCAL CURRENCY GOVERNMENT BOND YIELD



Source: PWM - AA&MR Factset, 10.03.2022

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