

FAQ: Russia/Ukraine debt outlook

March 15, 2022



This FAQ is designed to help provide perspective on the current Russia/Ukraine crisis.

Q. How likely is it that Russia will default on its sovereign debt?

A. The Russian government's willingness to pay on its debt obligations is now explicitly in question following comments by the Putin regime, despite economic buffers put in place before the events of recent weeks.

Russia sits with a large current account surplus (meaning that the country is a net lender to the rest of the world) and deep international reserves suggested to be as large as \$650 billion prior to the start of the invasion at the end of February. Approximately 50% of these reserves are based in U.S. dollars, euros, or sterling, and are held with western institutions. With recently imposed sanctions, these reserves are now inaccessible.

Approximately 12% of the country's reserves are in gold which, while accessible, are not liquid. The remaining assets are either in rubles (which have devalued significantly) or Asian currencies (Chinese yuan is the largest holding). This accessibility problem changes the fundamental picture for "Fortress Russia" (the notion that Russia's reserves would allow it to withstand Western sanctions) considerably.

As of March 9, market expectations (based on the pricing of credit default swaps) suggested a high probability of sovereign default of both Russia's local (denoted in rubles) and hard-currency (generally U.S. dollar, euro, sterling, Japanese yen, and Swiss franc) obligations.

A coupon on a key Russian corporate (Gazprom) delivered a hard-currency coupon payment March 7. At the sovereign level, the next significant event is March 16, when a hard-currency coupon is due.

Q. What happened the last time that Russia defaulted? Should we expect the same to happen this time?

A. Russia's previous debt default in 1998 followed the Asian crises in 1997, which contributed to lower energy consumption, a decline in oil prices, and a decrease in the region's trade with Russia. At the time, the ruble was a floating-peg currency (managed within an artificial range). In quick succession and unable to prop up its currency and meet debt obligations, Russia defaulted on its domestic debt and moved to a free-floating ruble.

A \$20 billion financial package approved by the International Monetary Fund helped stabilize the Russian market at the time. Additionally, improving relations with the Paris Club (a group of officials from major creditor countries whose role is to find solutions to payment difficulties experienced by debtor countries) helped negotiate a rescheduling of old Soviet debt.

The interest payments remained burdensome, although they arguably would have been manageable were it not for externalities such as the Asia crises and decline in oil prices. It is unlikely the country will see similar support for its debt this time around.

Q. Would a Russian sovereign-debt default impact Russian corporate debt the way it did in the U.S. when the country's rating was cut?

A. Rating agencies often use a corporation's country of primary residence as a floor for rating corporate debt. This is particularly true when firm revenues are intertwined with the trade of that country for either domestic demand or its composition of exports.

Several Russian state-owned and corporate entities have been sanctioned due to the nature of their business or ownership structure. These entities are the most at risk of receiving rating downgrades.

At the sovereign-debt level, Fitch Ratings has already cut the rating on Russian sovereign debt to below-investment grade status (aka “junk”).

- Q. What would a default mean for investor portfolios (how big is the index exposure), and does it appear to be accounted for by the current trading halt?

In general, exposure to Russian debt in most major emerging-market bond indexes was minimal before the invasion of Ukraine. With valuations falling, they are smaller post-invasion. For example, at the end of February, index exposure in the 50% JP Morgan Emerging Markets Bond Index-Global Diversified 50% and JP Morgan Government Bond Index-Emerging Markets Global Diversified blended benchmark (a common benchmark for some of SEI’s emerging-market debt portfolios) was 1.40%. As of March 9, EMD blended benchmark exposure was less than 0.11%.

Accordingly, a default is unlikely to have a significant direct impact on most portfolios, particularly if they are well diversified.

- Q. What are the spillover effects to the global economy?

- A. Net importers of energy will face higher input costs. This event is inflationary in nature, but it may have also second-order growth effects and create risks to the global economy. There is also the potential to tip from a reflationary path to a stagflationary path if growth is tepid and inflation soars.

While Russia is known for its energy exports, it also contributes significantly to other world commodities, including 13% of fertilizer, 17% of nickel, and 8% of cereals. The first could directly impact crop yields, which would create food inflation, while the last is disproportionately sent to sub-Saharan Africa to meet consumption demands. Exporters more generally may benefit from the increase in commodity prices, albeit absent meaningful growth, this may be short-lived.

Glossary

Credit default swaps: Credit default swaps are contracts that transfer third-party credit risk from one party to another. For example, if an investor believes a bond issued by a company may default, they can enter into an agreement with a bank, insurance company or other entity by which they agree to cover the cost of the possible default in exchange for periodic payments. An investor does not need to own the bond issued by the company in order to purchase a credit default swaps related to it.

International Monetary Fund: The International Monetary Fund (IMF) is an international organization of 189 member countries that promotes global economic growth and financial stability, encourages international trade, and reduces poverty. Monetary policy: Monetary policy relates to decisions by central banks to influence the amount of money and credit iJunk bonds: Junk bonds or high-yield debt is rated below investment grade and is considered to be riskier. Junk bonds carry a higher risk of default than most bonds issued by corporations and governments.

Reflation: Reflation refers to a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which occurs after a period of economic uncertainty or a recession.

Sovereign: A sovereign refers to government-issued debt.

Stagflation: Stagflation refers to slow economic growth and high unemployment, or economic stagnation, which is also accompanied by rising prices and inflation.

Treasury Inflation-Protected Securities (TIPS): TIPS are sovereign securities issued by the U.S. Treasury that are indexed to an inflationary gauge to protect investors from the decline in the purchasing power of their money. The principal value of TIPS rise as inflation rises, while the interest payment varies with the adjusted principal value of the bond. The principal amount is protected so that investors do not risk receiving less than the originally invested principal. Yield: Yield is a general term for the expected return, in percent/

Index definitions

JP Morgan Emerging Markets Bond Index-Global Diversified: The JP Morgan Emerging Markets Bond Index-Global Diversified tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the JP Morgan Emerging Markets Bond Index-Global Diversified includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least \$500 million.

JP Morgan Government Bond Index-Emerging Markets Global Diversified: The JP Morgan Government Bond Index-Emerging Markets Global Diversified is a market capitalization weighted total return index of U.S. dollar and other external currency denominated Brady bonds, loans, Eurobonds, and local market government debt instruments traded in emerging markets.

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Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments. Treasury Inflation Protected Securities can provide investors a hedge against inflation, as the inflation adjustment feature helps preserve the purchasing power of the investment. Because of this inflation adjustment feature, inflation protected bonds typically have lower yields than conventional fixed rate bonds. Commodity investments and derivatives may be more volatile and less liquid than direct investments in the underlying commodities themselves. Commodity-related equity returns can also be affected by the issuer's financial structure or the performance of unrelated businesses.

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