VIEWPOINT

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Prepared for professional clients only

UPDATE ON RUSSIA

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Urban is a full time member of Standish's Emerging Markets Debt team, responsible for communicating the team's views both internally and externally. He participates in all of the team's strategy discussions, speaks regularly with existing and prospective clients and writes all of the monthly and quarterly reports.

THERE CONTINUES TO BE TENSION IN EASTERN UKRAINE BETWEEN SUPPORTERS OF THE UKRAINIAN AND RUSSIAN GOVERNMENTS AND IT APPEARS THAT RUSSIA IS INCREASING ITS MILITARY PRESENCE ALONG UKRAINE'S EASTERN BORDER.

Current situation: At the time of writing (March 18th), the Crimea peninsula (an autonomous region of Ukraine but part of Russia from 1783 to 1954) has voted in a referendum to secede from Ukraine and join Russia. The referendum is regarded as unconstitutional and illegitimate by the Ukrainian authorities and by both the US and the EU but Russia has recognized the result and is moving to officially annex Crimea in the short term. The US and the EU have responded with limited sanctions and Ukraine has stepped up military preparedness but at this point the crisis does not appear likely to go beyond Crimea.

There continues to be tension in Eastern Ukraine between supporters of the Ukrainian and Russian governments and it appears that Russia is increasing its military presence along Ukraine's eastern border. Russia has asserted a right to intervene in Ukraine to "protect" ethnic Russians but President Putin has said that Russia has no intention of moving into other parts of the country.

Further sanctions have been threatened by both the US and the EU and a wide range of financial and other measures are apparently under consideration. It is not clear what further measures will be taken at this point. Sanctions would clearly be tightened should Russia make further advances into Ukrainian territory but we do not currently expect that to happen.

Military action does not appear to be on the table, although NATO has dispatched additional war planes to the region. Russia in turn has threatened to cut off gas supplies to Ukraine and has said that it may ask Ukraine to repay its share of the former Soviet Union's outstanding debt.

President Obama has made a public show of support for Ukraine, including receiving the Ukrainian Prime Minister at the White House and announcing some sanctions but remains under pressure from Congress to act more aggressively to punish Russia. In Europe the former members of the Communist bloc – notably Poland and Lithuania – have been the most vocal supporters of Ukraine and of imposing sanctions on Russia while Germany and others have been somewhat more cautious.

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To reiterate, we do not currently expect the dispute to spread beyond Crimea and we do not expect a significant ratcheting up of sanctions. As a consequence we do not expect this situation to have an impact on the markets beyond Russia and Ukraine.

How does this affect the bonds of Russia and its neighbors?

Independently of this situation the economic fundamentals of Ukraine are extremely fragile and the country will require substantial funding from the IMF in order to avoid default. Ukrainian bonds and the Ukrainian Hhryvnia remain very volatile and sensitive to developments. We have no direct exposure to Ukraine in any of our strategies.

THE FUNDAMENTALS OF RUSSIA REMAIN SOLID AND THE CURRENT VALUATIONS OF THE COUNTRY'S BONDS ALREADY REFLECT A HIGH DEGREE OF RISK

In contrast, we believe that the fundamentals of Russia remain solid and the current - very compelling - valuations of the country's bonds already reflect a high degree of risk. We do not anticipate a deterioration in Russia's credit quality, although the current situation is likely to be reflected in lower growth in the Russian economy while the currency should remain under pressure from capital outflows. We expect oil prices to remain high, with Brent likely to stay in the $100 per barrel range this year. This is very supportive of the fundamentals of major oil exporters such as Russia. The country has a low level of debt to GDP, a strong fiscal position, a high level of reserves and a current account surplus.

We have, however, reduced our exposure to Russia in recent weeks. In our US dollar strategies we have trimmed our holdings of state-owned Gazprom and quasi-sovereign VEB, both of which have direct links to Ukraine. We have also reduced our holding of state-owned Sberbank. In our local currency strategies we have reduced our exposure to the Russian ruble from an overweight to an underweight. We have not changed our positions in Russian external and local currency sovereign debt.

Kazakhstan is in an even more solid position than Russia, as an oil exporter with a sound fiscal position and a high current account surplus. Kazakh quasi-sovereigns have no direct exposure to Ukraine (the country has not issued sovereign bonds) and should see no effect from the current situation. The Eurasian Development Bank - a supranational agency owned by Russia, Kazakhstan and their trading partners - also has no direct exposure to Ukraine. This bond offers steady performance and solid credit quality.

The fundamentals of Russia, Kazakhstan and the EADB remain attractive while valuation more than reflects the level of risk.

How does this affect Central and Eastern Europe?

Effect on natural gas: Central and Eastern Europe are heavily dependent on Russian natural gas transported via Ukraine, which accounts for over 75% of the region's natural gas supply. Natural gas accounts for 10 – 35% of the region's energy consumption[1], with Poland, Bulgaria and Slovenia being the least dependent on this form of energy while Hungary, Romania and Slovakia are the most dependent. Should Russia choose to cut off gas supply (which happened once before due to a dispute between Gazprom and Ukraine) the region would quickly feel the effect. The approaching end of the winter heating season is a mitigating factor but the region's industry would clearly be seriously affected. Alternate sources of gas are not at this point sufficient to replace the region's imports from Russia.

Trade links: Aside from natural gas, economic ties between Central and Eastern Europe on the one hand and Russia and Ukraine on the other are relatively limited as the region trades much more heavily with Western Europe:

[1]Source: Morgan Stanley 10 March 2014

	Exports (% of Total)		Exports (% of GDP)	
	To Russia	To Ukraine	To Russia	To Ukraine
Czech Republic	3.3	1.0	2.2	0.7
Hungary	3.0	2.5	2.4	1.9
Poland	5.2	2.9	2.1	1.1
Romania	2.5	1.9	0.0	0.7

Sources: JP Morgan, IMF, Eurostat March 2014

CENTRAL AND EASTERN EUROPE ARE HEAVILY DEPENDENT ON RUSSIAN NATURAL GAS TRANSPORTED VIA UKRAINE, WHICH ACCOUNTS FOR OVER 75% OF THE REGION'S NATURAL GAS SUPPLY.

FDI: from CEE countries into Russia and Ukraine is even more limited due to the region's westward orientation while Russian and Ukrainian investment into the region is minuscule, in part due to the political sensitivity of Russian investment into countries that were under Soviet occupation not that long ago.

2012		Czech Rep.	Hungary	Poland	Slovakia
% of total FDI abroad	In Russia	1.4	2.3	2.5	0.6
	In Ukraine	0.2	1.6	1.9	2.8
% of investing country's GDP	In Russia	0.1	0.6	0.3	0.0
	In Ukraine	0.0	0.4	0.2	0.1
% of total local stock of FDI	From Russia	0.3	-0.1	0.3	-0.7
	From Ukraine	0.0	-0.2	0.1	0.0
% of local GDP	From Russia	0.2	-0.1	0.2	-0.4
	From Ukraine	0.0	-0.1	0.0	0.0

Sources: Citigroup, Central banks of Poland, Hungary, Czech Republic and Slovakia March 2014

Financial ties: Central and Eastern Europe's financial links are primarily with the Eurozone and the region's financial institutions do very little business in Russia and Ukraine. Hungary's largest locally owned bank, OTP, is the exception as it has a significant presence in Ukraine, which accounts for 9% of its total loan book. Foreign financing in Central and Eastern Europe is primarily from Eurozone banks such as Austria's Raiffeisen and Erste and Italy's Unicredit, among others.

Our conclusion is that Central and Eastern Europe has very limited direct exposure to events in Russia and Ukraine, aside from the region's key vulnerability: dependence on Russian natural gas, transported via Ukraine. The key external driver for the region is the economy of the Eurozone.