Investing in emerging markets

The Ukraine crisis: What global and emerging market investors need to know

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- In the last 24 hours, Russian troops have taken over key strategic points in the Crimea region of Ukraine, violating international law. President Obama has warned President Putin of the potential consequences of such actions and the United Nations Security Council has called for Russian restraint in the use of military force. These events have significantly scaled up the potential global consequences of the political crisis in Ukraine.
- In this note, we look at three possible scenarios of how this could play out. In our base case, Russian troops stay in the Crimea, the International Monetary Fund (IMF) provides emergency financing to Ukraine and elections take place in May. Under that scenario, we expect Russian equities to recover from the sell-off observed last week. In terms of sovereign bonds, we see Russia remaining a solid sovereign with strong credit fundamentals. We, thus, remain comfortable with Russian sovereign credit and see corrections as a buying opportunity. We would expect volatility in Russian corporate bonds to be elevated on the back of negative headline noise. We remain comfortable with holding bonds of the Russian majority state-owned banks and Gazprom to maturity, given the high probability of state support to be provided in case of need. We expect the Russian ruble (RUB) to remain under pressure and trade largely in a range of 35.5 to 37.0 against the US dollar (USD).
- While the current developments in Ukraine will have negative implications for growth in the region and increased volatility for its asset prices, we do not believe there will be a spill-over to global growth or asset prices in our main scenarios and for our 6-month tactical horizon.
- But the situation is very fluid, and the risk of an escalation is high. A spike in energy prices from a pipeline disruption is one of the channels for a negative impact to global growth and global risk assets. We are monitoring the situation closely.

Assessing the impact of Ukraine turmoil

The importance of Ukraine has been magnified by that country's extremely serious financial situation, political turmoil and the links to Russia. From a narrow emerging markets (EM) asset class perspective, though, direct exposure to Ukrainian-registered assets is very small. Ukraine's equities are not part of the benchmark EM equity index (MSCI EM) nor is its currency part of the EM foreign exchange (FX) index (ELMI+).

Its government bonds represent 2.3% of the EMBIG index and its corporate bonds constitute 0.45% of that reference index (CEMBI).

While the situation is quite fluid, we foresee three possible scenarios:

Scenario 1 (50% probability): Russians troops stay in the Crimea, the IMF provides emergency financing and elections take place in May. Under this scenario, Russian actions have two primary objectives:

1. to ensure that the Crimea region, where Russia has naval bases and strong popular support, does not fall under control of the interim government in Kiev, and
2. to send a message to the Ukrainian coalition being formed ahead of the upcoming elections in May, to take Russian interests seriously.

In this situation, we do not foresee further escalation of hostilities and no interruption of the flow of gas from Russia to Europe through the Ukrainian pipelines. A disorderly default of Ukrainian debt is avoided, but the IMF will likely require moderate private sector burden sharing.

- Impact on the economy: Despite the IMF deal, the economy goes through a recession; the currency weakens further and monetary policy needs to be tightened significantly. We foresee a limited economic impact on the European Union (EU), given limited trade and financial links. The earnings impact on Russian companies is manageable.
- Impact on Ukrainian Eurobonds: A disorderly default can be avoided, and the IMF will likely require some private sector burden sharing. Spreads remain elevated. Rating agencies could reclassify bonds "SD" (selective default).

For asset class impact, see asset allocation implications for global investors and asset allocation implications for EM, below.

Scenario 2 (40% probability): Russian troops stay in the Crimea but interim Ukrainian government is unable to successfully hold elections. The situation in the run-up to May 25 deteriorates as the legitimacy of the interim government is challenged, secessionist movements grow. Elections are postponed or canceled. Russia's military remains alert and threatening near the Crimea military bases, but doesn't enter further into the Ukraine or clash with opposition forces. IMF negotiations fail and the country has to restructure its debt. Gas supply from Russia to Western Europe gets temporarily interrupted.

- Impact on the economy: the economy goes through a severe recession, Ukrainian currency weakens significantly further and the central bank runs out of dollars. There is limited economic impact to EU given limited trade link. Manageable impact on Russian companies despite missed payments.
- Impact on Ukrainian Eurobonds: Ukraine defaults on Eurobonds; other payments are missed too. Debt restructuring with significant private sector burden sharing and oversight from the IMF takes place.

For asset class impact, see asset allocation implications for global investors and asset allocation implications for EM, below.

Scenario 3 (10% probability): Russian troops advance to the interior of the Ukraine and a broad-based conflict unravels. Russian military is brought in to regain Kremlin control. Violence escalates as do tensions between Russia and the West. Secessionist movements in the Crimea grow, adding to theses tensions and increasing the risk of a country break-up. IMF negotiations fail and the country defaults on payments in June. Gas supply from Russia to Western Europe gets interrupted.

- Impact on the economy: The economy goes through a severe recession and Ukrainian hryvnia (UAH) weakens significantly further. Limited economic impact to EU given limited trade and financial links. Russian companies are directly affected as payments are missed and risk premium for Russian assets increases significantly, also affecting the growth outlook for the Russian economy.
- Impact on Ukrainian Eurobonds: Default on the Eurobonds; other payments are missed, too.

For asset class impact, see asset allocation implications for global investors and asset allocation implications for EM, below.

Road signs to watch to determine probability of scenarios

- A sharp and sustained rise in violent confrontations between ethnic Russian and pro-government groups in major Eastern-Ukrainian cities.
- Informal, but material Russian military support for ethnic Russian groups outside of Crimea (sending paramilitaries over the border to engage pro-government groups, etc.).
- A breakdown in cohesion among main factions in the current "unity" government - with far-right/nationalist groups gaining control, leverage and influence, and sustained oil/gas pipeline disruptions.
- A clear breakdown or failure in western/IMF support negotiations.
- The Crimea referendum scheduled for March 30 is another signpost. The referendum question will be important (since the outcome will likely be "yes"). "Increased autonomy/closer ties with Russia..." is likely to be more supportive for markets, whereas "secession and becoming a province of Russia" will be negative and a trigger for higher tensions.

Table 1. Scenario descriptions and impact on economy

	Scenario description	Trigger points for a reassessment	Economy	Ukrainian Eurobonds
Scenario 1 (50%)	· Despite heightened political tension, the interim government successfully negotiates an emergency package with the IMF before the May 25 elections. · Gas supply from Russia to Europe is not interrupted, in part thanks to the gas reserve on the Polish-Ukrainian border. · Tensions remain high within Ukraine, and between Russia and the West. However, Russian military presence remains passive and contained to Crimea region. · Relevant time horizon: <3m	· Interrupted or failed negotiations with the IMF · Persistent and significant increase in violence · Rising tensions between Russia and the Ukraine / the EU or the US; negative wording in the Crimea referendum scheduled for March 30	· Despite the IMF deal, the economy goes through a recession, UAH weakens further and monetary policy need to be tightened significantly. · Limited economic impact to EU given limited trade link. · Manageable impact on Russian companies · Relevant time horizon: >12m	· A disorderly default can be avoided, and IMF will require some private sector burden sharing. Spreads remain elevated. · Rating agencies could reclassify bonds "SD" (selective default).
Scenario 2 (40%)	· The situation in the run-up to May 25 deteriorates as the legitimacy of the interim government is challenged, secessionist movements grow. Elections are postponed or cancelled. . · Russia's military remains alert and threatening near the Crimea military bases, but doesn't enter Ukraine or clash with opposition forces. · IMF negotiations fail and the country has to restructure its debt. · Gas supply from Russia to Western Europe gets temporarily interrupted. · Relevant time horizon: <3m	· Failed negotiations with the IMF · Dismissal of the interim government · Growing secessionist movements · Material Russian military involvement outside of Crimea	· The economy goes through a severe recession and UAH weakens significantly further, and the central bank runs out of dollars. · Limited economic impact to EU given limited trade link. · Manageable impact on Russian companies despite missed payments. · Relevant time horizon: >12m	· Ukraine defaults on Eurobonds; other payments are missed too. · Debt restructuring with significant private sector burden sharing and oversight from the IMF.
Scenario 3 (10%)	· Russian military is brought in to regain Kremlin control. Violence escalates as do tensions between Russia and the West. Secessionist movements in the Crimea grow adding to theses tensions and increase the risk of a country break-up. · IMF negotiations fail and the country defaults on payments in June. · Gas supply from Russia to Western Europe gets interrupted. · Relevant time horizon: <3m		· The economy goes through a severe recession and UAH weakens significantly further. · Limited economic impact to EU given limited trade link. · Russian companies are directly affected as payments are missed and risk premia for Russian assets increase significantly, also affecting the growth outlook for the Russian economy. · Relevant time horizon: >12m	· Default on the Eurobonds; other payments are missed too.

Source: UBS CIO WM

Asset allocation implications for global investors

- While the current developments in Ukraine will have negative implications for growth in the region and increased volatility for its asset prices, we do not believe there will be a spill-over to global growth or asset prices in our main scenarios and for our 6-month tactical investment horizon.
- For our global asset allocation and portfolios following the above scenarios, we maintain an unchanged moderate overweight in risk assets, in particular in equities, investment grade credit and US high-yield (HY). In equities, this is expressed via overweights in US and Europe, and a neutral weighting to EM equities.
- We maintain our neutral allocation to EM government bonds (EMBI) and for our lower risk profiles also to EM corporate bonds (CEMBI) in USD. We see valuation as neutral and expect spreads to be roughly unchanged on a 6-month horizon, as the underlying cash flows supporting these bonds are expected to be broadly unchanged.
- A spike in oil prices from a pipeline disruption is one of the channels for a negative impact to global growth. Still, we would expect the impact of even a USD10-20/barrell increase in oil prices to have only a marginal negative impact in terms of global growth, such that a negative reaction from equity markets would most likely be temporary. We would also expect HY corporate bonds to continue to do well in such a scenario.

- In the low probability event of a further military escalation spilling over to a conflict between Russian and the West, we would expect some negative consequence for global risk assets, such as equities. Should we see a further military escalation, we would, in particular, highlight our currency preference for USD as the main safe-haven beneficiary in this low probability event.

Asset allocation implications for EM

Russian equities (MSCI Russia)

Scenario 1: In the base case where Ukraine avoids a default, we expect Russian equities to recover from the sell-off observed last week. While the damage caused by the political turmoil in the economy would imply delays in payments to Gazprom, this should not have a major earnings and valuation impact, given the outstanding balance of USD1.6 billion (bn), and total expected 2014 revenues of USD9bn are manageable amounts for the company. Similarly, in a six-month horizon, we would expect any write-offs on Sberbank's USD5bn direct (9% of equity) exposure to have a limited impact on its valuation.

In this scenario, we would expect the Russian equities to re-rate and trade at 5.0x-5.5x next twelve months' earnings (average valuation level in 2012-13), which would translate to 14-25% potential upside from current level. The upside risk to our base case scenario would be higher than expected dividend payment announcements in April and supportive guidance for 2015, leading to a further closing of the 60+% price-earnings discount of MSCI Russia to MSCI EM.

Scenario 2: In this scenario, we are likely to see a further de-rating of Russian equities to the historical lows last seen in 2013 of 4.3x (currently 4.4x). Given the negative sentiment impact and the unfavorable EM backdrop, it is reasonable to expect the market to price in negative earnings impact on Gazprom of approximately 8% and a potential dent in Sberbank book value of 9%. Under these assumptions, where the index heavyweights Gazprom and Sberbank lose earnings and de-rate further, we expect the combined index weight-adjusted valuation pressure on equities to be 8-10%. Considering the sell-off since the break of events in Ukraine has already resulted in a 5% drop in Russian equities (excluding the RUB impact), the remaining downside would be c.3-5%. Therefore, while recognizing the possibility of a panic mood may lead to a temporary undershooting, we think the equity market has already priced in Risk Case 1 scenario implications to a large extent.

Scenario 3: In this scenario, Russian equities would face a meltdown on the possibility of a major blow to the economy led by Gazprom and Russian banks. We would reconsider our overweight recommendation in case any escalation of events in Ukraine leads to a conviction that the possibility of this scenario increases substantially.

Russian and Central and Eastern Europe (CEE) sovereign bonds (hard currency)

Scenario 1: Despite heightened political tensions between the Ukraine and Russia, Russia remains a solid sovereign with strong credit fundamentals. Russia is a net external creditor (net external assets of 17% of Gross Domestic Product, or GDP, as of end-2013), with high international reserves (24% of GDP, as of end-2013). In a political muddling-through scenario between Russia and the Ukraine, we expect the US Federal Reserve tapering to be a more relevant driver of EM sovereign bond spreads over coming weeks. As such, Russia should still stand out compared to its BBB-rated peers, given its strong external credit metrics. We, thus, remain comfortable with Russian sovereign credit and see corrections as a buying opportunity. We see little impact on sovereign bonds of issuers in CEE that are not directly involved in the Russia-Ukraine conflict.

Scenario 2: A default of the Ukrainian sovereign would not have any significant impact on the Russian sovereign, in particular as Russia has withdrawn – at least for now – from providing further financial assistance to the Ukraine. Accordingly, the Russian sovereign remains a solid creditor. As gas supply from Russia to Western Europe may become temporarily interrupted, Russian tax revenues may be temporarily affected, given that oil and gas revenues account for roughly 50% of Russian federal government revenues. However, due to Russia's sizable sovereign wealth fund (8.5% of GDP at end-2013) and high international reserves (24% of GDP at end-2013), we think the Russian sovereign will be in a comfortable position to service its debt liabilities. We note, however, that Russian sovereign bonds may experience heightened volatility, but we remain comfortable with increasing exposure during periods of correction. Any impact on sovereign bonds of CEE issuers that are not directly involved in the Russia-Ukraine conflict is likely short-lived.

Scenario 3: Even though Russia's ability to service its debt over coming years is unlikely to be materially affected in this scenario, Russian sovereign bonds may take a hit as the domestic economy weakens further amidst a rising policy rate environment and international sanctions against Russia. Furthermore, the tense political backdrop may lead to further international investors retreating out of Russian sovereign bonds. While investors looking to hold their Russian sovereign bonds until maturity, and willing to stomach heightened volatility and lower liquidity, can hold on to their exposure, new money should not be put into these bonds as further downside is likely. The impact on sovereign bonds of CEE issuers that are not directly involved in the Russia-Ukraine conflict should remain relatively limited., in our view.

Russian corporate bonds (hard currency)
Gazprom has the most visible exposure to Ukraine via direct exports of gas to the country as well as by transporting around 50% of its gas exports to Europe via a gas pipeline going through Ukraine. The gas sales to Ukraine represent around 7% of the total sales volumes. We note that the majority state-owned Gazprom has healthy credit metrics with net leverage of around 0.5x and annual sales of over USD150 bn.

Russian President Vladimir Putin stated that VTB, VEB, Gazprombank and Sberbank have exposure to Ukraine of around USD28 bn. In our estimation, the exposure represents around 4% of the loan book and under 25% of the total equity of these four quasi-sovereign banks combined. The exposure might consist of existing subsidiaries in Ukraine (owned by VTB, VEB and Sberbank), loans extended by the banks to Ukrainian entities or secured by assets in Ukraine and holdings of Ukraine sovereign and corporate debt. Fitch ranked the Russian banks in terms of their exposure to Ukraine in relation to their equity, estimating that VEB's exposure is at 74%, Gazprombank's exposure is at about 40%, VTB's exposure is at least 14%, Sberbank's exposure is around 8% and Alfa Bank's exposure is at 3%. We see the four quasi-sovereign banks as having strong links with the state and would expect a high probability of support in case of need to be provided. Turning to the overall exposure of the banking sector to Ukraine, the Russian Central Bank stated in December 2013 that it is around 1% of its total assets.

Scenario 1: A potential Ukraine sovereign bond restructuring could trigger a restructuring of the Ukrainian corporate debt. We see the impact of these events on the Russian bank's fundamentals to be manageable, given a relatively strong capitalization of the banks and high probability of state support in case of need. As gas supply to Europe is not interrupted, impact on Gazprom also remains manageable. We would expect the volatility in Russian corporate bonds to be elevated on the back of negative headline noise. We remain comfortable with holding the bonds of the Russian quasi-sovereign banks and Gazprom to maturity, given the high probability of state support to be provided in case of need.

Scenario 2: Ukraine sovereign debt default is likely to result in the moratorium of external debt payments on corporate debt, with a high likelihood of corporate debt restructuring. A temporary gas supply interruption is likely to result in gas supply being postponed rather than completely lost and, thus, we would see as manageable. While the impact on the Russian banks and Gazprom is non-negligible, it remains manageable with the state providing support as and when needed. We would expect Russian Eurobonds to experience a more pronounced correction and remain volatile for a longer period of time.

We remain comfortable with holding the bonds of the Russian quasi-sovereign banks and Gazprom to maturity, given the high probability of state support to be provided in case of need.

Scenario 3: Russian companies are affected due to direct exposure to Ukraine, a slowdown in the domestic economy and a weaker RUB. As negative sentiment intensifies, we see the pressure on the Russian corporate bonds to become more pronounced and the bonds becoming illiquid. Under these circumstances, one should reduce exposure to this segment, as a material downside is likely.

Russia and CEE currencies

The RUB is the most exposed currency in the region, besides the UAH itself. The additional pressure on the RUB comes at a time of an already weak outlook, with several structural factors pointing toward further weakness in the medium to longer term. Hence, rising tensions would lead to further RUB weakness. At current levels, however, the RUB trades close to the upper end of the central bank's intervention band, which typically results in significant central bank interventions and should help to slow down the pace of RUB depreciation going forward.

The currencies in CEE are less exposed, in our view. Compared to RUB, we expect a lower impact on the Polish zloty (PLN), Hungarian forint (HUF) and Czech koruna (CZK), but investors have to expect temporarily bouts of volatility on the back of negative news flow.

Scenario 1: We expect the RUB to remain under pressure and trade most of the time in a range of 35.5 to 37.0 against the USD. Currencies in CEE (PLN, HUF and CZK) are less exposed and we expect no permanent FX impact, except temporary bouts of volatility.

Scenario 2: We expect a more pronounced impact on the RUB, including high volatility and spot levels between 37.0 and 40.0 against the USD. This weakness is expected to result in FX pass-through on inflation and rate hikes cannot be ruled out. This would potentially mean an unfavorable situation in Russia: tighter monetary policy, rising inflation pressure and negative implication for the already weak growth outlook. Currencies in CEE would also temporarily depreciate some 3-5% versus the euro. Within CEE, we think the HUF is most vulnerable, followed by PLN and the CZK.

Scenario 3: In this risk case scenario, we expect further significant RUB weakness, with USDRUB potentially trading above 40.0. The central bank would have to tighten its monetary policy amid a lackluster growth outlook. PLN, HUF and CZK would also suffer due to rising economic contagion and adverse investor sentiment, and could depreciate by more than 5% versus the euro.

Table 2. Scenarios and impact on asset classes

	Global Impact	Impact on EM equities in the region	Impact on EM bonds in the region	Impact on EM currencies in the region
Scenario 1 (50%)	· Global financial markets see modest volatility	· We expect Russian equities to recover from the sell-off observed last week over 6m tactical horizon. Limited earnings and valuation impact for Gazprom and Sberbank. · In this scenario, we expect the Russian equities to re-rate to 5.0x-5.5x next 12m earnings (average valuation level in 2012-13), ~14-25% potential upside from current level. Dividend payment announcements in April should be supportive.	· Despite heightened political tensions, Russia remains a solid sovereign with strong credit fundamentals. · The negative impact on Russian banks fundamentals is manageable, with state support provided in case of need. Russian corporate debt sustains a more prolonged volatility and a sell off under restructuring scenario. · In both cases, we remain comfortable with holding the bonds of Russian sovereign and quasi sovereign banks to maturity.	· RUB most exposed. We expect it to remain under pressure and trade in the range of USDRUB 35.5~37.0). · FX in CEE (PLN, HUF, and CZK) are less exposed and we expect no permanent FX impact, except temporary volatility.
Scenario 2 (40%)	· Temporary increase in oil prices (10-20 USD/barrell) and pressure on financial markets globally, specially in the EU.	· We are likely to see a further de-rating of Russian equities to the historical lows last seen in 2013 of 4.3x. With Gazprom and Sberbank lose earnings and de-rate further, we expect further downside of 3~5%. We think the equity market has partially priced in Risk Case 1 scenario to a large extent.	· Russia remains a solid sovereign with strong credit fundamentals due to sovereign sizable wealth fund and international reserves. · Impact on the Russian banks and Gazprom intensifies, but remains manageable with state support. Russian Eurobonds sell off for a more prolonged period of time. The access to the external market for the Russian borrowers becomes more difficult, with pressure on their credit ratings. · We remain comfortable with holding the bonds of the Russian sovereign, quasi sovereign banks and Gazprom to maturity, given the high probability of state support to be provided in case of need.	· More pronounced impact on RUB (USDRUB 37.0~40.0). Potential tightening monetary policy amid lackluster growth. · PLN, HUF, and CZK would also temporarily depreciate up to 3-5% (HUF most sensitive, followed by PLN and CZK).
Scenario 3 (10%)	· All risk assets globally would suffer amid further military escalation. · We would highlight our currency preference for USD	· Russian equities would face a meltdown led by Gazprom and Russian banks. We would recommend reversal of our OW to an UW in case any escalation of events in Ukraine leads to a conviction that possibility of this scenario increases substantially.	· Russian companies and banks are hit by exposure to Ukraine and domestic economic. Russian banks, corporates and potentially sovereign see rating downgrades over multiple notches; external markets are closed for the Russian issuers for prolonged periods of time; mass selling of Russian sovereign and corporate debt by investors, as the bonds become increasingly illiquid. · Should the probability of such a scenario increase, we would recommend closing long positions for Russian debt.	· Significant RUB weakness (USDRUB >40.0) and tightening monetary policy amid lackluster growth. · PLN, HUF, and CZK would also suffer due to rising risks and adverse sentiment. FX depreciation of more than 5%.

Source: UBS CIO WM

Appendix

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