

## Rates: Russia priced for default

Reactions to the Ukraine crisis have been quite stark. Russia is effectively in default territory, in part anticipating a forced exodus. Central Europe has seen selling pressure, pushing down currencies and forcing market rates higher. The US and western Europe are the relative safe-havens. Market rates have fallen here, and are liable to fall further



### Russia in 'default'

The Russian dollar bond curve is now priced as if in a state of default. Bonds that are supposed to pay USD\$100 at maturity are priced in the marketplace in the area of 30 to 50 cents, and the curve is heavily inverted with the ultra-front end yield technically in the area of 1000%. Being a low debt economy, Russia can afford to service these bonds, but its ability to pay has been compromised by the back and forth on sanctions.

To boot, investors are questioning Russia's willingness to pay. Hence there has been an exodus, especially as Russian debt is also on index-watch, where exclusion from emerging market indices would warrant forced selling in any case. Local currency rouble debt is under pressure too, and as the central bank has put a hold on coupon payments, is undergoing a technical default.

## Central Europe feels the heat

These circumstances show that Russia is hurting from a financial markets perspective, and while defaults have negative reverberations outside of Russia for bondholders, the biggest pain is being felt by the Russian system. Financial market fallout is spread beyond Russia in different guises.

Central European economies have seen their currencies come under pressure, and bond yields have come under upwards pressure. They were under upward pressure before the Russia/Ukraine crisis kicked off, but this has been amplified by its elevated energy price impact, as most of these economies are energy importers. Market rates have come under further upward pressure, but nothing like that being felt by the Russian bond market.

## Western Europe as a safe-haven

As we move further west, the overwhelming theme has been downward pressure on market rates. Not only has the German 10yr bund yield crashed back below zero to trade negative again, but the Italian spread over Germany has tightened quite remarkably, back below 150bp. Two things from this. First, there is a flight to safety play. That explains the moves lower in German and core European yields. Second, there is a group safety effect by being part of the eurozone, one that benefits higher-yielding Italy. On top of that, the European Central Bank will tread far more carefully in terms of stepping away from its ultra-loose policies, ones that have been super supportive for the likes of Italy. Either way, there is a safe-haven flow to western Europe.

## US Treasuries the ultimate safety vehicle

And a key element of this has been a flight into US Treasuries. The 10yr, which had successfully broken above 2% before the Ukraine crisis, has since fallen back down to the 1.7% area. There is every chance that it could drift down towards 1.5% as the safety flight theme persists alongside deteriorating circumstances, and sanctions bite further. Most likely a 1.5% to 1.75% range gets mapped out for as long as the Ukraine crisis persists. Front end yields should remain elevated (2yr now at 1.35%) as a string of rate hikes are still coming. The curve can directionally flatten from the back end when market rates test lower, bolstered by the approach of the first hike from the Federal Reserve from the 16 March meeting.

Even though the dominant core reaction has been towards lower market rates on a safety play - and we can see more ahead - a resolution can quickly see the focus shift back towards elevated inflation and robust growth dynamics. So even if we were to hit 1.5% on the US 10yr as an echo of the awful events occurring in Ukraine, we could also subsequently snap back up to 2% should events turn for the better.

It's important that a better outcome occurs sooner rather than later, as remaining in crisis mode for a prolonged period risks sustaining the 10yr rate at a deep discount to 2%.

Other market rates will correlate with this; western Europe positively and central Europe negatively. Russian debt though does not correlate, as it is down and out for now.

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