

## Russia sanctions: Opening Pandora's box?

What US sanctions on Russian companies and oligarchs really mean for the Russian economy and financial markets



The US extension of SDN (Specially Designated Nationals) sanctions against several oligarchs and their public companies last Friday saw the visible market reaction only this week. This is the first material impact seen since 2014 as the measures open the way to the uncharted territory of sanctioning any company in Russia. Retaliation measures on foreign business, which have so far been nearly non-existent (apart from the food imports ban) as well as potential losses of global investors/banks from Russian assets, are factors to watch. Non-US business reaction will determine the ultimate effects of the sanctions. Yet, the Russian economy overall is more protected than in 2014-15.

### The sanctions...

Russian assets suffered heavy losses with stocks down nearly 10% on Monday and corporate bonds and sovereign eurobonds plunging too. OFZs decline of 0.7-1.5% in price terms and the RUB drop of around 5-7% look modest for now. The response came after the US government announced a new wave of sanctions against 24 Russian individuals and 15 companies last Friday.

The official rationale is an accusation of Russian meddling in the US elections and its behaviour in Ukraine and Syria. This comes in addition to the most recent escalation of accusations of Russia's responsibility for the poisoning of the ex-Russian spy and its backing of the Assad regime, which is blamed for the use of chemical weapons. Effectively, the mix of accusations against Russia has soared, clearly aimed at raising the pressure on President Putin and his inner circle after his re-election and before the formation of the new government.

## ...and their surprise effect

The first negative effects of the US sanctions stem from the fact that such sanctions against public companies hadn't been expected. We think the market was mostly assuming that financing restrictions to raise new capital and buy technologies/equipment (which work against state-owned energy giants and banks) were the most probable options for sanctions against Kremlin oligarchs. Yet, the US has chosen the SDN approach (assets freeze, a ban on many transactions between sanctioned entities and US residents) which may create more pronounced and long-lasting primary and secondary effects on both sides (Russia and the West).

## The indirect effects of sanctions are the primary focus

The direct impact on the Russian economy through the sanctioned entities doesn't look too biting. Yet, as was the case in 2014, the indirect effects are the primary focus. The financial market sell-off suggests investors may start looking at all of the Russian 'oligarchs/businessmen' on the US Kremlin list (released in January) through the prize of similar sanctions, which is the biggest threat.

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*The mix of accusations against Russia has soared*

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Moreover, as we have already learned, non-US entities may start behaving in a way that poses additional restrictions not stated in the official sanction wording (eg, Euroclear/Clearstream ban on settlement of sanctioned bonds before the stated deadline in early May, a ban on trading them, etc). Together with the defending strategies used by global banks' compliance/legal departments, this creates another layer of self-made sanctions from global banks and financial firms. These effects are impossible to quantify and properly analyse as they could have the potential to lead to a tail-risk scenario of uncharted waters of sanctions and likely retaliatory measures.

## Russia previously largely reluctant to use 'economic' retaliation measures

It is worth mentioning that apart from the food import ban of 2014, Russia has been very reluctant to use 'economic' retaliation measures in response to various waves of sanctions. Foreign businesses working in Russia have seen no pressure (sometimes even the opposite) and the only example has been retaliation bans on Turkish businesses after Turkey shot down a Russian military jet in Syria. This time the authorities may be more responsive even though we still hope that the government will weigh all short-term political "gains" vs mid/long-term economic losses from higher economic isolation from the West.

Also, the threat of secondary sanctions against non-US entities working in Russia will be key for

assessing the full effects of the sanctions, and their response is worth watching given the active presence of non-US businesses in Russia. These risks of foreign businesses losing the market share in the country may be material for many companies from abroad as the Russian market is still a top priority for many, given corporate surveys and our contacts with clients.

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*This time the sanctions create a precedent*

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As for financial markets effects, when assessing restrictions on sovereign debt in January, the US government acknowledged risks to the global financial system which stopped them from being seriously considered. This time the sanctions create a precedent which could be used against (any) Russian company without clear and transparent arguments. So investors may try to limit exposure to Russian stocks/bonds, yet suffer direct losses. The same arguments work for foreign banks working in Russia (and mostly European, not the US banks) exposing them to potential losses via direct P/L effects and a loss of future business. Overall, we hope that the US is not planning to start the economic sanctions war against Russia given potential spillover effects, even though risks have increased.

## **The Russian economy itself is in a much better shape now than in 2014-15**

On the macro side, the economy itself is in a much better shape now than in 2014-15 to withstand sanctions which may help limit the scale of the market panic:

- (1) it has adjusted to much lower oil price levels and returned back to growth (even still low);*
- (2) the fiscal policy is benchmarked to US\$40/bbl real oil price under the new fiscal rule;*
- (3) the monetary policy is still moderately tight;*
- (4) net external assets position of the private sector is negative (more fx assets than liabilities);*
- (5) FX reserves recovered visibly and RUB is fully flexible with very low risk of capital controls.*

Banking sector effects and the general financial stability are the most import sources of concerns, but we think the Central Bank is capable of managing these risks further.

## **RUB: The big washout of the consensus trade**

On RUB, the drop so far looks rather contained. The YTD BoP data suggested it has been fairly valued and the recent drop puts it closer to the levels which we assessed in Dec-17 as fair given the current oil prices and the fiscal rule via the BoP-based methodology. With financial markets' concerns and signs of USD/RUB being used as a hedge vehicle by bond investors, the selling pressure may continue for some more time, especially given that long-RUB positions have been a consensus view among investors for quite a long time.

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*The rouble drop looks rather contained, so far*

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Indeed, the net speculative RUB-longs have been above 60% of total positions (CFTC data) and foreign holdings of OFZs are above 30% (and above 50% after adjusting for illiquid bonds). With the positive C/A seasonality coming to an end, the role of capital flows will be key now. However, RUB high carry status and likely capital repatriation by major Russian businessmen/oligarchs and wealthy individuals may offset or, at least, ease the negative pressure from financial investors selling RUB now.

With the USD/RUB 60 level easily passed, the market may keep the USD/RUB 65 level in mind. Yet, we still see RUB stabilising at better levels over the course of 2018 in our base case scenario of no significant widening of the sanctions list. We don't think the CBR will be concerned about the RUB weakness unless its moves start questioning the financial stability issues and/or puts the central bank's 4% inflation target at risk.

## OFZs: Abundant RUB liquidity in the banking sector to provide a backstop

As for sovereign bonds, Russia's pure fiscal position doesn't flag any material risks. As authorities mentioned several times before, the primary supply of OFZs may be decreased if needed under a negative scenario, as the federal budget will likely have a breakeven oil price at around US\$55/bbl in 2018-20, so the only story is how to rebalance the sources of funding under the fiscal rule still requiring debt issuance by its construction.

The scale of the CBR policy easing may be revisited under the negative scenario of prolonged pressure on ruble assets, as these expectations have been supportive for OFZ. But this may allow for only a modest correction, not a major selloff. And abundant RUB liquidity in the banking sector will provide a backstop here. The low OFZs reaction so far backs the argument. Foreign bonds are even a much less important source of funding for the coffers, especially after the Finance Ministry already tapped a part of the annual gross issuance plan of US\$7bn. So, we might suggest using any decent price weakness as a buying opportunity unless one turns serious about the sanctions extension to sovereign debt and/or other corporates.

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