Russia: Bracing for new sanctions

The US is reportedly about to announce a new round of Russian sanctions that may involve sovereign debt, prompting a negative reaction in the local FX and bond market. Our initial take: don't panic, and wait for the details. A ban on foreign participation in new OFZs would not threaten financial stability, but would reduce foreign demand for RUB assets

US media reported that the Biden administration may announce today wider Russian sanctions involving both diplomatic measures, such as the expulsion of diplomats, and a ban on the participation of US financial institutions in the primary placement of Russian sovereign debt. Presumably, the sanctions would be a response to alleged cyber activity, election meddling, and threats to US soldiers in Afghanistan. Sanctions related to Alexei Navalny's chemical poisoning are not covered and are to be announced before 2 June. It remains unclear if US banks or all individuals would face the ban, and if the rouble section of sovereign debt (OFZ) will be targeted, but if news reports are true in general and cover all US citizens and OFZs, then this is a negative development for the Russian FX and debt market, at least for the near-term.

The local market has been speculating on the likelihood of OFZ sanctions for several years, and since mid-2020, the perceived risk of sanctions has gone up. Following a series of political events related to Belarus and opposition activist Navalny, as well as the change in US administration and accusations of Russian cyber activity, the RUB discount to EM/commodity peers doubled from 8% to 16%, a two-year high. However, in recent days, a phone call between Presidents Biden and Putin, and an agreement to meet, were taken as a sign of softening in the diplomatic tensions, thus today's news comes as a negative sign for the market.

Fundamentally, a ban on foreign participation in new OFZ issues is not a threat to Russia's financial stability as the state debt is low (around 20% GDP), local banks with $1.5tr (100% of GDP) assets have the balance sheet capacity to absorb the Minfin placement appetite, especially with the Bank of Russia's refinancing tools available. Year-to-date, Minfin placed $17bn worth of OFZs amid $3.7bn of foreign portfolio outflows (as 10-year yields went up over 130 basis points), and will need to place $31-32bn worth of OFZs ($850 mln per weekly auction) until year-end to fulfil the annual plan. The latter could be reduced in the event of higher than expected non-fuel revenue collection, which based on the 3Q21 budget fulfillment seems to be the case, however a potential increase in spending following the presidential address on 21 April ahead of the September Parliamentary elections could be an obstacle.

The lack of non-residents would affect prices through reduced demand. In successful years (2015-2017, 2019) non-residents bought two-thirds of the net placement volumes. In 2020, Minfin gross placed $73bn worth of OFZs, with non-residents buying only $5bn. As a result, the share of non-resident holdings of OFZs went down from 35% as of March 2020 to below 20% currently.

In terms of the direct effect of the potential lack of foreign portfolio inflows on the balance of payments - it should also be small relative to capital flows exercised by residents. For example, in 2018, non-resident outflows from OFZs were $7bn vs. $63bn of private capital outflows by local banks and the non-financial sector. Still, OFZ flows will steer the rouble's direction in the medium term. It is therefore critical to see whether current non-resident OFZ holders of $37bn decide to dump the paper or keep it as an antique asset, given Russia's strong financial solvency. A full exit of non-residents from OFZs (not a base case) would lower RUB's fair value by USD/RUB 5, but the near-term market reaction could be sharper.

In terms of the potential response by authorities to sanctions against new OFZs, we find additional key rate hikes unlikely. In the event of an administrative ban on foreign participation and possible pressure on Russia's weighting in the bond indices, a higher real rate would fail to increase RUB assets' attractiveness for residents. However, a higher key rate might be prompted if the rouble were to depreciate sharply and this resulted in higher inflationary expectations. A 10% RUB depreciation leads to an extra 0.5-1.0ppt rise in the CPI. Currently, the Russian CPI has peaked at 5.8% YoY and is on track for a gradual deceleration, with the Central Bank of Russia poised to elevate the key rate from 4.5% to the 5-6% range, assuming CPI returns to 4% next year, and GDP shows signs of a strong recovery.

The Russian government and Finance Ministry in particular could react by pulling forward the pre-announced programme of investing RUB1 trillion of FX from the sovereign wealth fund (NWF) into local infrastructure projects, which would potentially lower the amount of FX to be purchased on the market by the CBR by $4-5bn per year in 2021-2023, providing some support to the FX market.

We would not exclude, however, that the Bank of Russia might consider halting FX purchases to reinforce the balance of payments, similar to the situation in August-December 2018, especially if USD/RUB hits 80, as that level would correspond to a widening in the RUB's lag to its peers and oil to levels equivalent to the situation of 2H18. The adverse foreign policy backdrop reduces the likelihood that USD/RUB will strengthen out of the current 75-80 range in the near-term.

We also note that the latest news reports have suggested that the timing of US sanctions on Russian debt is uncertain. If the US administration opts only for the sanctions on individuals and entities at this point, RUB downside should be limited, as the market seems to be currently reacting to the sharply rising risk of debt sanctions (which may not come just yet). This would suggest USD/RUB stays below the 78 level and possibly experiences a modest rebound – assuming no decision on sanctions on debt is made at this point.

Takeaways from the sanctioning of Eurobonds in the primary market for OFZs

Gauging the potential impact on OFZs we can look at the experience of Russia's Eurobonds. On 2 August 2019, the US administration imposed a ban on US financial institutions participating in the primary market for non-rouble denominated Russian sovereign debt through the second round of the Chemical and Biological Weapons Control and Warfare Elimination Act of 1991 (CBW Act).

This initially weighed on bond spreads (36bp widening for 10yr US$-denominated bonds in subsequent days) in the secondary market as well but the risk premium disappeared rapidly, given Russia's strong credit fundamentals, which have mitigated the impact from reduced Eurobond issuance going forward while technically, this should also see a gradual reduction in the amount of Eurobonds outstanding over time. Nonetheless, geopolitical risks have continued to weigh on bonds since then, and we note that they have traded wide vs peers in recent weeks.

In the primary market, Russia has been still able to issue Eurobonds, with the sovereign raising €2bn of EUR-denominated bonds in November 2020. The new bonds don't trade with an additional risk premium over outstanding ones, albeit we do not rule out that some US investors have steered clear of the bonds in the secondary market. All in all, the share of non-resident holdings in Eurobonds has however remained stable (55.1% in end-2020 vs 54.9% in mid-2019) while the share of Russian debt in the JPM EMBI Global Diversified index has equally remained largely unchanged (3.4% currently vs 3.2% in July 2019).

For OFZs, this means that new sanctions could very well result in an initial sell-off but unless sanctions also include debt in the secondary market (not our base case), we believe that the impact is manageable. We also see a low risk of index exclusion as long as liquidity and foreign investor access are established, with Russia's country weight in the iShares JPM EM Local Government Bond ETF currently at 6.1%.

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