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Russia: contextualisation of geopolitical risks on global markets through scenario analysis

Current state of affairs

Deliberations between Russia, the US and Europe surrounding the Ukraine crisis – which have been building up since summer 2021 over a Russian military build-up near the Ukrainian border – have gone from bad to worse. There are increasing signs of posturing and escalation than of progress since the turn of the year. This has included a cyber operation against Ukrainian government websites on 14 January, the announcement of new Russia-Belarus military exercises for February, UK arms shipments to Ukraine on 16 January, new US sanctions against separatist individuals in Donbas on 20 January and a US State Department request for the departure of all nonessential personnel and their families from Ukraine on 21 January. Yet dialogue also continues. Russian Foreign Minister Lavrov and US Secretary of State Blinken both indicated after their 21 January meeting that their talks were productive. Lavrov said the US agreed to provide a written response to Russian security proposals this week. Blinken said the US and Russia "are on a clearer path to understanding each other's positions".

Impact on Russian financial assets year-to-date

The highly uncertain geopolitical outlook has markedly intensified in recent weeks, contributing to pressures on Russian and Ukrainian markets across asset classes. Thus far in 2022, the RUB is down 5.3%, Russian 5 year CDS spreads have risen 113bp to 237bp (surpassing the COVID-19 peak of 203bp registered in March 2020), the Russian equity market is down 18.5% and the 10 year OFZ yield has increased 134bp to 9.74%.

Scenarios of what comes next (within the next 3 months)

Short-term (3 month) scenarios from here include:

1. Limited escalation but diplomatic resolution (probability: 65%). Despite a hardened build-up of Russian forces on Ukraine's border, with the prospects of further cyber operations, diplomacy prevails. The latest corroboration between Russia and the US on 21 January (Lavrov – Blinken meeting) is positive for diplomacy with both sides displaying signals of a continued interest in dialogue. Granted, the course of the dialogue remains connected to the written proposals Russia wants from the US and NATO, and the diplomatic track is complex with subjective interpretation of proposals crucial in determining the next steps in negotiations. However, our base case is that there will be enough substance in the spirit of diplomacy to ultimately warrant the path towards de-escalation, albeit with still elevated security

risks on the table.

2. Moderate Russian incursion and limited occupation of Ukraine (probability: 25%). Should Russia interpret that the US and NATO address are not willing to entertain issues they consider non-starters – (i) Russia's demand for a formal ban on Ukrainian and (ii) Georgian membership in NATO and a withdrawal of NATO forces and equipment from states that became members after 1997 – then Russia could see its chances to get its way with military intervention within Ukrainian territory. What's more cyberattacks against core infrastructure could increase in frequency. For its part, the US may sanction Russian financial institutions and secondary market trading of new sovereign debt. The US may also push Germany for additional Nord Stream 2 delays beyond the summer.
3. Acute Russian invasion and prolonged occupation of Ukraine (probability: 10%). A replay of the 2014 Crimea annexation with Russian attacks and occupation of major parts of Ukrainian territory would be a worst case outcome. Russian could also follow through with cyber-kinetic attacks. In this scenario, on top of US sanctions on Russian financial institutions and secondary market trading of new sovereign debt, Russia would be at risk of being cut-off from SWIFT which could lead to broader contagion effects for emerging markets and the commodities space (Russia is a major oil, gas, palladium, platinum, gold and coal producer – amongst other commodities).

Global markets implications of scenarios (within the next 3 months)

Whilst not our base case, failure to reach an agreement which leads to escalation of military conflict (*scenario 2 or 3 above*) will almost inevitably trigger further US and potentially EU sanctions on Russia. Indeed, whilst markets have already begun to price in geopolitical risk premia onto Russian assets, prospects of a further deterioration is almost certain. Having said that, we consider the Russian economy as better prepared to face sanctions restrictions relative to the past, but not immune. Conditional on the type of sanctions, we see the economy being affected with the immediate impact via weaker FX, higher inflation and tighter monetary policy. The blow to economic sentiment is another channel that could hurt growth.

			Base case: 65% probability	Bear case: 25% probability	Worse case: 10% probability
	Metric	Current level	Limited escalation but diplomatic resolution	Moderate Russian incursion and limited occupation of Ukraine	Acute Russian invasion and prolonged occupation of Ukraine
1	5 year CDS spread	207bp	155bp	279bp	380bp
	Up/Downside		-25%	+35%	+80%
2	USD/RUB	77.5	73.0	85.0	95.0
	Up/Downside		+5.8%	-9.7%	-22.6%
3	Inflation	8.4% y/y	7.6% y/y	10.1% y/y	21.8% y/y
	Up/Downside		-9.5%	+20.2%	+159.2%
4	Benchmark rate	8.50%	8.50%	9.50%	12.00%
	Up/Downside		0bp	100bp	350bp
5	MSCI Russia index	668.8	768	534	315
	Up/Downside		+14.8%	-20.2%	-52.9%
6	Real GDP growth	3.2% y/y	2.9%	1.4%	-3.6%
	Up/Downside		-0.3%	-1.6%	-6.8%
7	EU Gas (EUR/MWh)	EUR78.9/MWh	EUR43.4/MWh	EUR102.7/MWh	EUR173.8/MWh
	Up/Downside		-55%	+30%	+120%
8	Brent crude (USD/b)	USD87.9/b	USD83.5/b	USD94.9/b	USD122.6/b
	Up/Downside		-5.0%	+8.0%	+39.5%

Source: Bloomberg, CBR, Russian Federal Statistics Service (FSS), MUFG Research

Policy options from the Central Bank of Russia (CBR)

The Central Bank of Russia's (CBR) operational policy framework is orthodox yet flexible. We consider that the CBR would not remain inactive in the event of our base case not transpiring. There are two immediate tools at the CBR's disposal, one of which has materialised today (24 January):

1. Suspension of FX purchases. The CBR is currently purchasing about USD500m per day within the framework of its fiscal rule – aimed at reducing the economy's exposure to fluctuations in oil and gas prices. During trading hours today (24 January), it said it is halting these purchases in a bid to reduce financial market volatility in Russian risk assets. To put this into context, the CBR suspended its FX purchases of USD250m per day in September 2018 so as to not add to the precipitous depreciation of the currency. Apprehensions of US sanctions at the time weighed markedly on broader Russian risk assets. Moreover, during the height of the initial draconian COVID-19 mobility restrictions in March 2020, the CBR reversed its policy and started to sell USD. Fast forward to now, the latest pause comes amid mounting geopolitical tensions and it is evident that the CBR does not want regular FX purchases linked to the budget rule to be an added dynamic source of selling pressure on the currency.
2. More aggressive interest rate hikes. The CBR is already in a tightening cycle – hiking by 425bp thus far since early 2021 to 8.50% – and intends to push the level of real rates firmly into positive territory. Having a policy rate above the neutral range of 1-2% in real terms is a core CBR strategy, in our view. The risk of acute pressure on Russian risk assets and the currency could lead to a more challenging inflation outlook which could warrant even more aggressive policy action. Whilst the CBR has not advocated a double-digit policy rate does not foresee (for now) a double-digit policy rate, its perspectives could change if the geopolitical situation were to deteriorate and increase inflation risks (see table in the *global markets implications of scenarios section* above).

FX implications

The RUB has already moved along way to price in a higher geopolitical risk premium. USD/RUB has just risen back above the 78.000-level for the first time since April, and reached the highest level since the November 2020 when it peaked at 80.954. It marks a sharp turnaround for the RUB in recent months after USD/RUB it hit an intra-day low of 69.220 on 26th October 2021. Up until that point the RUB had been the best performing EM currency in 2021 supported by the higher price of oil and inflation fighting credibility of the CBR who had raised rates aggressively boosting the RUB's carry appeal. In recent months though the RUB has significantly underperformed other EM currencies. After USD/RUB put in place the low on 26th October, only the TRY (-29% vs. USD) has declined more sharply than the RUB (-11%). In contrast other popular EM carry currencies such as the ZAR (-2.5%) and MXN (-1.5%) have declined much more modestly than the RUB. Heightened geopolitical uncertainty has also lifted USD/RUB volatility back up to its highest level since November 2020 undermining the RUB's carry appeal.

We see three main potential outcomes for RUB performance going forward:

1. Limited escalation but diplomatic resolution (probability: 65%). In our base case scenario, the geopolitical risk premium currently priced into the RUB would gradually be pared back. It would allow the undervalued RUB to rebound. We would expect USD/RUB to initially fall back towards last year's

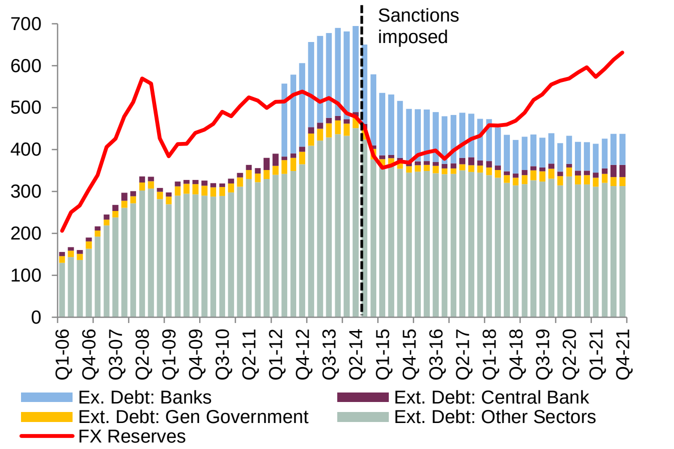
average of around USD73.700 before falling closer to the USD70.000 later in the year supported by our forecast for the price of oil to end the year above USD90/barrel. Tight global liquidity conditions are though creating a more challenging backdrop for risk assets this year and could dampen a rebuilding of carry demand for the RUB.

2. Moderate Russian incursion and limited occupation of Ukraine (probability: 25%). In the moderate escalation scenario, we would expect the RUB to weaken further even after recent losses. Looking back at price action in 2018 when sanctions on Russia were imposed in April and August. On both occasions USD/RUB initially rose by around 10% although the RUB partially reversed losses later in 2018. Assuming that Russia avoids the most disruptive form of sanctions, we see further upside potential for USD/RUB under this scenario of between 5%-10% which could take the pair closer to or above the record high from January 2016 at 85.957.
3. Acute Russian invasion and prolonged occupation of Ukraine (probability: 10%). In the more severe sanction scenario, the RUB could weaken even more sharply to new record lows. Our best guesstimate is that USD/RUB could rise by between 20-30% although we would not be surprised if RUB weakness proved even greater.

In the two escalation scenarios above, we would expect wider negative spill-over effects to other FX markets as well. Over the past week there are already signs that other regional currencies such as the HUF and PLN are starting to underperform given their close proximity. The negative spill-over effects could further boost the relative appeal of the USD relative to the EUR. The euro-zone economy would be more at risk from geopolitical tensions exacerbating the energy price shock given greater reliance on Russian energy supplies.

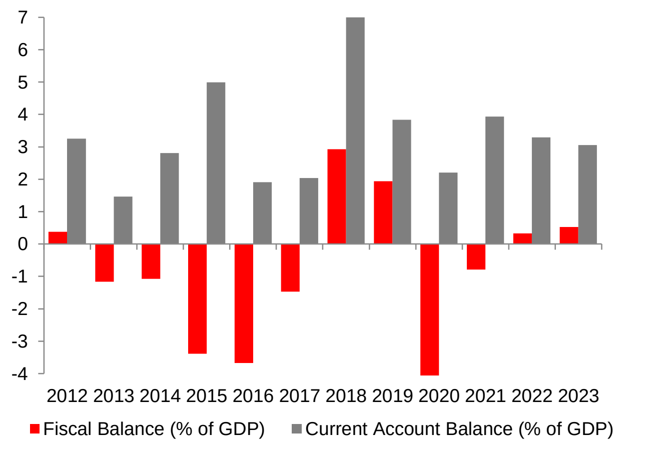
RUSSIA'S MACRO IS AT ITS STRONGEST WITH FX RESERVES EXCEEDING TOTAL EXTERNAL DEBT

RUSSIA FX RESERVES AND TOTAL EXTERNAL DEBT (USD BN)



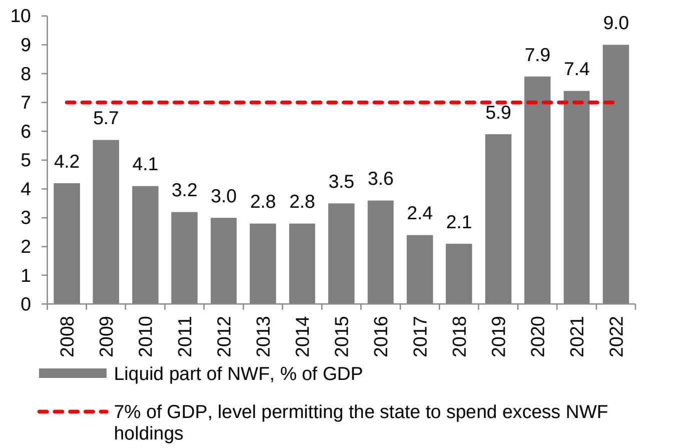
RUSSIA ENJOYS A TWIN FISCAL AND CURRENT ACCOUNT SURPLUS, REDUCING FUNDING NEEDS

RUSSIA FISCAL BALANCE AND CURRENT ACCOUNT BALANCE (% GDP)



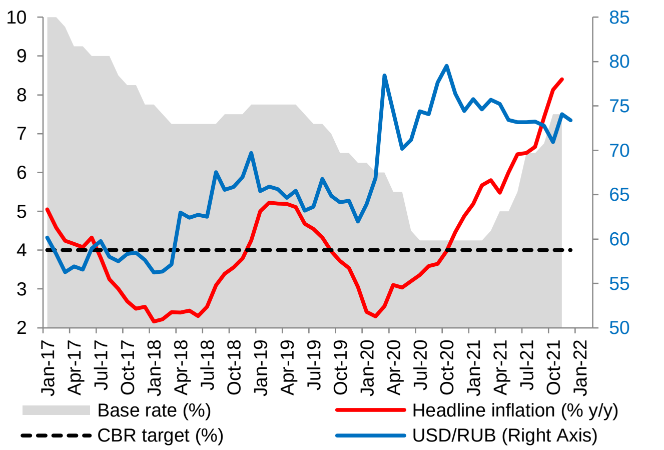
LIQUID PART OF THE SWF REMAINS NORTH OF 7% OF GDP – PERMITTING THE STATE TO SPEND THE EXCESS

RUSSIA LIQUID PORTION OF THE NATIONAL WEALTH FUND (% GDP)



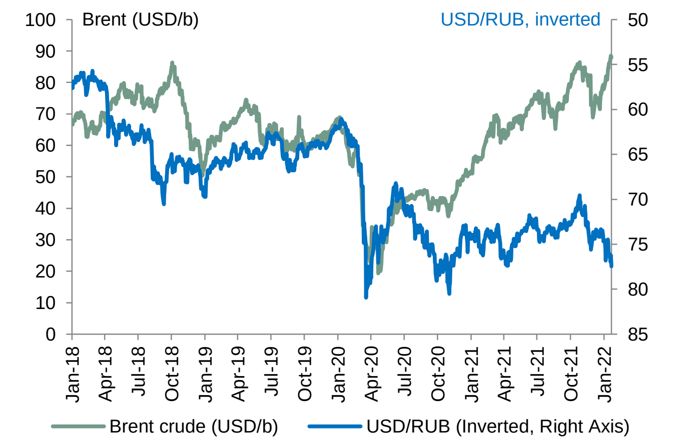
SURGE IN GEOPOLITICAL RISK CAN TURN THE CBR SIGNIFICANTLY MORE HAWKISH NEAR-TERM

RUSSIA KEY RATE (%), CBR TARGET (%), INFLATION (% Y/Y), USD/RUB



RUB SOLD OFF DESPITE A POWERFUL BULL OIL MARKET – HIGHLIGHTING THE GEOPOLITICAL RISK PREMIA

USD/RUB AND BRENT CRUDE (USD/B)



CDS SPREADS HAVE SURPASSED THE COVID-19 PEAK OF MARCH 2020 BUT BELOW THE 2015 CRIMEA EPISODE

RUSSIA 5 YEAR CDS SPREADS (BASIS POINTS)

Source: Bloomberg, Russian FSS, MUFG Research

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