

Russian and Argentinian Woes

The recent escalation of Russian sanctions and Argentinean bond default could be a blow to these markets, but the risks of contagion to other Emerging Markets appear limited

Russia and Argentina both hit the headlines this past week. Argentina defaulted on its sovereign debt on 30 July. Just prior to this, the European Union launched a host of tougher sanctions on Russia, prompted by the downing of the Malaysian airplane MH17, allegedly by pro-Russian separatists. These developments are set to unsettle Emerging Market investors in the near term, but are not expected to have a lasting impact on the Global Emerging Market sector.

The reasons for this are multiple. In the case of Argentina, the country has been locked out of the international capital markets since its previous default in 2001. Indeed, this week's "selective default" is the result of the failure by the government and holdout creditors of the 2001 defaulted bonds to strike a deal. Since its default in 2001, Argentina's weight in the Emerging Market (EM) debt indices dropped to just 1.7%, roughly half its index weight in 2006. Going forward, while the default suggests that borrowing costs could rise for the country and weigh on the economy, the contagion impact on the Emerging Market Debt universe is likely to be contained, especially relative to its 2001 default.

Over in Russia, following the first set of (limited) sanctions in March, the US announced further sanctions on July 16, banning Rosneft, Novatek, VEB and Gazprombank from raising financing of more than 90 days from US persons or within the US. Eight defence companies and a port in Crimea also had their assets frozen and all transactions with US persons were banned. These measures have been matched by the European Union, and include the closing of European capital markets to Russian state banks, and an embargo on new weapons sales and the transfer of sophisticated oil drilling technology.

While the immediate impact on the affected entities is expected to be contained, given the relatively low level of debt repayments this year, sustained sanctions will likely have a significant adverse impact as Russian companies struggle to get financing for longer term major investment projects. These tighter financing conditions will exacerbate the already substantial decline in investment.

Overall, although systemically important corporations are likely to receive government assistance, Europe's actions will likely weigh heavily on the wider Russian economy. Sanction pressures do not bode well for an economy already in the midst of a mild recession. In our May publication, we had highlighted the strains under which the country was struggling, including sizeable capital outflows and weak consumer/business confidence levels. Last week, despite the economy's weak growth, the Russian central bank was forced to raise interest rates by 50 basis points to 8%, in order to support the weak rouble and quell inflation.

Against this backdrop, we maintain our cautionary stance on Russian assets. Investors holding sanctioned assets will have to grapple with both higher price volatility and reduced liquidity. Meanwhile, tougher sanctions cannot be ruled out as long as progress in stabilising Eastern Ukraine remains lacking and evidence of Russian support to the rebels grows.

However, we do not expect Russia's problems to spill over into the other EM markets. In particular, we continue to favour Asia within EM, on the belief that its fundamentals will continue to improve on the back of the improving global growth backdrop.

Market Flash

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