Renaissance Capital

Navigating through the Great Unknown

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25 YEARS LEADING IN EMERGING FRONTIERS

INVESTMENT BANK OF THE YEAR
FOR EMERGING MARKETS IN EUROPE
by The Banker magazine's
annual Investment Banking Awards, 2020

BEST INVESTMENT BANK
IN FRONTIER MARKETS
by Global Finance magazine, 2018

Russian Eurobonds – the Endangered Species

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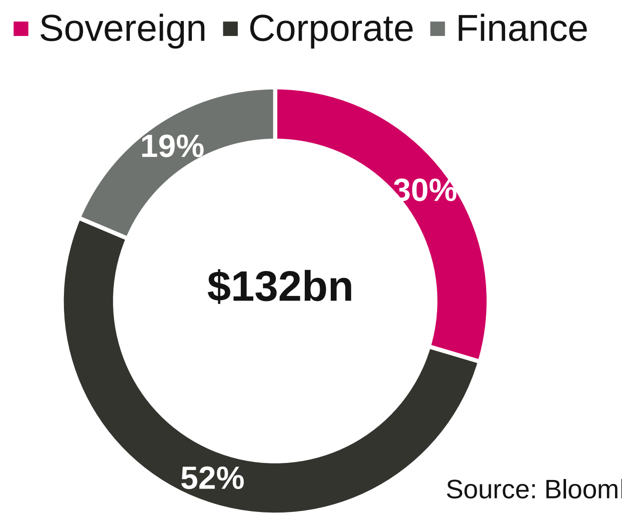
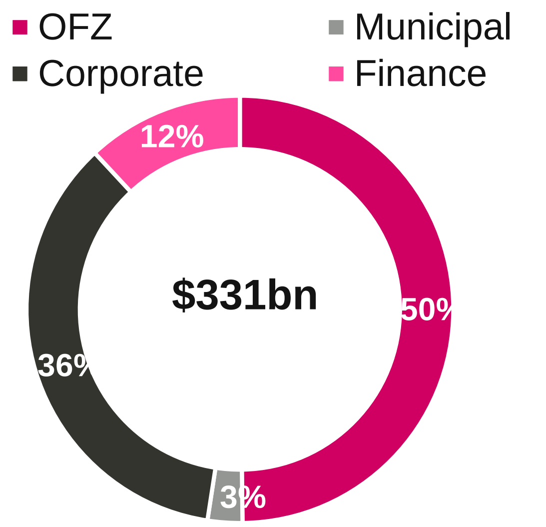
- The volume of RU Eurobonds has been constantly declining for the past 5 years, shrinking by around 35% vs 2017 to **$132bn.**
- The volume of local ruble-denominated bonds in contrast has been on the rise since 2016 as the sanctioned corporate borrowers (such as Rosneft, Gazprom Neft, state-owned banks) were switching from the international to the local debt market.
- Now, the local debt market's volume exceeds **$330bn** (which is almost three times as big as the RU Eurobonds market).
- Any further squeeze of the RU Eurobonds market, which currently looks unavoidable, is affordable given its modest size.

Chart 1: RU Eurobonds market structure



Source: Bloomberg

Chart 2: Local debt market structure

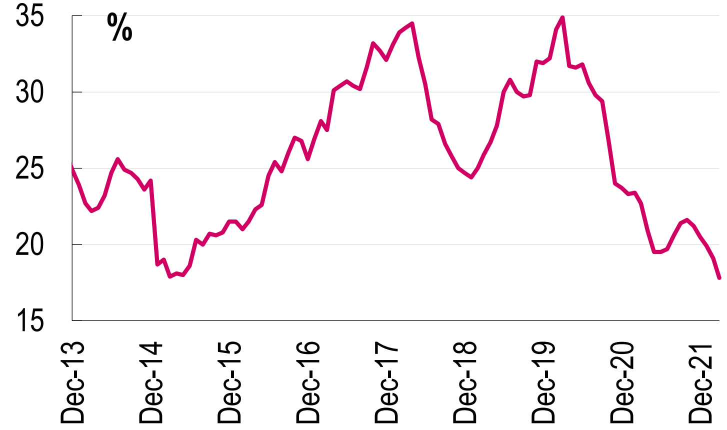


Source: Bloomberg

Local investors – core investment base on Russian debt market

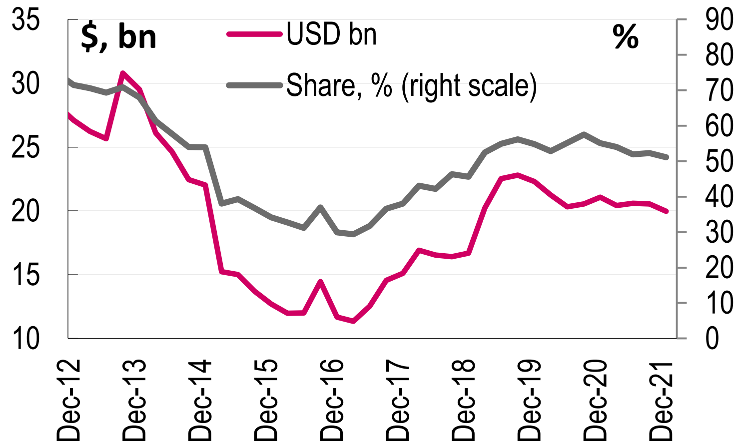
- As of March 1, the share of foreign investors in the OFZ market declined to **17.8%** (its lowest since March 2015).
- Russian Finance Ministry's OFZ auctions have been put on hold since late February.
- Trading in OFZ on MOEX was resumed on March 21, but it didn't cause strong selling pressure as foreign holders still cannot participate (OFZ yields hover around 13-17%).
- As of late 2021 foreign investments in RU Sovereign Eurobonds stood at **$20bn** (making up 51% of the market). These bonds are still tradable via Euroclear and their prices have so far collapsed to 15-25% below par. Concerns with regard to Russia Sovereign default remain in place despite successful coupon repayments.
- As for the corporate Eurobonds, any current problems in servicing this debt are caused by sanctions rather than the companies' insolvency. However, these issues and concerns have not deflected interest from local investors for high-quality corporate Eurobonds given their attractive yields of above 30% (e.g. NorNickel).

Chart 3: Foreign investors share in OFZ market



Source: Bloomberg

Chart 4: Foreign investors share in Russian Sovereign Eurobonds



Source: Bloomberg

CIS+ Eurobonds Under Pressure

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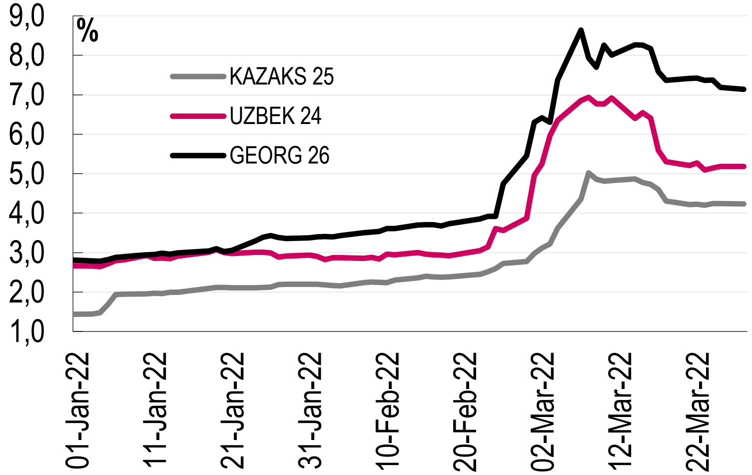
- Strong correlation between the Russian and CIS+ Eurobonds highlights the fact that for many investors the CIS+ credit risk is still linked with Russia. Sovereign Eurobonds of Kazakhstan, Uzbekistan, and Georgia have experienced massive sell-off, thought these countries are not involved in the current conflict.
- Modest price recovery in late March indicates some decrease of fears, though yields remain elevated if compared to the debt of other EM countries with comparable credit rating (Indonesia, Brazil) – current yield premiums amount to 100-200 bps.
- The hike in commodity prices is supportive for some CIS+ economies (Kazakhstan, Uzbekistan) due to a high share of commodities (oil, gas, metals, soft commodities) in their exports.
- Most of CIS countries have accumulated sufficient reserves and don't depend on financing from Russia (excl. Belarus), and they don't have to face big external debt repayments in 2022-2023.
- We highlight AGARVI 26 Eurobond, issued by the Moldovan cooking oil producer and grain trader Trans-Oil (-/B-/B). The military operation in neighboring Ukraine has driven this bond's yield to 15%. The issuer is supposed to benefit from the recent spike in soft-commodity prices while high yield protects investors from increasing market risks.

Chart 5: CIS Sov Eurobonds yield



Source: Bloomberg

Chart 6: ARAGVI 26 Price Chart

Source: Bloomberg

Global bonds under pressure as risk appetite subsides

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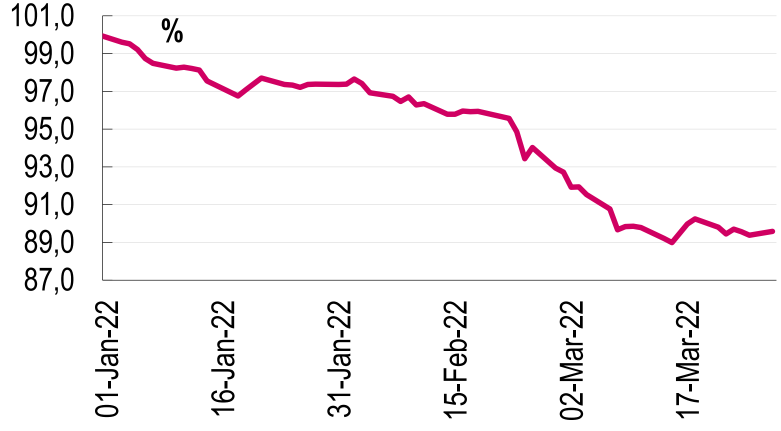
- Accelerating inflation in US and the economic growth slowdown increase the recession risks. UST 10 yield have reached 2.5% while the inversions along the US Treasuries curve indicate the market's concerns about a looming economic downturn
- Since early January 2022 fixed income instruments have become far less attractive for market participants than equity as investors seek to protect their portfolios from inflation. Bond indexes have posted sizable losses YTD and we don't expect a rebound in the near-term as the US Fed has just recently begun to tighten its monetary policy
- Barclays US Corp HY Index (which reflects an average yield premium of US HY bonds over UST 10) has been on the rise since January and have moved above 3.5% while UST 10 yield has also been on the rise. The growing cost of funding for HY US corporates is a bad sign – it means that default risks are increasing.
- Recent data indicate that the consumer sentiment is falling both in US and EU, whereas the new COVID restrictions in China add to the concerns about post-covid recovery
- Global market conditions indicate rising risks of stagflation which is hard to ignore, so, risk-off mood is likely to prevail

Chart 7: EM USD Aggregate Total Return Index



Source: Bloomberg

Chart 8: BarCap US Corp HY YTW - UST10 spread

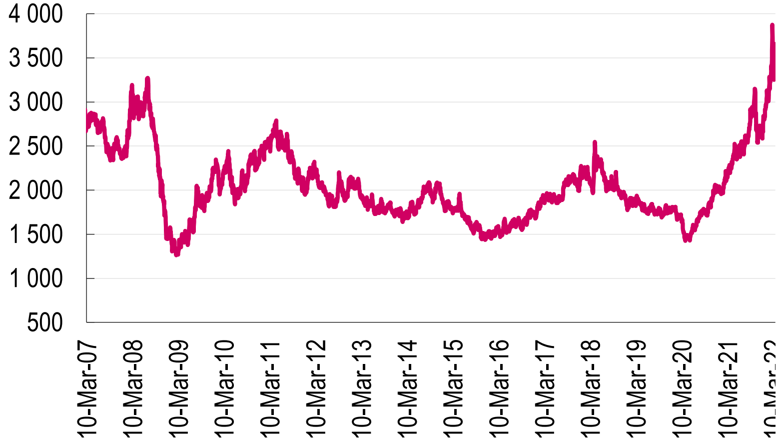
Source: Bloomberg

Commodities prices hike adds to the inflation risks increase

Chart 9: Brent

Source: Bloomberg

Chart 11: Aluminium

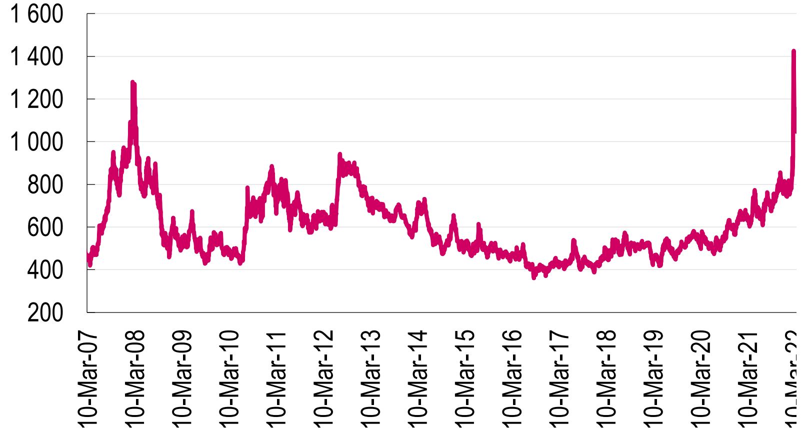


Source: Bloomberg

Chart 10: Zinc

Source: Bloomberg

Chart 12: Wheat



Source: Bloomberg

KEY TAKEAWAYS

- Russian debt market remains a black box due to its political exposure. Still, massive defaults due to issuers' insolvency in the near future are unlikely.
- Going forward, Russian borrowers will have to concentrate on the local debt market. Withdrawal of the international credit ratings by the major global providers have become an additional restriction for the Russian corporates eyeing to tap the international public debt market.
- Progress in negotiations between Russia and Ukraine (if at least they manage to agree on a ceasefire) can be positively viewed by the global markets. However, any rebound (if any) is likely to be short-lived as the accelerating inflation in US combined with the economic growth slowdown will bring global recession risks high on the agenda.
- Certain CIS+ sovereign and corporate Eurobonds (Kazakhstan, Uzbekistan, Georgia) look relatively attractive as the currently wide spreads should be viewed as a hedge against any further sentiment downturn, whereas the issuers' credit quality is acceptable.
- Overall, we expect the risk-off mood to persist in the next 2-3 months and believe that further deterioration is probably more likely than substantial improvement. So, we view building up one's positions in bonds at the moment as a rather risky exercise. At the same time, we think it would be reasonable and cost-effective to hedge one's current positions via CDS (Mexican, Brazilian and Indonesian CSD-spreads are still narrow).

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