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Russian rou(b)lette: The risk of another debt default in Russia

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Executive Summary

- The collapse in oil prices and the rouble mirrors the events of 1998, which resulted in the Russian government's defaulting on its domestic and external debt.
- In contrast to 1998, however, the Russian government has significantly larger foreign currency reserves today and is not as dependent on foreign capital.
- Valuations for Russian equities have fallen and fixed-income spreads have widened. We caution against moving into the equity market, but debt yields appear attractive despite the heightened risk.

1998

On August 17, 1998, following months of speculative attacks on its currency, Russia devalued the ruble, defaulted on its domestic debt, and declared a moratorium on payments by commercial banks to foreign creditors. The default led to a 4.9% collapse in GDP that year, but the consequences spread beyond Russia's borders. Emerging-market equities — already weakened by the Asian financial crisis — fell a further 18%, and spreads on the J.P. Morgan Emerging Market Bond Index (EMBI) leapt to over 1,400 basis points (bps).

The recent collapse in the rouble has raised worries of contagion and a broader selloff in emerging-market assets, and even of another debt default either by the government or by Russian companies. There are several parallels between the events of 1998 and today, most notably the fall in oil prices. Revenue from oil exports accounts for a meaningful part of the Russian government's budget. The nearly 50% plunge in oil prices since June of this year will significantly crimp government spending if the drop is sustained. Oil prices also fell by nearly half in 1998, from $25 per barrel to $12 (see Figure 1).

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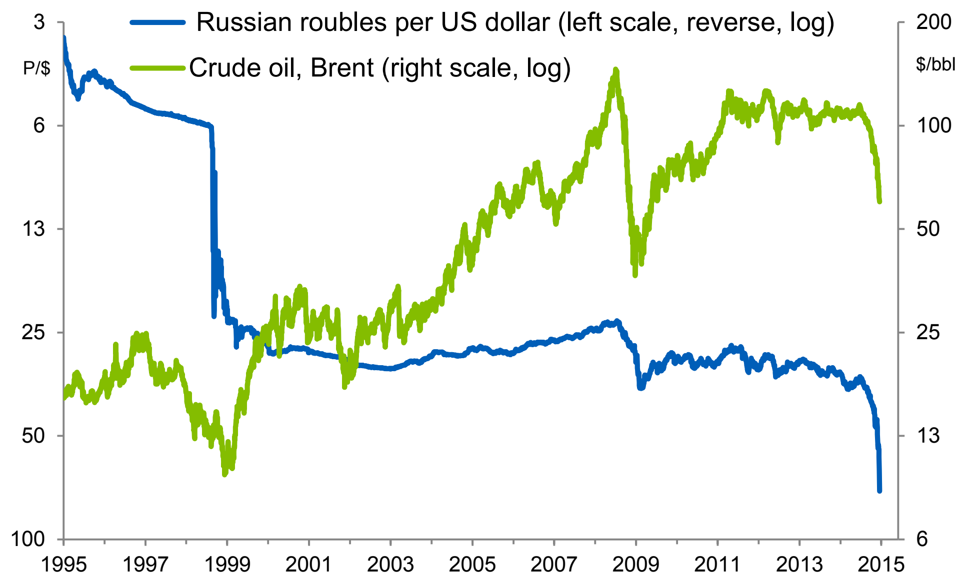
Figure 1: Rouble exchange rate and oil price



Last data December 19, 2014. Sources: FactSet, TIAA-CREF Asset Management.

Investor confidence in Russia was low in 1998, as it is today.

The confidence of Western investors and international agencies in the Russian government was low in 1998, as it is today. Though the International Monetary Fund and the World Bank crafted a rescue package for the government, President Boris Yeltsin's dismissal of his entire government in March of that year, and the Duma's failure to pass adequate tax legislation, caused many to doubt the ability of the government to manage the crisis.

2014

There are enough differences, however, between 1998 and 2014 to suggest that the current crisis in Russia will not have equally negative consequences this time.

A key difference is that in 1998 the government was trying to defend an exchange-rate peg. The Asian financial crisis had already led to the collapse of the Indonesian rupiah, South Korean won, and Thai baht, and investors were betting heavily that the rouble would follow suit. The government's defenses against the attack were weak, as it had foreign exchange reserves of only $18 billion, compared to over $400 billion today (and external debt obligations currently of approximately $100 billion).

The Russian central bank has maintained a managed floating exchange rate regime since 2010, meant to allow the value of the currency to adjust to changes in macroeconomic fundamentals without excess volatility. The dramatic fall in oil prices this year forced the Bank of Russia to abandon the policy last month, meaning further attacks on the currency are unlikely.

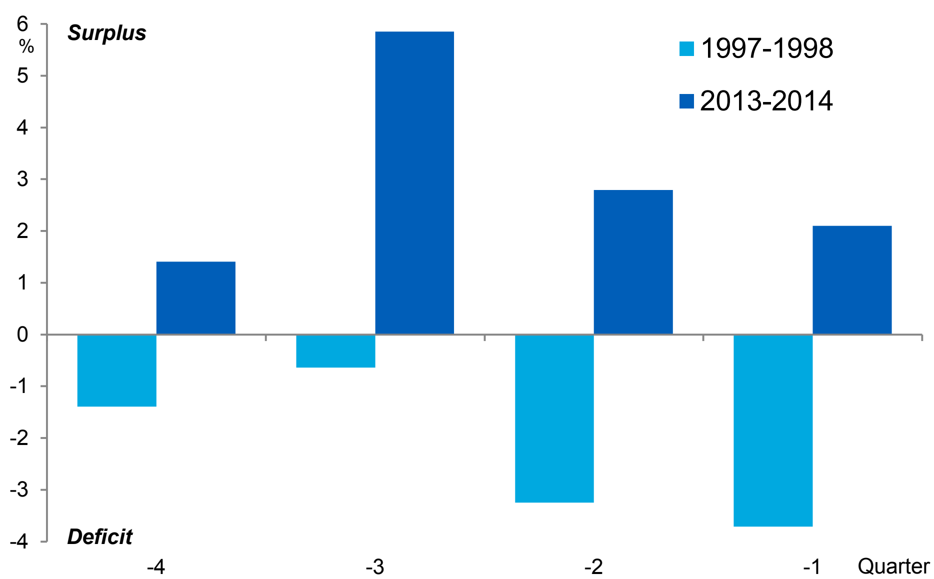
In 1998, the government of Russia had also been running large budget deficits for years and so was dependent on foreign investment to plug the gap. As expectations for a depreciation and default rose, neither domestic investors nor foreigners were willing to purchase Russian debt, despite interest rates that rose to 150%. The increase actually made investors less willing to purchase debt as the interest rate was clearly unsustainable. The government needed to refinance large amounts of debt in the latter part of 1998 but would clearly be unable to at the then-current exchange rate.

The sharp hike in interest rates to 150% in 1998 actually speeded the demise of the currency peg.

Today, the financial position of the government is much better. There is little external government debt maturing over the next year. The country has had small budget deficits over the last several years and is running a current account surplus. Though lower oil revenues will shrink the surplus in the future, the government will not have to finance itself abroad (see Figure 2).

Figure 2: Current account balance prior to crisis: 1998, 2014

Percent of GDP



Last data September 2014. Sources: Oxford Economics, TIAA-CREF Asset Management.

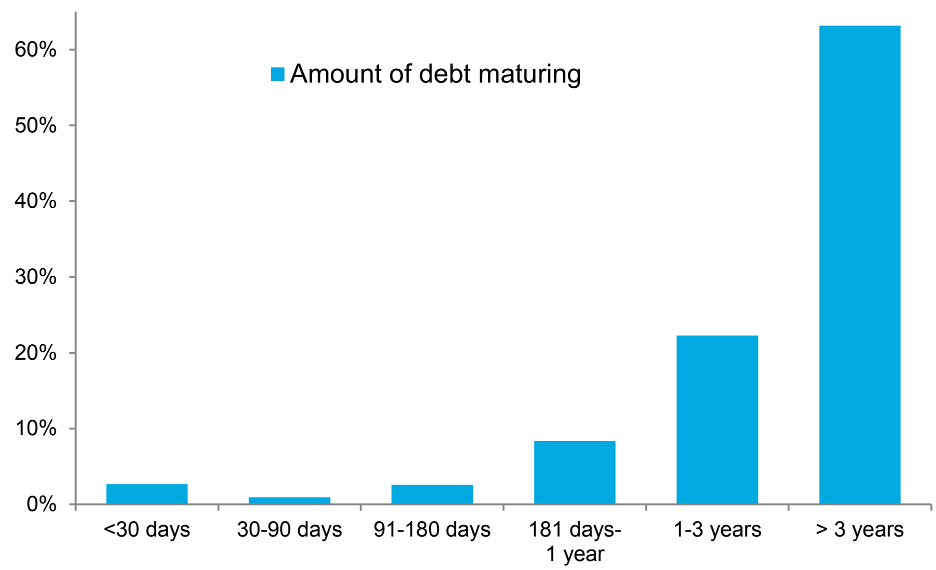
While there are bonds maturing in 2015 that many Russian corporates would be unable to refinance in public markets under current circumstances, we anticipate most will be able to meet redemptions and find other sources of funding. One company with a large amount of debt falling due, Gazprom, likely has recourse to the resources of the Russian state and had $28 billion in cash on its last published balance sheet, compared to bond redemptions in 2015 of approximately $3.9 billion (and total short-term debt maturities of $8.7 billion).

Even counting all foreign currency loans, a large majority do not mature for more than three years (see Figure 3). Raising money on the domestic market in roubles will, nonetheless, be more expensive. The Bank of Russia has raised its benchmark rate from 10.5% to 17%, which if sustained is likely to lead to an increase in corporate defaults.

One factor that is substantially worse today for Russia is that thanks to sanctions imposed by the U.S. and European Union following Russia's annexation of Crimea and continued involvement in Ukraine, Russia is largely cut off from Western sources of funding. Whether this will ultimately lead to a change in Russia's politics is one of the biggest uncertainties in the current situation.

Low multiples on the Russian equity market are deceptive, as analysts have yet to mark down earnings.

Figure 3: Foreign currency loan maturity schedule



Last data September 2014. Sources: Central Bank of the Russian Federation, TIAA-CREF Asset Management.

Time to buy?

We anticipate the collapse in oil prices, depreciation of the rouble, and increase in inflation will to lead to a deep recession in Russia in 2015 compared to expectations of 3% GDP growth that economists forecasted at the beginning of the year. We do not, however, expect a default on the country's debt or significant contagion to other emerging-market countries (with the possible exception of other oil exporters) as the EM debt market is much broader than it was in 1998.

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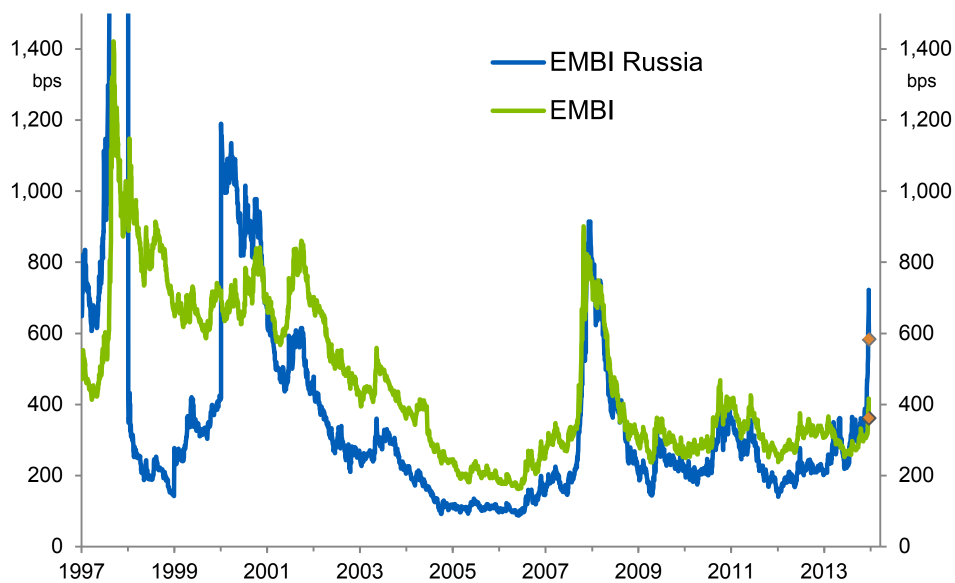
Have the dramatic falls in the value of Russian assets been enough to make them attractive? The equity market has tumbled about 50% since June, but this is much less than the 94% decline following the 1998 devaluation or the 79% fall in 2008. Forward multiples on the MSCI Russia index have dropped to just 3.4x, but this understates the P/E ratio as analysts have yet to revise down their earnings expectations. The current multiple is also not as low as the level reached in 1998 (2.5x) or 2008 (2.8x).

Much depends on the outlook for oil prices. The Russian equity market is dominated by the energy sector, which accounts for 58% of the value of the MSCI Russia Index. The current price for Brent of approximately $60/barrel is near the average of 2005-2006, before the dramatic run-up and collapse in prices around the global financial crisis. While we anticipate oil prices will begin moving higher again in 2015, there is still too much uncertainty about Russia's macroeconomic outlook to warrant an overweight in the equity market.

Fixed-income spreads, on the other hand, are now so wide they appear attractive despite the increased risk to revenues for both the government and corporate issuers. Yields on local currency debt have moved even higher. If the currency's depreciation has largely run its course, U.S.-based investors should reap most of the reward from the high yields. And since oil is priced in dollars, issuers in the oil and gas sector have a natural hedge against the currency, meaning they should not face undue difficulties making payments on their outstanding debt.

While the country is almost certainly going to fall into a recession next year, there are still opportunities in some Russian assets.

Figure 4: Emerging-market debt spreads



Last data December 18, 2014. Note: Index is EMBI Global Diversified. Sources: J.P. Morgan, TIAA-CREF Asset Management.

Conclusion

There are uncomfortable parallels between the events of 1998 and today, but emerging-market countries have learned the lessons of the Asian financial crisis and built up substantial foreign exchange reserves to tide them through periods of investor aversion. Russia has a significant buffer of reserves and is also not as dependent on foreign capital as it was during the previous crisis. While the country is almost certain to fall into a recession next year, there are still opportunities in some Russian assets.

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