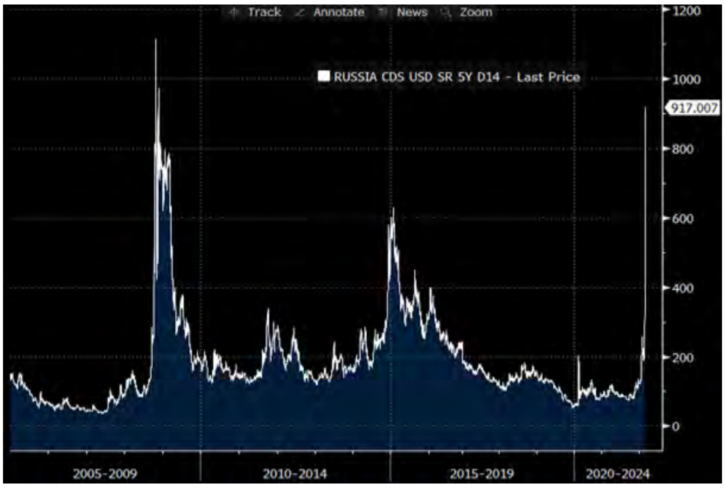
# Russia - Ukraine crisis

On February 24, 2022, Russian military troops entered Ukraine.

This invasion has caused a wave of panic on all financial markets and particularly on the Russian market, which lost 38% in dollar terms, with the RUB losing 6.6% during the day. The price of oil gained 7% and approached $105 during the day, while the price of gas rose 40% during the day.
The level of CDS spreads exceeded that of 2014 and approached the 2008 level:




The GemEquity fund was negatively affected but outperformed its index on the day. In € terms, the fund lost around 2% over the session of 02/24/2022, of which 0.4% was explained by the exposure to Russia. The index corrected by about 3% while the S&P, after a spectacular rebound, ended the session at +1.5% in $.

> In fact, since October we had reduced our exposure to Russia (from 6% to 2.5% at the end of January). After yesterday sharp correction, **our exposure stands at 2.2%, concentrated on two energy cpmpanies, Novatek (gas) and Lukoil (oil). We are not exposed to Eastern Europe, which has been heavily affected by the prevailing uncertainty. Recently, we increased the weight of Saudi Arabia to 1.6% of the fund (stock exchange Saudi Tadawul and oil company Aramco). We also invested in Thai oil and gas company PTTEP (1.1% of the fund).** These stocks are benefiting from the recovery of oil price.

**Our Russian stocks:**

**Unlike Gazprom and Rosneft, both Novatek and Lukoil are not owned by the Russian state and their corporate governance is far superior.**

Gennady Timchenko and Leonid Mikhelson own 23% and 24.7% of Novatek's capital respectively. They have both been under US sanctions since the annexation of Crimea in 2014 and have reduced their weight in Novatek since then. This has not affected the company's operations. In particular, they have allowed TotalEnergies to increase its weight from 11% to 19.2% in 2018. Apart from being a direct shareholder in Novatek since 2011, TotalEnergies is also a shareholder in the JV specializing in the gas project in the Arctic (with Chinese CNPC).
The oil company Lukoil is 28% owned by Vaguit Alekperov, who is not considered close to the Kremlin. He is not under sanctions.

**The western sanctions:**
On Thursday 24 and Friday 25 February President Joe Biden and British Prime Minister Boris Johnson announced a new series of sanctions:

### 1. Financial sanctions:
2nd largest Russian bank VTB, close to the government and the main financing source for state-owned enterprises, is cut off from the Western system. Other smaller banks are also sanctioned. Sberbank (largest bank of the country) remains for the moment spared except for its accounts of entities under sanctions (individuals and companies). Biden does not plan to cut Russia off from SWIFT for the moment because this will primarily affect its commercial partners (sales of raw materials). In addition, it is important to note that since 2014 Russia has developed a proprietary NPCS system, which it can activate at any time on Russian soil and the government says that many of its foreign partners are ready to switch to the new system.

### 2. Sanctions on individuals and companies
A new list of individuals and companies considered to be close to the regime are subject to sanctions (asset freeze, travel ban, etc.). Our portfolio is not affected. Sanctioning Vladimir Putin remains an option.

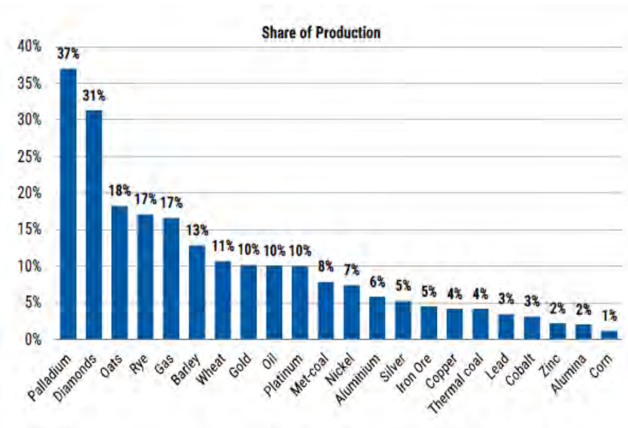
### 3. Export control
The US, UK, EU and Japan are adding Russia to the blacklist of critical aviation, defense and maritime technology exports. Equipment for upgrading refineries is also on the table.

Nordstream 2 pipeline: for the time being, the certification of the gas pipeline connecting Russia to Germany has been suspended. This pipeline was planned to compensate for the end of the contract with Ukraine scheduled for 2024 and possibly an increase in gas supply. The suspension of NS2 approval does not prevent Russia from supplying the same volume of gas to Europe as in 2021.

Russian sanctions have not yet been announced, but should not be far in the future. For the moment only the Russian sky has been closed to British airlines, in response to the sanctions on Russian airline Aeroflot by Boris Johnson.

**What's next ?**

**1. Commodities:** Joe Biden made it clear in his speech yesterday that the American consumer should not pay for what is happening in Ukraine. This is also the opinion of the Europeans. In fact, Russia is an important partner (see graph below) and in a tough pricing environment, the risk of inflation is likely to be exacerbated. In terms of gas, by the summer, Europe will have to purchase gas for next winter. Current stocks are low. Higher inflation risks plunging the western world into recession and history repeats in many countries in the years to come. So the question is: how long will this conflict last and what impact will it have on inflation? Russia is aware of its place in the global business world and may respond to Western sanctions by reducing gas exports to Europe. However, gas destined for Europe cannot be redirected elsewhere on a massive scale due to the lack of infrastructure. The gas pipeline from Russia to China is gradually being built up by 2025, but the volumes currently delivered are still low.




**Russia's importance in commodities**

**2. What's next for Ukraine?**

In his speech on February 22, 2022, the day before the Day of the Defender of the Fatherland (February 23), Vladimir Putin spoke at length about the history that links Ukraine to Russia and the union of the two peoples. The current Ukrainian government's desire to join NATO and nationalistic rhetorics are contrary to Mr. Putin's agenda. The overthrow of power in Ukraine and the establishment of a corridor of control with access to the Black Sea are to be considered (see map below).

Russian Invasion Of Ukraine 2022


SOURCE: EVAN CENTANNI AND DJORDJE DJUKIC, WWW.POLGEONOW.COM. © BCA Research 2022

Moreover, a military intervention of Western troops on Ukrainian territory has been officially ruled out by Western leaders for the time being. However, NATO has announced that it will deploy additional defensive military forces in member countries bordering Ukraine and Russia (Poland, Hungary, etc.). In this context, a Russian military intervention in the countries of the former Soviet bloc (west of Ukraine) appears to be extremely unlikely.

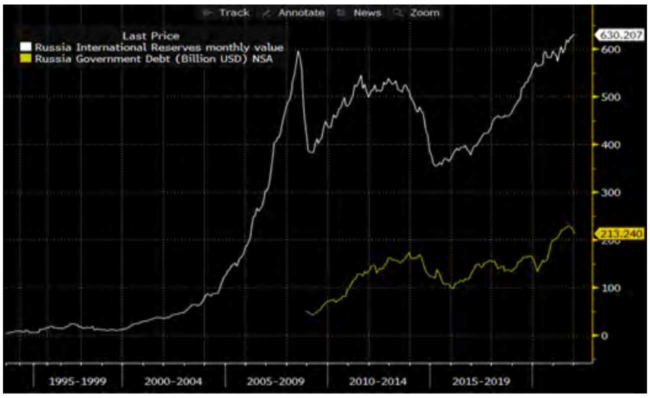
**3. What's next for financial markets?**

Geopolitical risk has now significantly increased. The Ukrainian conflict is likely to create volatility in the coming weeks and the evolution of commodity prices will affect the monetary decisions of world central banks. In the Far East, what about the fate of Taiwan? There are lots of talks about China potentially taking action to " reclaim " Taiwan. We do not think this is an immediate priority. Beijing is pursuing its own agenda and domestic issues in a slowing economy are the current priority. Nevertheless, medium/long-term actions in the Taiwan Straits cannot be ruled out.

## RUSSIAN DEBT

With reserves of $630bn at the end of January and positive current and fiscal balances, Russia's financial capacity to service its debt is not in question.
The government's total public debt at the end of January was $213bn (18% of GDP), of which $63.6bn was denominated in international currencies (89% in USD and 11% in EUR).

**Graph. 1: Evolution of Russia's public debt and international reserve**




However, sanctions could interfere with the country's ability to make timely cross-border payments regardless of Moscow's willingness to meet its debt repayments.

**<u>GemBond positioning</u>:**

Exposures to Russian and Ukrainian sovereign debt denominated in USD were initiated in the fund on January 26 and 27. Following the widening of risk premiums observed on the two countries at the beginning of the year, we cut our under-exposure, while maintaining a relatively cautious position given the still uncertain political context at the time. As of February 23, the fund had a 2.4% exposure to Russia and 1.7% to Ukraine, compared with 2.7% and 1.7% for the index respectively. In addition, the fund had no position in Belarus, Hungary or Poland and moderate exposure to Kazakhstan (1.2% versus 2.5% for the index) and Romania (0.9% versus 1.4% for the index). After the historic correction in Russian (-41.5%) and Ukrainian (-44.6%) bond prices during yesterday's session, the fund's exposure as of February 25 is as follows:

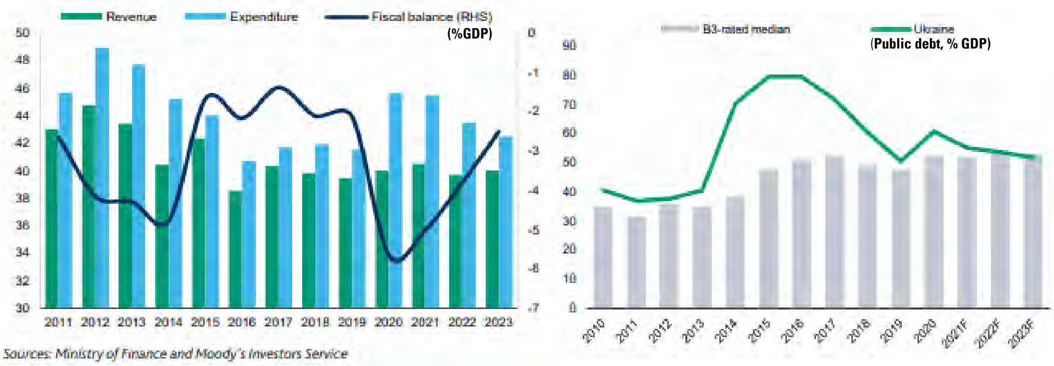
| 25-Feb | Exposure (%) | | | Yield (%) | Spread (bp) |
|---|---|---|---|---|---|
| | GemBond | Index | +/- | Index | Index |
| Russia | 1,36 | 1,62 | -0,26 | 15,90 | 1398 |
| Ukraine | 1,00 | 1,00 | 0,00 | 30,24 | 2848 |

The fund was affected by yesterday's very sharp market decline (-3.11%), with Russian and Ukrainian exposure contributing 100bp and 70bp respectively. Although the fund's absolute performance was very poor over the session, its relatively defensive positioning enabled it to outperform its index by 60bp.

The magnitude of the correction seen in yesterday's session on Russian and Ukrainian international debt seems excessive to us. The spread of risk premiums on Russian bonds (+890bp to 1398bp) was much greater than that on the derivative CDS market (+470bp to 920bp), a sign of a liquidity deficit specific to disrupted markets with indicative price ranges between 10 and 15%.

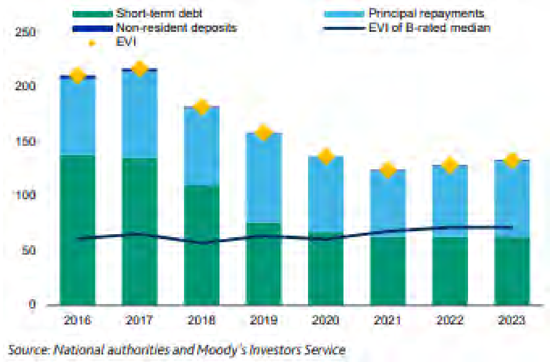
In this context of illiquidity, with valuation levels as of yesterday evening implicitly anticipating a default rate of 23% on Russian debt and 47% on Ukrainian debt, we are maintaining our positions. Apart from a potential technical default, we are confident in the ability and willingness of the Russian government to repay its external private creditors (see chart 1 above). The Ukrainian case is less favorable because although the country's macroeconomic and structural financial situation has improved since 2014 (see chart 2 below), it remains largely dependent on external financing needs (see chart 3). The upcoming developments in Ukraine and the likely change of government will be decisive for the continuation of support from multilateral lenders in particular (IMF) and the updating of our country risk assessment.

**Graph.2 : Primary surpluses associated with a decline in debt between 2014 and 2019**



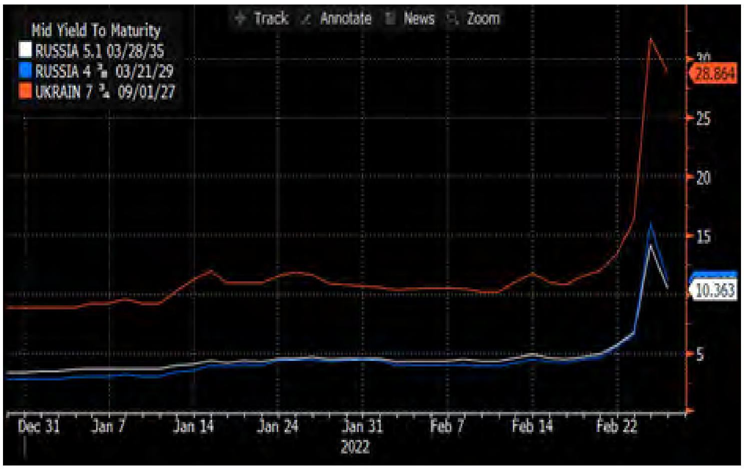

*Sources: Ministry of Finance and Moody's Investors Service*

**Graph.3 : Ukrainian foreign exchange reserves insufficient to meet external financing needs:**




Source: National authorities and Moody's Investors Service

**Evolution of the purchase yields of Russian and Ukrainian bonds held:**




In a still disrupted pricing environment, indicative OTC quotes this morning indicate an easing of risk premiums of around 400bp on Russia (-170bp on CDS) resulting in a 20% rebound in international bond prices. On Ukrainian debt denominated in USD, the easing of the average risk premium is of the order of 250bp, i.e. a rebound in USD bond prices of around 8.5%.

In conclusion, the situation remains extremely tense on the ground. The sharp fall in the markets makes the valuation of Russian assets extremely low, especially in the energy sector. Therefore, at this stage, we do not plan to sell our current positions. The new sanctions announced by President Biden seem "reassuring" in view of the recovery of the US market. It is still too early to conclude on them. Therefore, our positions could change in the coming days/weeks.

In these difficult times, we thank you for your trust and remain at your disposal for any further information.

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