What is happening in Ukraine and Russia?

A long simmering sovereign and geopolitical confrontation moved to the main stage over the last three months, and erupted into full-fledged conflict over the last three weeks. The confrontation turned into a conflict when demonstrators in the Ukraine ousted their president and set up a transitional government. Russia, unhappy with the events in the Ukraine, used force to take control of the Crimean peninsula, which belongs to Ukraine. Western nations are debating how to punish Russia for its transgression. Global financial markets experienced increased volatility because of these events

Background

Previously part of the Soviet Union, Ukraine moved quickly to improve their relationship with the European Union (EU) following the fall of the Berlin Wall and the break-up of the USSR. In 1994 the EU and Ukraine signed a Partnership and Cooperation Agreement. More recently, after years of negotiations following the 2004 "Orange Revolution", Ukraine signed deals on free trade and political association with the EU in 2012. The two sides began serious discussions to ratify these agreements, likely a precursor to joining the western nations and integrating with those economies. Such a union would have many favorable repercussions for Ukraine, including vast new markets, foreign direct investment, and expanded sources of technical and intellectual capital. But, the approach required some short-term pain including fiscal austerity, opening to competition, addressing corruption, freeing political prisoners including the previous President Yulia Tymoshenko, and strengthening the rule of law. Most Ukrainians favored this path.

However, Russia had different plans for Ukraine. Russia, under Vladimir Putin, has embarked on reestablishing the Soviet Union and regaining its geopolitical clout. Crimea had been part of Russia until Khrushchev gave it to Ukraine in 1954 and Russia's large naval port in Sevastopol is currently home to their Black Sea fleet. Sharing centuries of cultural, economic and military interaction and fearing the West's encroachment on its borders, Russia did not want Ukraine to join the EU and began an effort to undermine the EU's overtures by offering financing and a trade union of their own. Russia's significant trade with Ukraine, their control over gas supplies and their support from a large number of ethnic Russians, enabled them to coerce Ukraine's president into abandoning the EU effort. In November 2013 President Yanukovich announced a commercial union with Russia instead of the EU, leading to the demonstrations that culminated in his ouster.

Ukraine – What's next?

Ukraine is a country of abundant resources that has been mismanaged. It is the third largest grain exporter in the world and corn output has increased six fold over the last decade. The Ukraine also possesses over 30% of the world's supply of "black soil", considered the richest soil for agricultural production. It is also one of the world's most significant mineral producing countries with iron ore, mercury, titanium, and nickel. Since the fall of the Soviet Union it has struggled to elect a strong government and build a robust economic infrastructure. A deficit of energy resources, mostly supplied by Russia, has been a source of perennial budgetary challenges. About 20% of the population is ethnically Russian, but 33% speak Russian as their native language. Most live in Crimea and the eastern part of the country and are arguably partial to a commercial union with

Russia. Western Ukraine identifies more with Europe and other former Soviet countries like Poland and Slovakia.

Longer term we believe Ukraine would be better off in a commercial union with the EU than with Russia. The country's mineral and agricultural resources would find interested consumers and investors bringing employment and productive efficiency to the country. Perhaps the most valuable aspect the EU could bring to Ukraine is the institutionalization of the economy and the degradation of its pervasive corruption.

After staying on the sidelines during the demonstrations in Kiev, the EU and the USA moved quickly to support Ukraine and condemn Russia following Russia's occupation of Crimea by offering money and sending an IMF team. The transitional government is moving ahead with the EU and preparing to implement an IMF program that Yanukovich had rejected. All of this is good news, but it is too early to consider it a victory because a presidential election is scheduled for May. Many things can happen between now and then, including an underhanded effort by Russia to disrupt the country and the election.

As it transitions to the West, Ukraine will likely suffer another recession, but we believe the longer term outlook is promising. In our opinion, the authorities have been wise to refrain from military confrontation with Russia on the Crimea. Ukraine may not control that territory during the Russian occupation, but its importance is more political than economic. From an investment perspective, the currency will likely become undervalued, corporate bonds may suffer with a recession, but ultimately recover, and the sovereign may request a restructuring. Longer term, we believe the country should be an attractive investment destination.

With respect to corporate bonds in general, we anticipate further volatility as Russia's intentions become clearer and as the presidential election approaches. Any indications that the country will complete a commercial union with the EU should help lift the country's sovereign and corporate bond prices.

Russia - Do sanctions matter?

The USA and the EU are currently discussing sanctions against Russia for its Crimean incursion. The subject of sanctions has many implications and complexities because of Russia's size and role as energy supplier to the EU and the world. There is no question that restrictions on commerce and banking will affect Russia, but they may take a toll on many European countries, as well as burden the very country the West is trying to protect. While Russia is a major exporter of raw materials and oil, it has a sizeable domestic market and sanctions may be more symbolic than economically damaging. Potential sanctions against Russian individuals who have extensive holdings outside of Russia could put additional pressure on Putin.

It is possible though, that Russia's Crimean incursion could have a very valuable result for the West and for the world even without sanctions. Vladimir Putin has controlled Russia since the beginning of 2000 and has managed to take control of the economy

without much opposition. He also has reestablished Russia's geopolitical clout by aligning with, and supporting, nations that have shown antagonism toward the West. A key pillar of his strength has been his vocal support for nations' sovereignty and territorial integrity. By failing to observe his own "principles," he may have put a fatal dent in his credibility. As Russia opened to the world both economically and culturally after the fall of the Berlin Wall, many of its citizens became more interested in national pride through commerce and cultural integration than through geopolitical intransigence. The Sochi Olympics were a great demonstration. It is possible then, that a better response than sanctions involves supporting political factions within Russia that oppose Putin.

Russia has many world class companies across various industries. In all likelihood most of these companies will overcome sanctions and work to retain their international presence. We expect prices to remain depressed while the question of sanctions is discussed, and we expect the ultimate punishment to be light. For the near term the Russian risk premium has increased, but if markets become very pessimistic, they could become an attractive buying opportunity.

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