Ukraine

Country update

3 March 2014

Overview

The Russian parliament's decision to allow President Putin to use military force in Ukraine, and the subsequent increase of military presence in the Crimea has substantially increased geopolitical risks in the region. Russia's intentions to block Ukraine's move towards the European Union, firstly by imposing trade sanctions and then by providing a financial assistance package have failed in the face of street protests and now a second-rate solution of bringing Crimea into the Russian Federation looks more likely.

It must be noted that the Ukrainian conflict comes at a time when the Russian government has already exhausted most options to stimulate growth, and will help detract attention from the administration's inability to address structural economic weaknesses. Furthermore, while the escalation of the conflict in Crimea will have a negative impact on Russian asset prices, the country's stock balances (debt, reserves) remain very strong, though the flow balances might further deteriorate due to increased capital flight.

Ukraine's situation is aggravated by large debt repayments and the current account financing needs it faces. Our base case is that the new government will work with the International Monetary Fund (IMF) to establish a new financing program. IMF requirements include allowing a flexible exchange rate (which is currently happening) and gas tariff hikes (which the previous administration refused to implement).

The IMF may potentially also require a private sector bail in with holders of Eurobonds taking a net present value (NPV) cut as debt maturities are extended but with no reduction in the outstanding nominal amount. Forcing investors to take a private haircut will trigger credit default swap contracts (CDS) and initiate prolonged law suits, thus effectively closing capital markets for Ukraine for a long time.

Fixed income exposure

Our blended fund, the Aberdeen Global – Select Emerging Markets Bond Fund is underweight Ukraine. We initiated a position in Ukraine in the fourth quarter of last year and added to the position before the announcement of US$15bn in Russian support. We trimmed a portion of the position over December and January following positive price gains to 1% underweight the benchmark.

We reduced some portfolio exposure to Russian external debt to close to neutral last month, keeping diversified holdings across sovereign, quasi-sovereign and corporate debt. We have reduced off-benchmark exposure to local currency debt. We have had no exposure to the ruble, as we see the currency as fundamentally the most vulnerable Russian asset.

Emerging Markets Bonds Team

Equities exposure

Our core global emerging markets and eastern European equity funds have no direct exposure to Ukraine. They are also underweight Russia at least in part due to our long-held concerns over corporate governance in the country. We expect stockmarkets to continue to be volatile until there are signs of a peaceful settlement.

Global Emerging Markets Equity Team

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The value of investments, and the income from them, may go down as well as up and your clients may get back less than the amount invested.