Russia-Ukraine war raises stagflation risk for sovereign, corporate credit quality

The war in Ukraine will have a far-reaching impact on credit risk given the global economy was already confronted with the worst inflation data in decades and increasingly hawkish central bank guidance when Russia invaded its neighbour.

The main link between the Ukraine crisis and the rest of the world is its impact on commodities prices and the risk of tightening economic sanctions as the conflict drags on and/or expands. Given that there seem to be no realistic prospects of diplomatic de-escalation of the conflict, there are few upside scenarios for credit, except for sectors such as oil & gas, the OPEC group of oil-producing countries and other exporters of raw materials whose prices are rising fast.

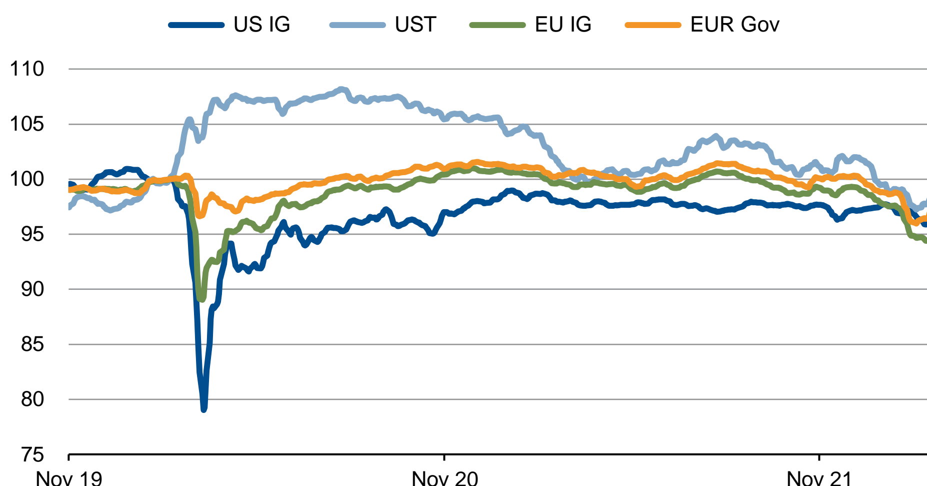
Higher-for-longer inflation represents a headwind for global growth that central banks will find hard to respond to because it piles more pressure on them to at least normalise their policy to pre-Covid settings. While the global economy has shown strong growth momentum this year, which provides a buffer to economic confidence, the risks are now tilted to the downside.

Beyond the pure economic aspects of the crisis, there are overriding geopolitical concerns that could further damage market confidence and therefore access to credit. Already, the Russian leadership has hinted at the use of nuclear weapons and attacked a nuclear power station in Ukraine. Western countries continuing weapons shipments to Ukraine and are faced with Ukrainian demands for a no-fly zone over the country. Belarus could join the conflict on the Russian side. Risks of escalation abound without any encouraging signs of possible de-escalation.

Credit markets: double blow of rising inflation and Ukraine war

Financial markets started pricing higher interest rates at the beginning of the year, sending equities lower while yields moved higher, and credit spreads widened. This had a negative effect on credit conditions, especially in high-yield markets, which had one of their worst starts for some considerable time.

Figure 1: Bond prices (2020 = 100)



Source: Scope calculations, Bloomberg

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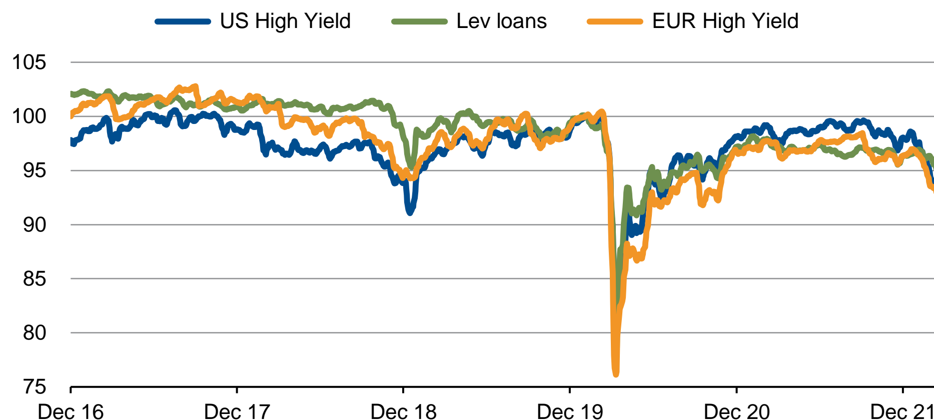
Figure 2: Leveraged loan & HY bond Prices (2020 = 100)

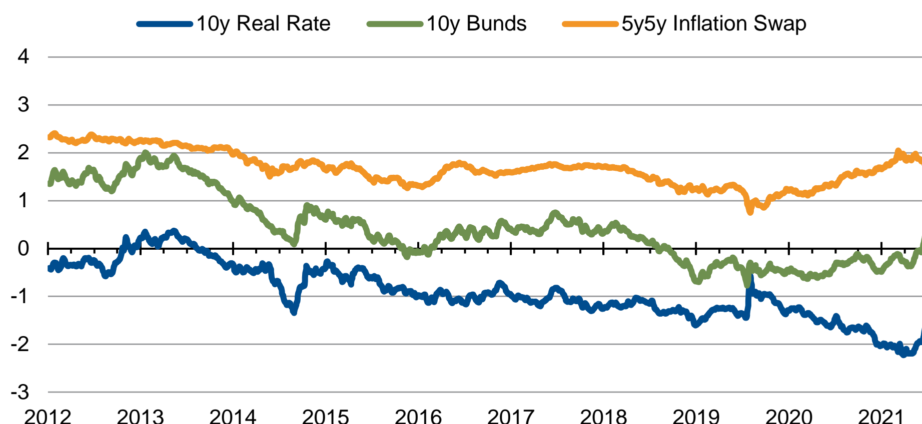


Source: Scope calculations, Bloomberg

Commodity price spike unnerves equity markets

Following the outbreak of the Ukraine war on 24 February, sharply rising commodities prices and the prospect of a prolonged and potentially escalating conflict in Ukraine added to negative risk sentiment sending equities lower again and spreads higher but also lower bond yields in anticipation of slower economic growth ahead. While rate hikes remain firmly on the agenda, markets pared back bets on their pace. Thus, after their brief recovery in early 2022, real yields in the euro area and the US dropped back into deeply negative territory, thus providing support to highly indebted borrowers.

Figure 3: Bund Yields and EUR inflation swap



Source: Macrobond

Upside risk for bond yields given high debt, resurgent inflation

However, the risk remains that yields eventually move higher as investors demand greater compensation for fixed income instruments amid high inflation and debt levels. At their low yields, government bonds have also proven to be poor diversifiers against an equity selloff in the run-up to the crisis, which may require investors to demand higher yields long-term.

Ukraine war has far-reaching impact on credit risk

War, sanctions drive commodities prices higher

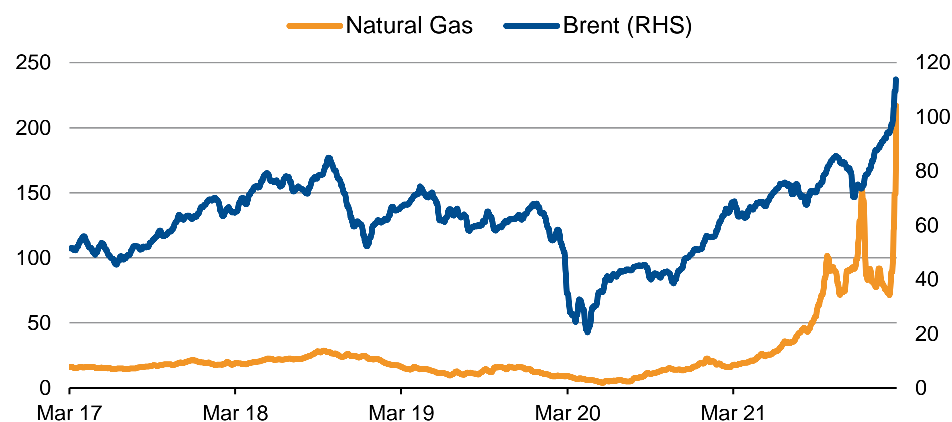
The main link between the Ukraine crisis and the rest of the world have been commodities prices and the risk of increasing economic sanctions as the conflict drags on and/or expands. Given that there seem to be no realistic prospects of diplomatic de-escalation of the conflict, there are few upside scenarios for credit, except for sectors

such as oil& gas or OPEC countries that directly benefit from rising commodities or agricultural producers.

Pressure grows to boycott Russian crude, gas exports

Western sanctions are likely to escalate for as long as the conflict gets worse. Having imposed a surprisingly effective first wave of economic sanctions on Russia early in the crisis, the US and several other countries further increased the pressure by declaring a ban on Russian oil imports, which prompted Russia to threaten a stop gas deliveries. As a large importer of Russian oil, the EU is unlikely to follow these steps for now, though the pressure will be rising for as long as the conflict escalates.

Figure 2: European energy prices



Source: Macrobond

While an effective global ban followed by all importers, incl. China, could in theory undermine the Russian government's key source of revenue, it is unlikely to be implemented in view of its sheer cost to the world economy. Likewise, it is difficult for Russia to stop gas exports because it has few pipelines outside Europe and no storage capacity, forcing it to cap its wells.

Russian financial sector in sanctions spotlight

Along with oil, the Russian financial sector is likely to be hit by further restrictions to close energy-related loopholes. Key operators such as Sberbank and Gazprom Bank have yet to be included into the EU sanctions package and the US also still allows processing of energy-related payments by sanctioned Russian banks. Like with oil imports, there is already an element of "self-sanctioning" because several banks have stopped financing commodities trading with Russia.

Economic sanctions so far have had a punitive effect on the Russian economy without yet slowing the Russian onslaught on Ukraine. The collapse of the rouble and subsequent doubling of the central bank rate to 20% puts the Russian economy at risk of a recession. Russia has reacted with capital controls on foreign investors and by reneging property rights, e.g. threatening to seize foreign-owned aircraft leased by Russian airlines.

Kremlin raises nuclear stakes

Beyond the pure economic aspects of the crisis, there are overriding geopolitical concerns that could further damage market confidence and therefore access to credit. Already, the Russian leadership has hinted at the use of nuclear weapons and attacked a nuclear power station in Ukraine.

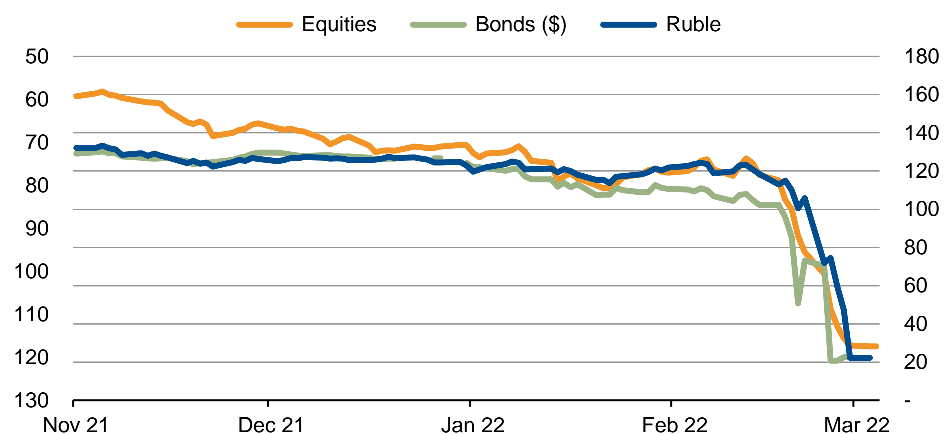
Meanwhile, Western countries have started supplying weapons and are faced with Ukrainian demands for a no-fly zone while Belarus may join the conflict on the Russian side. Thus, there are plenty of avenues of escalation without any realistic de-escalation scenario.

Russian sovereign downgraded to CCC

Risk of Russian default rises steeply

Since the outbreak of the war, Scope Ratings downgraded Russia's sovereign ratings in two steps to CCC from BBB+, with the ratings under review for further downgrade. This was mainly based on Scope's reassessment of Russia's willingness to honour its debt obligations following the imposition of capital controls, which include prohibitions on residents from servicing new foreign-currency-denominated debts and from transferring rouble payments to foreign investors.

Figure 3: Russian asset prices



Source: Scope Calculations, Bloomberg

However, the crisis will also severely undermine Russia's credit fundamentals and medium-run macroeconomic outlook, financial stability, institutional credibility, and already weak investment conditions, leading to a severely curtailed access to foreign capital and financial markets, higher capital outflows, tighter financial conditions and weaker financial buffers.

Next to Russia, similar concerns arise for Ukraine (CCC) and Belarus.

Financial stability concerns re-emerge for European banks

More resilient European banks face new test

Having mastered the Covid crisis much better than expected, European banks outside the conflict zone are once again faced with investor scrutiny over their exposures. The sharp negative reaction of share prices would above all reflect rising uncertainty rather than anticipation of catastrophic losses.

Overall, the exposure of the global banking system to Russia, Ukraine and Belarus is very limited with only USD 117bn of BIS reported net cross-border claims as of Q3 2021. Thus, the overall systemic risk appears to be low. So far, sanctions led to the failure of one Russian banking subsidiary in Europe.

Direct Russia-linked risk concentrated among few lenders

European financials only have modest exposure to the region, concentrated in a few banking groups with direct investment in Russia, Ukraine and Belarus – such as Raiffeisen International, OTP (BBB+/stable), Société Génerale SA or Unicredit SpA – with the latter's exposures appearing manageable. Few other banks have reported their offshore exposures at this point. Main fear is that while banks with net exposures may appear low, banks may be able to recover very little, if any of their monies in case sanctions escalate.

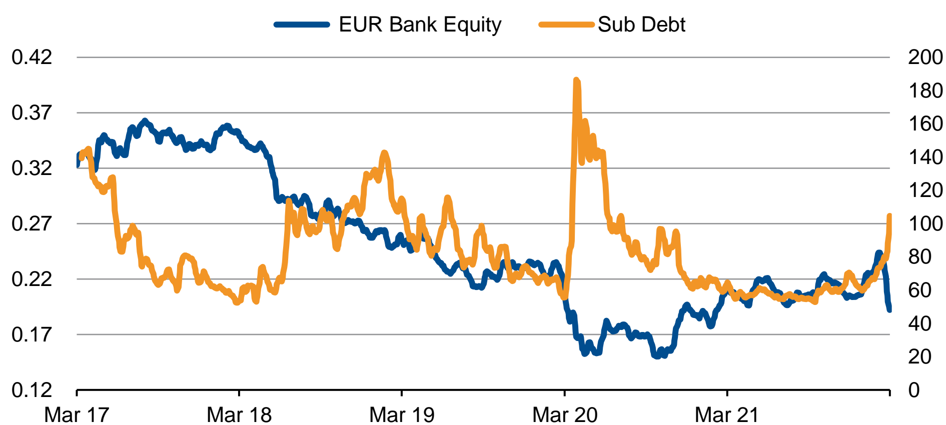
Zooming out from direct exposures, the deterioration of the macroeconomic outlook for Europe will likely weight on asset quality, and much anticipated increases in interest rates may be put on hold, at least temporarily.

Market volatility creates extra uncertainty

Other sources of uncertainty are market closures and sanctions that could result in unexpected risk concentrations in investment banking, wealth and asset management operations. The sharp, unanticipated moves in commodities, derivatives and currency bear the risk of unanticipated margin calls and surprise trading losses in Q1 results.

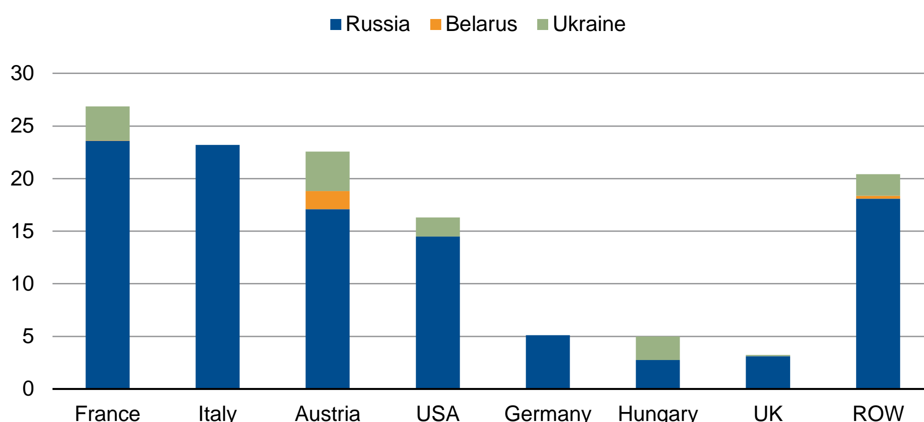
Beyond the immediate impact, tougher sanctions also raise the possibility of future money laundering investigations or the misuse of crypto currencies to circumvent restrictions. More broadly, cyber risks are recurring theme for the sector, which is hard to trace and therefore adds to uncertainty.

Figure 4: Relative performance of bank capital



Source: Scope calculations, Bloomberg

Figure 5: Bank exposures to conflict zone



Source: BIS, company reports

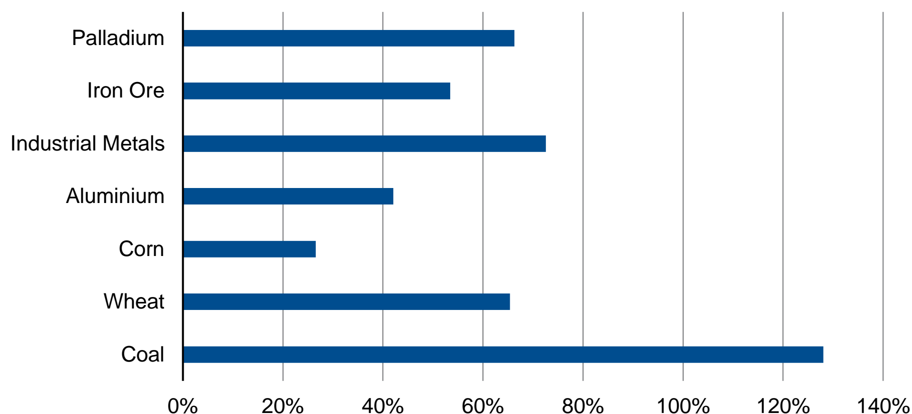
Sanctions lay bare world's reliance on Russian raw materials

Sanctions roil commodities, financial markets

Outside of the Baltics, the potential of direct spill-overs from trade into the euro area are very limited because Russia accounts for less than 3% of EU exports.

However, next to energy, sanctions risk exacerbating supply chain pressures, especially in soft commodities such as wheat and corn, fertiliser, as well as uranium, industrial metals such as iron ore, nickel, palladium, titanium, and neon gas.

Figure 6: Commodities 3M Price Change



Source: Bloomberg

Russia is important supplier of precious, industrial metals

Russia supplies 40% of global palladium and 30% of titanium, crucial materials for the car and aerospace industries already experiencing supply-chain disruptionss. Interruptions in these supplies will push up inflation and have a negative effect on growth in key sectors of the European economy. Thus, manufacturing is likely to be adversely affected, leading to reduced growth, notably in Germany, Europe's biggest economy.

Furthermore, Ukraine and Russia together account for a third of the world's wheat exports and a fifth of its corn trade. Wheat prices are up more than 60% over the past three months, while corn prices have risen 30% and supply disruptions and rising prices for fertilizer could have negative repercussions on food prices not only in Europe.

Mixed fortunes for the energy sector

Russia's belligerence exposes Europe's energy weaknesses

Because Russia supplies between 30% and 40% of Europe's gas, and about one third of Russian gas exports to Europe flow through Ukraine, the threat of sanctions on Russian gas has pushed European energy prices higher. There are no short-term fixes because Europe needs to expand its storage and LNG in addition to long-term expansion of alternatives such as renewables or nuclear energy.

Figure 7: European integrated oil company (IOC) exposure to Russia

European IOCs	% 2021 EBITDA	% total production	% reserves	Main exposure
Wintershall Dea	15-25%	48%	61%	Minority stakes in large Urengoyskoye and Yuzhno-Russkoye fields, Nord Stream and financing for Nord Stream 2
BP	5-10%	33%	47%	19.75% stake in Rosneft
TotalEnergies	5-10%	Around 20%	24%	19.4% stake in Novatek, stakes in Yamal LNG, Arctic LNG
OMV	5-10%	Around 20%	16%	25% stake in Yuzhno-Russkoye field, Nord Stream 2 financing
Shell	<5%	4%	n/a	Exploration projects, Sakhalin LNG, financing for Nord Stream 2
MOL	<5%	4%	n/a	Limited exposure (51% stake in small Baitugan field)
Equinor	<5%	2%	n/a	Exploration projects
Eni	<5%	n/a	n/a	Exploration projects, stake in Blue Stream gas pipeline
Repsol	<5%	n/a	n/a	Exited Russia in January 2022
PKN Orlen	<5%	n/a	n/a	Very limited exposure, if any

Source: Scope Ratings, company reports, Bloomberg

Meanwhile higher oil, gas and coal prices lead to higher electricity bills because power generators can usually pass on higher procurement costs under long-term contracts. Liquidity demands can go up, however, because suppliers need to meet margin calls.

Energy prices squeezing margins for European industry

While there a few European gas and LNG producers that benefit from rising prices, higher oil prices are good news for international oil companies' exploration and production activities. These will only partly be offset by lower refining and petrochemicals margins. Looking at the most energy-intensive industries, it is particularly basic iron and steel, cement, fertilizer, refineries, and organic chemicals companies that are the most pressured by sustained high gas and electricity prices in Europe.

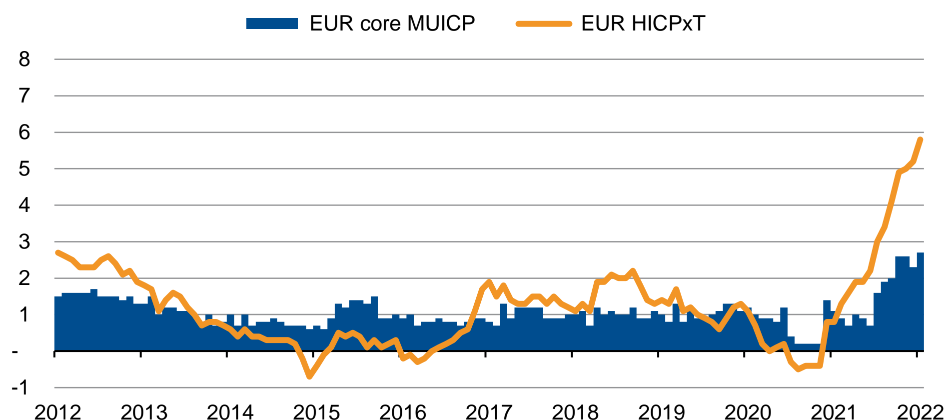
The risks for the sector lie in domestic and geopolitics. Unsustainably high prices will bring economic growth and therefore demand to a halt. European governments may react by freezing energy prices or tax windfall profits. High prices will also reshape the supply side with higher output by OPEC members, US shale producers and possibly Iran. Given the large Russian share of global oil & gas production that is at risk of sanctions, extra supply is unlikely to lead to move prices down materially in the short-term.

Volatile inflation rates will weigh on credit sentiment

Central banks face inflation challenge amid crisis

Higher-for-longer inflation represents a headwind for global growth that central banks will find hard to respond to because it adds more pressure on them to at least normalize their policy to pre-Covid settings.

Figure 8: Euro area core & headline CPI (YoY, %)



Source: Macrobond

With respect to inflation, we see upside risk to many central bank projections of inflation. There is a structural component of higher inflation longer term, partially reflective of more accommodative policy, increasing wages, and supply-chain disruption, which may test 2% inflation mandates long run especially in the US and the UK, less for Japan of course, and comparatively less for the ECB.

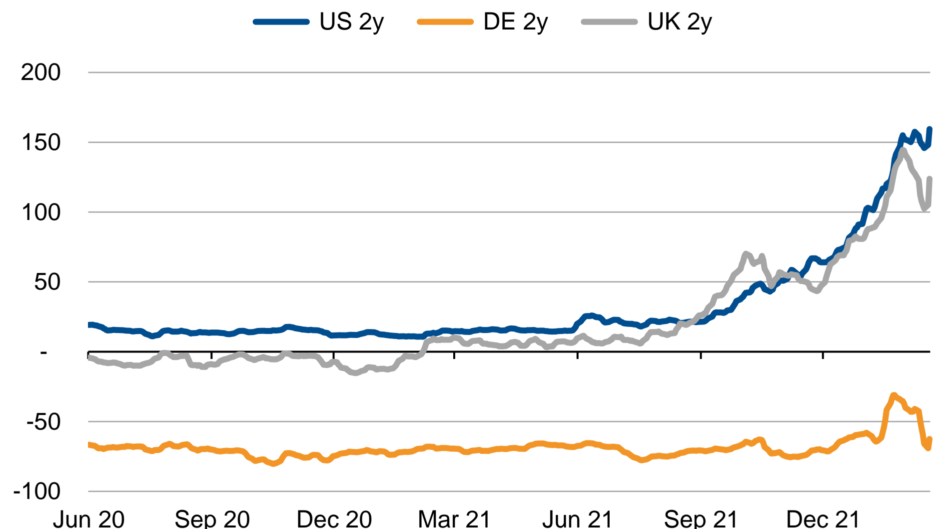
Upside risk to central banks' inflation projections

Rising energy and food prices exacerbate supply-side inflation, leading to higher headline inflation with the risk of second round effects that push up core inflation in Europe, where the trend is reinforced by a weaker Euro, and the US that is already above target as well, through yet higher prices for durables or services and higher wages.

Compared with the convergence of monetary policy during 2020 peaks of the Covid crisis, we expect greater divergence of monetary policy. This includes hawkish tilts by the Federal Reserve and the Bank of England compared to gradual stimulus removal by the

ECB. The ECB will halt PEPP in March and likely accelerate the pace of monetary normalisation via a faster drawdown of APP and/or advancing a timetable as regards future rate hikes.

Figure 9: 2-year government bond yields (bps)



Source: Macrobond

Politics might weaken impetus behind tighter monetary policy

However, while policy rates are headed higher, there may be less political pressure to contain inflation because higher energy prices erode household spending power and weigh on business sentiment. This will allow the ECB to move more slowly and alleviates prior concerns that more hawkish central banks such as the Federal Reserve or the Bank of England raise rates too fast and too far. Nevertheless, central banks are faced with high and volatile inflation rates for the foreseeable future and therefore the risk of policy mismanagement remains elevated.

Global economic outlook under threat from expanding sanctions

Global recovery well underway but sanctions cloud outlook

The global economy entered the crisis with strong growth momentum, which provides a buffer to economic confidence. We started 2022 with the baseline of an uneven but robust economic recovery, expecting growth to remain above potential, even if slowing/normalising across most countries from very high recovery rates of 2021. This expectation applies to China (5.2% in 2022), US (3.5%), UK (4.6%), France (4.2%) as examples. But there are several exceptions of economies growing faster in 2022 than in 2021: Japan (3.6%), Germany (3.5%).

However, the risk is tilted to the downside. Next to high inflation and geopolitical tensions around Ukraine, other downside risks include renewed virus transmission and variants, slowdown in China and a correction in bubbly financial asset markets, which is already underway. On the upside, there remains incremental growth from budget stimulus, pent-up demand and a faster economic normalisation to “living with Covid”.

An accelerated implementation of renewable energy and energy efficiency projects as well as defence spending could end up boosting investments in EU economies, thus helping to offset falling business confidence. Germany already performed a significant U-turn on defence and energy spending, which may lead to further fiscal flexibility in the euro area if these expenses were to be excluded from the stability and growth pact.

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