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Emerging Markets Debt | Global Investing

Russia-Ukraine Conflict Hard to Analyze and Harder to Predict

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"In our view, these events could have unintended consequences and potentially unexpected results. The world order may be reordering before our very eyes."

Boston - Global trading this week suggests that investors should avoid owning any Russian assets. Developments over the weekend may also indicate brighter prospects for Ukrainian assets, as evidenced by Ukraine's success in slowing Russia's advances and securing military and financial support from foreign governments and international institutions.

Here are the latest situational and capital markets updates relating to Russia's widespread invasion and attack on Ukraine, now in its seventh day. What follows are the views of the Emerging Markets Team. We work with primary and secondary sources of information, much of which cannot be easily or quickly verified. Still, the research we have collected has helped us develop a mosaic view. In many ways, this effort has been no different from our regular work, which always involves solving complex problems using only incomplete information.

Situation so far

Progress by the Russian military has been materially slower than expected. To the extent that Russia planned a blitz attack to capture Ukraine's capital, it has failed. Credible sources including U.S. officials have characterized Ukrainian resistance as stiffer than expected. On Monday, we heard directly from a Ukrainian government official that no major town or city is under Russian control, and Russian casualties are mounting.

President Zelenskyy has been able to maintain the morale of his citizens and armed forces, while also winning over the leaders of other nations who may have been reluctant to stomach the consequences of imposing penalties on Russia. This resulted in additional sanctions over the weekend, along with announced shipments to Ukraine of anti-aircraft and anti-tank missiles and other military supplies. More financial commitments are expected soon.

Capital market impacts

In response to the unprecedented sanctions, Russia's central bank has more than doubled its interest rate from 9.5% to 20% and established capital controls that force Russian companies to sell 80% of their foreign currency and ban Russians from transferring foreign currency abroad. Russia's equity market remains closed on Tuesday. Altogether, we estimate that local Russian fixed income assets are down about 70% in value.

Despite the deployment of significantly harsher sanctions, global capital markets appear to be confining their attention largely to Russian and Ukrainian assets.

Also affected are external assets like some central European banks and manufacturers who may have significant business with Russia. Spill over into other emerging and frontier markets has so far been limited. Asian equities were largely positive on Monday, although European equities were weaker, and Kazakhstan's local market was suspended. Through February 28, the U.S. broad equity market as measured by the S&P 500 Index was up since the invasion.

Possible scenarios from here

Given the stiff resistance so far, we believe one scenario is that the conflict could become protracted, with Ukraine pursuing a guerrilla war. This might in turn become a proxy war between NATO and Russia. In that event, financial and military support for Ukraine may be sizable, and the scope of damage to Ukraine's infrastructure would be significant.

To counter the probability of a protracted guerrilla war, Russia could choose to escalate the conflict. Already we may be seeing Russia's tactics change toward a siege strategy, with more arbitrary artillery attacks and random firing of missiles into urban areas. We urge our readers to be prepared for a protracted conflict and immediate, potentially shocking escalation by Russia, as a 40-mile long convoy of Russian troops and equipment heads toward Kyiv.

Another scenario is that Russia's provocations could spread beyond the borders of Ukraine. So far Ukraine has been the principal target of Russia's cyberattacks. But we believe those attacks could extend to outspoken countries like Romania and Poland. Cybersecurity experts have told us that these weapons can be hard to control — think ofworms that get into the wild and cause collateral damage. Investors may need to keep that risk in mind.

We continue to contemplate the potential for wider implications of what capital markets have so far priced as a regional skirmish. Those impacts could be further supply-side inflation through a commodity price channel, which would exacerbate global inflation. We must also consider how the deployment of never-before-seen financial sanctions could affect the world's capital markets beyond Russian and Ukrainian assets.

No playbook for what comes next

When thinking about what might come next, we have to revise our *priors*, or assumptions. Russia's leadership has disregarded norms — for example, Russian commercial flights have ignored several of the no-fly zones announced by 33

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