Deutsche Asset
& Wealth Management

Our Point of View

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Asoka Wöhrmann, Co-CIO Deutsche Asset & Wealth Management, on the geopolitical tensions

I. Ukraine-Russia conflict: political implications

The incident of the Malaysian airplane MH17 poses significant risks for political relations between Russia and the West as well as the political situation in the Ukraine.

Political scenarios and implications under different scenarios

1. Political relations between Russia and the West deteriorates markedly: Stepping up in the rhetoric since Barack Obama's press conference on Friday when the President said it was clear that Russia supports separatists, who fired the missile
2. Muddling-through with high uncertainty (political goodwill signs, disappointed by concrete action, ongoing frictions within Ukraine) (current status quo)
3. Best case: In the face of severe impacts, Putin will review the situation. The incident may change the vision of locking Ukraine firmly into Russia's sphere. Near-term key is whether the Russian president Vladimir Putin allows a full ICAO-led investigation into the crash and declares that Russia will not provide support to the separatists in favor of working seriously on a permanent ceasefire

In his address from 20th July, Putin said that everything would be done to ensure safety of international experts. This statement would support that the 3rd scenario is materializing and the Russian market appears to reflect this also. However, so far only in words. In our view, observable actions rather suggest the 2nd scenario ("muddling through").

Russian economy, effect of current and potential further sanctions

Current situation: Severe capital outflows seem to have stabilized. Economic downswing recently found a halt. Scenario of stagnation gained probability.

Effects on Russian economy from latest round of sanctions: Restrictions to external bond financing of selected Russian corporates, cutting them off from global financial markets

- High external financing need of the Russian corporate sector. Rising borrowing cost
- Changes in Bond Indices: since April 2014, Russian Ruble bonds are included in the Barclays Global Aggregate Index. Besides rating, a necessary precondition for being included in the index is free market access and market liquidity. If further sanctions are imposed, these preconditions might not be fulfilled which could lead to Russian local government bonds and investment grade corporates being taken out of the index again.
- Hard currency government bonds should not be affected.

Effects of a more likely scenario of further sanctions

- Russia potentially drifting into outright recession. Capital outflows creating a major problem for economic policy.
- The Institute of International Finance (IIF) estimates capital outflows would jump up 50% relative to the baseline. Expect fiscal deficit to jump to 6.5% of GDP by 2015, external financing need could rise to 120bn USD a year (a magnitude the IIF considers problematic)

With the BRICS development bank being established, Russia might possibly be able to obtain temporary help there

II. Other geopolitical events (Middle East)

There are various hotspots in the Middle East which could see further instability, leading to oil supply disruption and oil price spikes and a lasting higher risk premium on oil markets. Depending on the duration of these developments, these events could be a trigger for lower global growth. The concrete triggers could be:

- Either a regional spill-over of the conflicts in Syria/Iraq (potential knock-on effect on Turkey where this would add to economic, financial and domestic policy weakness)
- Further escalation form Israel/Palestina or Israel-Iran escalation (potential pre-emptive attack by Israel on Iran nuclear facilites, and potential retaliation via increased terrorism by Hezbollah, Palestinian Jihad)

III. Market impact: Effects on asset classes

- **Core market rates:** We expect the situation to take a long time to abate in rates markets, but do not expect safe-haven flows to increase, as a lot is priced in already
- **Emerging Markets (EM) sovereign external debt:** Russian sovereign debt is not directly affected by the sanctions and is e.g. not on the new U.S. sanctions list. The debt profile remains one of the strongest in EM. Biggest impact at the moment is deterioration of sentiment.
- **Credit:** We stay positive on developed market credit, but watch developments around potential new sanctions very closely with regards to Emerging Markets Credit (EMC). Russian corporate bonds will trade, over the medium, primarily based upon the perceived probability of harsher sanctions being implemented (especially valid for CEMBI index members). As such, over the medium term, earnings from Russian corporates will be somewhat less relevant than normal. Both for the Ukraine-Russia conflict as well as events in the Middle East, we do not see significant spillover effects into the broader EM corporate universe so far.
- **Equities:** Until now, the Dow Jones just looked through Russia sanctions. We expect Equity markets to react to a series of events rather than to single events, but it’s clearly getting worse and volumes are low in the summer. One of the biggest concerns is the impact on European earnings as a lot of companies are exposed to Russia. With regards to the situation in the Middle East, higher volatility across the Middle East is to be seen, but so far without an impact on global markets.

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Deutsche Asset & Wealth Management
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