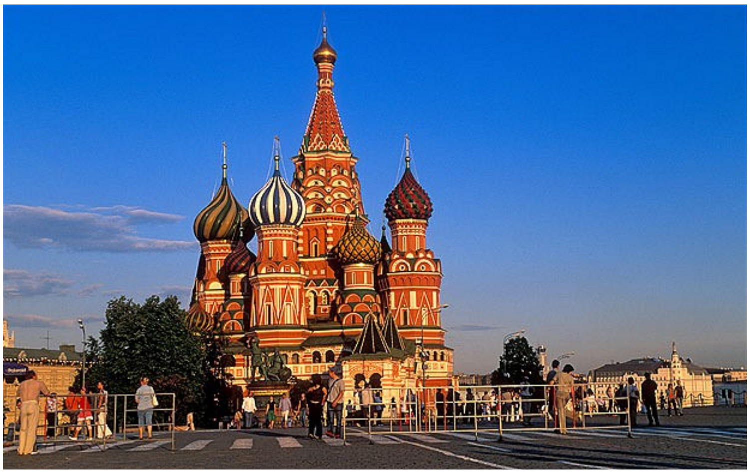
Russia's bond market is Achilles Heel as showdown with West escalates

Country's private companies shut out of global bond markets, raising prospect that they may need state support



According to some, Russia's economy is already in recession Photo: Alamy

By Ambrose Evans Pritchard

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Russia is at increasing risk of a full-blown financial crisis as the West tightens sanctions and Russian meddling in Ukraine pushes the region towards conflagration.

The country's private companies have been shut out of global capital markets almost entirely since the crisis erupted, causing a serious credit crunch and raising concerns that firms may not be able to refinace debt without Russian state support.

"No Eurobonds have been rolled over for six weeks. This cannot continue for long and is becoming a massive issue," said an official from a major Russian bank. "Companies have to roll over $10bn a month and nothing is moving. The markets have been remarkably relaxed about this, given how dangerous it is. Russia's greatest vulnerability is the bond market," he said.

Lars Christensen from Danske Bank said Russia's economy is already in recession and may contract by as much as 4pc if there are fresh sanctions, risking a repeat of events in 2008 when capital flight set off serial defaults and a banking crisis. "There is a credit squeeze under way and a significant shock to the cost of capital. This could prove to be as bad as the Lehman crisis for Russia. Capital outflows have already been $65bn so far this year, compared to $135bn in late 2008," he said.

"Markets seem to be betting that the Kremlin can't let things get worse in Ukraine because it would be insane, yet it is happening it anyway. We think there will be a much more serious correction in the Russian markets," he said.

Bank of America said the dramatic showdown in Eastern Ukraine over the last three days "sharply increases risks of an all-out civil war" and raises fears of tougher measures by the EU, the US, Japan, and Canada.

The warnings came as EU foreign ministers agreed to draft plans for " Stage III" sanctions - this time hitting economic and financial targets - if Russian president Vladimir Putin sends troops into East Ukraine or tries to sieze territory. William Hague, Britain's Foreign Secretary, suggested that this line has already been breached as heavily-armed units seize buildings and air fields, and set up roadblocks in several Ukrainian cities, repeating what happened in Crimea.

"I don't think denials of Russian involvement have a shred of credibility. It has all the appearances of a further gross, deliberate and premeditated violation of the independence and sovereignty of Ukraine. There have to be consequences to a further and further escalation by Russia," he said.

However, the EU is sending mixed signals. It is pushing through fast-track plans to cut reliance on imported oil and gas from Russia, and has quietly frozen Gazprom's South Stream pipeline. It has also defied the Kremlin by signing an association deal with Ukraine, including a defence clause that locks the country into Western security.

Yet the EU's sanctions policy has so far been largely symbolic, kept to a minimum by Bulgaria, Cyprus, Luxembourg, and other EU states that have special dealings with Russia. This may harden as Germany takes the political lead with a tougher stand. Vice-Chancellor Sigmar Gabriel said Europe is being dragged into "a long smouldering and incendiary conflict" but warned that the West must bear the burden even if this means paying a price with a further sanctions.

Washington is forcing the pace in any case as is tightens the noose by other means, using regulatory "stealth" power to force banks across the world to pull back from Russia. The US said Russian operations in six Ukrainian cities involve well-trained units in bullet-proof vests and olive-green uniforms without insignia, constituting an assault on the country. Such language points to likely escalation of US sanctions within days unless there is a diplomatic break-through.

Chris Weafer from Macro Advisory in Moscow said foreign investors are already pre-empting tougher measures by the West, battening down the hatches in case clashes escalate out of control. "Self-sanctions have gone well beyond that required by the US and EU as major companies deem it prudent to delay investment and trade deals," he said.

Mr Weafer said the economic slump and the weak rouble -- down 9pc this year -- will force the Kremlin to seek a way out of the crisis, adding that the decision by the Donbass miners union to stay loyal to Kiev and disassociate itself from pro-Russian protestors should be a cautionary development for Mr Putin.

The Swedish Defence Research Agency said Russia risks a protracted battle with Ukrainian resistors and "military-strategic overstretch" that will weaken its position in Central Asia and the Chinese border if it tries to occupy Eastern Ukraine.

The Russian central bank has a $490bn war chest to defend the rouble but this cannot easily be deployed without tightening the money supply and deepening the downturn. The authorities are walking a tightrope, allowing the currency to slide but spending $200m of foreign reserves each day to slow the pace.

A report by Sberbank said Russia has $714 bn of foreign debt: $427bn for compaines, $207bn for banks, and $62bn from state bodies. The oil group Rosneft relies on foreign debt for 90pc of its funding. Foreigners also own 70pc of the free-float of Russian stock market, which has not yet dropped heavily but has been held back by 15pc relative to emerging market peers since late February.

Sberbank warned that an escalation of sanctions could lead to 30pc crash in Moscow's RTS index of equities to 800. Yet if conflict can averted this may now a perfect time to buy Russia stocks, currently trading a price-earnings ratio of 5.5 for 2014, or below 5.0 for Gazprom, Lukoil, Aeroflot, LSR Group and the state banks. The average price-to-book ratio is 0.59. "At this oil price, we are close to the valuation trough reached in 2009," said the bank.

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