Trading the Russian Invasion

Time of writing: Thursday 24, February 2022

Introduction

On Thursday, Russia launched a massive attack on Ukraine, spurring talks that an armed conflict might be about to start in eastern Europe. In this article, we pitch a **directional global macro trade** based on the currently unfolding scenarios, after a brief discussion of the geopolitical backdrop and its impact on markets.

First, Germany has placed the Nord Stream 2 project on hold as the Kremlin recognized the independence of the Donetsk People's Republic and the Luhansk People's Republic. Previously, Berlin has been hesitant to make moves that may threaten the pipeline. A subsidiary of Russia's state-owned Gazprom controls the Nord Stream 2, which is intended to carry natural gas straight from Russia to northern Germany. The €10 billion project, which was finished in September but has yet to start operations, has long been regarded as a security danger in Ukraine, since it circumvents its territory and thus deprives the country of transit fees.

Russia's foreign exchange and gold reserves amount to more than $600bn and have been growing since 2014. In reaction to the sanctions from the EU, the US, and its allies, Russia's Central Bank is aiming to avert a run on the Ruble. In an eventual worsening of the Ukrainian situation, the Central Bank could resort to even more drastic steps, including freezing citizens' foreign currency money. With many traditional cash currency exchanges in Ukraine closing or reporting major shortages of USD banknotes, similar scenarios might occur in Russia, resulting in a Cold War-style USD banknote underground market for fiat.

The Central Bank has already intervened in the FX market, managing to stabilize the Ruble, although it is still close to its all-time low. Even though no formal limitations on USD and euro trading appear to have been placed yet, the Central Bank stated that it will guarantee the maintenance of financial stability and the business continuity of financial institutions using all necessary means available to it.

On the other hand, Western countries announced sanctions against Russian banks, oligarchs, and exports. Nonetheless, it remains unclear whether Russia will be excluded from the Swift system, even if there is shifting momentum towards a ban. Two of the countries that have expressed some doubts, Germany and Italy, are still considering their response. Being out of Swift would have a major impact on Russia, as its banks would struggle to transact with the rest of the world. As an alternative to Swift, Russia has established its banking messaging system, known as SPFS, which local authorities claim will help offset the impact if the country is cut off. However, given the limited number of users internationally, it cannot be considered a solid replacement. According to press reports, European officials were concerned that such a move would result in the non-payment of billions of euros in outstanding debts to Russia. This would not be the first time when such a measure is discussed, as in 2014, after the Crimea annexation, the US threatened to cut Russia off from Swift, in a move that would have reportedly cut Russia's GDP by 5% in a year.

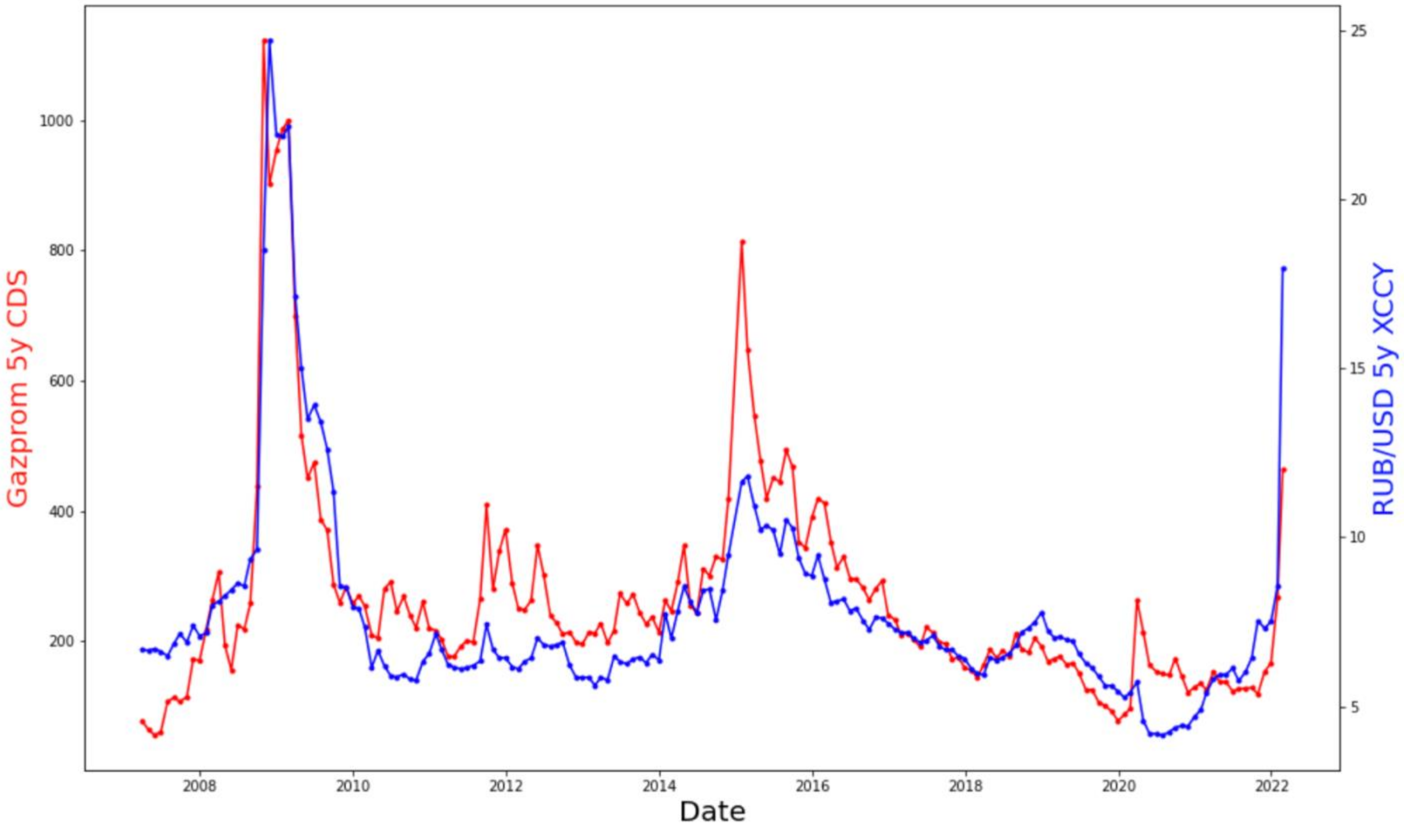
The Trade

Considering the geopolitical turmoil, market participants have rapidly reacted by transacting a broad spectrum of Russian-related assets. The rush has been driven, among other factors, by the fear of a trading halt on Russian securities, whether due to political or financial reasons.

On the matter of Russian government debt, the first piece of news came from the rating agency Standard & Poor, which downgraded Russian domestic debt to BBB- from BBB. This would logically spur strong demand for protection and speculation in the form of Credit Default Swaps (CDS) in US dollars, which are also anticipating the sanctions on the economy. What is more important, however, is that the historically illiquid nature of that specific CDS curve – excluding the 1-year and 5-year tenor – make the risks far outstrip the potential payoffs in paying for insurance.

What is more, we believe that market participants are discounting the consequences of the Ukrainian war asymmetrically. If on one side the dollar-denominated Russia 5y CSD is pricing default probabilities as high, if not greater than the 2015 Crimea invasion, on the other hand, key Russian companies such as Gazprom are viewed still as fundamentally solid, as of time of writing. Based on these considerations, we propose the following trade:

- **LONG** Gazprom 5y CDS,
- RUB/USD 5y XCCY swap: **RUB FLOAT receiver**, USD FIXED payer.



Source: Bocconi Students Investment Club

Gazprom is a majority state-owned company which is key for the commodity-exporting Russian economy, currently accounting for one-fifth of Europe's natural gas supply, as well as being responsible for all the gas pipelines built (Turk Stream and Nord Stream) and in construction (Nord Stream 2). Even though competitive gas prices, a decreasing indigenous production and its huge gas reserves will guarantee Gazprom a high long-term market share in Europe, we argue that the macro risk-off currently under way will prevail on fundamental considerations on the valuation of the company. We therefore advise to buy the dollar denominated 5Y tenor CDS, which closed today at 463.64bps, only 1.17 standard deviations from the 20-year historical mean (as of time of writing), very far from Crimea annexation (2015) and GFC (2008) scenarios, where it was respectively at 3.23 sigma and 5.04 sigma from the mean. We see as additional motivating factors the end of the winter in Europe, as well as American support to keep unilaterally energy pipelines open for Europe, while cutting Russia out of the global supply chain as soon as next week.

In parallel, we propose to enter a fixed-for-floating cross-currency (XCCY) swap between the Ruble and the US dollar, receiving floating RUB and paying fixed USD. The contract is currently trading 17.97bps. The functioning of XCCY swaps is described in a previous article here. In this setting, we believe demand for dollar in the local (Russian) financial market could well increase in a flight-to-safety scenario. We expect this scenario to materialize should Western countries coalesce to prevent Russian banks from accessing the Swift system. The XCCY swap is currently trading 3.2 sigmas above its mean, compared to 1.22 during the Crimea episode and a maximum of 5.31 in 2008.

We remark that this second leg is not a hedge. As the figure above clearly shows, the two series show co-directionality. What is more, a statistical test confirms the presence of cointegration, indicating that the two derivatives prices move in pairs. We believe that taking this “double” position (i.e., two identically directional positions) is appropriate given the macro rationale laid out above and the statistical confirmation that the spread between the two time series is on average constant. To have a hedge, we would have to be fixed receiver in RUB and float payer in USD, so that if Russian rates went down due to lower risk premia demanded by market participants, we wouldn’t suffer from this.

While we recommend an immediate entry point for the trade, we believe it should be exited as soon as the contracts are trading at 2008 levels or slightly above, as we expect risk premia to increase to a comparable if not higher level.

TAGS: Russia, Ukrain, war, invasion, credit default swap, cross currency swap, macro, global macro, directional