MV Capital Management Weekly Market Flash

Ukraine, Markets and the Geopolitical X-Factor

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The magnitude, timing and predictability of cash flows are what determine the returns investors expect to receive from any given asset. With that in mind, it is worth considering the language of a Standard & Poor's credit report issued today regarding Ukraine's credit rating, which it dropped from CCC+ to CCC: "We now believe it is likely that Ukraine will default in the absence of significantly favorable changes in circumstances, *which we do not anticipate*" (italics ours). On a related, unsurprising note, Ukraine pulled a $2bn Eurobond that was to have been issued today.

A Geopolitical Crisis

For most people Ukraine is a faraway place, a country about the size of France with a population of 45 million. The current crisis is largely geopolitical in nature: it stems from the government's decision last year to abandon talks aimed at bringing Ukraine closer to the European Union, and opting instead to tie itself more closely to Vladimir Putin's Russia. The population itself is split, with pro-Russian eastern regions supporting the government and the Europe-friendly western areas (including Kiev, the capital) demanding the ouster of President Viktor Yanukovich.

No Isolated X-Factors

Is this country important enough to have a real impact on world markets? In this day and age the answer is yes. Not because of the economic punch that Ukraine packs on the world stage, but because in our tightly interwoven, linked-in day and age there is really no such thing as an isolated geopolitical X-factor. The issue is not how big a country is, or what percentage of the world's outstanding debt issuance is from Ukraine (very little). The issue is collateral damage – what impact would a default have on systemically critical institutions with an unhealthy exposure to Ukrainian debt? What other dominoes might fall, not just in Ukraine but farther afield?

Remember the CDO…

The domino effect is unpredictable. In 2007, credit markets remained sanguine after the collapse of two Bear Stearns hedge funds with overexposure to nonperforming subprime loans. Here again, subprime loans were themselves a tiny fraction of the total global bond market. Subprime loans didn't bring down the house in 2008 – it was the CDOs (collateralized debt obligations) and CDSs (credit default swaps) that Wall Street used to engineer astronomically leveraged exposures to subprime debt. The credit rating agencies never issued anything as dire-sounding as today's Ukraine downgrade language to suggest problems lurking behind the sterling ratings of those alphabet-soup derivatives. Yet the scenario few expected was the one that played out.

…and LTCM

Think back as well to 1998, when Ukraine's neighbor to the north defaulted on its debt. Russia's default sent its currency spiraling overnight from 6 roubles to the dollar to 25 to the dollar. That might not have been much more than a local problem, except for the fact that Long Term Capital Management, a systemically critical hedge fund, was overexposed to Russia and collapsed. A larger financial contagion was averted only after a massive bailout engineered by the U.S. Fed, Treasury Department and Wall Street's bulge-bracket banks.

The National Bank of Ukraine has spent about $1.7 billion in the past few days to shore up its currency. Today the government and protesters are trying to find a mutually acceptable compromise that would defuse the crisis. Asset markets are mostly calm. We believe this to be more likely a brief tempest than a gathering storm. But no X-factor lives alone. We must constantly monitor not just the surface, but what lies beneath the surface.

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