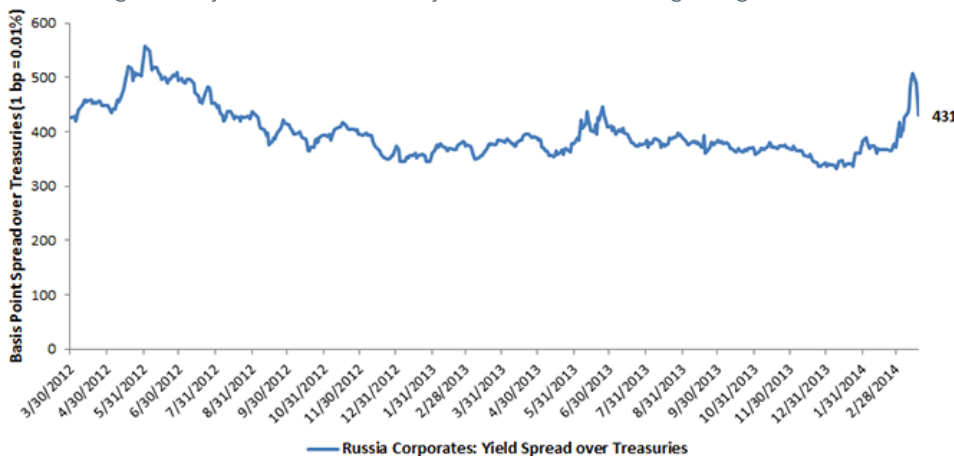


AN UPDATE ON RUSSIA AND RUSSIAN CORPORATE BONDS

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• Near-term [volatility](#) will continue to be driven by an escalation or reduction of tensions on the ground in Ukraine and the political chess match between the West and Russia. • European dependency on Russian energy exports provides a clear economic cost to the EU, should it impose more aggressive sanctions. • For long-term investors, Russian [corporate bonds](#) offer attractive levels on an absolute and a relative basis compared to corporate bonds from both U.S. issuers and from other emerging market (EM) countries. • Market conditions merit a high degree of scrutiny. We remain biased toward bond sectors that are strategically important and can potentially benefit from a falling ruble, as well as issuers that have a proven track record and adequate access to capital. Investors continue to monitor developments on the ground in Crimea and the Ukraine as well as the political chess match between Russia and the West. As a result, volatility has increased dramatically as investors react to headlines. For many, memories of losses from Russia’s default in 1998 have resurfaced along with the pervading distrust during the Cold War. For investors, the fear of the political unknowns is continuing to complicate investment decisions. Last week, Russian assets sold off markedly ahead of the succession vote in Crimea. Now, with Russia’s annexation of Crimea countered by only an incremental response from the West, credit markets have recovered somewhat. Russian corporate bonds have rallied significantly from the lows both on an absolute basis and compared to corporate credits in other countries. But corporate bond [spreads](#) and [credit default spreads](#) remain significantly wider than they were at the beginning of March. **[Yield Spread over Treasuries](#)**



— Russia Corporates: Yield Spread over Treasuries
Russia corporate exposure of the JP Morgan Corporate Emerging Market Bond Index - Broad. Past performance is not indicative of future results. You cannot invest directly in an index.

As investors, we continually assess [risks](#) on the basis of the likelihood of various potential scenarios. We see three scenarios emerging from current tensions. • **Uneasy Stability** – Crimea is annexed, the West delivers a face-saving wrist slap, and tensions die down but don’t severely dent the economic interests of either side. • **Prolonged Chess Match** – Tensions rise and fall but remain relatively elevated in the coming months. Some economic pain is experienced on both sides, as fundamentals particularly in Russia and Ukraine show further deterioration. The risk premium built into Russian assets fades slowly and the ruble depreciates as the Russian Central Bank partially reverses its temporary interest rate hike to support growth. • **Significant Escalation** – The prospect that tensions escalate via further Russian incursions into Ukraine increases the potential for a policy mistake between the West and Russia. At present, this is the biggest risk that markets are trying to react to each day. The understanding that significant economic consequences are likely to result for both sides mitigates this risk. But there is some danger that economic considerations might be superseded by Russia’s desire for increased influence in the former Soviet republics. In our view, the market is currently wrestling with uneasy stability and a

prolonged chess match as the most likely options. [Risk premiums](#) are still high, but the risk of a full-scale military conflict has faded. While the West has said that more sanctions may be forthcoming, the U.S. and EU allies are struggling to impose meaningful punitive measures without threatening their own economic interests, particularly in Europe. As many analysts have noted, Europe receives 30% of its natural gas from Gazprom, the state-controlled Russian gas giant. For Western European consumers, a near-term alternative supplier is nonexistent. However, even before Putin decided to get involved in Crimea, Russia has seen a gradual deterioration in its economic [fundamentals](#). Its [current account](#) surplus has dissipated rapidly and its trajectory for growth has faded as well. In light of the current political situation, most analysts believe the Russian economy will grow by less than 1% this year.¹ Amid continued volatility, we believe that Russian risks will fade slowly and the ruble is likely to experience a modest depreciation. As for corporate bonds, the situation suggests that investors should gravitate to sectors and issuers that are strategically important and largely export focused. Sectors such as oil & gas, metals & mining and chemical issuers are neutral or positively disposed to a falling ruble, particularly against the euro. Corporations that are more domestically focused and derive a larger portion of their revenues in ruble will potentially come under pressure as their revenues depreciate relative to their foreign currency-denominated debt. To summarize, we prefer outward looking to inward looking, and strategically important to discretionary. As investors continue to monitor developments in Russia, it is important to remember that a majority of EM corporate bonds are [Euroclear eligible](#), custodied outside Russia and governed by U.S. or UK rule of law. Many of the well-known, export driven issuers have management teams that have weathered past bouts of volatility successfully. Ultimately, the essential question for credit investors is whether the companies have the ability and willingness to pay. For the patient investor, we believe they will. ¹Source: Bloomberg, as of 03/20/14.

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Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Investments focused in Russia, Crimea and Ukraine are increasing the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Corporate Bonds : a debt security issued by a corporation.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Credit default spread : a market derived measure of risk that seeks to signal the likelihood that a borrower will default.

Yield spread : the amount of incremental income a bondholder receives for assuming credit risk.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Current account : The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

Euroclear eligible : a trade settlement system in Europe that allows for the efficient delivery of bonds and funds.