HIGHLAND

MARKET BRIEF
DECEMBER 2014

GLOBAL IMPACT OF RUSSIA'S RUBLE CRISIS

- The Russian Central Bank (CBR) raised its main interest rate from 10.5% to 17% on December 15th, citing concerns about the recent devaluation of the ruble and rising domestic inflation.

- Over the past two months, the ruble has declined sharply in response to Western sanctions over Russian interference in Ukraine and falling oil prices. Geopolitical tensions have stepped up in recent days following votes by U.S. lawmakers approving more sanctions against Russia and the delivery of military equipment to Ukraine. However, the heart of the problem is plunging oil prices, as half of Russia's revenues comes from oil & gas.

- This is clearly not good news for the world economy, as the CBR's actions risk pushing Russia closer to recession. Nonetheless, the links between Russia and the rest of the world remain too small to have major global implications. For two reasons:

    - First, Russia accounts for only 2.7% of world GDP, and its share of world trade is approximately 1.7%. [1]

    - Second, financial institutions in the world's leading economies have minimal exposure to Russia. According to BIS data, U.S. bank lending to Russia accounts for only 0.1% of U.S. GDP, while figures for Japan, the U.K., China, and Germany are all below 1% of GDP. [1]

- While Russia is not large enough to make a difference to global economic prospects, four further points are worth making:

    - First, Russia is just the most recent and extreme example of the negative effects of lower oil prices. As we discussed in "The Effect of Falling Oil Prices on the Current Economic Landscape" published in late November, the risks are significant.

    - Second, the incentive for Russia to keep producing and exporting commodities has only increased. As a result, we would not expect Russia to cut its oil production, and thus any upward pressure on oil prices is unlikely to come from the world's second largest producer.

    - Third, President Putin must choose whether to escalate the conflict in Ukraine as a distraction from his domestic problems, or reach out to the U.S. and Europe in an effort to calm the tension. As Stratfor wrote in a recent memo, "Putin is well aware of the impacts of major economic crisis on past Russian governments, as it was Russia's 1998 financial crisis that ushered in the downfall of former President Boris Yeltsin and facilitated Putin's own rise to power. At the same time, the United States and European Union understand that pushing a nuclear-armed country as large and powererful as Russia towards full-scale collapse can have serious unwanted consequences, and such aim ultimately may not be in their interest. [2]

- AGGRESSIVE ACTION TAKEN BY RUSSIAN CENTRAL BANK ATTEMPTING TO SLOW CURRENCY DEVALUATION

- LINKS BETWEEN RUSSIA AND REST OF THE WORLD REMAIN TOO SMALL TO HAVE MAJOR IMPLICATIONS

- BIGGER ISSUES IMPACTING EMERGING MARKETS INLCUDE DECLINING OIL PRICES, GEOPOLICTICAL TENSIONS AND STRENGTHENING DOLLAR

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *General support*

GLOBAL IMPACT OF RUSSIA'S RUBLE CRISIS, CONTINUED

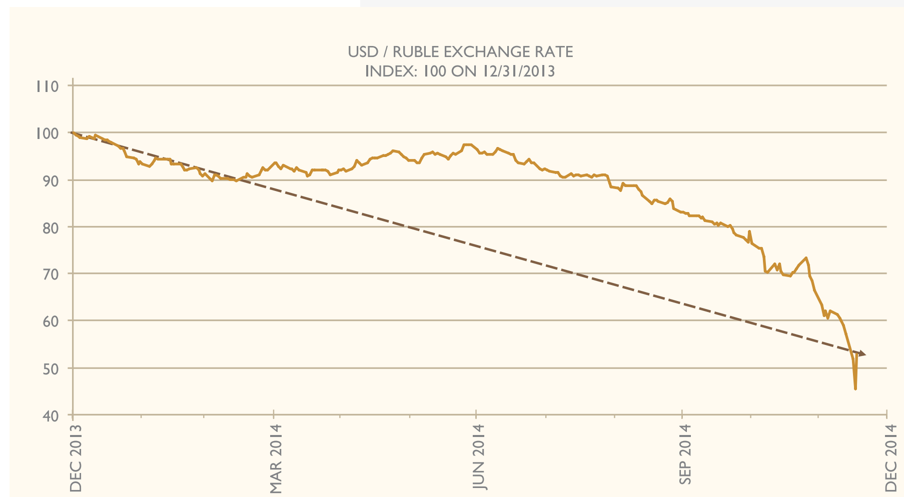
- It is important to note that the selloff in emerging market currencies and assets over the last week has as much to do with concerns about future interest rate increases in the U.S. and a stronger dollar redirecting investments out of emerging markets as it does with a potential recession in Russia or plunging oil prices. This unwinding of the so called "carry trade" is something Highland has been monitoring for some time, and one reason we have been hesitant to increase the emerging market exposure in portfolios despite attractive valuations.

- When the dollar is weak and U.S. interest rates are low, emerging market participants have ratcheted up borrowing in general and especially from U.S. investors, as fixed income investors seeking to enhance the yield on their portfolios have been happy to participate in this so called "carry trade." Eventually, however, as an improving U.S. economy gives way to periods of dollar strength and rising U.S. rates, capital tends to rush out of emerging markets and into the more stable and suddenly higher yielding U.S. market. Essentially, investors decide that emerging markets' dwindling yield advantage is not enough to offset the risk of currency losses. The most memorable examples of this phenomenon include the early 1980s Latin American debt crisis and the late 1990s "Asian contagion" that sent emerging market economies, currency values, and equity values into a deep downward spiral. This is why you are hearing comparisons to those periods today.

- Continued dollar strength could begin to entice this enormous supply of foreign capital out of emerging markets and back into the U.S., with potentially violent impacts on credit-dependent emerging market growth. If there are significant capital outflows from these emerging markets, their governments are likely to substantially raise interest rates and restrict credit expansion further stifling economic growth. Given that emerging markets are home to the strongest economic growth rates in the world, the reverberations from this scenario could be felt in the U.S. and around the world.

1 Capital Economics

2 Stratfor Global Intelligence



SOURCES: FACTSET; BANK OF ENGLAND

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HIGHLAND

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH
SUITE 200
BIRMINGHAM, ALABAMA 35205-2478
P. (205) 933-8664
F. (205) 933-7688

HIGHLANDASSOC.COM