

Russia Update: Rising Instability, Syria and Sanctions

The last 30 plus days have seen a dramatic unfolding of events involving Russia. The combination of rising political tensions, new U.S. sanctions and another chemical weapons attack in Syria have put investors on edge. The conundrum facing investors is whether this new Syria crisis will quickly fade or linger given other cumulative effects. Based on our analysis of instability and sentiment data, the expectation is that this crisis should prove momentary rather than paradigm shifting. Absent further escalation we expect a return to normal levels albeit at a more gradual pace. Overshadowed by events in Syria, but equally interesting, are the recent U.S. sanctions against Russia. Specifically, the character of these new sanctions will have a more significant impact on U.S. investors, especially if broadly applied going forward.

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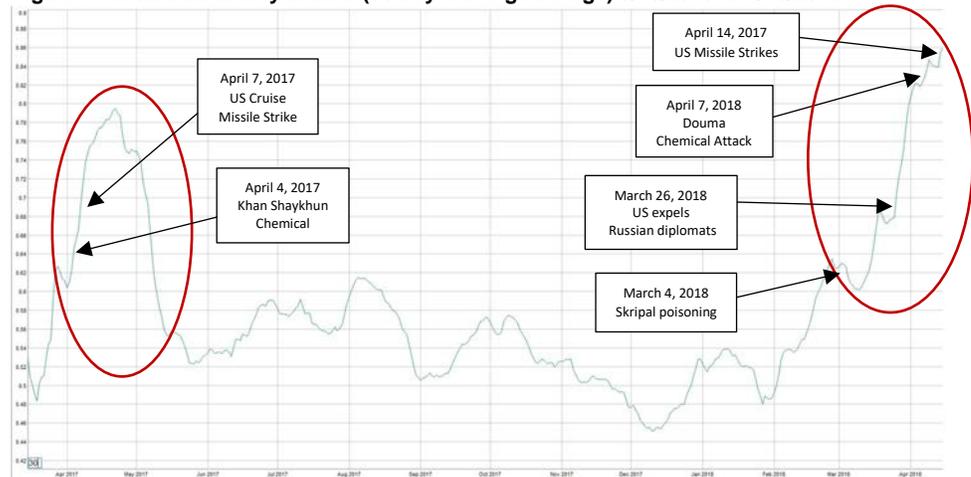
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Trends in Russia Instability and News Coverage Sentiment

The volume of instability related news events involving Russia has spiked over the past month, hitting a yearly high on April 15 of .86, based on the 30-day moving average.¹ This exceeded the year-to-date average (.64) by 34 percent. The last time Russia instability reached such levels was after the last Syrian chemical weapons attack at Khan Shaykhun on April 4, 2017, and the U.S. retaliatory strike. That spike proved short-lived, lasting about 30 days before returning to pre-crisis levels (see Figure 1).

This time, however, we are at a notably higher take-off point for the latest Syria crisis. Russia instability was climbing on the news of the diplomatic crisis caused by the poisoning of former Russian spy, Sergei Skripal, in the U.K. on March 4. The average instability levels since April 8 are the highest recorded for Russia since we began tracking country instability in November 2016. Back in April 2017, instability jumped 15 percent following the U.S. military response. So far, while still at a very elevated level, instability has not moved as dramatically in the aftermath of the U.S. missile strikes on Saturday. Overall, while anticipating reversion to the average, the steeper and higher climb likely means a longer, more gradual path.

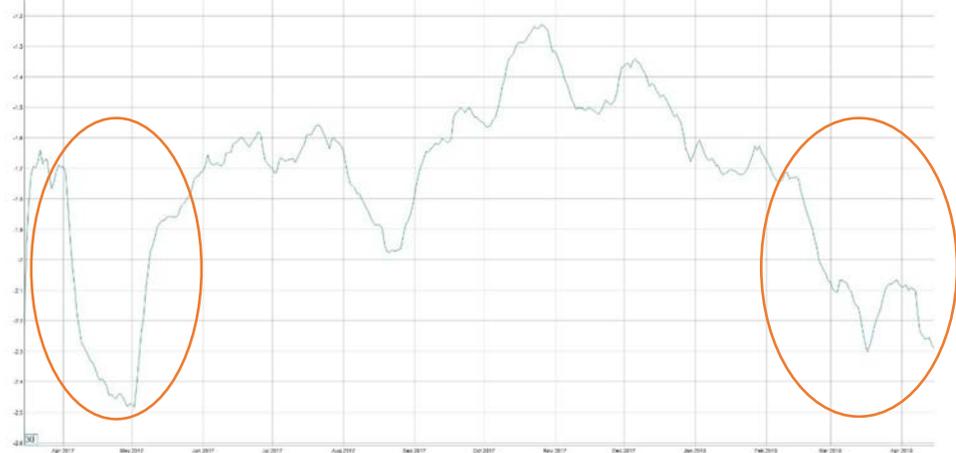
Figure 1. Russia Instability Events (30-day Moving Average) 3/15/2018 to 4/15/2018



Source: Northwest Passage Capital Advisors, GDELT

As to the overall tone of media sentiment, we observe differences between the two spring swoons in 2017 and 2018 (see Figure 2). April 2017 sentiment fell sharply before bottoming out and quickly rebounding. Since the start of 2018, we observe a steady downward trend. A more rapid decline began on February 7 following reports of 300 Russian private military contractors being either killed or injured in Syria following an attack against a U.S.-held position. The decline accelerated as the diplomatic crisis with the U.K. roiled. A slight recovery was stunted by the April 7 Syria chemical attack. Unlike in 2017, a return to normal likely will be more gradual as other events (U.K. Spy incident) must also abate.

Figure 2. Russia News Sentiment (30-day Moving Average) 3/15/2018 to 4/14/2018



Source: Northwest Passage Capital Advisors, GDELT

The Possibility of Syria Escalation

In the wake of the chemical weapons attack at Douma, saber-rattling tweets from President Trump fueled uncertainty over escalation and a Russian response. Adding to this were boastful comments coming from Russian officials suggesting Russia's ability to thwart a U.S. cruise missile attack and possible reprisal should Russian military personnel in Syria be harmed.

Ultimately, the U.S. response, three coordinated missile strikes at Syrian chemical weapons-related facilities, has been viewed as in line with the strike in 2017. So far, other than publicly denouncing the strikes, the Russian government has not escalated matters militarily. Absent additional strikes by the U.S. in the coming days, we do not anticipate further escalation.

New U.S. Sanctions

Before the Douma attack, on Friday, April 6, the Trump administration imposed new sanctions against Russian interests. On the surface, these sanctions followed the pattern of specifically targeting individuals and corporations. However, aside from breaking with the perceived reluctance of President Trump to impose additional sanctions, the new sanctions are different in character. The several Russian nationals and a dozen Russian corporations were all added to the Office of Foreign Assets Control (OFAC) Specially Designated Nationals (SDN) list rather than the previously used Sectoral Sanctions List (SSL).

Designation on the SDN list represents an escalation of sanctions risk for Russian corporate bonds. U.S. persons are generally prohibited from engaging in transactions with designated individuals and entities. Non-U.S. persons could face sanctions for engaging in certain transactions with the designated individuals and entities. In essence, this means that U.S. persons can neither buy nor sell the sanctioned security; further U.S. holders cannot receive principal or interest payments, as receiving or facilitating payments on the security would violate U.S. law for both the holder and any U.S. financial intermediaries processing the payment. Although the dollar amount of affected securities is small (under \$2 billion), the stronger sanctions negatively impacted Russian markets,

driving a significant sell-off in the Ruble, pushing Russian stocks down by more than 20 percent and widening Russian sovereign dollar credit spreads.

To date, the U.S. Treasury has not sanctioned the Russian sovereign, so Russian sovereign bonds face no restrictions. However, while we consider it unlikely for a variety of reasons, the probability of broad application of SDN designations to Russian Eurobond issuers has increased.

Conclusion

- While we expect a return to normal levels of Russia instability and sentiment, the path back will be gradual and will take longer than in 2017 given other cumulative events still unresolved.
- In Syria, the U.S. response was proportional to that of last April. Accordingly, failing any further chemical attacks, no further U.S. military action or a Russian response are expected
- In the medium term, the changing nature of U.S. sanctions against Russian entities presents the bigger potential risks to U.S. investors. Broader use of the SDN designation would pose substantial problems. Future sanctioning actions of the U.S. Treasury will warrant close attention.

¹The instability and news sentiment data used in this report was obtained from GDELT. Launched in 2011, GDELT (The "Global Database of Events, Languages and Tone") is the biggest open data database of political events in the world. Updating every 15 minutes, GDELT monitors the internet providing historical data since 1979 for all broadcast, print and web news from nearly every country in over 100 languages and identifies people, locations, organizations, counts, themes, sources, emotions, quotes, images and events. For more information go to <https://www.gdeltproject.org/>.

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