12 August 2014

The Ukrainian Crisis

The Nordic angle

- We analyse the economic and financial impact of the Ukrainian crisis with a special focus on our footprint Nordic markets. We view the situation in Ukraine as far from de-escalating as fighting continues in Donetsk and Lugansk, which we expect to weigh on market sentiments near term.
- However, we believe an escalating trade war would be unbearable for both Russia and the EU and that the EU will revoke the sanctions within one to three months, with Russia abolishing its own sanctions.
- Both the EU and Russia have too much to lose if the bilateral energy trade is not kept out of the conflict. Consequently, the risk of a near-term supply disruption is limited with modest impact on oil and gas prices.
- The Ukrainian crisis will have a modest direct impact on the European economy given manageable trade and financial links for the bigger economies. Instead, the biggest risk to EU activity is likely to come from negative sentiment.
- Of the Nordic countries, Finland is clearly the most vulnerable due to trade, tourism and foreign direct investment (FDI) links. We have revised our 2014 Finland GDP forecast down to -0.2%.
- The Ukrainian crisis should have limited impact on the Scandinavian countries, with Norway potentially gaining over the longer term if the EU substitutes Russian gas with Norwegian gas. However, this would mainly strengthen public finances unless the conflict is prolonged.
- We expect the PLN, CZK, HUF and EUR to continue to underperform on the Ukrainian crisis. However, stabilisation of the crisis should trigger a relief rally in Eastern European currencies. We see the crisis as marginally positive for the NOK relative to the SEK and DKK given lower trade links and potential EU gas import substitution towards Norway and away from Russia.
- If the newsflow out of Ukraine stabilises, we expect the global fixed income markets to give back some of their recent gains. This would mean higher rates in the US and steeper curves in EUR core and swap markets.
- We believe the recent sell-off in equities is a reflection not of changes in fundamentals but of political turmoil. However, a number of Nordic companies are exposed to the Ukrainian crisis where Finnish and selective Swedish accounts stand out. We examine the individual companies' links to Russia.

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The Ukrainian crisis – what next?

Geopolitical risks have surged further as Russia hits back at sanction-imposing countries, limiting agricultural products and food imports from them. Last week, on 6 August 2014, Russia's Prime Minister Dmitry Medvedev signed a decree banning completely imports of meat (beef, pork, poultry) and meat products, fish, milk and dairy products, vegetables and fruits from Australia, Canada, the EU, Norway and the United States. The ban is due to last for one year but can be abolished earlier. In the decree, the government urges Russian authorities not to let 'prices on agricultural products, raw materials and foods to increase'. The decree came into force on 7 August. At the same time, the Russian government is considering banning the EU and the US airlines from transiting through Russian territory to Asia. The government has already banned transit of Ukrainian airlines over Russian airspace.

Russia's food imports from the EU account for approximately USD15bn per year but the value of the trade sanctions will be less than this, because alcohol and some processed food, such as coffee and bakery items, can still be imported. However, at a country level, the effect of Russian sanctions could be more dramatic for the Baltic countries, Finland and Poland, which export large amounts of fruit, vegetables and dairy products to Russia. For example, Finnish food exports to Russia account for 25% of all food exports. This is around EUR450m annually.

Geopolitical risks in focus again

In a TV interview, last week Polish Foreign Minister Radoslaw Sikorski warned Russia about the impact of a conventional war in Europe. Bloomberg reported that according to Poland's Prime Minister Donald Tusk, Poland has reason to believe that the risk of an incursion is greater than a few days ago. NATO stated that it sees a risk that Russian troops will enter Ukraine under the 'pretext' of a humanitarian or peacekeeping mission.

We view the situation in Ukraine as far from de-escalating as fighting continues in Donetsk and Lugansk, where more than 1,000 people have been killed since April 2014, according to the UN. The UN refugee agency UNHCR stated that according to the Russian authorities more than 168,000 displaced people applied to Russia's federal migration service in the first seven months of this year. The UNHCR estimates that the number of people displaced in eastern Ukraine is 117,000.

What's next?

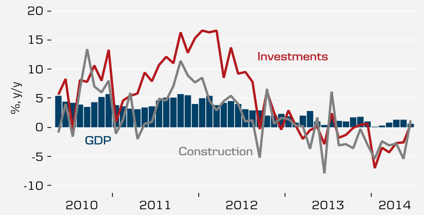
We see the current situation as being far from stable and in equilibrium. Our base-case scenario suggests an escalating trade war would be unbearable for both parties and that the EU will revoke the sanctions within one to three months, with Russia abolishing its own. Even if the food import ban gives some support to local food producers in Russia, the short-term effect would be an acceleration in prices with the CPI approaching 8% y/y in 2014. This means we would see tighter monetary policy in Russia, which would enforce a demand-side shock. The supply-side shock would increase in banned imports and thorough continuing capital outflows deepening long-term economic prospects. Despite tightening monetary policy, we expect Bank Rossii to keep providing good liquidity for local banks and believe it will try to avoid FX intervention as recent data show that the RUB is not weak enough: the real effective exchange rate has risen 1.4% year-to-date.

Agricultural products, raw materials and foods originating from the US, the EU, Canada, Australia and Norway banned from import into Russia*

- Meat (beef, pork, poultry)
- Fish and shellfish
- Milk and dairy products
- Vegetables
- Fruits and nuts
- Sausages and meat products
- Cheese and curd on vegetable oil base
- Milk containing products on vegetable oil base

** The current ban does not include children's food*
Source: Russian Government

Russia's main macroeconomic indicators



Source: Macrobond Financial, Danske Bank Markets

Russian private sector's capital net flows (USDbn)

Source: Bank Rossii, Danske Bank Markets

Currently, Putin's support inside Russia remains very strong, hitting five-year highs. As economic growth is slowing gradually without considerable drama, we do not see a significant political risk in Russia. In the current economic environment, Russia is planning to tighten its economic and political links with Latin American and Asian countries. Nevertheless, a sudden escalation of the situation surrounding Ukraine could trigger new turmoil for Russian markets, hitting Russian private consumers further.

We still expect the Russian economy to shrink 0.3% y/y this year and fall 1.8% y/y in 2015 as the continuity of current sanctions is still unsure. However, we see further downside risks from demand and supply shocks for our 2015 GDP forecasts.

Low risk of energy supply disruption

So far, the energy market has taken the escalation of the conflict with relative ease. The oil market looks more concerned with the longer term ramifications of the conflict than the risk of a near-term supply disruption. The forward discount on Brent has thus declined quite sharply since late July probably reflecting expectations that the future crude supply from Russia will be hampered by the conflict – current sanctions already target export of energy technology to Russia.

We have registered some jitters in the European natural gas market lately. Natural gas prices have been on a rapid decline over the past year but this trend has reversed recently. However, natural gas prices in Europe remain at a low level, which should not be a cause for concern.

Oil and natural gas exports from Russia cover around 8% of global oil demand and 7% of global natural gas demand. The EU counts on the lion's share of Russia's energy exports. Imports from Russia cover around half the EU's oil demand and around 25% of natural gas consumption. Other large markets for Russian energy include its Eastern European peers Turkey and China.

Hence, Russia is an instrumental supplier of energy to the global market and, in particular, Europe, which makes the energy sector harder to target with sanctions. At the same time, Russia is highly dependent on revenue from the energy trade, which limits its ability to use the threat of a shutdown of energy exports as a pressure point.

In our view, both sides of the conflict, therefore, have great incentive to leave the bilateral energy trade out of the conflict. Consequently, the risk of a near-term supply disruption is limited. This further means that the near-term risk of markedly higher oil and natural gas prices is, in our view, fairly limited.

Although it is not our base scenario, we cannot completely rule out a situation where Europe has to manage without Russian energy, at least for a short while. Western Europe on an aggregate level currently has enough oil in stock to replace 224 days of supply from Russia assuming unchanged demand. If we include the strategic reserves from the US, Europe could replace 339 days of demand from Russia.

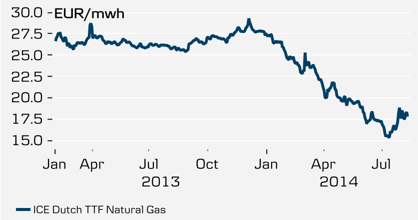
In terms of Europe's supply of natural gas, the process of refilling stocks before winter temperatures arrive is well ahead of schedule. Total EU natural gas stocks are currently 81% filled – around 5% more than normal for this time of year. The present stock level means that Europe on an aggregate level would be able to replace Russian gas for 228 days. However, the mere logistical difficulties of moving natural gas around within the EU mean that some countries are more dependent on Russian gas than others.

In terms of the price reaction in the worst-case scenario, it is difficult to assess how high the oil price would rise, as there is no precedent for the top world supplier shutting down exports to its largest market. During the Arab Spring in early 2011, the oil price rose more than 30% and moved above USD120/bl. The oil price may climb even higher given that Russia is more important to the global market than, for example Libya.

One key departure from early 2011 though is that the market is now well supplied on the back of the North American oil boom. However, currently OPEC has little spare capacity, which limits its ability to dampen upwards pressure on the oil price.

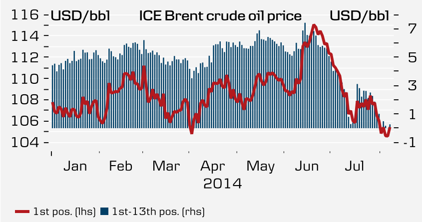
The effect on European natural gas prices is likely to be even higher given the difficulty of obtaining supply from outside Europe.

Downtrend in European natural gas prices reversed



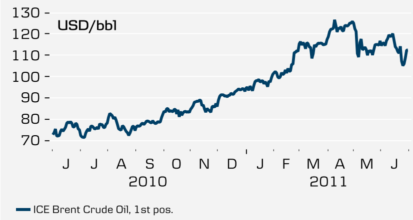
Source: Macrobond Financial

Oil forward discount has declined



Source: Macrobond Financial

Arab Spring triggered sharp oil price increase



Source: Macrobond Financial

Global growth: main impact of negative sentiment

The European economy is clearly the most exposed area of the world economy. Still, the direct impact on Europe from the tensions in Russia and Ukraine is likely to be rather modest given the limited direct trade links from Russia to Europe. Russia accounts for 4% of total exports in the euro area, whereas the US accounts for above 12% and China's share is around 7%.

The investment flow to/from Russia is also limited. Foreign direct investments from Russia exceed 5% of GDP only in The Netherlands, whereas the share is below 1% of GDP in the other large euro area countries. The Netherlands and Ireland have foreign direct investments in Russia accounting for more than 5% of GDP, while the share is between 2% and 5% in Austria and below 1% in the other biggest euro countries.

The biggest risk to euro activity should instead come from negative sentiment. A continuation of the conflict could result in businesses being increasingly cautious, resulting in weaker or even negative growth in investments together with weakness in the development of employment as businesses postpone the decision to hire more workers.

Some of this has already been seen in the euro business surveys, which have overall trended lower since January. In the PMI report for July, it was noted that 'Part of the weakness of growth can be attributed to geopolitical concerns and notably worries about the potential economic impact of the escalating situation in Ukraine'. Nevertheless, some of the weakness in the business surveys also reflects the slowdown in the US and China in Q1.

The impact on sentiment stemming from the tension in Russia and Ukraine is largest in the eastern European countries and moderate in the biggest countries. This is reflected in the IFO report released in August. Here it appeared that most companies in the biggest euro countries expected the effect due to the Ukraine conflict to be weak. Only Italian businesses expected a moderate negative impact, while companies in Finland expected to be strongly affected.

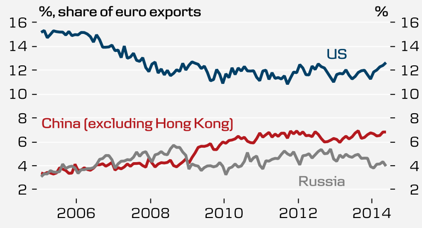
Having said this, a tit-for-tat development could suddenly see things spin out of control, resulting in a larger negative sentiment effect. In our view, there are two key determinants that could lead to a bigger impact on the global economy.

1. **Russia moves troops across the border and into Ukraine.** This would lead to a severe escalation that would involve very high uncertainty and a strong response from the West in terms of more and harder sanctions that would lead to counter-sanctions from Russia.

2. **Energy and gas supplies become part of the economic warfare.** Given the limited direct trade links from Russia to Europe, we believe this is the main area where Europe could be hit directly. It would also increase the negative sentiment effect significantly.

None of these is in our baseline scenario, which is still that the crisis will not lead to a material impact on the European economy and both parties to the crisis know that taking the conflict to the next level would have significantly greater implications economically. However, any signs that the crisis continues to escalate and could lead to one of the two issues – or both – would warrant great caution. **However, in our view, the political situation relating to the Ukraine crisis should be watched closely.**

Limited direct trade links from Russia

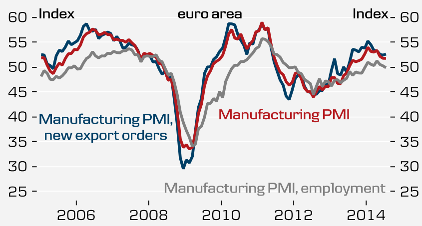


Source: Macrobond Financial

Weakness in industrial production could be related to geopolitical risks

Source: Macrobond Financial

Weaker euro sentiment



Source: Markit PMI

Denmark – limited effect of sanctions

The Danish economy is not very dependent on trade with Russia and therefore we do not expect the escalating diplomatic conflict to have major direct macroeconomic consequences for Denmark. Danish trade with Russia ran up to DKK17bn in 2013, equivalent to 1.7% of Danish exports, or 0.9% of nominal GDP in 2013. Goods exports to Russia amounted to DKK11.8bn in 2013 (1.9% of goods exports).

The effect is even more limited if you only look at the products that so far seem to be subject to sanctions. Food exports to Russia ran up to DKK4.2bn in 2013. The major components were pig exports, which last year amounted to DKK1.6bn, and cheese exports, which amounted to DKK0.5bn. The sanctions will cover these products but exclude, for instance, cereal exports, which amounted to DKK0.3bn last year. When adjusted for the goods not covered by the sanctions, exports amounting to DKK3.5bn could be jeopardised by the sanctions. Exports of DKK3.5bn compare with total agricultural exports of DKK111bn. This corresponds to approximately 3.1% of Denmark's agricultural exports. DKK3.5bn is equivalent to 0.2% of GDP.

Although we do not expect the sanctions to be a macroeconomic challenge, they could hit some parts of the agricultural sector hard. If we look at the categories that are most severely affected in relation to the total exports of a particular good, then exports of pork and poultry fat stand out. Approximately 72% of these exports are sold on the Russian market. The next on the list is edible offal, with 7.1% (cereals are not sanctioned). In other words, some categories could potentially be hit quite hard but this is not the case in general.

Exports of food products to Russia were, as mentioned, DKK4.2bn in 2013. However, a large proportion of exports were actually already subject to sanctions, as at the end of January, Russia imposed a boycott on European pork products due to the outbreak of swine fever in Poland. Since February, exports of pork and pigs to Russia have been DKK0. Thus, the new sanctions include exports of only a further DKK1.5bn compared with what has been covered for half a year. DKK1.5bn is equivalent to 0.08% of GDP. Thus, the new sanctions do not affect the Danish economy in a significant way.

However, we expect the effect on the Danish economy of the new sanctions to be significantly less than DKK1.5bn. Many of the agricultural products that cannot be sold in Russia because of the sanctions can be exported to other markets. These exports may not necessarily be at the same price and with the same earnings but the goods will not be sold for free. As the global demand for food is not likely to be affected in any significant way, as the Russians will also need food over the coming months, the sanctions are likely to bring new export opportunities in other markets globally, as the Russians are likely to increase their imports from these countries.

What proportion of exports can be saved through exports to other markets is difficult to say but that exports of pork products have been sanctioned for a while allows us to see the actual effects of a boycott. As illustrated in the table above right, exports of pigs and pork to Russia were 6% of total Danish exports of pigs and pork. These exports have disappeared as a result of the boycott but as you can see from the chart on the right, total exports of pigs did not decrease correspondingly to the disappearance of exports to Russia. Danish exporters of pigs and pork have in other words been able to adapt.

Limited food exports to Russia

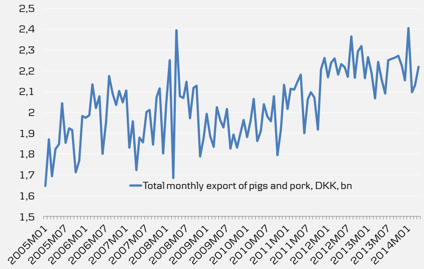
Source: Statistics Denmark

Danish food exports to Russia

	Share of global export	Export to Russia
	%	DKK bn
Live pigs and pork	6,0	1,6
Other manu. agri. products	3,2	0,8
Cheese	5,7	0,5
Pig fat and poultry fat	71,2	0,4
Feeding stuffs	5,5	0,3
Cereals	9,6	0,3
Edible offals of cattle, pigs etc	7,1	0,2
Others		0,2
Food exports to Russia	3,2	4,2

Source: Statistics Denmark

Pig exports almost unaffected by the Russian boycott since February



Source: Statistics Denmark

In conclusion, we do not expect the Danish macro economy to be affected in any significant way by the direct trade link. However, other economies may be affected more than the Danish economy and then affect Denmark through secondary effects, although we do not expect the second-round effects to be significant as Denmark's main trading partners – Germany, Sweden, the USA, the UK and Norway – are not that dependent on Russia either.

Another way the Danish economy could be affected is if the diplomatic crisis escalates, further jeopardising Danish imports from Russia. However, the risks on the import side also seem to be very limited. Danish goods imports from Russia amounted to DKK14.8bn in 2013, which corresponds to below 3% of total Danish goods imports that year. Goods imported consist mainly of petroleum and related materials (DKK10.2bn), iron and steel (DKK1.9bn) and coal, coke and briquettes (DKK0.9bn). While the absolute numbers do not describe how dependent Denmark is on specific product groups, we can get an idea of the dependency by calculating the ratio between imports from Russia and total imports for the individual product groups. The three aforementioned product groups amount to 17.1%, 12.6% and 34.7% of total goods imported, respectively. For these three groups, finding alternative countries to import from might be challenging but, in general, Denmark should be able to substitute from other markets to cover its needs. This is not the same as saying the sanctions will leave Denmark unaffected, as prices might, for instance, be higher but, in our view, the direct impact is quite limited.

Goods imports from Russia

SITC groups	% af total goods import	DKK m
Petroleum and related materials	17.1	10166
Iron and steel	12.6	1922
Coal, coke and briquettes	34.7	871
Feeding stuff for animals (not including unmilled cereals)	5.2	521
Cork and wood	6.6	370
Fertilizers	16.5	330
Fixed vegetable fats and oils	5.7	120
Cork and wood manufactures other than furniture	2.2	109
Inorganic chemicals	3.3	90
Special transactions and commodities not classified	1.3	89

Note: % of total imports is calculated as the imports from Russia to total imports for all product groups measured in %
Source: Statistics Denmark

Larger impact on Finland

Russia is Finland's largest trading partner calculated by the value of total cross-border trade and an important partner in many key sectors. Thus, swings in the Russian economy have direct impacts on the Finnish economy, which can be summed in three parts.

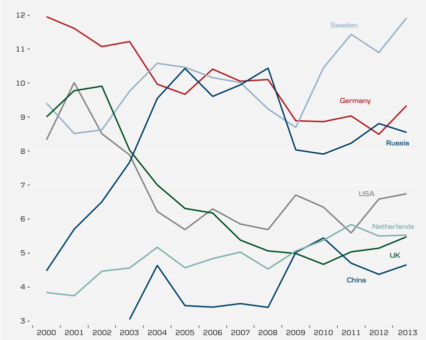
- **The most obvious link comes through exports and imports.** Finnish export and import companies that do business directly with Russia are dependent on undisturbed trade channels. Extensive trade sanctions would hurt them immediately. The embargo on imports of agricultural products has already led to the closure of product lines in Finland. Although the amount of exports under the current sanctions adds up to only 0.5% of Finland's goods exports and 0.14% of GDP, the possibility of further escalation is having an effect on confidence. Russia was Finland's third-largest export country last year after Sweden and Germany with slightly less than 9% of market share. The share of imports was over 15%, which makes Russia Finland's largest trading partner. The main export goods to Russia are machinery and equipment, forestry and chemical products as well as milk and dairy products. Imports consist particularly of energy but wood, iron and steel are also significant.

- The second key channel is **tourism**. Russians are by far the largest group of foreign citizens visiting Finland, as nearly 50% of foreign tourists come from Russia. Russian citizens use almost EUR1bn annually in Finland. In particular, the retail trade, hotels and local service businesses in south-east Finland rely on Russian consumers. The most recent statistics tell us that overnight stays by Russian tourists were down by 27% y/y in May. The weak RUB has already cut purchasing power and the escalation of the crisis in July to August spells trouble for industries relying on travellers from the eastern border. Tourism income can also be harder to replace than that from the export of goods, where companies can search for new markets in other countries. Retail sales may be helped by some Russians crossing the border to buy food.

- The third effect is the **direct investments** that Finland receives from Russia. Russia is a prominent source of foreign direct investments in Finland. The most topical investment is the new nuclear power plant Fennovoima. This would be owned partly by Rosatom, which would also supply the reactor and machinery. The final investment decision should be made in autumn 2014 but the current environment could hinder the process. Russia has also been a major target for Finnish FDI and emerging market portfolio investment, which has implied losses for some investors in Finland.

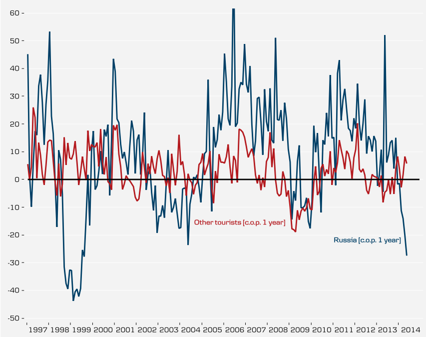
The weakness of the Russian economy has already been felt in Finland. The effect of the depreciation in the RUB could be seen late last year when exports to Russia turned into a decline. In January to May, goods exports declined by over 13%. We revised down our outlook for the Finnish economy in June and forecast that GDP will decline by 0.2% in 2014. Following the latest sanctions and escalation of the crisis, the risks to our forecast remain on the downside. Wider sanctions by the West and reciprocal action by Russia could push Finland into a deeper recession. As a rule of thumb, a 3% decline in Russian GDP cuts Finnish GDP by 0.5%.

Russia accounts for 9% of exports



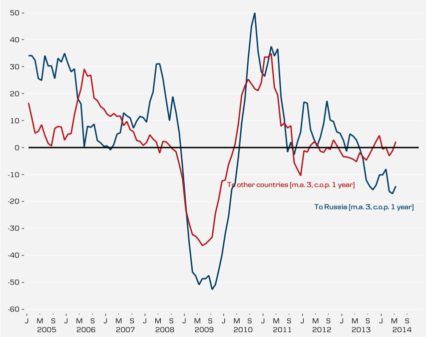
Source: Statistics Finland

Russian tourists are staying home



Source: Statistics Finland

Exports to Russia already down



Source: Statistics Finland

Sweden – direct effects are limited

Facts first

The direct links between Sweden and Russia are insignificant. In terms of trade **links**, Russia constitutes less than 1.5% of the Sweden's export markets for goods (mainly automotive, telecom and chemicals) and approximately 1% of its services export markets (mainly tourism). The unilateral food trade restrictions recently imposed by Russia on the West are thus of little significance for the Swedish economy, not even reaching SEK1bn in export value (<0.03% of Swedish GDP and less than 0.1% of total goods exports).

Imports from Russia are almost exclusively raw materials and other input goods, with the lion's share being crude oil. Russia is nonetheless considerably more notable as a source of imports, supplying almost 5% of Swedish imports of goods (services imports being virtually non-existent) concentrated on crude oil and other raw materials.

The data on **financial links** is less transparent but the latest information from the Bank for International Settlements, the IMF and the Riksbank indicate that Russia's FDI and portfolio holdings in Sweden are virtually non-existent. Swedish (FDI and portfolio) investments in Russia are, however, of some magnitude (in both absolute terms and relative to GDP), constituting almost 4% of Swedish GDP. Some 400 Swedish companies are present in Russian markets, with Atlas Copco, Modern Times Group, Oriflame and Vostok Nafta all demonstrating large exposures to Russia in terms of both sales and profits. In addition, Swedish banks' (mainly Swedbank and SEB) claims on Russian companies exceed 2%. Note lending carried out by Swedish banks is mainly to Russian subsidiaries or corporates with a Swedish parent.

Sweden's exposure to Russia (imports/debt in parenthesis)

	Goods	Services	Total	FDI	Claims	Portfolio	Total
SEK bn	23.0 (45.0)	33.0 (5.0)	56.0 (50.0)	112.0 (-0.5)	76.0 (57.0)	30.0 (0.0)	218.0 (57.0)
% of GDP	1.3 (0.7)	0.8 (0.1)	1.1 (0.4)	3.1 (0.0)	2.1 (1.6)	0.8 (0.0)	5.9 (1.0)

Source: Statistics Sweden, Riksbank, IMF, Bank for International Settlements, OECD. Danske Bank calculations and estimates

Danske Bank's views

As the *direct* links between Sweden and Russia are quite small, the **current trade restrictions do not pose any severe challenge for the Swedish economy**, at least in the short run. The total effects should not exceed SEK1bn but this is only under the rather strict assumption that it cannot redirect exports destined for Russia elsewhere.

Even if all trade and financial ties to Russia were severed it is hard to fathom how *direct* effects, under any scenario, could constitute a major threat to the Swedish economy. Some companies would suffer but with the exception of a very small number of corporates, the **Swedish business and financial sector remains very well insulated**.

Instead, **the main risks to the Swedish economy come from *indirect* and *second-round* effects**. The first and most obvious indirect effect is on confidence. Over the past few weeks, we have seen equity markets fall, ever lower yields and widening credit risk premiums. Even some international survey data has taken a beating. Should the conflict escalate or be prolonged, there is a significant risk that this will push economic agents to postpone consumption and investment decisions on a more widespread basis. Also, should the sanctions be extended to include a Russian export ban on gas or other strategic products, it might very well push Sweden's main export market – the euro area – back into recession.

A recession in Europe would be very hard fought for Swedish policymakers, as the economy is marred by falling prices, the Riksbank's repo rate is already at the nominal interest rate floor and additional fiscal stimuli are near impossible given the strict legal framework surrounding public finances.

To make things worse, should the Ukrainian situation deteriorate further, we see a risk of investor focus shifting again to economic fundamentals, which in the wake of the financial crisis has all too often meant a stronger SEK, possibly aggravating a dire policy situation further.

Admittedly, the Riksbank could opt to go 'nuclear'; seeking to weaken the SEK via, for example, a EUR/SEK floor linked to specific inflationary developments. However, this would be regarded as an extremely aggressive policy under any circumstances and might be near impossible should Sweden's competitor nations again flirt with recession.

Norway – limited trade links

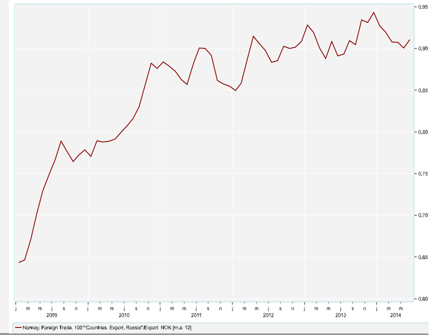
Potential positive gas effects further out

There are two main effects from the Ukrainian crisis on the **Norwegian** economy. First, the Russian sanctions on various food imports will hit the aquaculture sector directly. Second, the risk of an escalation of the crisis could affect Norway indirectly through the European/global energy markets.

The trade links with Russia are limited. Only 0.9% of Norwegian exports are to Russia. However, more than 90% of these is from the aquaculture sector and hence affected by the Russian sanctions. Even so, the overall effect will probably be limited as fishery products could find their way to the Russian market either through Chile or through a third-part country outside the EU. Anyway, the effect on the Norwegian economy will be negligible, unless the spillover effects from other European countries become more severe.

If the crisis escalates and changes the outlook for the European or global energy markets, the effects on the Norwegian economy could increase. There are two alternative scenarios here. If energy prices rise sufficiently to create a negative supply-side shock to the global economy, the effect would be negative. On the other hand, if energy prices remain subdued but Norwegian gas exports to Europe increase to replace Russian gas, the effect could be positive. However, this would mainly strengthen public finances unless the conflict is prolonged.

Limited exports to Russia (% of overall exports)

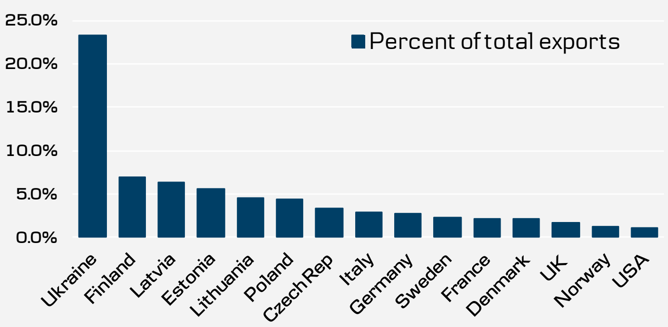


Source: Macrobond Financial, Statistics Norway

FX implications

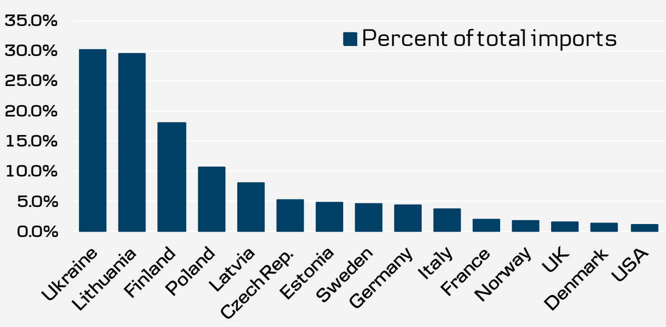
We use different angles to assess the impact on FX markets. First, we use our vulnerability index, which shows that Eastern Europe is most vulnerable, Western European countries have medium vulnerability and Scandinavian countries are less affected. Russia is a major export market for Ukraine, the Baltics, Finland and to a lesser extent Eastern European countries. Russia accounts for a relatively small part of exports from Western Europe, Scandinavia and, in particular, Norway. As flagged above, we do not expect the Ukrainian crisis to have a significant near-term impact on Russian gas supply and prices. Hence, the short-term impacts of imports from Russia should be limited.

Eastern Europe vulnerable, Scandinavia insulated



Source: Bloomberg, Danske Bank Markets

Eastern Europe imports from Russia



Source: Bloomberg, Danske Bank Markets

Nordics

We see the impact on the Nordic countries as minimal, with the exception of Finland, which is of course pegged to the EUR. Of the Nordic countries, Norway has the smallest export exposure to Russia, which accounts for only around 1.22% of total exports. In addition, if Norwegian gas exports to Europe over the longer-term increase to replace Russian gas, the effect could be positive. However, this will mainly strengthen public finances unless the conflict is prolonged. In 2012, Russia accounted for around 24% of the EU's gas imports and Norway 22%. To provide an estimate of the increase in Norway's possible gas supply to the EU, we assume that Norway can produce as it normally does in Q4 and Q1. This implies an 8.4% increase in Norway's gas supply, which would imply a 6% increase in Norway's trade balance. In percentage of GDP, Norway's trade balance surplus would increase 0.76 percentage points to 13.26% from 12.50%. In nominal terms, this implies that Norway's trade surplus would rise by NOK22.7bn to NOK293.2bn. Note that our calculation is under the assumption that prices do not change. As such, our estimates are conservative as they assume no price effect and that Norway is able to increase capacity 'only' up to what it currently produces in the winter months.

Overall, we see the Ukrainian crisis as having a marginal impact on the SEK, NOK and DKK. However, on balance we see the risk as favouring the NOK compared with the SEK and DKK given less export exposure to Russia and potential longer term positive impacts for Norway's gas exports. We target NOK/SEK to reach 1.12 in August.

G10

We see the Ukrainian crisis as being negative for the EUR. Of the G10 markets, Europe is the most interlinked with Russia in terms of trade and financial links. Negative sentiment, is also likely to affect the eurozone the most as seen in the recent eurozone business survey. Even if the Ukrainian crisis eases, we expect EUR/USD to fall on diverging monetary policy and portfolio flows. We forecast a grind lower in EUR/USD to 1.30 in 6 months and 1.26 in 12 months. While we are fundamentally bearish on the JPY and CHF, we see the Ukrainian crisis as short-term bullish for these currencies given their safe-haven status. Japan and Switzerland also both have very few trade links with Russia and hence the negative sentiment due to geopolitical risks should have limited impact on domestic sentiment. We view the Ukrainian crisis as having a limited impact on the GBP, AUD, CAD and NZD given negligible trade and financial links.

Emerging markets

Ukraine, the Baltics, Bulgaria, Poland and the Czech Republic all have substantial trade and financial links with Russia. Hence, the BGN, PLN, CZK and RUB are likely to continue to underperform other emerging market currencies as long as the crisis continues. In contrast, we expect heavily managed Asian currencies such as the Chinese yuan (CNY) to outperform. However, if we are right that the EU will revoke its sanctions in one to three months and sentiment improves, this should trigger a short-term relief rally in CEE currencies.

Rates implications

The main impact on the global fixed income market of the situation in Ukraine has been and is likely to be sentiment driven. Over the past couple of weeks, it has been evident that an increase in geopolitical uncertainty has led to a measureable flight-to-safety effect in the financial markets. High-quality bonds have benefited at the expense of more risky assets such as equities, credit products and sovereigns with a lower rating.

Flight to safety moves often catch onto their own dynamics, which implies that in many case markets tend to overreact. A ‘thin’ summer market might have been a factor this time as well. Following the price action over the past couple of weeks, we now believe that the market is pencilling in a situation that is worse than is currently the case. Hence, if the newsflow out of Ukraine stabilises and the situation does not escalate further, we expect the global fixed income markets to give back some of the recent gains, i.e. higher rates in the US and steeper curves in EUR core and swap markets.

Should the situation in Ukraine begin to improve (i.e. the rebels surrender or Russia backs off), we would be inclined to expect a sharper increase in interest rates as global macro data – in particular in the US and China – is picking up and the Federal Reserve has been less soft (see *Rates Strategy: Higher US rates and a steeper EUR curve in H2*, 1 August).

However, should one or both of the above-mentioned risk scenarios materialise, the market is not ready for this. In this case, we would expect another measureable flight-to-safety move to take bonds yields to new cycle lows.

What are the implications for Nordic companies with exposure to Russia?

We remain of the view that the recent sell-off in equities is not a reflection of changes in fundamentals (macro, earnings) but of political turmoil. There is a large difference between performances in US and European equity markets, driven by the Ukraine/Russia conflict. The most recent data out of the eurozone points towards a soft reading for Q2.

Fundamentals are tracking a positive development. Q2 earnings have been fine with approximately 10% gains in earnings growth y/y (excluding financials and utilities) in the US, Europe and Japan. Activity data suggests that global growth is rebounding. Recent data out of the eurozone point towards a soft Q2 GDP reading but credit data point to stronger growth in 2015.

The Euro Stoxx 50 is down by 7.7% since 1 July, while the drawdown in the S&P 500 is 3.2%. We still expect the correction to track the five corrections seen since summer 2012, with an average drawdown of 5.5%, where the average correction lasted 21 trading days.

The Russian ban on food imports from Western countries is likely to have a negative impact on European and Nordic companies. However, Russia imports 40% of its food and it is questionable whether it will be possible to substitute these imports short term. The ban, if upheld strictly, holds the largest risk for an already-weak Russian economy. European exports to Russia are small in scale and should not have a growth effect.

Nordic companies could potentially be affected in a number of ways.

- Weaker top-line growth as Russia enters a deep recession, or even depression when sanctions trigger a credit crunch.
- The FX effect as the RUB collapses – both translation and transaction effects.
- The political risk – the tangible risk that assets owned by Nordic companies will be confiscated if the conflict deepens.
- Or that assets or revenue flows become worthless as they will be locked into Russia.
- Comparable situations? Iran, Argentina.

All these different risks mean a number of Nordic companies are exposed to these different risks to a varying degree. First, though, it is important to recognise that at a country level, Finland stands out here. Of Finnish exports, 10% are to the Russian Federation.

On an individual country basis, only Sweden is a bigger market for Finnish exports. For the other Nordic countries, Russia represents 1-2% of total exports (according to the OECD Monthly Statistics of International Trade). It is no surprise then that there are a number of companies with large exposure in Finland.

Nordic companies exposed to Russia

Finland

- **Fortum (Sell, 12-month target price EUR15, FUM1V FH, EUR18.7)** has close to a fifth of sales to Russia and the share is growing. Financial risks are mainly translation risks, with a 10% decline in the RUB estimated to reduce pre-tax profit by EUR25m.
- **Nokian Tyres (Hold, 12-month target price EUR31, NRE1V FH, EUR25.1)** has large exposure, as a third of sales come from Russia. Therefore, there is a clear negative translation effect, somewhat dampened given the company also exports 50% of its production to Russia (which benefits from a weaker rouble). Still, 2013 saw a bigger negative effect than expected, so there is a clear risk here.
- **Oriola-KD (Buy, 12-month target price EUR2.80, OKDBV FH, EUR2.34) –** 36% of its sales come from Russia (currently loss making). This is an import business, with currency transaction risks carried mostly by contract by suppliers. There is a translation risk but, as operations are loss making, the impact of a weaker RUB is initially positive.
- **Stockmann (Sell, 12-month target price EUR9, STCBV FH, EUR10)** has 17% of its sales from Russia. Again, this is largely an import business, so a weaker RUB also means a translation risk.
- **Tikkurila (Hold, 12-month target price EUR21.5, TIK1V FH, EUR17.7)** – a third of its sales are to Russia. The company imports some products from Finland, so there is also some margin impact on top of translation effects.
- **YIT (Hold, 12-month target price EUR8.5, YTY1V FH, EUR6.92)** generates around a quarter of its housing development in Russia and even more of its EBIT, as this is a high-margin business. This is a local operation with costs and sales in RUB.

Denmark

- **Carlsberg (Buy, 12-month target price DKK630, CARLB DC, DKK522)** stands out, with 40% of group EBIT derived from Russia. On top of this, Ukraine is also quite a large market for Carlsberg. The rouble exposure has no hedging.

Norway

- **Telenor (Hold, 12-month target price NOK160, TEL NO, NOK141)** has a large rouble exposure through VimpelCom, an associated company. In our sum-of-the-parts valuation, 12% stems from this company and close to a fifth of our projected EPS 2015 stems from the same.

Sweden

- **Atlas Copco (Buy, 12-month target price SEK235, ATCOA SS, SEK200)** (close to 5% of sales) and **Modern Times Group (Hold, 12M target price SEK290, MTGB SS, SEK282.5)** (close to 40% of EBIT comes from Russia and Eastern Europe).
- **Oriflame (Buy, 12-month target price SEK210, ORI SS, SEK140)** has 80% of sales in emerging markets, with Russia being the most important individual country.
- **Vostok Nafta (Buy, 12-month target price SEK52, VNIL SS, SEK31.7) –** Russia's Avito represents 40% of the current share price, with further RUB exposure through TCS.

Note all price as at close on 8 August 2014. Details of how our 12-month target prices are derived and the risks that might impede the stock reaching our target price can be found in the most recent company document for each stock (see *https://de-research.valuatum.com/Index.action*). Note that all 12-month target prices and recommendations were in line with our stated recommendation structure at the time we last published on the individual companies and will be reviewed when we next publish on the company.

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