

Russia: the fundamental story is intact, sanctions pose downside risks



Alessia Berardi
Senior Economist



Debora Delbo
EM Strategist



Gon Abhishek
EM Strategist



Karine Herve
Senior Economist, PhD



Yerlan Syzdykov
Deputy Head of EM
Co-Head of EM Fixed
Income

“At this stage, we remain constructive on the outlook for Russia as we still see some supportive factors such as oil price and low external vulnerability”.

- **The macro outlook:** The outlook for the Russian economy is positive, supported by expansive monetary policy, robust global trade and increasing oil price, even though the current context has deteriorated on the back of the last round of sanctions. Russia external position makes the economy resilient to external shocks. The biggest risk is represented by a decline of the oil price, although the recent adoption of a new fiscal rule has made the country fiscal accounts less vulnerable than before to oil price swings.
- **Rouble:** We expect that the Rouble will continue to be a shock absorber given the tail risks brought up by the latest round of US sanctions. However, from a valuation perspective, our model shows USDRUB to be fairly valued at 61-62 range, as the oil price remains supported. We do not expect Central Bank of Russia (CBR) to hike rates in near term but CBR might take a pause in 1H18 from its current easing stance and re-establish it once the ‘dust’ settles.
- **Equity:** We remain constructive on Russian equity however risks of further additions of new firms or businessmen to the list of sanctions will remain an overhang. The Russian equity index appears quite cheap, we believe it will be crucial to select the names and the sectors less exposed to chain disruptions and more sheltered from potential future sanctions.
- **Fixed income:** We maintain a constructive stance in the Russian fixed income market, preferring sovereign, quasi-sovereign issuers and financials on the credit side. We see limited risk of broad contagion to other EM countries, Russia being an idiosyncratic story.

What is your outlook on the Russian economy, following the imposition of the latest US sanctions?

KH: After two years of recession, GDP growth returned to 1.5% last year. At this stage, we remain constructive on the outlook as: inflation has slowed (leaving the CBR with the option of easier monetary policies if needed), global trade has remained robust despite trade tensions and oil prices have recently increased on the back of geopolitical tensions in the Middle East. The impact of sanctions on real GDP growth is difficult to estimate, as effects potentially include direct and indirect factors. While direct effects should be limited, indirect effects could be much more detrimental, especially due to any tightening of financial conditions for the whole economy: First, uncertainty and new pressures on the rouble could mean that the CBR has to pause its easing path. Second, inward investment could be deterred and some outflows could also stall both direct and portfolio investments. Currently, foreigners hold around a third of Russian government bonds. Barring a further escalation of economic sanctions against Russia, we would estimate that on a one-year horizon, the negative impact of the current sanctions regime on GDP growth could be anywhere from 0.2% to 1.0%. This could be offset by positive terms of trade shocks and continuous fiscal impulse given the infrastructure programme associated with the football World Cup, which Russia is expected to host this summer. Longer-term effects of sanctions will depend on the evolution of Russia’s relations with the West.

Has Russia’s resilience against external shocks improved in the past years?

AB: Russia has usually sat quite high in our external vulnerability ranks, meaning that it has a low external vulnerability. Current account/GDP was in surplus at 2.6% at Q417, which is not an historical high, but the highest level recorded since 2Q16. External debt/GDP is below the average of 49% for EM countries at 33% as of 4Q17. In particular, the short-term portion is very contained, at around 11% of total external debt. Moreover, reserve adequacy ratios have been showing some ability to defend the currency by the monetary authority. On that basis,

rouble depreciation has to be viewed not as a consequence of vulnerability, but actually ultimately as a shock absorber used to re-establish current account equilibrium (although potentially at the cost of higher inflation which currently is at historical lows). The biggest “external” shock for Russia would be represented by a significant decline in the oil price.

The Russian economy strongly depends on oil prices: what are the current drivers of oil price? What are the risks in case of a decline?

AB: Russia’s fortunes are still tied to the oil price. Despite a more favourable environment for stronger oil prices, further progress is needed in terms of fiscal reform to protect the country’s fiscal accounts. We view the oil price fair value, based on the fundamentals (supply and demand dynamics), between \$60/bbl - \$70/bbl. Having said that, geopolitical events currently look to be pushing oil prices higher and in the short term it could move up further.

With regard to Russia, the recent adoption of a new fiscal rule has made the country’s fiscal accounts less vulnerable than in the past to oil price declines. The threshold fixed for the current year’s budget is at USD40/bbl which is allowing for the buildup of a significant fiscal buffer at the current oil price. This threshold was very prudent when it was originally defined; it’s even more prudent now, and it can be increased at the next budget discussion. Having said that, a more comprehensive fiscal reform reducing inefficiency on the expenditure side should be enacted, in our view, to protect the country’s fiscal accounts for the future.

What is your view on the rouble?

AG: The latest round of sanctions on Russia was a negative surprise both for the market and policymakers. As a result, policymakers have left the rouble to float in order for it to act as a shock absorber for the Russian economy. We expect that the rouble will continue to be under pressure, given the tail risks brought about by the latest round of US sanctions and increased risk of repatriation of capital by foreigners. However, from a valuation perspective, our model shows the USD/RUB to be fair valued in the 61-62 range, as the oil prices remains resilient.

Would you expect the Central Bank to raise rates to mitigate the rouble depreciation, deviating from its current easing path?

AG: We do not expect the CBR to raise rates in the near term, but it might pause from its current easing stance for few months. With the inflation rate currently well below the CBR’s target level (4%), the recent weakening in the rouble against the backdrop of geopolitical tension will tend to accelerate the pace towards the inflation target. However, according to the CBR, it does not create risks of inflation overshooting the target. Moreover CBR has explicitly stated that its estimate of the neutral rate has moved closer to the upper bound of the 6-7% range due to an increase in the Russian risk premium and higher rates in developed markets. CBR confirmed that it still plans to move to a neutral policy this year.

With nominal policy rate currently 7.25%, we expect 75bps of rate cuts in the second half or the year, once the ‘dust’ settles. The CBR has been vocal about reining in currency volatility, but it has not shown significant concern recently. Among the measures that the CBR has used so far, we see:

a. A pause in the government’s foreign currency purchase programme: The size of FX purchases is mainly determined by oil price. As a part of the government’s “fiscal rule”, FX-purchases are made when the price of Urals crude exceeds USD 40/bbl, subject to an upwards revision of 2% per year.

b. Vocal intervention by showing its readiness to deploy a wider range of instruments to contain potential risks. This includes holding or even reversing the easing cycle for rates, limiting foreign currency borrowing, and bank stress testing.

Having said that, if tail-risk remains high for an extended period, we could see significant pick-up in capital outflows from Russian assets (as foreign ownership of Russian bonds are at close to 30%). In that scenario, CBR may need to do more than their current stance, which we think is unlikely at this stage.

“The sensitivity of Russia to the oil price has improved but further progress is needed in terms of fiscal reform to protect the country’s fiscal accounts.”

“CBR confirmed that it still plans to move to a neutral policy this year: We expect rates cuts to resume in 2H 2018”

Political risk and economic risk have both increased after President Trump's recent decision to impose more sanctions. Do you see still opportunities in the equity market?

DD: Volatility on the Moscow exchange has surged since 6 April, when Washington imposed sanctions on major Russian firms and some of the country's most prominent businessmen.

But, we remain constructive on Russian equity because there are some signals of de-escalation. Risks of further additions of new firms or businessmen to the list for sanctions, however, remain in the background unless we see a significant breakthrough between Russia and the US (fairly unlikely near term). Furthermore, Syria remains an issue for disagreement.

The Russian equity index appears quite cheap currently. We still forecast a double digit earnings growth for Russia in 2018, supported by oil price, but recent sanctions could somewhat negatively affect the macroeconomic outlook and increase the risk of missing expectations with regard to results for many companies. Moreover, uncertainty could worsen risk sentiment. Counter-sanctions proposed by Russia (the decision has been postponed until mid-May, after the inauguration of President Putin, who won another six-year term in March presidential elections), include the following: 1) bans on imports of US food, pharmaceuticals, alcohol and tobacco products; 2) bans on US consulting, auditing and law firms that provide services to Russian state-owned companies; and 3) restrictions on cooperation on nuclear energy and on exports of titanium (used in aircraft engineering) to the US. In particular, the potential bans on pharmaceuticals and aerospace inputs could boomerang, however, in our view, and affect Russians most more than companies and individuals in importing countries. Where do we see opportunities in this environment? 1) with companies that are less vulnerable to supply chain disruption, because operations and raw materials are located in Russia, and they can also benefit from sanctions imposed on competitors; and 2) with oil sector-related companies which show the most resilience regarding risk/reward in this phase of a rising oil price and a lower rouble (good for exports). The potential for sanctions on oil is currently very low, in our view).

“We remain constructive on Russian equity on the back of fundamentals and valuation but selection will be crucial given the current risks.”

What could the implications be for on fixed income? Do you see risks of contagion to other EM, going forward?

YS: We maintain a constructive stance in the Russian fixed income market, preferring sovereign and quasi sovereign issuers, and financials in the credit side. We would suggest a more modest exposure to the basic industries across the sectoral range. Fundamentals look solid and the market probably overreacted to the sanctions due to a generally overweight position. For the future, we see the contagion risks to other EM as very limited, as the specific cause of the sell off in Russian assets is external, and investors will likely differentiate between the Russian case vs situations in other countries. Potential for supply imbalances in the metals markets caused by the imposition of sanctions remains a possibility, with associated impacts on other metals producers.

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