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Ashmore

Russia: Macroeconomic overview

By Jan Dehn

Why focus on Russia?

Both sentiment towards Russia and prices of Russian assets have moved out of line with fundamentals, creating significant value. The reasons for the negative sentiment towards Russia are well-known. The Ukraine situation and sanctions have been important negatives and so has the fall in oil prices. Lately, as year-end approaches liquidity has declined significantly and ahead of us lie a few weeks of holidays during which few investors will go against the prevailing momentum in the Dollar, in commodities and in Russian assets, almost regardless of valuations. As a result prices are falling too far and price volatility has become far greater than normal. Sovereign and corporate investing is about avoiding defaults and identifying situations where prices have become seriously out of line with fundamentals, that is, where risk is incorrectly priced. Of course, if the country in question also happens to have strong fundamentals so much the better. This is the case of Russia today.

What is the situation in Russia right now?*

Russia's EMBI GD spread (that is the spread of the sovereign and quasi-sovereigns over US treasuries) is currently 620bps. This is up from 164bps in early 2013 and 360bps as recently as October. To put this in context, Russia's EMBI spread is now:

- 400bps wider than Vietnam
- 385bps wider than Guatamala
- 320bps over Paraguay and Bolivia
- Nearly 300bps wider than Sri Lanka
- 256bps over Lebanon
- And 124bps wider than Senegal

We think Russia is a significantly stronger credit than any of these countries, indeed stronger than the average EM country that today prices at 387bps over US treasuries.

We think default risk for the Russian sovereign is very low

Russian capacity and willingness to pay are both very strong. Russia's debt to GDP ratio is around 14% and the government runs a primary surplus. FX and gold reserves stand at nearly USD 415bn. This means that:

- Russian reserves today cover 15 months of imports versus the IMF usual recommendation of 3 months
- The Russian central bank could cover the Dollar refinancing needs of sanctioned names for about eight years. The central bank provides detailed information on the Dollar requirements for sanctioned names in 2015. Currently, the central bank estimates that these Dollar needs are USD 100bn, but once you net out liabilities across corporates and derivative structures that are actually RUB liabilities we estimate that sanctioned names will require USD 50bn in 2015. The mechanism for getting Dollars to sanctioned names is already established via the recent Rosneft transaction. Rosneft issued the RUB equivalent of USD 11bn local bonds to local banks that swapped these securities with the central bank for Dollars. Needless to say, not all companies can rely on this mechanism – historically the Russian government has ensured that Dollars go to government and quasi-sovereign institutions that typically get stronger during RUB crises as a result. We expect the same to happen this time.

The Russian government's policy reaction is reassuring

The correct response to an external shock is to reduce domestic demand and to devalue the currency. This is exactly what the government has done. Unlike 2008/2009, the RUB is now a floating currency. A floating currency insulates the public finances from changes in oil prices. Of course, there is a risk that a weaker currency feeds into domestic inflation – this has already happened. To manage this risk and to reduce domestic demand the central bank has raised rates from 5.5% in February to 17% in December. There should be no doubt about the willingness of the central bank to fulfil its mandate. The combination of higher domestic interest rates and a weaker currency will weaken growth – we expect a recession in 2015. But this is purely a cyclical adjustment, not a structural problem, so growth should bounce back thereafter. Import demand will fall next year, so external balances should improve, particularly since the currency has now overshot, moving far beyond what is justified by the fall in oil prices.

Why has the Russian Central Bank not intervened in the currency more decisively?

So far Dollar sales have been small and the government has instead chosen to sell out of Dollar cash held at the finance ministry. The central bank has not appeared heavily in the FX market partly because it is committed to transitioning to a floating rate regime. Besides, there has been no need to intervene heavily, because households have not panicked. Without a meaningful shift in household portfolios in favour of Dollars there has been no need to burn reserves. So far it has mainly been speculation by Russian banks and High Net Worth individuals that

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* As at 18 December 2014.

have been buying Dollars. Finally, timing is obviously important. Oil prices have yet to find a new level and few investors are engaged in low liquidity trading towards year-end. Hence, intervention would probably be ineffective. As a central bank, if you absolutely have to intervene, when you go you want to go big and you want to inflict maximum possible pain. For this, you need participation.

Thus, despite the central bank's low profile in the FX markets so far there should be no doubt about its ability and willingness to intervene. With USD 415bn of FX reserves the Russian central bank could crush RUB speculators, in our view.

We do not think capital controls are likely to be imposed

Russia could yet impose capital controls, but this would be a last resort and not our base case. Russia understands that the world is heading in the direction of tighter financial conditions. As the financial pie shrinks the key will be to maintain or even increase the share of global capital. This is done by improving, not eroding, links with global capital markets. Russia has been doing precisely this over the last few years. It has made its OFZ market Euroclearable, for example. The move towards a floating rate also makes capital controls unnecessary. Yes, the RUB moves have been large, but they are taking place in very small volume, so moves can be expected to quickly reverse with little economic impact.

Worries about the Russian banks are probably misplaced

Russia, like many other EM countries, has significant scope to use policy to support various sectors during temporary periods of stress. The central bank this week introduced a number of measures that ease any stress from bank balance sheets arising from duration and FX mismatches, including more flexible marking of assets and liabilities, easing of loan conditions, and permission to raise deposit rates to encourage greater deposits.

Russia has huge untapped resources at its disposal

The resources naturally include IMF support and loans from New Development Bank (NDB, also known as the BRICS bank), but we don't think Russia needs to tap these sources.

One interesting thing to watch is whether Russia will draw on swap lines with other EM central banks, such as its USD 25bn swap line with China. One of the ways that China is expanding the role of its currency, the Renminbi, as a global reserve currency is to activate swap lines with countries that are experiencing currency stresses. Hence, when those central banks sell Dollars, China offers to replace the Dollars with Renminbi swaps. This is an opportunistic way to increase the share of Renminbi in central bank reserve holdings the world over, and often at very good entry points.

Oil

Oil prices are fundamentally important to Russia and have nearly halved since the end of June. What is the outlook from here?

We think there is a considerable speculative element to the recent move in oil prices. It is noteworthy that the Dollar index, DXY, started to rally sharply at the same time that oil began to fall – on the very same day in fact (30 June 2014). The two are obviously not entirely unrelated. This year the Dollar has rallied sharply against EUR, JPY and EM currencies. With no more currencies to rally against, the Dollar momentum moved on to the closest substitute to currencies – commodities. And that in turn has allowed the Dollar to stage a further leg higher against EM currencies.

However, global demand and supply for oil is unlikely to have suddenly shifted materially on 30 June. The world has not changed that much. Global growth this year is broadly similar to last year, while growth could be marginally higher next year. Inventories have been building up for some time due to more supply, but now that prices are nearly 50% lower two things will happen:

1. Demand for oil will increase
2. Supply will decline as marginal producers are priced out of the market

For this reason, inventories are likely to gradually erode over the next few months leading to a return to higher price ranges for oil in the course of 2015.

Ukraine

The Ukraine situation matters disproportionately for investor sentiment towards Russia. The situation remains fluid with the potential to worsen.

However, the Ukraine situation has changed significantly from ten months ago, when all sides had strong political incentives to escalate tensions, while no one paid attention to the economic consequences.

Today all sides have strong economic incentives to find an agreement, while the political upside from further escalation is approaching zero or even declining. Specifically, for Ukraine the election is now in the past and the government must secure an economic recovery or risk eventually losing power. For the West, it faces a recurring bill of USD 15bn every year to subsidise Ukraine unless the conflict in Eastern Ukraine ends. And for Russia it is now paying a heavy economic price for its involvement in Eastern Ukraine, which is bound to backfire on Putin's popularity unless it is contained.

When we look at the situation today we think it closely resembles conditions in the Balkans in the mid-90s, just ahead of the Dayton Agreement that ended that conflict (except that it is a great deal simpler).

In a worst case scenario, the conflict in Eastern Ukraine has now become frozen and is unlikely to spread further.

But there is an upside scenario the odds of which are increasing all the time that Eastern Ukraine is heading towards a binding peace agreement. A peace agreement in Eastern Ukraine would allow:

1. Eastern Ukraine to resume coal sales to Ukraine. This would increase income to Eastern Ukraine and thus ease the financial burden for Russia in keeping the region afloat.
2. Western Ukraine to resume imports of coal from Eastern Ukraine which would save the country USD 15bn in FX that would otherwise have to be used to import coal from abroad.
3. The burden for IMF and Western donors to decline by a similar amount, not just for 2015, but also going forward.

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EM outlook for 2015

In conclusion, a few words on the outlook for EM in 2015.

1. We enter 2015 with EM asset prices at very attractive levels after two years of very poor price action, where global markets have priced all their fears of tighter global financial tightening into EM assets.
2. 2015 promises to be a year of reckoning, but more so for developed economies than for EM. Developed economies have squandered the past 7 years of hyper easy policies without meaningfully deleveraging or reforming their economies. They now face higher interest rates, and the risks associated with this are simply not priced in.
3. By contrast, EM assets are now cheap, both relative to DM assets and in absolute terms. They trade at the widest spread levels we have seen since 08/09 and at levels that are consistent with much tighter US monetary policy conditions that we are likely to see.
4. Even so, investors will continue to have a cautious attitude towards EM, not so much because of the effects of Fed hikes per se as simply because of the uncertainty that surround the timing and pace of hikes. Those fears are overdone, in our view. The Fed will move slowly, in small steps, and over a long period.
5. When investors are cautious towards EM it is likely that fears will be overstated for troubled EM credits – such as Russia today – and understated for popular credits. This means that there will be good opportunities for active managers.
6. In general, a cautious attitude towards EM is not a bad thing: It keeps valuations at attractive levels – decent yields, spreads and carry. Bubble risks are non-existent. Cautious markets also keep EM policy makers on their toes, which means that EM credits remain fundamentally healthy.
7. There will be volatility, but EM is very well equipped to handle bouts of volatility and occasional serious mispricing:
   a. Technicals are strong after one third of US mutual fund money left the asset class during the 2013 Taper Tantrum and has not yet returned
   b. EM proved in 2013 that it easily handles rate volatility – recall that EM yield curves re-priced by 200bps in just six months with barely a dent in growth. If Japan, Europe or the US had faced a similar 200bps upwards shift in their sovereign yield curves they would have been in serious trouble. This underlines the relative resilience on EM fundamentals.
   c. Finally, EM central banks still control 80% of the world's FX reserves so they have all the means possible to manage FX volatility, should they chose to do so.

Longer term

The long-term case for EM remains strong, especially for local currency. Developed economies have enormous debt burdens and have proven unable or unwilling to reform, except under extreme pressure.

This is why developed economies have tried for more than half a decade to turn their enormous debt burdens into inflation through hyper easy monetary policies – which continue to this day.

So far, inflation has eluded them due to deleveraging and other structural drags, but these drags are easing a little bit every year.

Within the next couple of years we are likely to see inflation re-emerge, starting in the US.

Investors should not concern themselves so much with short term volatility that they entirely miss the bigger picture – the global imbalances that pit the big debtors in DM against the big reserve holders in EM will be resolved through inflation and currency realignment.

EM countries are not only much stronger fundamentally – less indebted, faster growing and with stronger reserves – but they also offer the only way to protect purchasing power of assets once the big inflation and devaluation party in developed economies really kicks off.

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