20.03.2020

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Our baseline scenario

On Friday, March 20, Russia's Central Bank is set to take one of the toughest and unpredictable decisions. The move should contribute to monetary and fiscal stimulus, given that the pandemic crisis is weighing on both supply and demand. Under our baseline forecast, the rate is projected to be kept unchanged (6%) until 24 April if the situation does not stabilize by that time. We expect the volatility to ease and the regulator to continue the rate cuts cycle. Otherwise, the tone will remain hawkish until the end of 1H20 due to the unprecedented volatility, which has already erased $15 trln (stocks and bonds) in global market value, including $10 trln in stocks. Due to epic financial turmoil, assets trade below the net worth (financial dislocation), which will inevitably trigger a global recession.

Harsher tone means that consecutive rate cuts will be ruled out. As of February 7, we expected the CBR to make three consecutive cuts, bringing the benchmark to 5.25% by the year-end. Harsher tone will imply neutral policy due to temporary inflation spikes in March and April amid rouble devaluation and panic-driven consumption growth. However, the effects of such policy will be eased by the year-end due to falling consumer demand and lower revenues amid the rouble volatility.

CB RATE DECISION: PROS AND CONS

1. Pro-cut. Social priorities and presidential decrees. Since panic gripped he markets, the priority now is to drive demand, provide support to poor families and improve demography in line with the presidential decrees sighed in January. According to Finance Minister Anton Siluanov, additional spending on demography through 2024 will amount to 4.1 trln roubles, including 1.4 trln roubles (main part) - payments to poor families with children aged from three to seven and 1.2 trln roubles for "mother's allowance." These measures should be accompanied by a lending rate cut.
2. Pro-cut. Real CPI (based on a weekly March inflation rate of 0.1%, annual inflation in March will be 2.3-2.4% in the aftermath of a devaluation, our forecast for the end of the year is 4.2%).
3. Pro-cut. Household inflation expectations (in February the indicator continued to decline, while the median gauge dropped to the all-tile low of 7.9%). Observed inflation rose by 0.1%, to 8.7%. We expect temporray spikes in infltion in last weeks of March and April.
4. Pro-cut. GDP growth rate in the country (with average oil price at $40/bbl and USDRUB 70, GDP growth is likely to slow down to 0.5% from previously expected 1.7%).
5. Pro-hike. Global volatility and geopolitics (the global recession is looming, as we will see from March and April macro data, the pace of recovery will largely depend on the size of stimulus measures, the Fed's has launched the largest programme on record).

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6. Pro-cut. **Impact of the key rate on the monetary market** (in December, mortgage rates dropped to all-time low of 9% and remained flat since then, but the gap with the real rate is record high topping 3%).
7. Pro-hike. **The rouble's volatility.** Since mid-March, the rouble has accelerated decline; weakening by more than 26% against the dollar year-to-date, while oil prices fell 2.5 times! The rouble's resilience results from the budget rule, in particular, from $2+ bln sales per month, as well as the dollar sales by exporters in the FX-market. Another important factor is the lack of panic among non-residents. The dollar growth is a global trend amid all-time high rate of assets depreciation. The Central Bank has repeatedly stated that it tends to address a three and six-month volatility instead of a short-term volatility. Current spikes are temporary, given the current crisis is highly speculative in nature. Non-residents do not panic; according to the latest data from the National Settlement Depository (NSD), the share of foreign OFZ-holdings increased to 33.4% by mid-March.

WHAT HAVE OTHER GLOBAL CBS ALREADY DONE?

From mid-February to mid-March, all major Central Banks have cut the key rates, according to G20 and OECD data. The average cut was over 50 bps, while the total cut was about 1000 bps. The Fed took a lead, cutting the rate by 150 bps from March 3 to March 16. This is the biggest cut in record across developed countries and the biggest cut in the Fed's history. In addition to the rate cuts, the Fed has launched its fourth quantitative easing programme (QE4), providing markets with short-term liquidity under REPO ($1.5 trln), commercial loans ($1.1 trln) to help companies with high and low credit ratings meet their operational needs. The current rate in developed countries is just over 0%, while in emerging markets it is about 6.5%, which is a record gap. Kazakhstan is one of the few countries to raise rates due to the collapse of oil prices and the rouble devaluation — the benchmark was hiked by 200 bps.

WHAT ELSE THE BANK OF RUSSIA CAN DO?

Oil prices and the rouble fall amid financial panic is the top problem for the Central Bank now as it can lead to interbank market panic and financial dislocation. The economic problems that will arise later will have to be solved using traditional stimulus. At present the interbank and financial markets look quite stable and do not require urgent measures. Now there are no problems with liquidity: the liquidity surplus is 2.5 trln roubles compared to the deficit of 3 trln roubles in the crisis of 2014–2015, sterilization of foreign currency liquidity is ongoing, dollarization has fallen by half, to 20%, the accumulated volume of FX-liquidity has reached $150 bln over five years, overall foreign debt fell significantly.

We believe that the Central Bank may well manage the rate using the established budget rule, according to which, at the current oil price, FX-purchases should amount to $4 bln a month, while the budget deficit at the current rate stands at about 1% of GDP.

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In addition, the Central Bank may drive FX-sales by exporters. Oil prices will stabilize, since Saudi Arabia and USA are the main losers in the price war, (though Russia at this prices will have to stop extracting oil) despite the fact that production costs in the kingdom is half as low as in Russia. Current prices may lead to bankruptcy of small oil shale producers, while the larger ones will have to make massive cuts to capex, opex, and dividends.

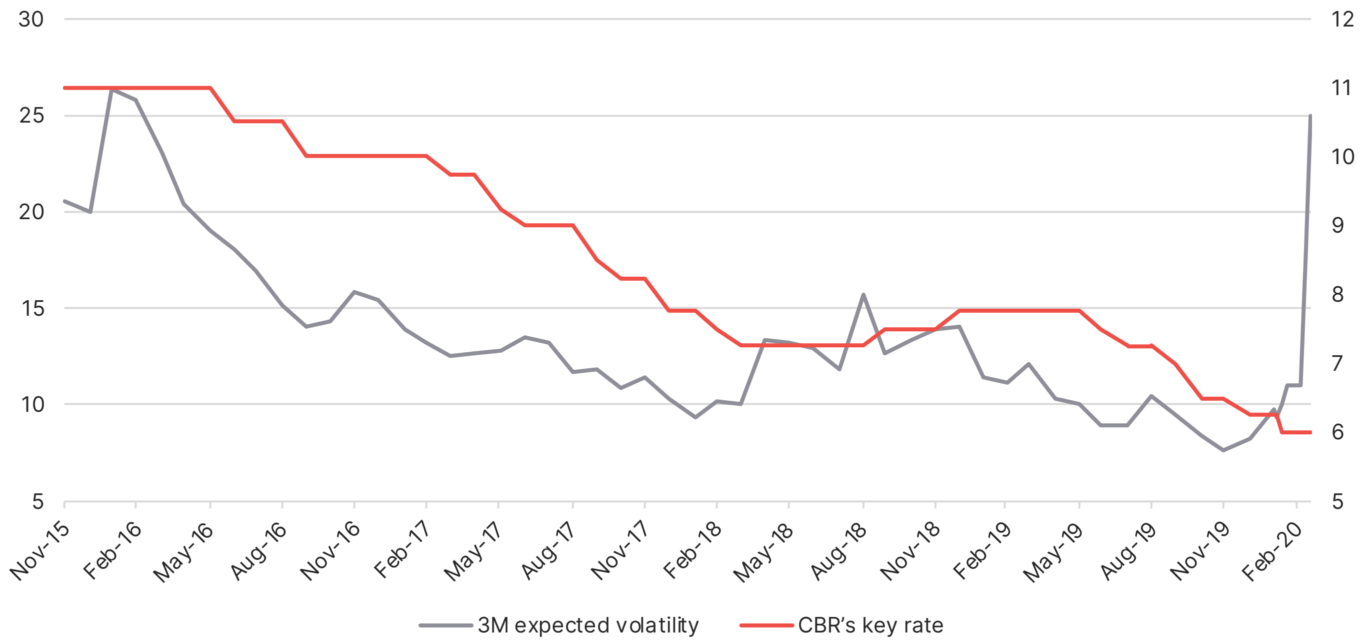
OFZ MARKET AND FORECASTS

Sellers dominate the Russian government bond market. After a brief positive correction at the end of last week, OFZs prices went down again. Currently, the 10-year issue is trading above 8% per annum (OFZ 26224 YTM 8.06%), while the maximum yield along the curve is 8.24%, which is about 220 bps above recent highs. Despite the fact that the Russian local debt market underperformed in recent weeks against its peers in other emerging markets, the decline does not yet look devastating in absolute terms. Summer 2019 was the last time when the government bonds traded at such levels, while in previous crisis OFZ posted bigger declines. The Ministry of Finance also provided some support to OFZs by dropping primary auctions, there have been no tenders for three weeks now (the primary supply will rebound only after the markets stabilize).

The Russian bonds curve will largely depend on the development of the coronavirus pandemic and on global stimulus aimed at stabilizing markets. Amid this backdrop, the actions and tone of the CBR during the regular key rate meeting scheduled for Friday, March 20, will be closely watched by the markets.

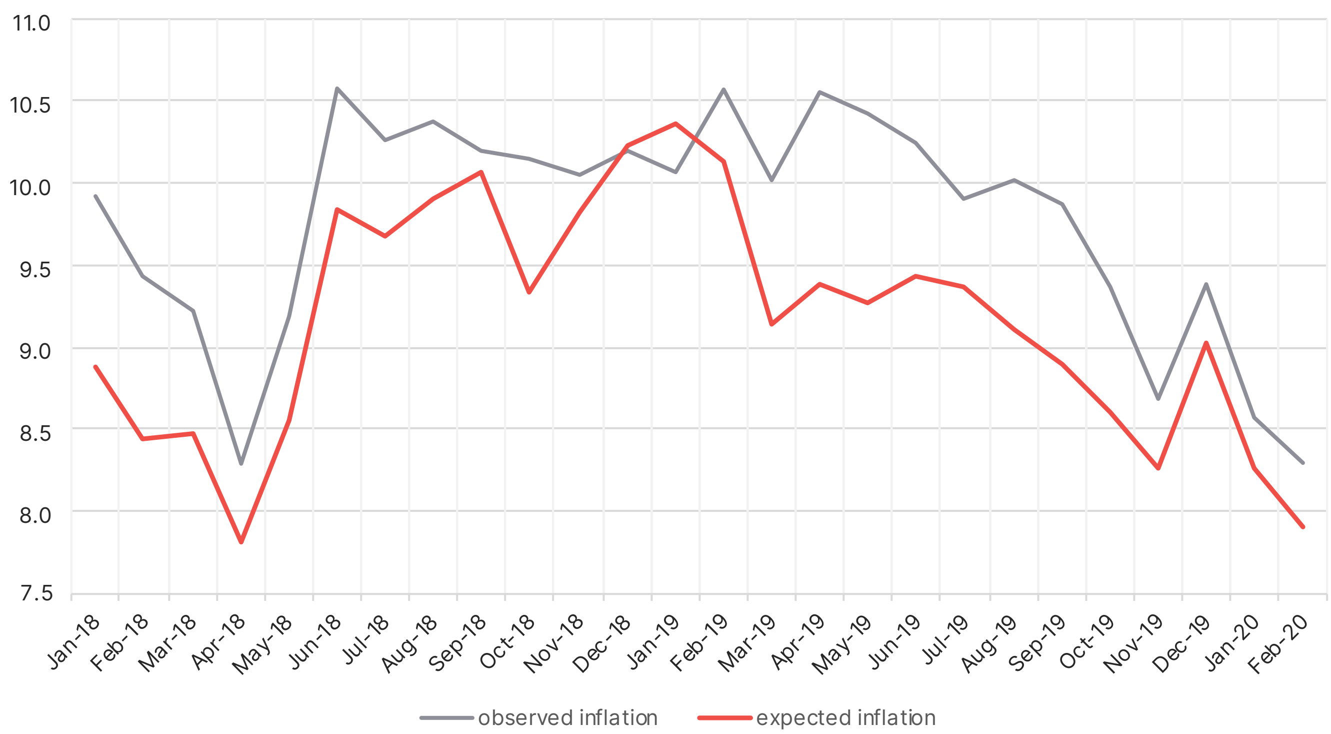
The current level of short-term securities rates implies tightening of monetary policy by at least 1% over the next year. Meanwhile, the key rate will remain unchanged in the near future, according to our estimate, which is in line with consensus. The Russian regulator has so far successfully managed to contain the rouble devaluation through daily interventions in the FX-market. Moreover, inflation risks, which the Central Bank considers to be significant, are short-term in nature. In other words, no visible acceleration of inflation is expected in Russia yet. A zero-rate policy the US regulator adopted recently also reduces the need for tightening in Russia. Thus, the OFZ market may gain a positive momentum in the coming days if the key rate is unchanged at 6% and oil prices continue to consolidate near the current levels.

THE ROUBLE'S VOLATILITY



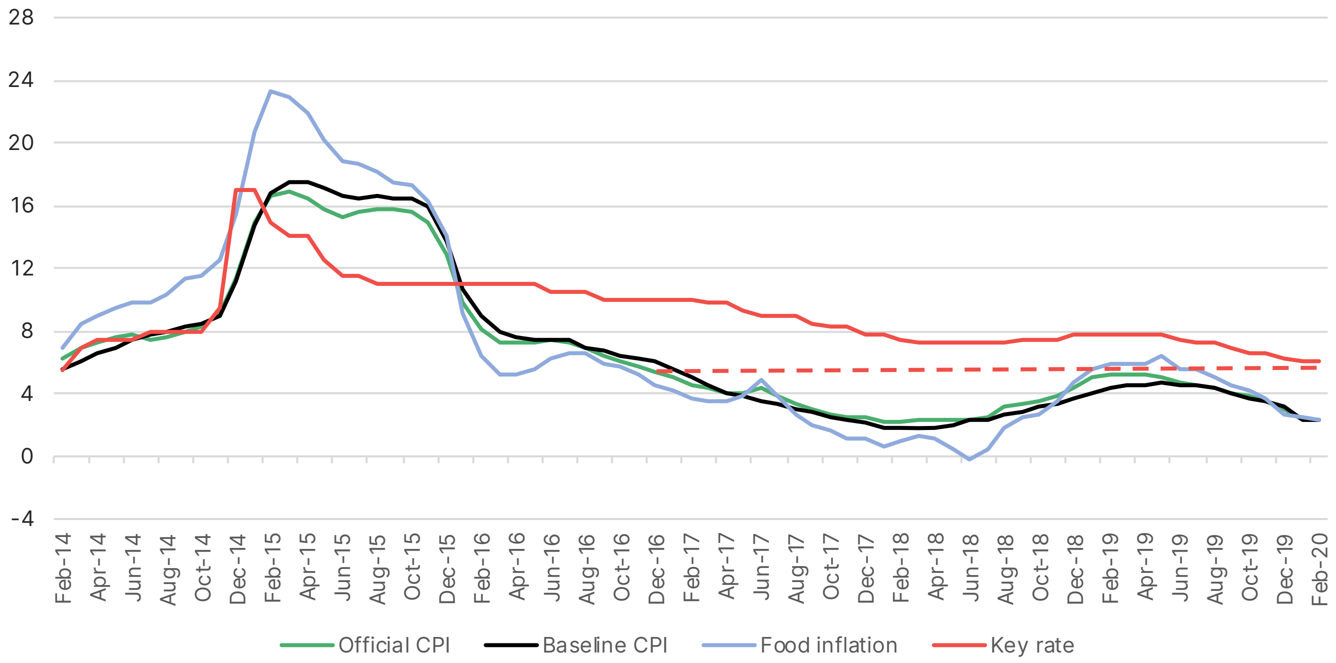
Source: Bloomberg, ITI Capital

EXPECTED INFLATION, %



Source: Bank of Russia, ITI Capital

OFFICIAL INFLATION, %



Source: Bank of Russia, ITI Capital

RUSSIA'S BUDGET'S ADDITIONAL O&G REVENUES/LOSSES

Urals, $/bbl, 2017	**Urals, $/bbl, 2020**	**Deviation of oil and non-oil export, $ bln/month** (from Urals scenario = base price)	**Budget's additional O&G revenues/losses, $ bln/month** (in terms of oil, oil products, gas condensate)	**In particular in terms of damping premium**
10	12.4	-7.9	-3.8	1.4
15	17.4	-6.6	-3.3	1.3
20	22.4	-5.3	-2.5	1.1
25	27.4	-4	-1.7	0.9
30	32.4	-2.6	-1	0.7
35	37.4	-1.3	-0.3	0.6
40	42.4	0	0.4	0.4
45	47.4	1.3	1.1	0.3
50	52.4	2.6	1.9	0.1
55	57.4	4	2.6	-0.1
60	62.4	5.3	3.3	-0.2
65	67.4	6.6	3.9	-0.4
70	72.4	7.9	4.6	-0.6

Source: Minfin, ITI Capital

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