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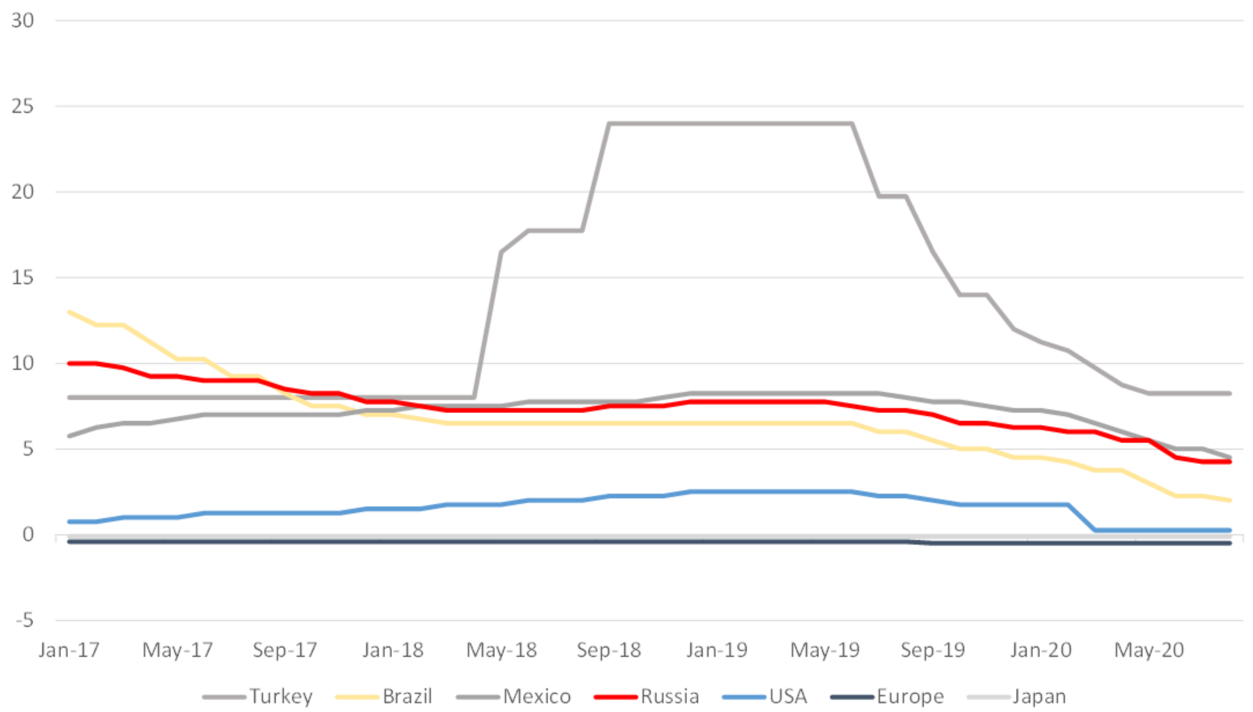
Bank of Russia meeting preview

OUR BASELINE SCENARIO

On Friday, September 18, the Bank of Russia is set to hold the first policy meeting after the summer break. This time the market players are almost unanimous about the rate forecast. We share the widely held view that the regulator will keep the key rate unchanged, at 4.25%. Below we summarize our rationales for such a decision. Meanwhile, we still believe that the monetary policy easing cycle has not come to an end, which has been recently made clear by the Central Bank. We assume potential for long term rate cut stands at 50 bps, and the regulator is likely to ease the policy, as the sentiment improves in the domestic and external markets. We expect that the final stage of the current monetary stimulus cycle is likely to be completed in 1Q21 (See our note " Rouble on the swings of geopolitics: hold on tight” with an updated basic forecast). This means that the rate is on track to reach our 3.75% target. More importantly, the Central Bank is expected to stick to stimulating monetary policy, all other being equal, at least until the end of next year.

GLOBAL RATES, %

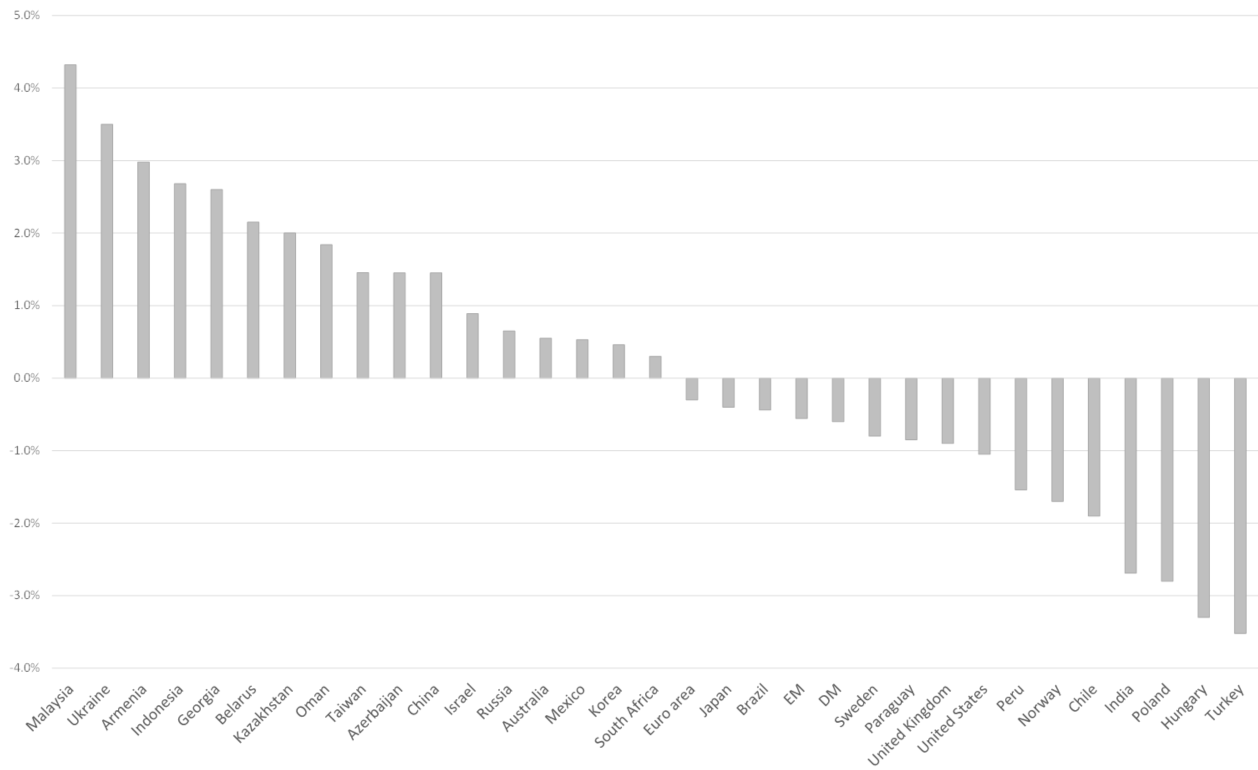


Source: ITI Capital, Bloomberg

ARGUMENTS FOR KEEPING THE RATE UNCHANGED:

- Impact of disinflationary factors has recently eased, which is also noted by the Central Bank. CPI growth in August and early September exceeded the regulator's expectations, as the rouble entered another weakening stage. At the end of August, annual inflation accelerated to 3.6% instead of the traditional deflation witnessed in previous years.
- **Global inflation spike and real rate drop**. August was a turning point not only for Russia, but also globally, due $17 trln of liquidity injected into the global economy through monetary and fiscal stimulus, which led the book value of G7 central banks assets to increase from $20 trln to $26 trln since the beginning of the pandemic. The U.S. inflation in August was 1.6%, the annualized figure for three months was 5%.
- Most emerging countries (EM), in particular Brazil, Mexico, Indonesia, South Africa and Turkey, do not plan to cut the key rate at the next meetings, as the real rate is around or below zero in many countries. The situation in Russia where the real rate is down 0.7% from 4% just a year ago has changed dramatically with the arrival of coronavirus. The hardest hit is Turkey with real rate -3.5%, as its Central Bank was the first in EM to halt the easing cycle, and now the rate is expected to grow.
- Average real rate in developing countries (-0,7%) for the first time in decades has equalled that of developed countries.

GLOBAL REAL RATES



Source: ITI Capital, Bloomberg

- Geopolitical risks for Russia have changed dramatically since the last Central Bank's meeting in late July. The risk of sanctions, which may be introduced in case of Russia's heavy involvement in Belarus and in response to Alexey Navalny's poisoning by the Novichok, has increased significantly. The risks of sanctions against Nord Stream-2 have also increased. Restrictive measures may add pressure on the rouble, which has already become the top loser among EM currencies in recent weeks.
- The current OFZ yield is already quite low (compared to historical data) and does not contribute to robust inflow of funds, primarily from foreign investors. At the same time, the borrowing needs of the Ministry of Finance have increased significantly, as the government is seeking to offset the falling budget revenues.
- Global volatility is rising in the run-up to the presidential elections in the US. Victory of Biden, who is leading the recent polls, is seen as the worst-case scenario for Russia, because of the sanctions risks.

OFZ MARKET AND FORECASTS

- Local debt market has been under pressure due to geopolitical factors over the recent weeks, which has had a negative impact on government bond prices, curbing demand from foreign investors. Long OFZs prices dropped by 9% on average since their peaks late spring. In particular, about half of the losses were due to the hardening sanctions tone. The primary market further weighed on bond yields, on the back of the Finance ministry's increased demand for domestic government debt. The recently updated borrowing plan through 2020 assumes more than two-fold growth of financing needs (up to ₽5.4 trln) as compared to the initial projections. The maximum rate along the curve has ultimately reached about 6.5%, and the total slope exceeded the all-time highs (about 250 bps).
- We had to take a more cautious stance with regard to the OFZ outlook for the coming months. We have revised our previous recommendations with respect to lower long “classic” issues' yield and do not recommend ramping up positions in these instruments as of now, since they are exposed to high volatility.
- At the same time, taking into account the baseline forecast of the "Monetary Policy Guidelines 2021-2023", which implies that monetary stimulus remains in place at least throughout the next year, the current slope of the curve is likely to be excessive as geopolitical risks decline. We do not rule out that the Bank of Russia will return to the final stage of the monetary easing cycle as early as 2021, ultimately cutting the key rate to our initial target of 3.75%.

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