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Authors

Olga Nikolaeva, senior fixed income analyst
Iskander Lutsko, chief investment strategist
Sergei Voloboev, head of fixed income research & credit strategy

Bank of Russia: Hike, not to hold is right. Time is of the essence

OUR TAKE

At its second rate-setting meeting, Russia's central bank embarked on a monetary tightening cycle for the first time since 2018. The CBR opted for a minimum rate increase step, by raising it by 25 bps to 4.5%. Economists were roughly evenly split on whether the central bank will deliver a 25 bps hike or keep the rate.

Most analysts in a Bloomberg survey predicted a hold.

We estimated the odds of tightening as 50/50. The move follows a larger-than-expected 75 bps hike in Brazil (most economists predicted a half-point increase) and a surprising 200 bps hike in Turkey (most economists predicted a 100 bps increase) which eventually led to the replacement of CBRT governor. The current level of rates on the short end of the OFZ curve has long indicated that investors have started to look at higher borrowing costs in 2021 as the base-case scenario. Therefore, timing of a new tightening cycle was the only big unknown. Central Bank Governor Elvira Nabiullina said that inflationary risks have increased, as she explained the rate decision. Observed inflation has been running above the forecast revised earlier by the Central Bank, as steady recovery of domestic demand is outstripping output growth. The most important point of the regulator's press release and subsequent press conference is that the monetary policy will probably normalize as early as this year (and we are not ruling out that we'll see further rate hikes in 2Q21), while the Central Bank's moves will depend on the economic data. The Bank of Russia holds open the prospect of further rate hikes at its upcoming meetings.

Our baseline forecast assumes a 4.75% end-year key rate (that is two further 25-bps hikes) and 5% as our upper end of froecast, the next 25bp is expected on 23rd of April, after that the next CBR meeting is on June 11, up around that period we expect normalisation in inflation (seasonal factors) and ease in global lockdowns. However, we are not ruling out that tougher U.S. sanctions or the lack of an imminent U-turn of growing inflation may push the regulator to step up its efforts. Our base case scenario suggests that OFZ 10Y yields would reach 6.6-6.7% per annum by the end of December 2021.

MARKET RESPONSE

There was no positive sentiment in the OFZ market ahead of the Central Bank meeting. Since the beginning of the week, the yields of ten-year government bonds have increased by more than 20 bps both due to expectations of an imminent and steeper tightening trajectory and new risks of tougher sanctions against Russia. The rate hike did not cause shocks during the trade session. The rouble moderately strengthened. On March 19, OFZs have been moderately recovering after recent declines. The first reaction to the CBR move was positive, but subsequent “hawkish” rhetoric benefited sellers. Therefore, the yield on the ten-year rouble benchmark rose to YTM 7.23% on Friday. The Russian government bonds market will be driven by geopolitics, namely prospects of tougher U.S. Sanctions in the coming weeks.

THE KEY HIGHLIGHTS DURING CBR PRESS CONFERENCE:

- Economy is recovering quicker than expected, consumer demand is steadily growing. The economy is expected to pick up further on the back of vaccination and extension of state-sponsored relief programmes. Russia's economy is projected to return to the pre-pandemic level by the end of 2021. The Central Bank will update its GDP forecast in its core meeting in April.
- The OFZ curve and the rouble reaction to the increase suggests that the regulator's move met market expectations. The rate increase was not a predetermined outcome. There were three options on the table: a hold , a 25-bps and a 50-bps hike. As a result, the Central Bank opted for a smoother path. If the CBR had decided to put off the rate hike until further board meetings, it would have to take a steeper rate hike trajectory going forward.
- Russia's end-year inflation will be below the current reading of 5.8% (as of March 15), but above the 4% target. The CBR updated its annual inflation forecast, the CPI will return to the target in the first half of 2022 (previous forecast suggested it would happen at the beginning of 2022). Annual inflation forecast will be published at the CBR's core meeting in April. Disinflationary risks in the baseline scenario have receded, but not faded. Opening up the borders after Covid incidence rate plays an important role, as it will impact redistribution of consumer spending.
- The Bank of Russia will factor in the implications for the forecast of potential investment decisions as regards the liquid part of the National Wealth Fund, that may be made as early as this year. The regulator is planning, as always, to mirror operations of the Finance Ministry.
- U.S. Sanctions against rouble sovereign bonds wouldn't create a systemic risk, but could cause short-term liquidity problems. The Russian Central Bank is ready to provide banks with liquidity irrespective of how they would use it for, including for OFZ purchases, if the US sanctions target Russian debt.

CONTACT LIST

Trading

Mikhail Durov | Fixed Income Trader | Mikhail.Durov@iticapital.com

Sales

Aleksandr Panfilov | Head of Fixed Income Sales | Aleksandr.Panfilov@iticapital.com

Research

Iskander Lutsko | Head of Research, Chief Investment Strategist | Iskander.Lutsko@iticapital.com

Olga Nikolaeva | Senior Fixed Income Research Analyst | Olga.Nikolaeva@iticapital.com

Stanislav Yudin | Senior analyst, Equity Research | Stanislav.Yudin@iticapital.com

Irina Fomkina | Research Analyst | Irina.Fomkina@iticapital.com

Elizaveta Herne | Research Analyst | Elizaveta.Herne@iticapital.com

Oleg Makarov | Chief Editor | Oleg.Makarov@iticapital.ru

CONTACT DETAILS:
ITI Capital Limited
Level 33 Tower 42,
25 Old Broad Street,
London EC2N 1HQ,
United Kingdom

PHONE:
+44 (0) 20 3889 8333
+44 (0) 20 3889 8331

WEB:
iticapital.com