

Russia: Limited scope for further cuts

The Bank of Russia delivered the much expected cut but indicated that the scope for further easing is very limited. A number of positive developments need to take place in order to see the key rate below 6.0% in 2020. In any case, investors should enjoy the positive momentum at least until the year-end.



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6.25%

Russia key rate

a 25 bp cut

As expected

Green light for the December cut emerged at the last minute

Russian key rate cut by 25bp to 6.25%, in line with consensus and our expectations.

We changed our outlook very recently and believe the CBR made its decision in response to last-minute positive developments:

- Local CPI persistently below expectations. Inflation decelerated from 3.8% YoY in October to 3.5% YoY in November (vs. our 3.6% expectation) and dropped to 3.3% YoY in the first week of December, mostly on a high base effect. Households' forward-looking CPI expectations also improved to 8.3%, the lowest re-reading since April 2018.
- Budget spending growth stabilised at around 15% YoY in September-November. This was below the rate needed to fulfill the annual plan, due to the clogged allocation process for investment spending. Now the annual spending plan may be underperformed by around RUB300bn (0.3% of GDP), highlighting the lack of immediate inflationary threats related to budget policy.
- The slowdown in retail lending growth to 19.7% YoY in October (vs. a peak of 23.8% YoY seen in April) and a likely further slowdown following the macro-prudential tightening since October 1 suggest a low risk of any re-emergence of consumption-driven inflationary pressure in the near-term.
- Risks of deterioration of external risks failed to materialise, as (1) optimism regarding a US-China trade deal received an additional boost, (2) the US Senate postponed discussion on the DASKA Act and Russia-Ukraine talks resumed, both limiting Russia country-specific risks, (3) the UK election outcome lowered the Brexit uncertainty, and (4) Fed rhetoric did not offer any overly hawkish surprise.
- The November balance of payments suggested improvements in the corporate capital account, so reducing RUB vulnerability to possible negative market developments
- As a result, near term CPI expectations for Russia improved. YE19 CPI is now looking to hit or be below the lower bound of the CBR's previous target range of 3.2-3.7% (now lowered to 2.9-3.2%) and to drop below 2.5% YoY in 1Q20 before any subsequent reversal (previously we expected 3.4% YoY as of YE19 and 2.5-3.0% for 1Q20).

Mid-term scope for further cuts is very limited

At the same time the CBR's mid-term guidance implies limited scope for further cuts. The CBR (1) kept the YE2020 CPI forecast unchanged at 3.5-4.0%, (2) mentioned no further improvement in corporate CPI expectations in the headline commentary, (3) indicated an acceleration of the consumer services CPI in November, (4) made no mention of a possible lowering of the equilibrium rate range of 6.0-7.0%, (5) changed the wording on the possible timeframe for the next possible cut from "one of the upcoming Board of Directors' meetings" (meaning one of 3) to "the first half of 2020" (meaning 6).

We are not surprised with this guidance given the abundance of mid-term risks to the CPI trend:

- The budget has a backlog of around RUB1 trn spending, or around 1% of GDP (RUB0.8 trn up until 2018, RUB0.2-0.3 trn for 2019). With the Audit Chamber (headed by ex-Minister of Finance Alexey Kudrin) drawing the president's attention to it, it is possible that there will be a catch-up next year, contributing to recovery in CPI rate later into 2020
- The high base effect for the CPI rate expires after 1Q20
- The current slowdown in CPI is driven by the food segment while other components are more stable. Services CPI indeed accelerated in November
- The recent slowdown in overall inflation might create an environment for relaxation of the local gasoline price freeze
- Upcoming protectionist measures, such as the decline in the duty-free threshold for personal cross-border purchases via the internet from the current EUR500 per month to EUR200 per delivery package from 2020 (and to EUR100 from 2H20, according to recent

proposals from the Finance Ministry) could lower local retailers' incentive for price competition. According to various estimates, cross-border e-purchases are growing by 20-25% p.a. and currently account for 2-4% of the Russian non-food retail trade. The primary cross-border e-platforms for bargain-hunting Russians are located in China.

- There is a growing risk of correction in emerging markets later into 2020 following a very successful 2019
- As 2020 elections in the US are approaching, it is possible that Russia may return on the forefront of the US domestic agenda, which would pose a risk for OFZ inflows

Implications for RUB and OFZ - near-term positive, some correction after 1Q20 is increasingly likely

Our take ahead of CBR governor's press-conference (to start 3 pm Moscow time) is that next cut to 6.0% is highly likely (and is more likely to happen early into 2020 rather than later given the expected CPI trajectory), but further decline is not guaranteed and would require combination of positive developments, such as no deterioration of external environment, no increase in foreign policy pressure for Russia, and no catch up on the budget spending backlog.

Nevertheless, positive market momentum remains and appears justified for the short-term, also in case of some positive actions by the rating agencies (Moody's release is expected later today). Our YE19 targets of 6.35% for 10Y OFZ yields and USDRUB 64.0 appear too conservative and have room for outperformance (especially on the RUB side). We expect strong 1Q20, supported by, among other things, favorable seasonality in the current account, however later in the year we would not exclude some correction. For now our base case for YE2020 remains unchanged at USDRUB 66.0 on continued foreign assets accumulation by corporates and households and 6.30% 10-year yields on limited scope for further non-resident inflows and increased net OFZ supply of RUB1.8 tr.

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