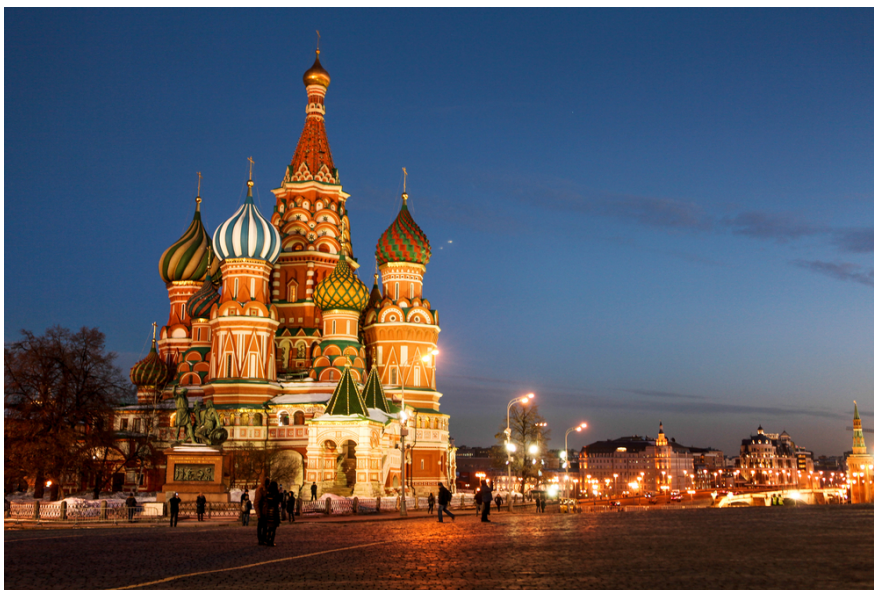


## Will S&P and Fitch 'congratulate' Russia?

We believe Russia deserves an investment grade rating, but there is a risk S&P will wait for another six months until after the presidential elections. Fitch is in a more comfortable position



### S&P and Fitch will announce rating decisions on Russia on 23 February

Rating agencies S&P and Fitch will release their sovereign rating decisions on Friday, 23 February, when Russian markets are closed for the Fatherland Defenders' Day holiday.

- S&P has held a BB+ rating on Russia since January 2015 with a 'positive' outlook since March 2017
- Fitch has maintained an investment grade rating of BBB- since January 2015 and surprisingly upgraded the outlook to 'positive' in September 2017
- Moody's is a clear laggard after changing the outlook to 'positive' only in January 2018 with a Ba1 rating.

Generally, the 'positive' outlook means that the rating could be upgraded within six months to two years.

## What did they say about Russia before?

As we look for clues about potential rating actions in the agencies' previous comments, we find similar arguments in both cases. In 2017, both agencies stressed the still-strong net external asset position of Russia and strengthened fiscal balance sheet. That was due to a conservative US\$40/bbl (in real terms) oil price assumption and codifying the new fiscal rule, which was already implemented in February 2017 and continued with some changes in 2018. The rule not only restricts the government's ability to use windfall revenues for extra fiscal spending but also makes it possible to replenish sovereign funds via MinFin FX purchases on the market (US\$58-60bn at US\$65/bbl).

A flexible exchange rate, inflation targeting and prudent monetary policy- with inflation falling to below the 4% target- were also mentioned as positive factors. Inflation was still above the level of its peers (about 2%), but has improved further since then with headline CPI at 2.2% and expectations of only a gradual rise to about 3-3.5% by the end of 2018.

Still, both agencies also cited relatively weak GDP growth potential (around 2% vs '3%+' in its peer group) as a major constraint though they explicitly mentioned that the outlook could brighten if structural reforms were to be announced after the presidential elections, as expected. Geopolitical tensions and the risk of sanctions, including against the sovereign debt, were mentioned as well, in addition to a weak institutional environment, poor investment climate and constrained political freedom.

There was some divergence in views, though, regarding the banking sector. Fitch looked at the CBR bail-out of the biggest private bank in 3Q17 a bit more constructively, seeing it as a sign that the CBR is committed to cleaning-up the sector, improving supervision and bank resolution framework. It, therefore, saw limited risk from the banking sector to the sovereign balance sheet. S&P, on the other hand, saw this as an indication of a fragile banking sector with potential risk for GDP growth and the fiscal coffers, also limiting the monetary transmission mechanism.

## It should be investment grade, but S&P/Fitch may have their own say

We believe that Russia should already have been upgraded to investment grade in 2017, given its monetary, fiscal and external fundamentals as well as its recovering GDP growth. So, we support the Fitch stance and believe there is room to see an upgrade from a more conservative S&P. Investors seem to fully agree with that narrative given where Russian sovereign bonds and credit default swaps are trading (5Y CDS of 110bp is at mid-2008 levels).

As a rationale, macro data in January this year suggests economic weakness in Q417 was temporary, oil prices are higher than the agencies expected in 2017 and the budget will probably have a surplus of 1-1.5% of GDP, if current oil prices hold. There is still uncertainty about the post-election reform agenda, but we've already heard some rumours about government initiatives to increase infrastructure spending funded by higher debt (still to remain at very low level) as well as changes to the court system. We agree that uncertainty about US personal sanctions remains, but they are unlikely to have any major economic impact and the risk of sovereign sanctions has significantly decreased after the US government report in January.

However, the agencies may still wait for another six months until after the presidential elections to

see the reform plan and how the banking sector environment changes, given that other private banks were bailed-out in late 2017. Also, institutional weakness and geopolitical risks are less quantifiable stories.

We note that recent comments from S&P about the remaining "GDP growth and banking sector" concerns have dampened expectations of an imminent rating upgrade. Our takeaway from the Fitch 2017 comments assumes they may upgrade, but the final decision will still depend on qualitative factors and Fitch is in a less pressured position compared to other agencies still having Russia at BBB-.

## Market implications look limited in any scenario

There might be some positive market reaction in Russian assets (primary US\$ bonds) but only if S&P decides to upgrade its rating, as that would mean two agencies hold an investment grade rating on the country, which could prompt additional "technical" demand from foreign investors. A Fitch upgrade without a move by S&P will likely have a much lower market impact, mostly just further differentiating the agency from the other two. The positive market impact would be stronger and longer if both were to issue upgrades.

If nothing changes and the 'positive' outlook is retained, we don't rule out some short-term negative pressure on US\$ bonds, OFZs and the Ruble. But it probably won't result in a big move, as the upgrade story will simply shift into 2H18, rather than go away completely. And OFZs and RUB are now more exposed to other positive local drivers rather than the rating story.

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