

Russia mid-year review: More positive on FX and FI, still cautious on economic growth

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Russia: markets propelled by global optimism

1H19 was very successful for the Russian financial market, with the rouble appreciating 10% against the USD, benchmark yields declining by almost 130bp and CPI underperforming expectations, bringing the Bank of Russia back onto its rate cutting path. **Adjusting our YE19 view for this success, we have recently improved our forecast of USD/RUB to 64.0, CPI to 4.0% and the key rate to 7.00%.**

Yet most of the credit goes not to Russia itself, but to the rest of the world, which has become more optimistic on the global rates trajectory, more concerned about the oil supply, and more confident in the future harvest. Given the volatile nature of the external markets, **we maintain our cautious longer-term view on the Russian market, constrained by local challenges.**

Our key concerns include slow economic growth, which is increasingly dependent on big-ticket state-funded projects, while private sector corporates and households prefer to accumulate international assets to local investments, making RUB increasingly dependent on volatile portfolio inflows. As **global investors value Russia's low macro risk profile**, the pivotal country-specific determinant for the flows would be whether the slow growth rate will be addressed with structural policies or with monetary/fiscal tools.

Key takeaways and forecasts

ECONOMY – growth slow, budget policy comes to the forefront

[SLIDES 4-7]

- 1H19 GDP growth expectedly weak on households and corporates, budget spending to support growth in 2H19
- Weak growth rate has challenged the tight budget policy, but macro risks are minimal for the next 2-3 years
- Government may potentially allocate up to US\$100bn from NWF for local investments in 2020-21

FX – near-term outlook improved on global optimism, LT risks remain

[SLIDES 8-12]

- Improved global mood and reduced previewed sanction risks allow us to improve our short-term RUB outlook in 2019
- Long-term risks to RUB persist, as private sector keeps reducing foreign liabilities, accumulates foreign assets
- Potential budget easing raises questions regarding parameters of CBR's open market FX purchases

RATES – we are constructive thanks to global mood, lower near-term CPI risks

[SLIDES 13-15]

- Expecting positive newsflow on CPI in the short-term thanks to low agro prices, strong RUB
- CBR may resume its rate-cutting cycle in 3-4Q19, keeping in mind the declining savings rate of households
- Strong macro fundamentals, high real rates, positive global mood allow to expect further foreign inflows to OFZ

KEY FORECASTS	4Q18	1Q19	2Q19	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)*	2.7	0.5	0.8	1.2	1.1	1.0	1.5
CPI (%YoY)*	4.3	5.3	4.7	4.4	4.0	4.7	3.5
Central bank key rate (eop, %)	7.75	7.75	7.50	7.00	7.00	7.00	6.50
3m interest rate (%)*	8.6	8.3	8.0	7.5	7.5	7.8	6.9
10yr yield (%)*	8.8	8.4	7.4	7.2	7.1	7.8	7.1
USD/RUB*	69.5	65.6	63.0	65.0	64.0	65.4	67.4
EUR/RUB*	79.5	73.7	71.9	72.8	73.6	74.3	78.1

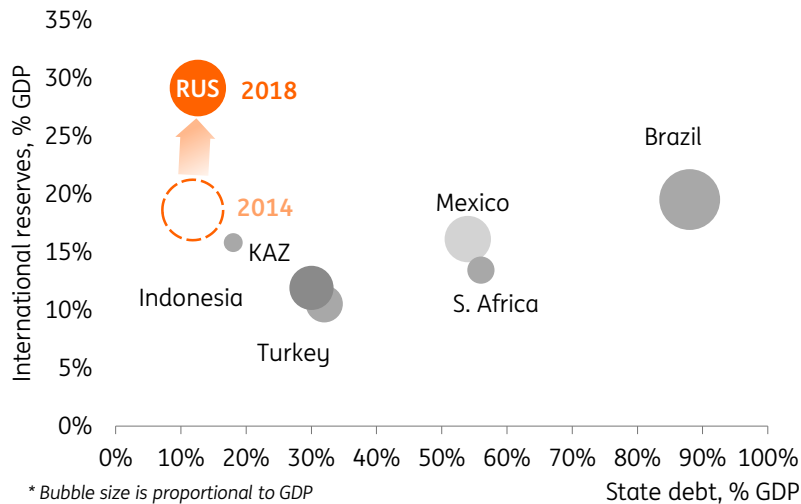
* Quarterly data is eop, annual is average

APPENDIX – the government's attempts to address challenges – quantified

[SLIDES 16-18]

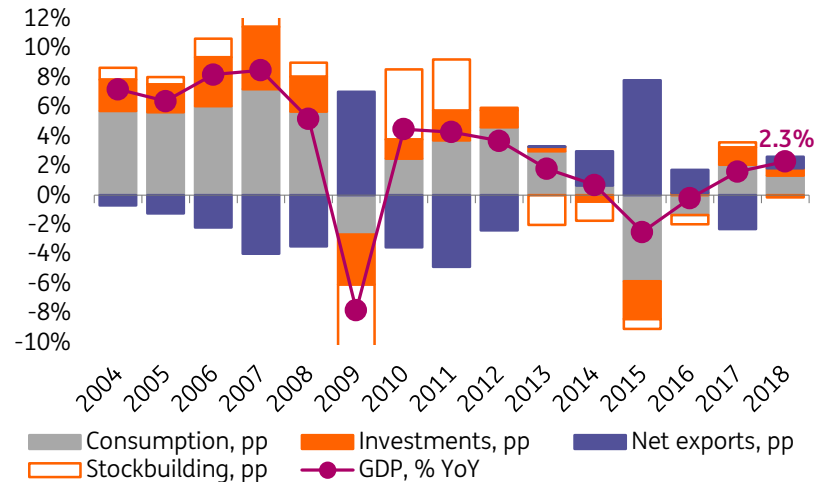
Big picture: low risk – slow growth, still

Russia's macro fundamentals are the strongest in EM
International reserves and state debt by country, % GDP

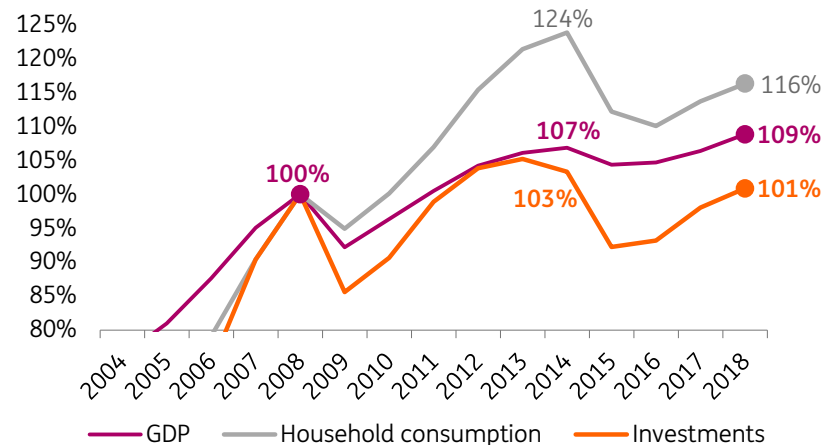


- Following 2014, Russia has succeeded in minimising macro risks, look at state debt, international reserves.
- The acceleration of GDP growth from 1.6% in 2017 to 2.3% in 2018 took place thanks to higher net exports, including a higher physical volume of exports and restrained imports on 17% RUB depreciation to USD.
- Despite a number of large state-sponsored and oil-related infrastructure projects, the annual real CAPEX has now barely reached 2008 levels, while real private consumption is 16% above its 2008 level.

GDP growth is increasingly dependent on the external sector
GDP growth by components, % pp in real terms



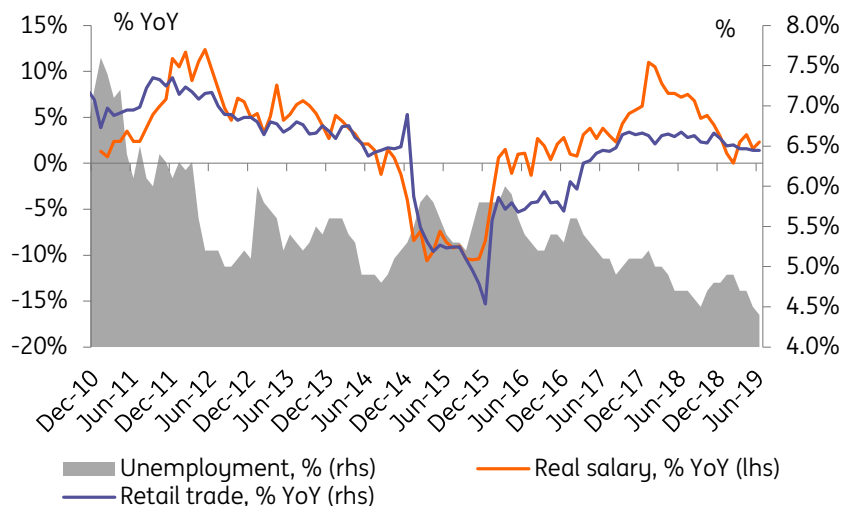
Fixed investments have just returned to their 2008 level
Index of GDP, consumption, investments, 2008=100%



Consumption: weak, relies on leverage and budget

Retail trade growth stabilised at low level of 1.4% YoY

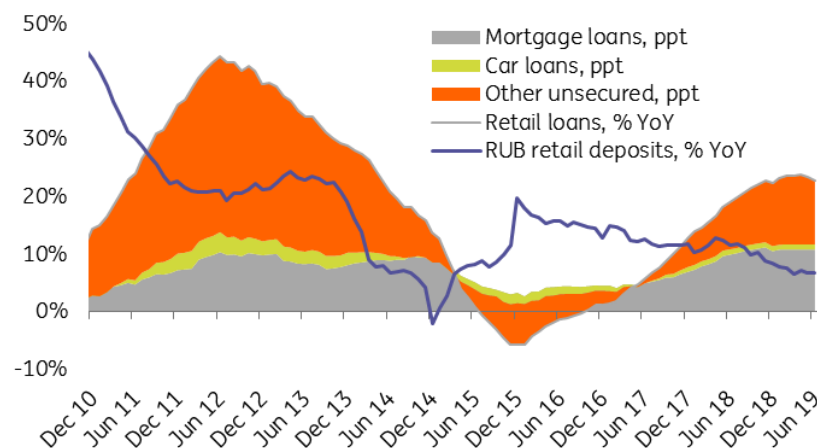
Key consumer trend fundamentals



- Following the VAT hike, retail sales growth seems to have stabilised at a low 1.4% YoY level in May-June 2019, real salary growth (2/3 of household income) also slow but stable, unemployment at historical lows.
- Retail lending growth started to decelerate in May-June, offering less financing support to consumption going forward.
- **Consumption may receive some modest boost through indexation of state sector salaries in 2H19**, but already high dependence of households on state support is a longer-term challenge.

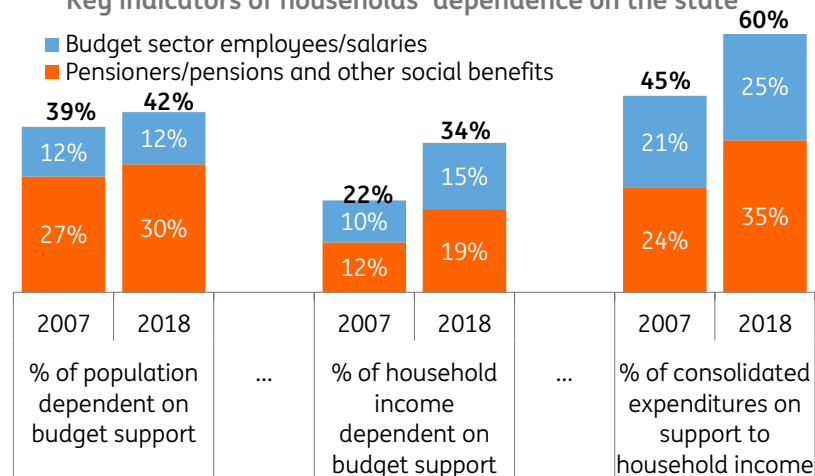
The scope for further leverage is limited

Deposit growth and composition of retail loan growth



Dependence of household income on state support has grown

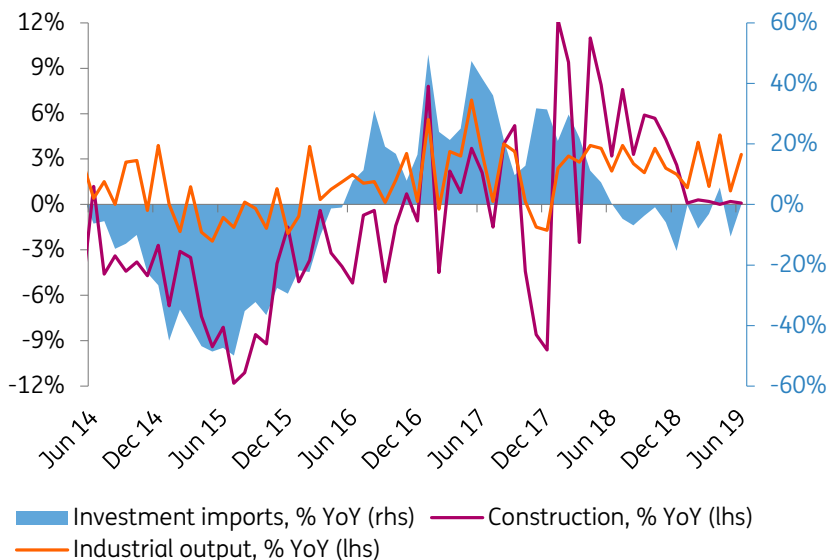
Key indicators of households' dependence on the state



Investments: increasingly concentrated

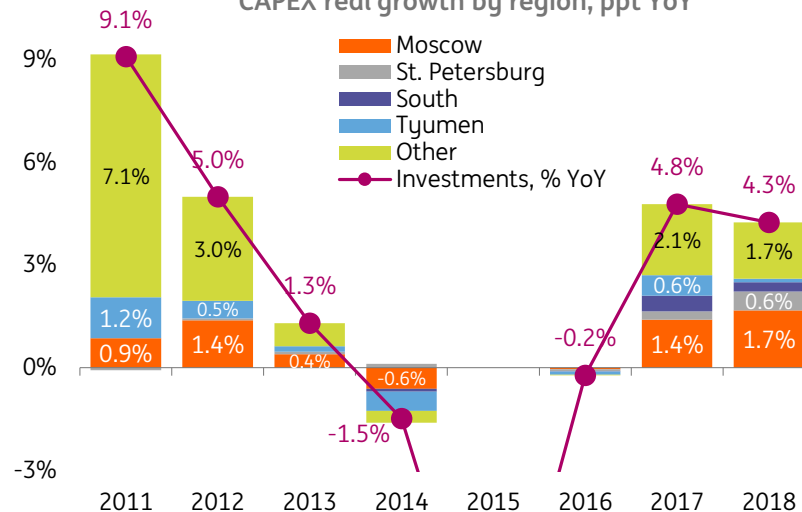
Corporate activity indicators point at slowdown in 1H19

Construction, industrial output, investment imports, % YoY



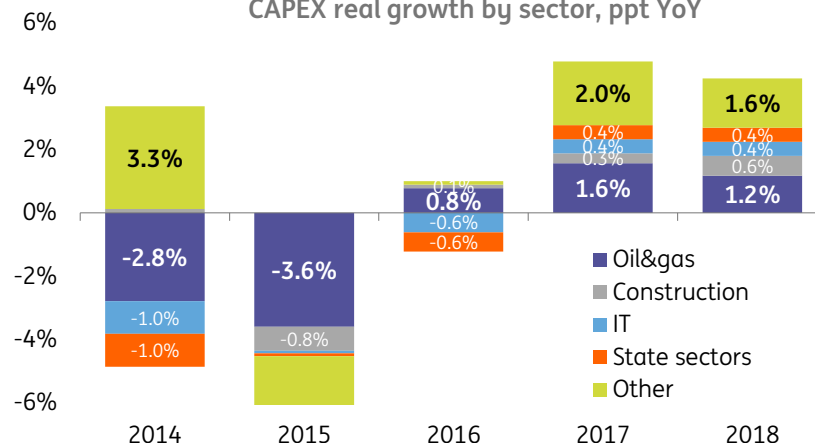
CAPEX focused on big-ticket infrastructure projects

CAPEX real growth by region, ppt YoY



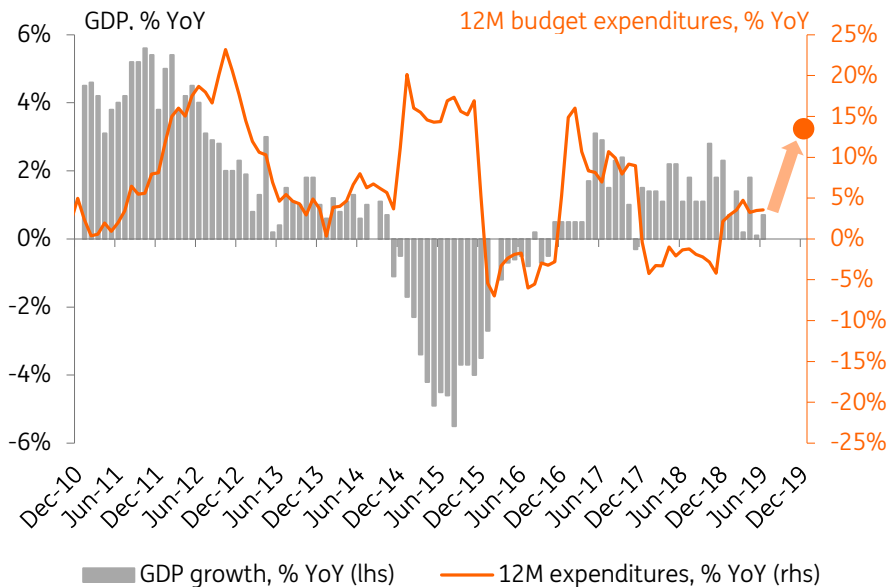
- After solid 4-5% YoY growth in real CAPEX in 2017-18, **the current corporate activity indicators, including investment imports, construction, point at a material slowdown to 0-1% YoY in 1H19.**
- Geographical structure of investments point to a high concentration around infrastructure projects in the most populated agglomerations and oil & gas regions.
- The leading sectors driving the investment growth are oil & gas, construction, public sectors, and IT.

CAPEX real growth by sector, ppt YoY

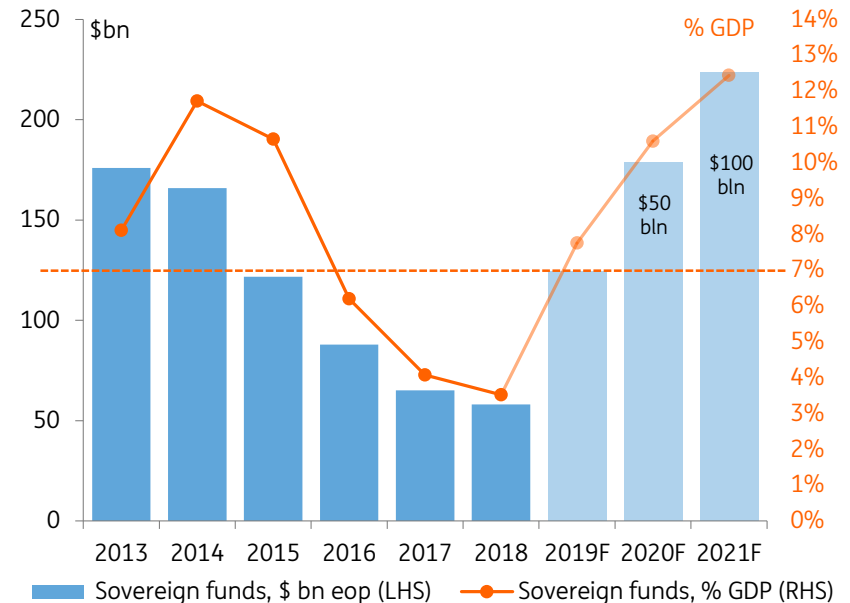


Budget policy set to ease

Budget spending to accelerate in 2H19, providing support to activity



Government plans to invest NWF locally after it reaches 7% GDP

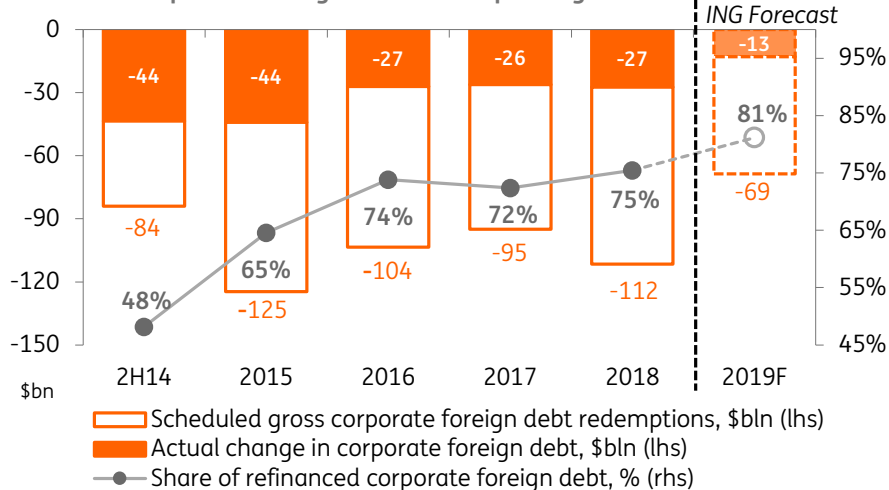


- In part, low producer activity in 1H19 reflects stringent approach to budget spending, but as 'National Projects' (more details on Slide 15) gain traction and state spending should accelerate from 4% YoY in 1H19 to 22% YoY in 2H19, the infrastructure-driven industries should receive support.
- Still, as the mood in the sectors not driven by big ticket state-supported projects remains cautious, **we keep our 2019 GDP growth forecast at a modest 1.0% YoY (vs 0.7% YoY in 1H19), and 2020 at 1.5%.**
- Concerned with weak GDP growth rates, the government is contemplating investing a portion of state savings (National Wealth Fund) locally after it reaches 7% of GDP. Given the current trends, the sum available for such investments could reach US\$100bn by the end of 2021. The actual scale of fiscal easing will probably be lower. The key question is whether this measure will boost the potential growth rate or be a temporary supportive factor.

Limited investment demand -> higher intl. assets

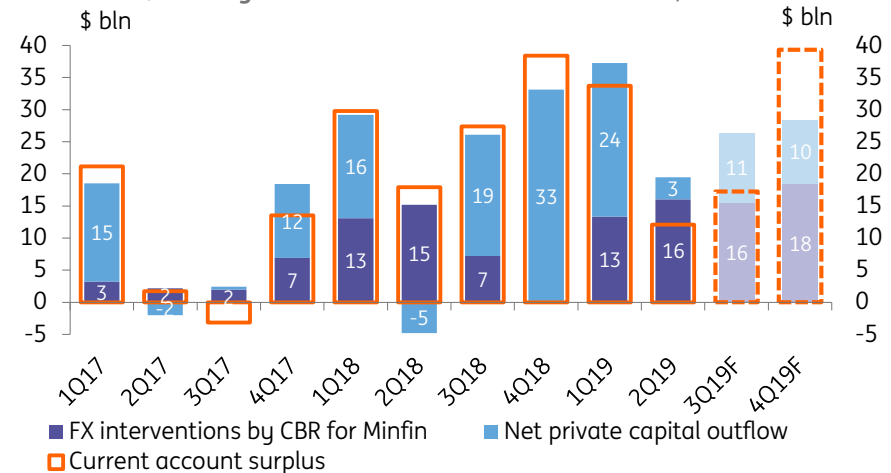
Foreign debt redemption schedule for 2019 is light...

Corporate foreign debt redemption: gross vs net



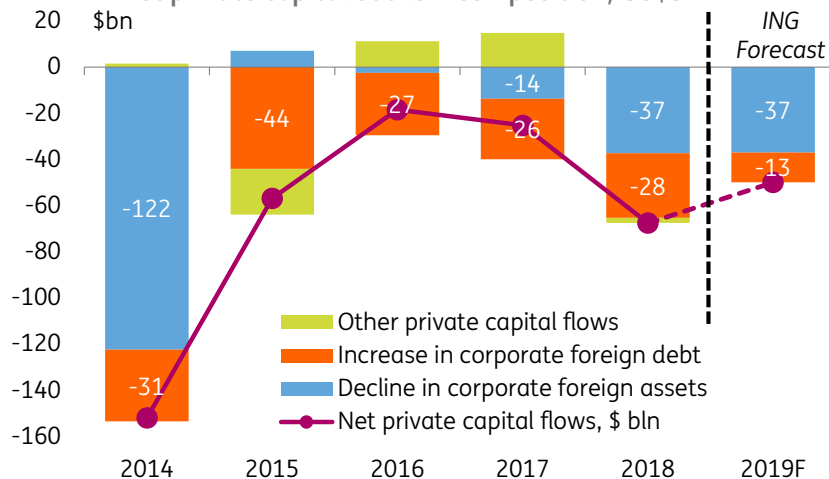
Current account is channeled into intl assets by Minfin, corporates households

Quarterly BoP: utilization of current account, US\$bn



... but the corporates are showing preference for foreign assets

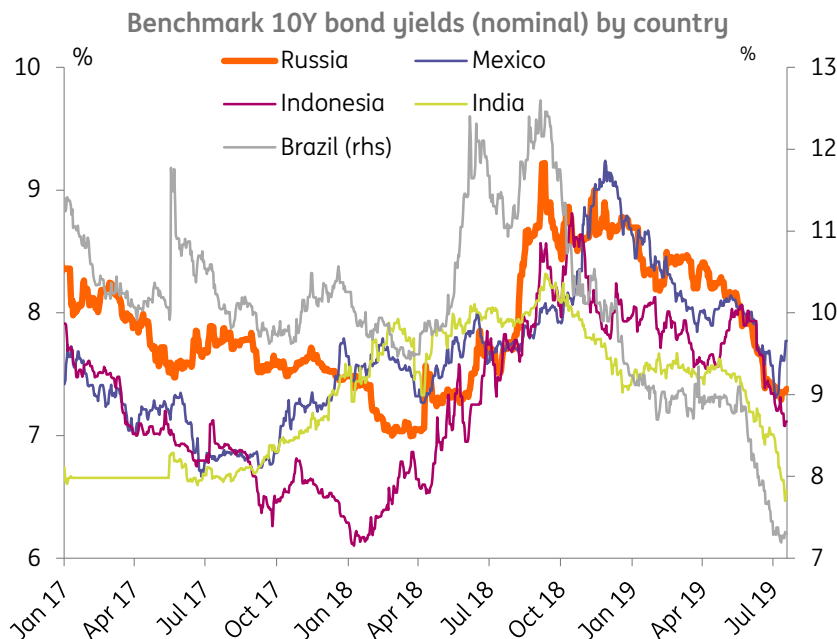
Net private capital outflow composition, US\$bn



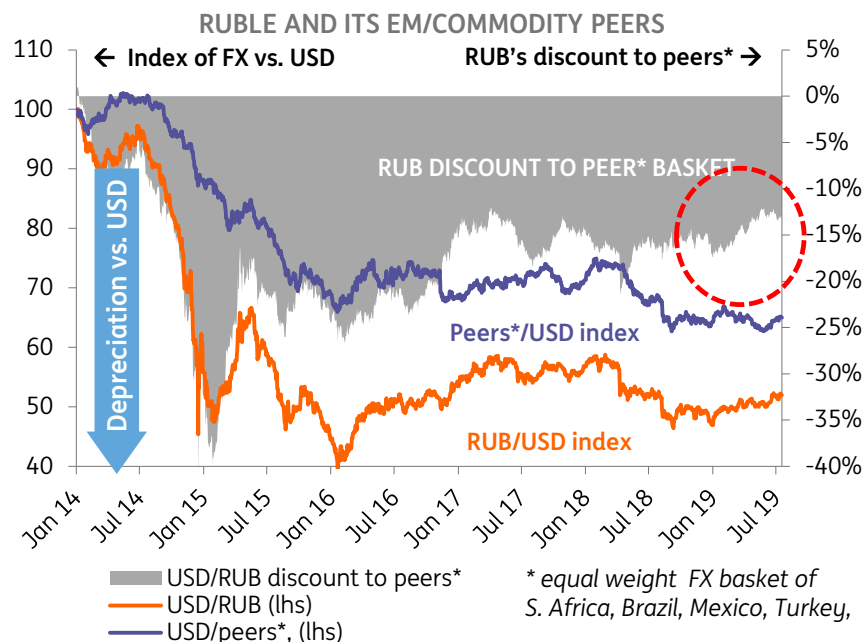
- Limited local investment demand (low corporate CAPEX) and the budget rule (requiring Minfin to purchase of FX in the equivalent of excess fuel revenues) results in current account surplus being routinely channeled into accumulation of foreign assets by the corporates and the government.
- The role of foreign debt redemption as a contributor to capital outflow has declined, but still remains a factor.
- **This year's US\$100bn current account surplus is likely to be sterilized by ~US\$60bn FX purchases and ~US\$50bn net private capital outflow.** Portfolio inflow into the state bonds (OFZ) is the only support factor (see slides 8-9 for details).

But in 1H19 RUB lifted by improved global mood...

OFZ yields down in line with peers



RUB is catching up with EM peers, possibly on lower sanction risks

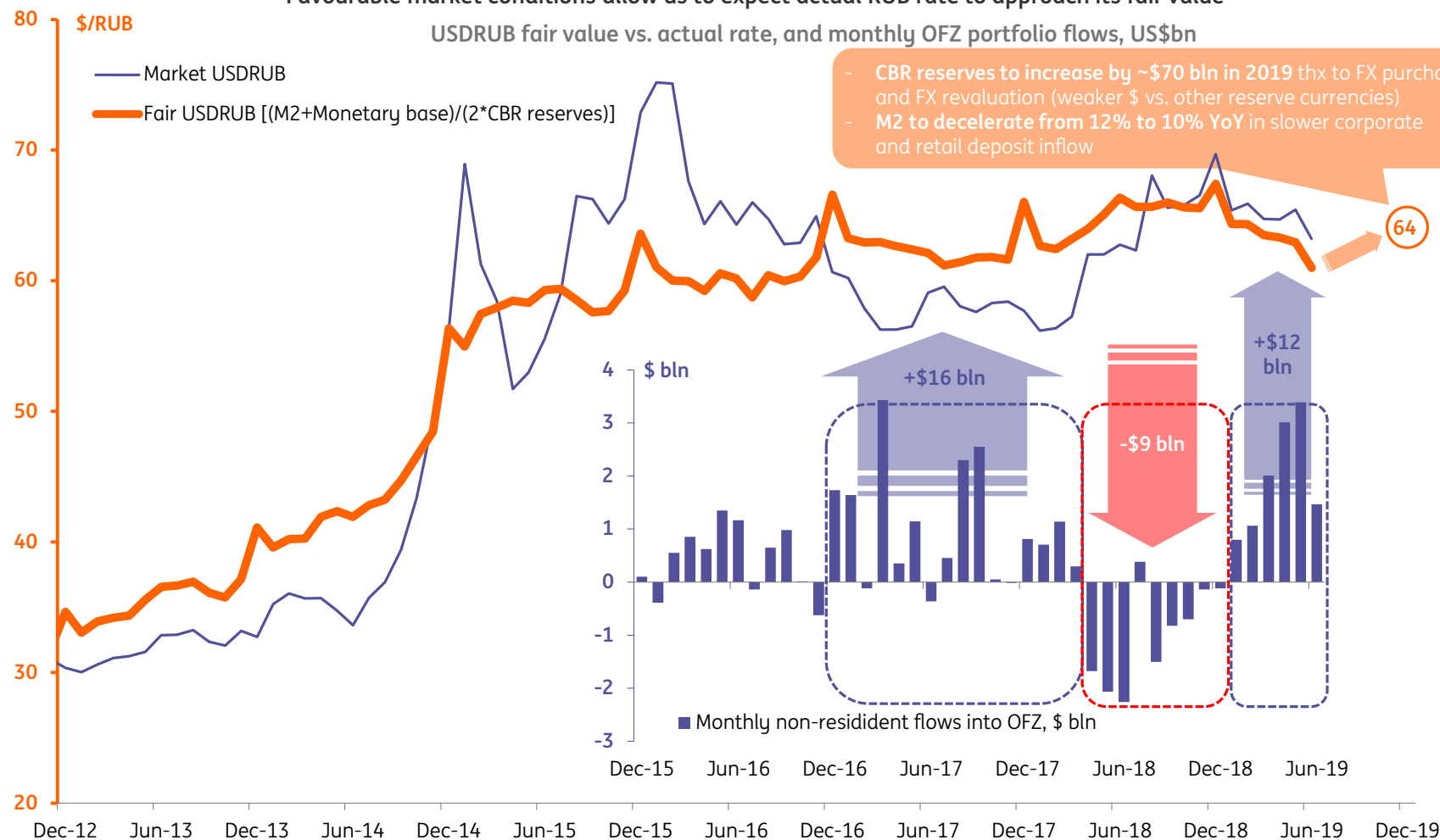


- 1H19 was still very successful for the rouble thanks to the positive external environment. The likelihood of a Fed rate cut increased from zero in 2018 to 100% by mid-year 2019, driving global yields lower and favoring portfolio inflows into EMs.
- As the Mueller Report de-prioritised Russia as a vehicle for internal US politics, sanction rhetoric subsided, compelling investors to rebuild their positions in local state bonds (OFZ) after a sell-off in 2018 (see more details on slide 9).
- As a result RUB appreciated against the USD by 10% in 1H19, outperforming peers struggling with their internal political and macro weaknesses. **Based on strong 2Q19 performance, we have improved our YE19 USDRUB target from 66 to 64.**
- Yet the strong US economic data, ignored by the market, creates risk that the Fed under-delivers on the 75bp cut expected by the market. Also, a possible competitive easing by other central banks questions USD weakening.

...through portfolio inflows into OFZ

Favourable market conditions allow us to expect actual RUB rate to approach its fair value

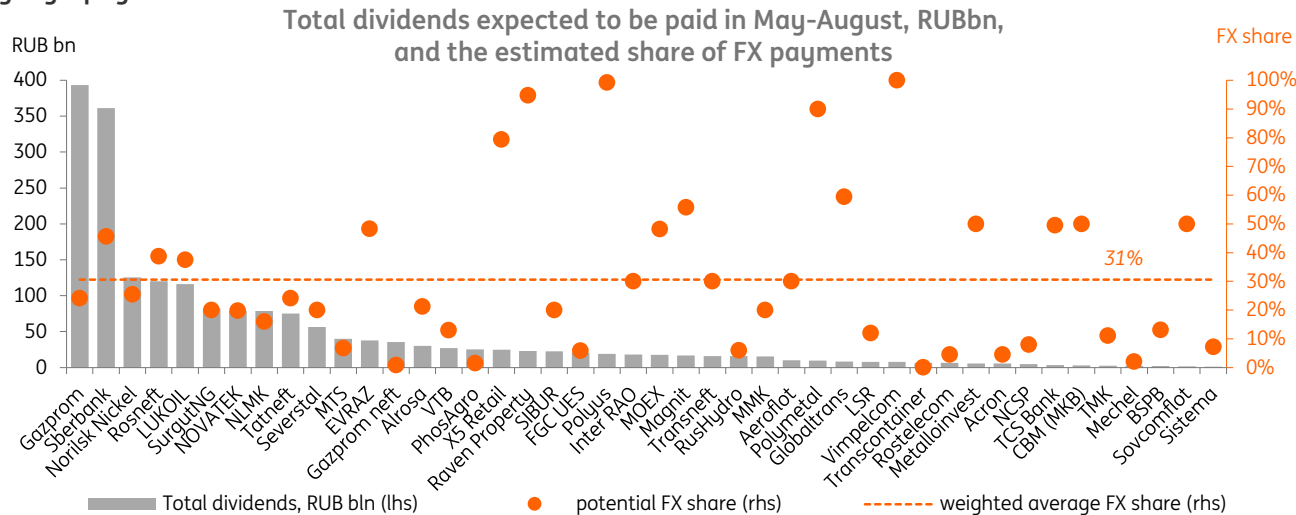
USDRUB fair value vs. actual rate, and monthly OFZ portfolio flows, US\$bn



- Our new year-end 2019 USDRUB forecast matches our estimate of the RUB fair value, as the portfolio flows no longer favour RUB's underperformance relative to it.

3Q19 may still see some depreciation on dividends

May-Aug is the high season for corporate dividends in Russia. According to the corporate announcements, this year RUB2.0 trillion is to be paid. We estimate that 31% of this sum, or RUB0.6 trillion, could potentially be converted into FX as per depositary receipts (DR) and indicative geography of holders.

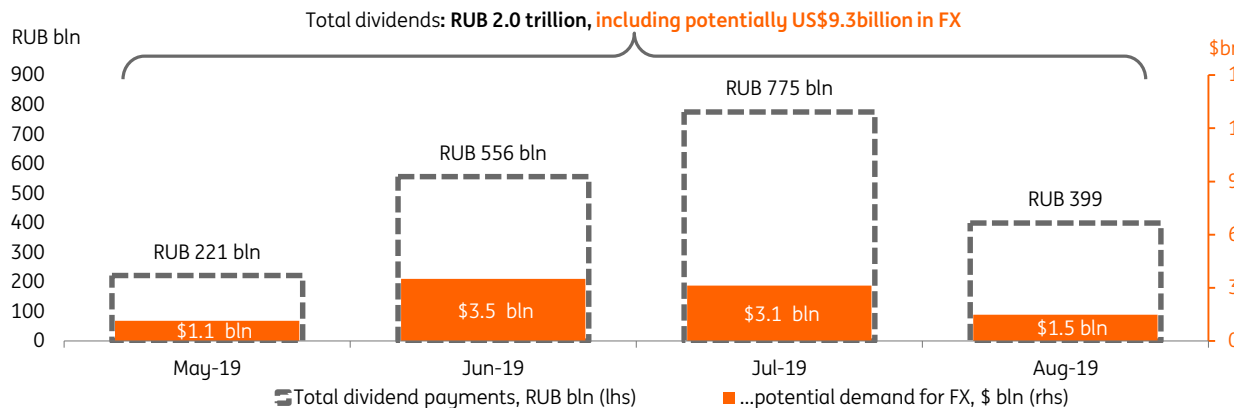


Our FX share assumption is based on various sources of data, including:

- self reported corporate DR programs
- self-reported geography of holders
- Bloomberg's HDS function, subsection "Ownership summary" -> "Top geographic ownership". Owners outside Russia, Cyprus, other tax havens and unknown locations are assumed to be non-residents with potential demand for FX dividends.

Actual demand for FX may differ from our estimates, as **none of the abovementioned sources can be considered definitive**: Locals can hold Depositary Receipts (DRs), self-reported geography of holders is only available for SBER, BBG data is incomplete

June-July are the heaviest months, with 68% of the total sum, including 72% of FX portion due
Expected monthly distribution of the dividend payments

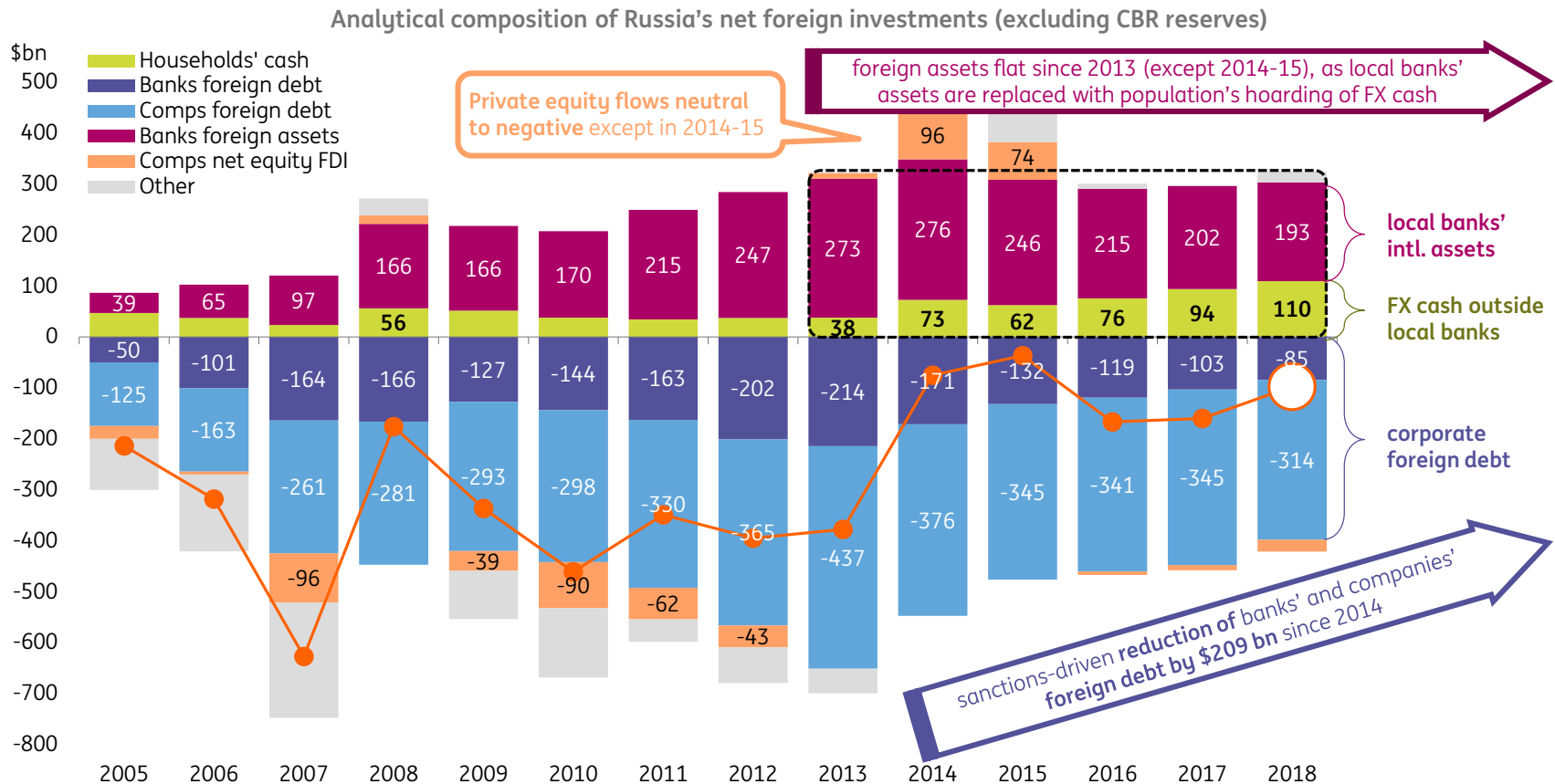


Our estimate of the timing of the payments is based on the various sources, including announced AGM and dividend record dates and direct indications from the issuers, available in the open sources.

Actual payment dates may differ from our estimates – most likely to further down the year.

LT RUB trend weak due to local preference for FX

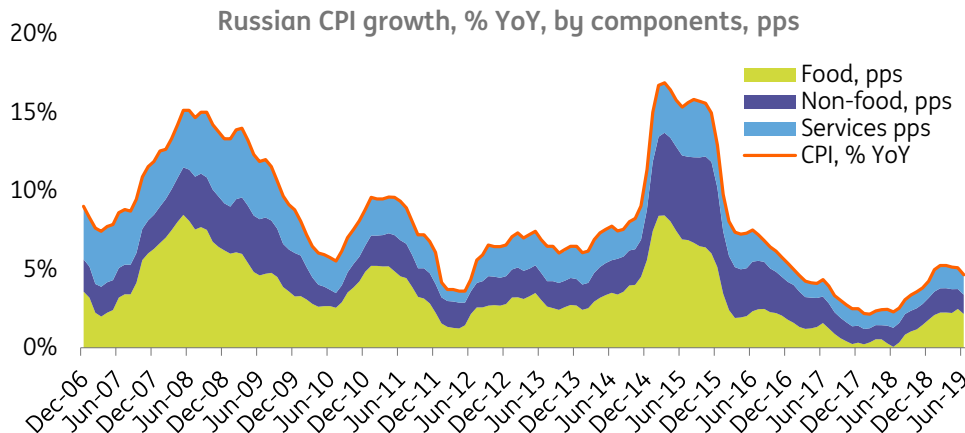
The key trends since 2013 (excluding 2014-15 shock) include shrinking corporate foreign debt due to sanctions amid flat assets. As for assets: households' cash outside Russian banks is growing, while local banks' foreign assets are shrinking amid foreign debt redemption. Net private equity has been consistently negative, close to zero.



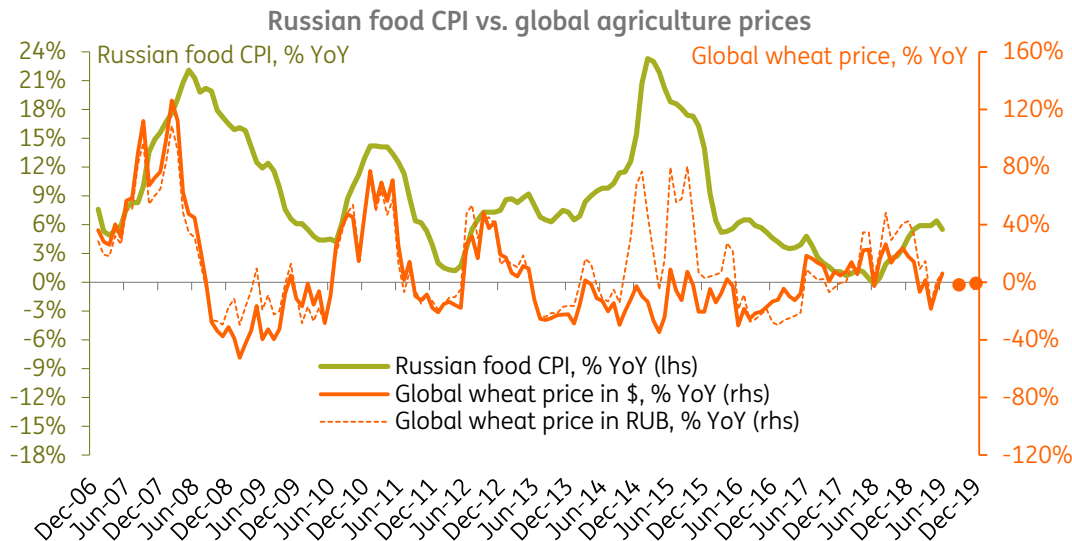
- Beyond 2019 however we see continued RUB depreciation due to continued foreign debt redemption and the structural preference of local corporates and households to accumulate international assets.

CPI growth pushed down by agro prices

Food prices (38% of CPI basket) are the key factor of volatility of Russia's inflation at the times of stable exchange rate environment



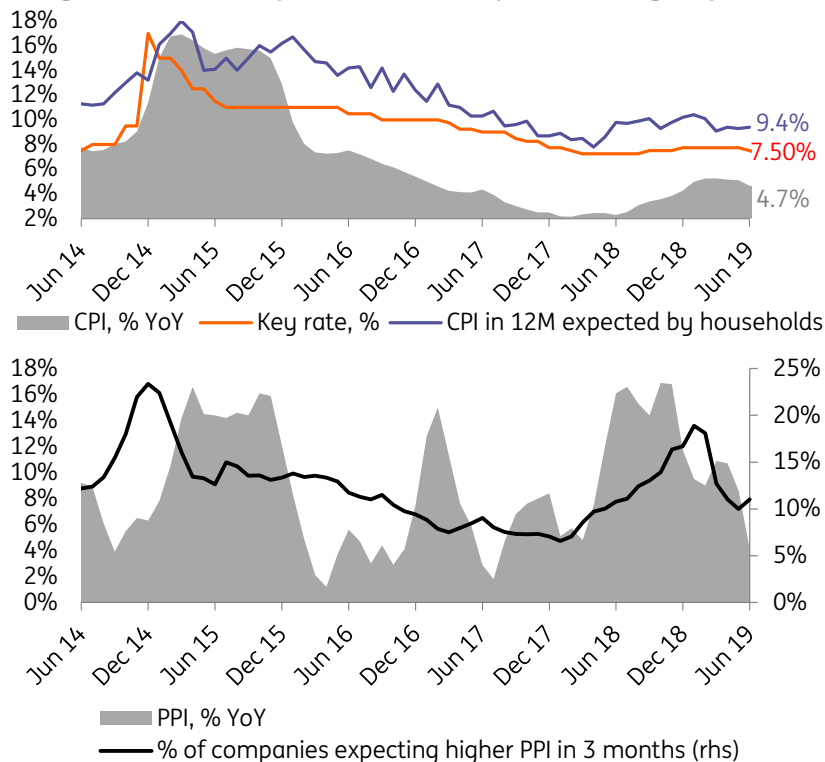
Favorable harvest outlook allows for positive expectations on food CPI



- Having peaked at 5.3% YoY in 1Q19, local CPI has decelerated to 4.7% YoY, underperforming expectations.
- The key driver of CPI volatility – both upward and downward – has been the food segment, which accounts for 38% of the CPI basket. The non-food and services inflation has been more stable.
- Russian food CPI is highly sensitive to global agro prices. Pickup or slowdown of the global RUB grain price growth by 10 pp translates into 1 pp acceleration or deceleration of the Russian food CPI.
- The slowdown of global wheat price (in RUB terms) from 40% YoY to 0 throughout 1H19 creates a 1.6 pp downside to the overall CPI growth rate, all else being equal
- Accounting for some pro-inflationary risks related to budget and local gasoline prices **we expect local CPI to decelerate to 4.0% by year-end 2019, which is below the CBR's forecast range of 4.2-4.7%.**
- CPI may temporarily drop to 3.0% YoY in 1Q20 on base effect. but then should recover to around 4.0 YoY

Near-term CPI and rate outlook has improved

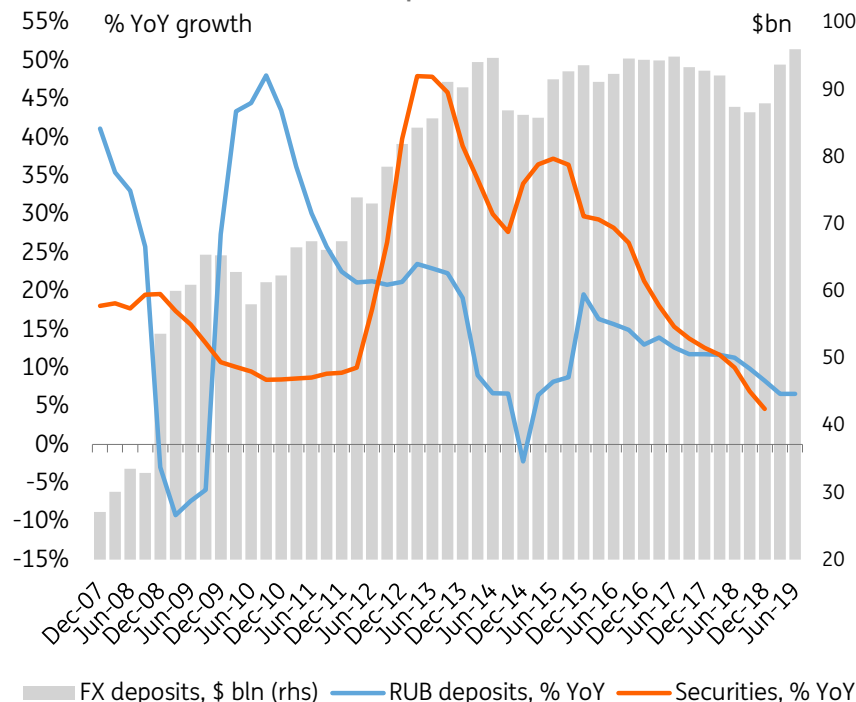
Inflationary expectations have moderated, but remain elevated
Key rate, CPI, and expectations and expectations by corporates



Arguments in favour of easing:

- CPI expectations moderated
- Actual CPI at lower forecast range
- CPI risks related to VAT hike accounted for
- Positive expectations on harvest
- GDP and consumption growth weak

Population's declining preference for RUB savings
Households, RUB savings in deposits and securities (% YoY), and FX deposits (US\$bn)



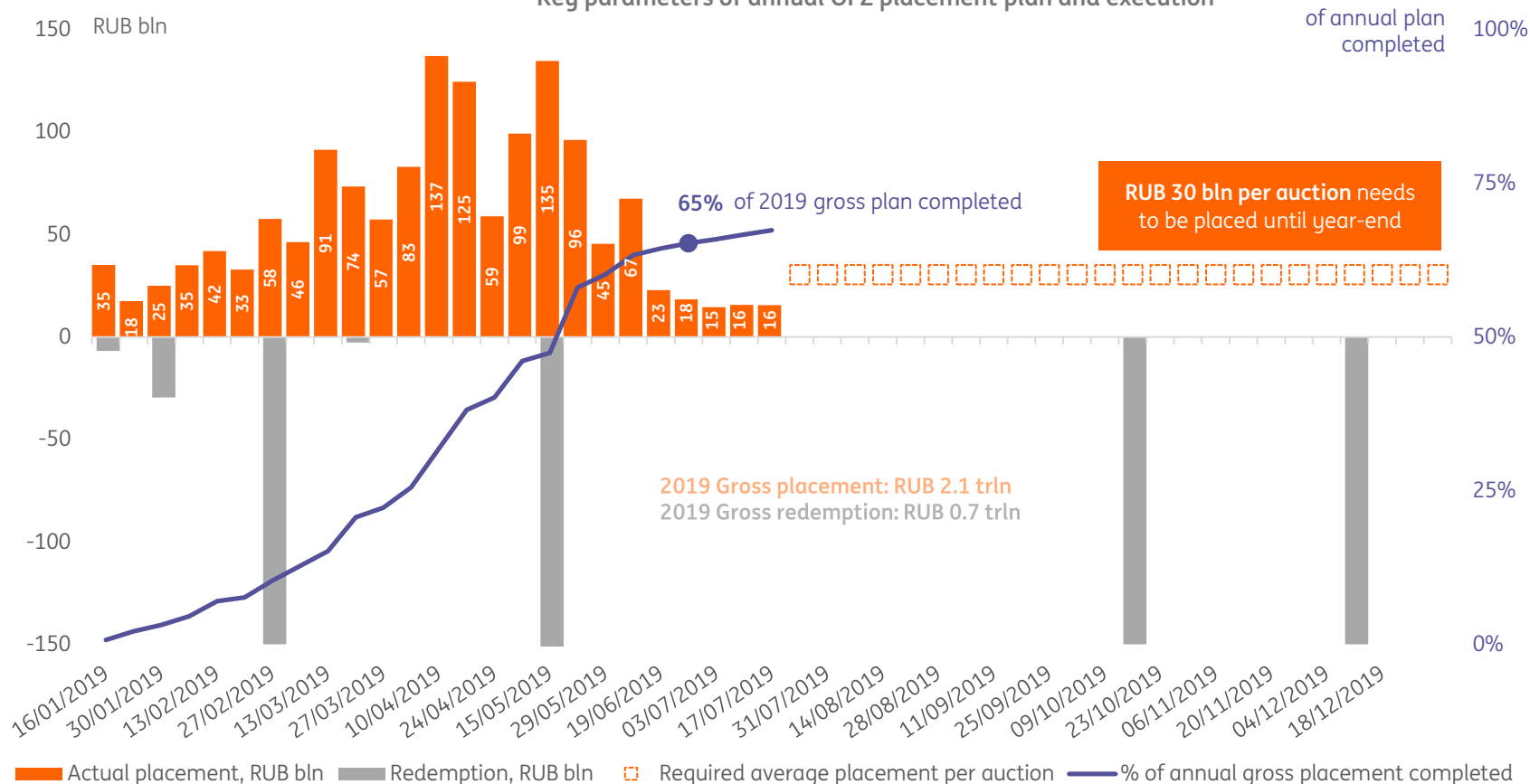
Arguments against aggressive easing:

- Further risk-off (global or Russia-specific), could weaken RUB
- Households' savings rate declining
- Gasoline price freeze beyond July uncertain
- NWF investments locally - ?

OFZ: supply growth to slow in 2H19

As of Mid-2019, 65% of the annual RUB2.1tr placement plan is executed thanks to positive global mood. If Minfin waives its right to buy back US\$4bn in Eurobonds, then annual OFZ plan could be further cut by up to RUB260bn

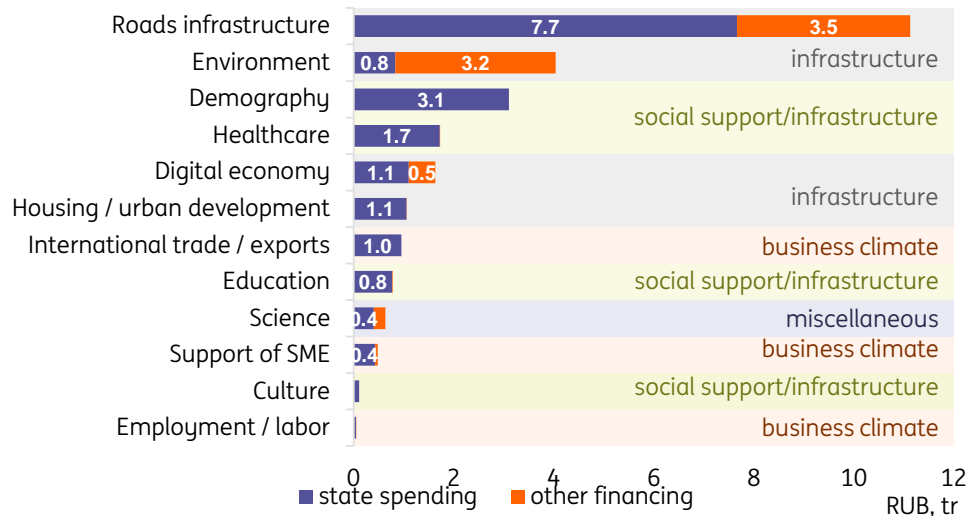
Key parameters of annual OFZ placement plan and execution



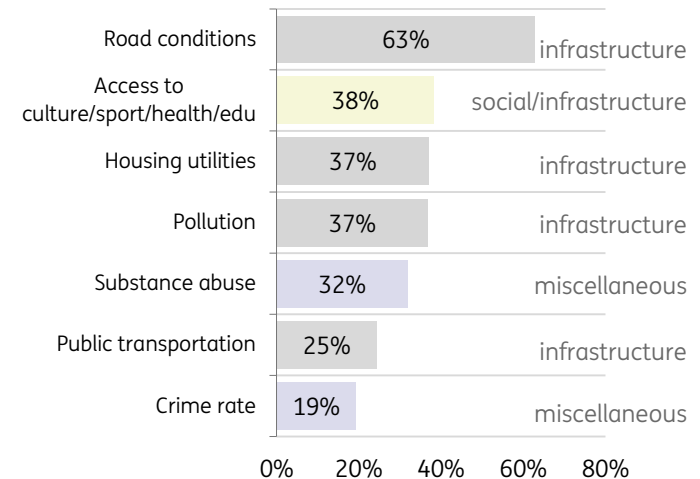
- 1H19 was very successful for Minfin, which placed OFZ for RUB1.4tr out of RUB2.1tr planned for the full-year. This makes it more comfortable with **focusing only on the most generous investor bids during weekly auctions in 2H19.**

Addressing low investments: National Projects

The size of National Projects for 2019-2024 is RUB 26 tr, or 3.6% of GDP* p.a...
Spending on National Projects by category and source of financing

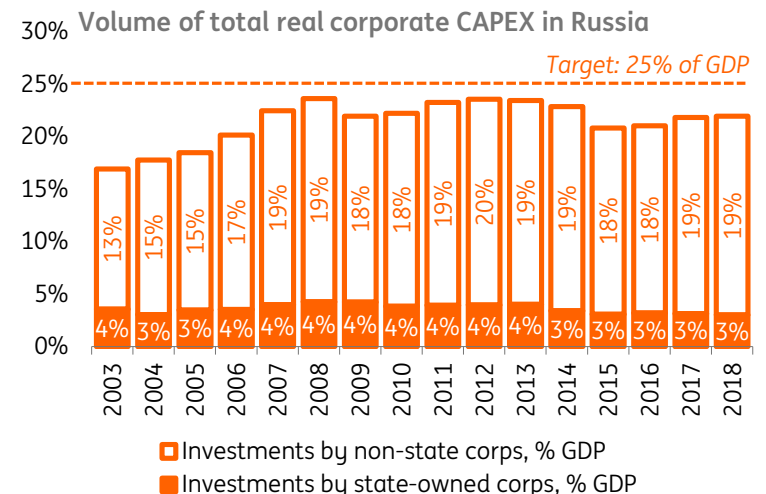


...aimed at addressing population's concerns
% of Russians, seeing a problem with:



- National Projects are 70% investments (2.5% GDP), 20% social support (0.8% GDP) and 10% business climate and miscellaneous (0.3% GDP).
- The National Projects are supposed to be 70% financed by the state and 30% by other sources.
- Currently, fixed investments account for 22% of GDP, including investments attributable to state-owned enterprises worth 3% GDP. The targeted volume of investments in Russia is 25% GDP.
- **It remains to be seen if state-sponsored infrastructure spending will translate into higher confidence in the private sector to boost its own CAPEX**

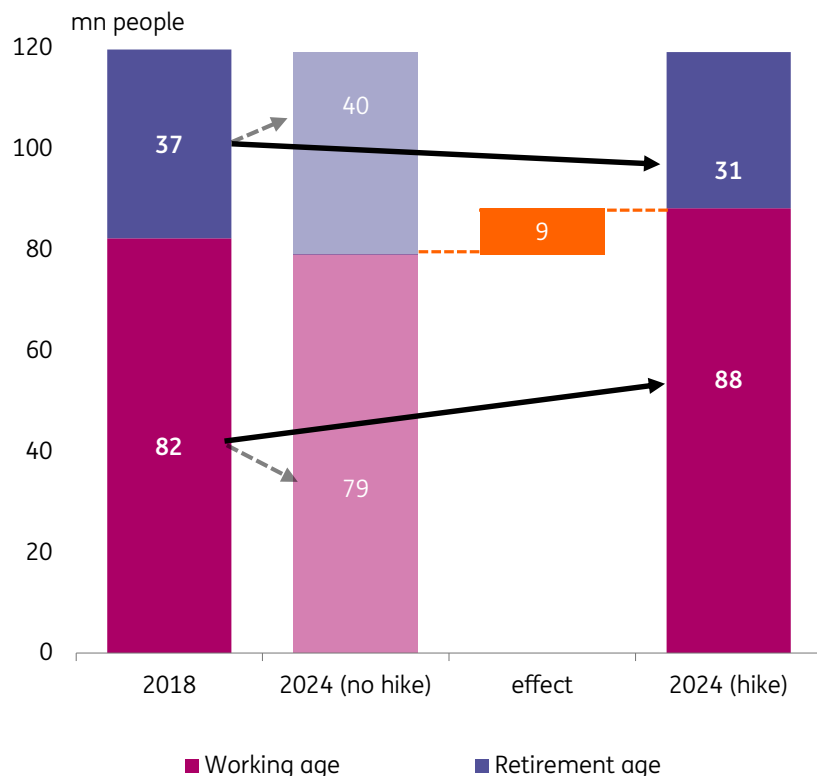
*Annual average GDP in 2019-2024 assumed at RUB 120tr



Addressing low labour: retirement age hike

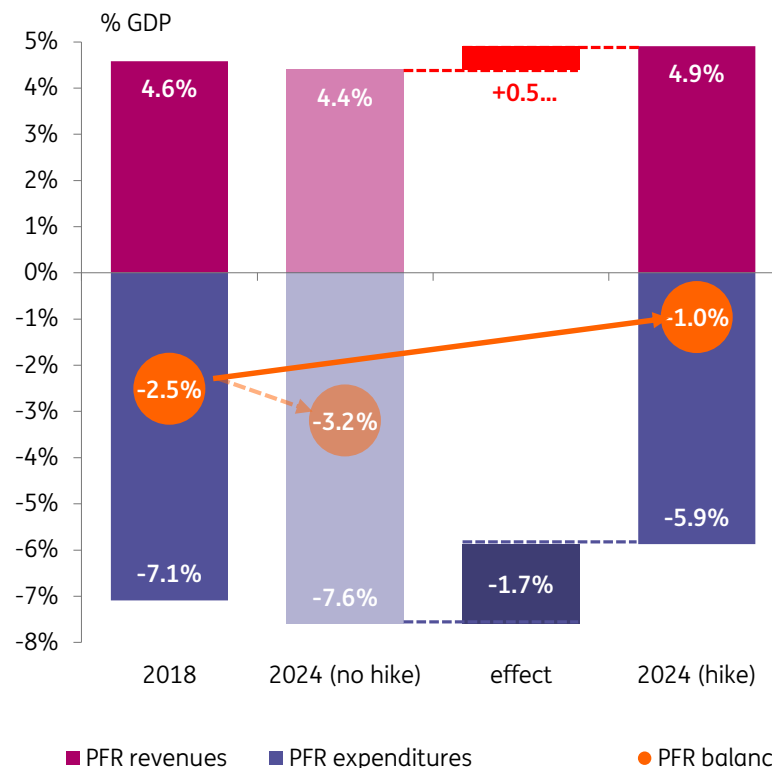
Retirement age hike will affect behavior of up to 9 million people...

Effect of retirement age hike on potential labor force, mn people



...with state finances being the key beneficiary

Effect of retirement age hike on the state pension fund's (PFR) financial balance, % GDP

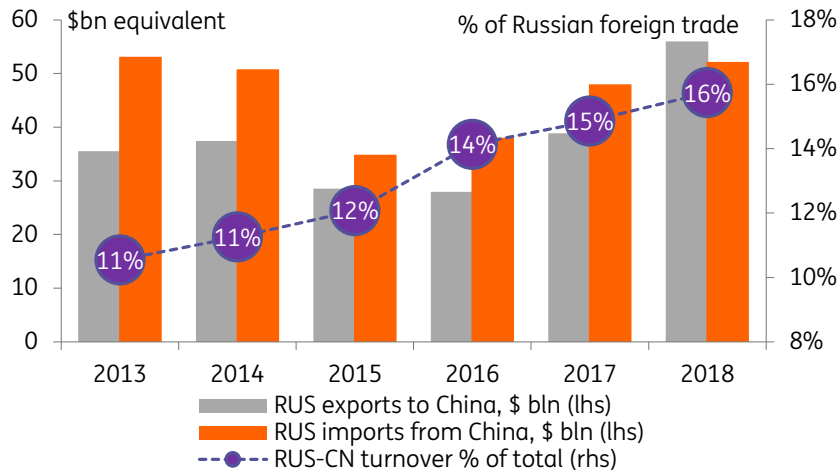


- The increase in the retirement age by five years for men (to 65) and women (to 60) shifts the border between working and retirement age for 9 million people by 2024 vs a no-hike scenario. Given that the same nine million people are already employed informally, **this will not affect actual household income or GDP growth...**
- ...but it **will improve the annual balance of the state pension fund (PFR) by 2.2% GDP by 2024** vs a no-hike scenario, assuming pension payments increase 5-6% pa in nominal terms (by RUB 1,000 per year).

Addressing external challenges: heading East

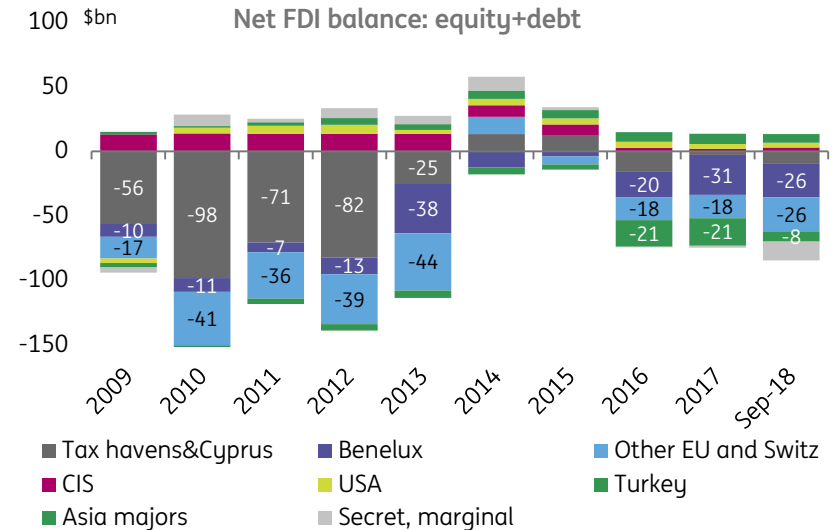
China's share in Russia's external trade is 16% and growing

China's trade turnover with Russia, US\$bn and % of total



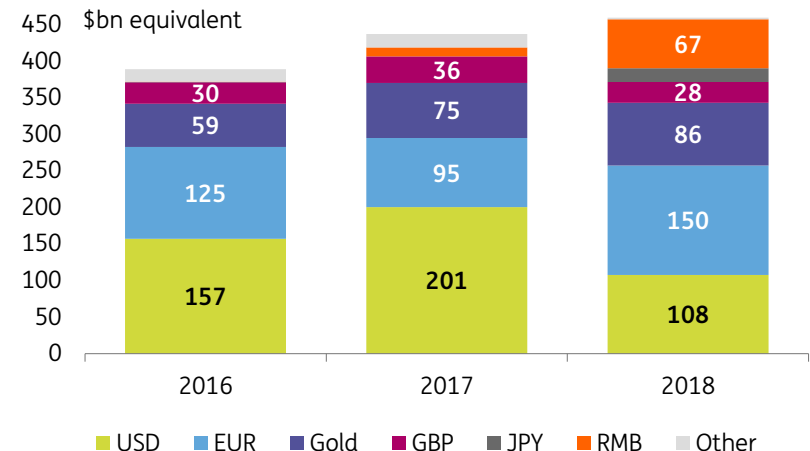
EU remains the primary FDI partner, but Asia is gaining importance

Net FDI balance: equity+debt



- The share of China in Russian international trade has increased from 11% in 2013 to 16% in 2018. On the Russian exports, this trend is reflected mostly in oil pipeline projects. On the imports, following 2014, China replaced some of EU imports.
- On FDI flows we see cautious return of EU (Benelux) capital after 2014-15 flight, lower re-investment of Russian capital from tax havens, and some inflow of FDI from Asia (mostly Singapore, during ROSN privatisation).
- CBR has adjusted its international reserves structure to reflect shifts in international politics and trade, lowering the share of USD in favour of RMB and EUR.

Structure of CBR FX assets, \$bn equivalent



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