Russia 2019: risk-averse mode

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Key messages and forecasts for 2019

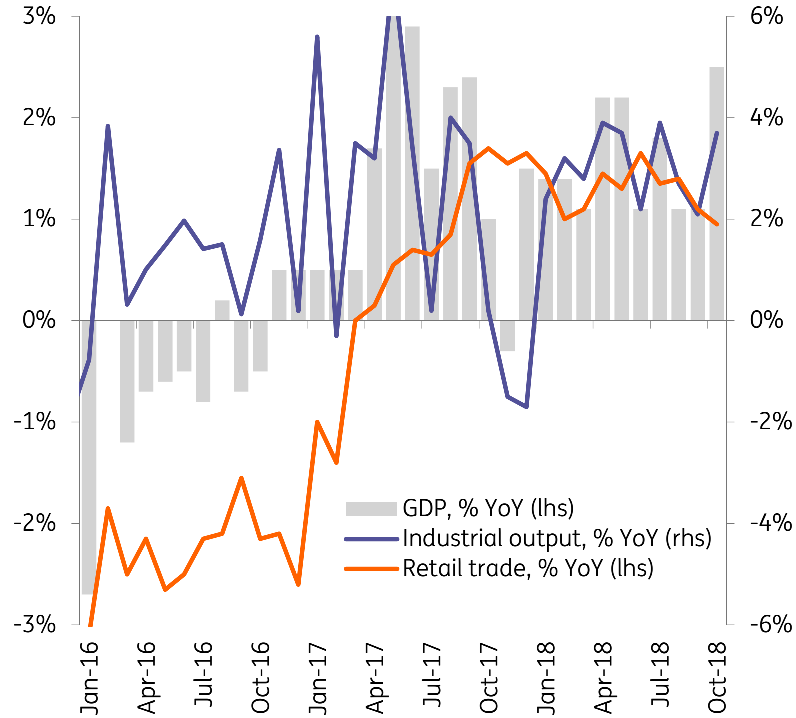
- **GDP growth at modest 1.0%** due to weakening household consumption as a result of higher VAT rate and declining confidence in sustainable income growth;
- **Corporate activity limited** around state-sponsored projects, local corporate loan growth not broad based, mostly reflects infrastructure projects and substitution of foreign debt;
- **rouble to remain stable on balanced current and capital accounts** unless portfolio flows deteriorate. Sanctions against new state debt not priced in, remain a downside risk;
- **Key rate unlikely to go lower** on mounting CPI risks (VAT hike, gasoline prices) and external uncertainties (US-China, US-Russia);
- **Budget policy likely to be eased** on expenditure in response to weaker GDP, declining popular support; and on revenues (oil tax manoeuvre/excise) in response to gasoline price risks;
- **Banking sector:** more interconnected with CBR and the Ministry of Finance. Interbank interest rates depend on budget rule-related FX purchases and key rate expectations.

Quarterly indicators	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18F	1Q19F	2Q19F	3Q19F	4Q19F
Real GDP (%YoY)	2.2	0.9	1.3	1.9	1.3	1.7	1.1	0.8	1.2	1.1
CPI (eop, %YoY)	3.0	2.5	2.4	2.3	3.4	4.0	5.2	5.7	5.4	4.8
Central bank key rate (eop, %)	8.50	7.75	7.25	7.25	7.50	7.50	7.50	7.50	7.50	7.50
3m interest rate (eop, %)	8.7	7.9	7.3	7.5	8.1	8.3	8.1	7.9	7.7	7.5
10yr yield (eop, %)	7.6	7.5	7.1	7.7	8.5	8.5	8.3	8.1	7.9	7.5
USD/RUB exchange rate (eop)	57.6	57.6	56.9	57.5	65.6	63.0	64.0	65.0	66.0	65.0
EUR/RUB exchange rate (eop)	69.1	69.1	68.3	67.3	75.4	72.5	73.6	76.7	79.2	81.3

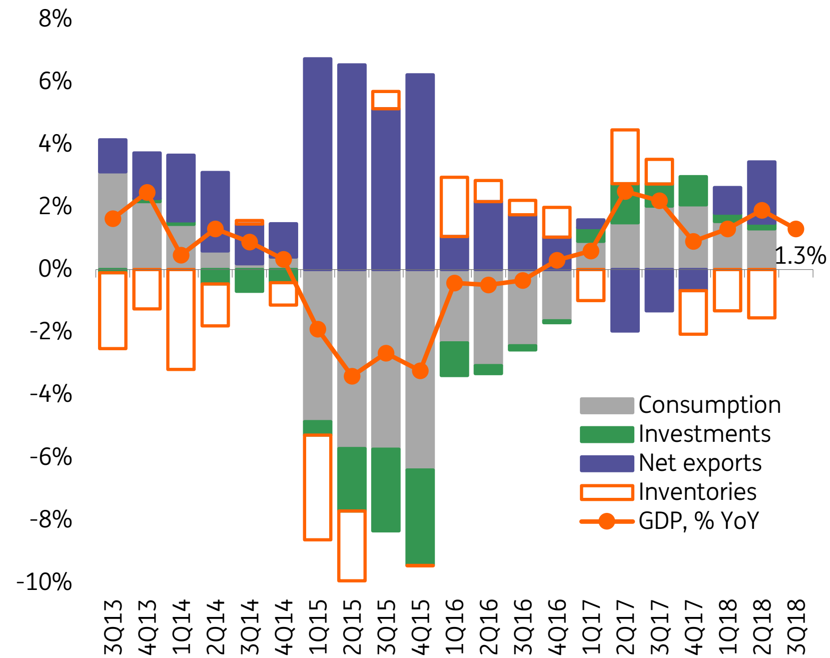
Sources: CEIC Database, Bloomberg, Rosstat, ING

Domestic demand under pressure

Producers and consumers' activity remains soft



GDP growth is increasingly dependent on the external sector



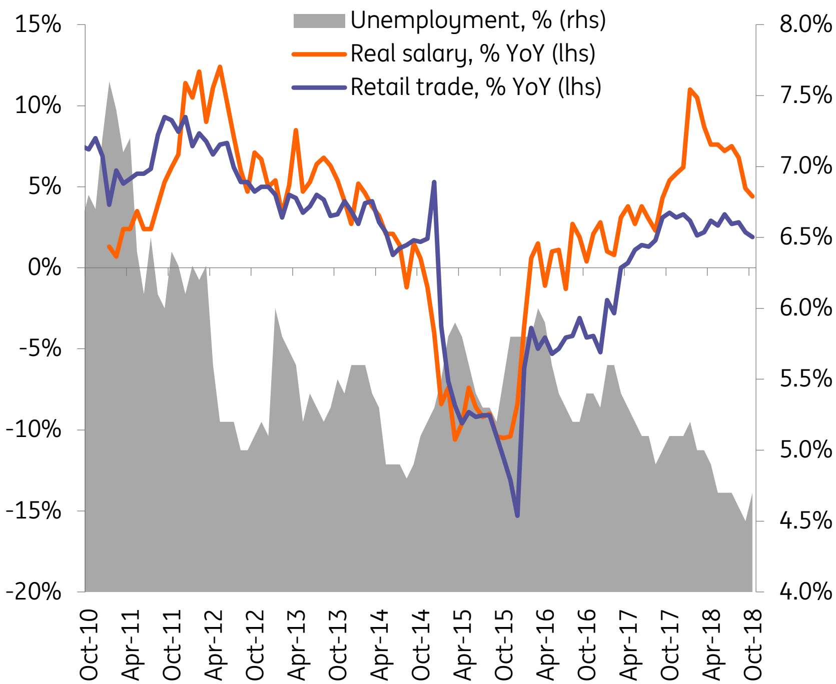
- In 3Q18 the GDP growth moderated to 1.3% year on year due to the slowdown in the activity of households and producers
- Contribution of the consumer demand and investment activity is decreasing

- Limiting factors: end of electoral cycle, completion of large investment projects (World Cup 2018 and Crimea), rising geopolitical uncertainty
- Reliance on the external sector is growing: through the rise in volumes of exports and lower imports amid weaker rouble

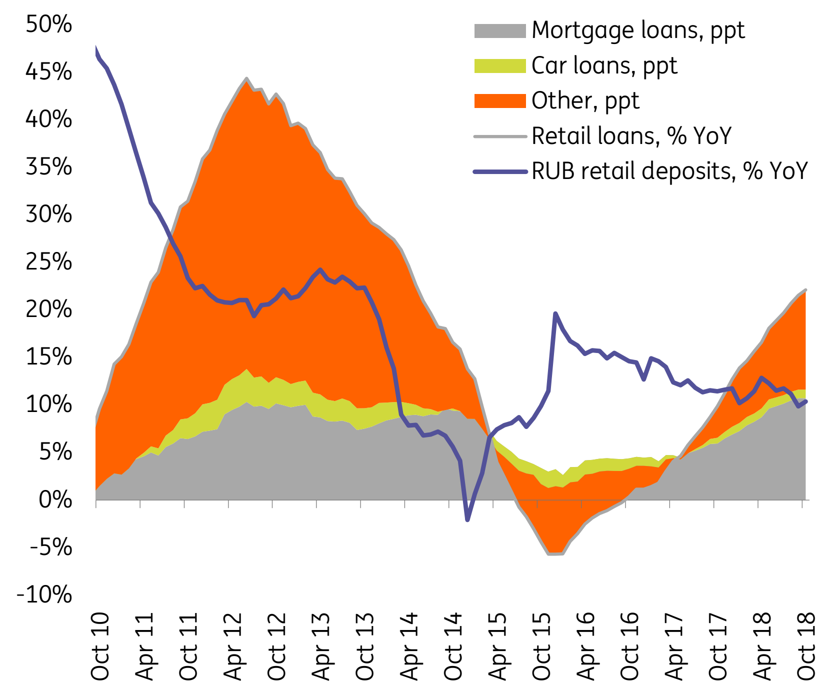
Source: Rosstat, MinEco, ING

Households keep a cautious stance…

Record-low unemployment together with the rise in wages do not accelerate the private consumption growth



Since 2017, the population has attracted consumer loans more actively, although not as much as in 2013



- Retail trade growth has stabilized around 2-3% YoY despite the drop in unemployment to the record-low level of 4.5-4.7% and the outperformance of real wages (account for 2/3 of the total households' incomes) at 5-10%.
- Consumer confidence (mostly driven by the low-income segment) remains under pressure: rise in public wages might be temporary, the planned increase in the VAT since Jan-2019, increase in retirement age.
- Acceleration in the retail loan growth to 22% (the share of mortgages and unsecured loans – 50/50) points to a moderately positive sentiment among higher-income households.

Source: Rosstat, CBR, ING

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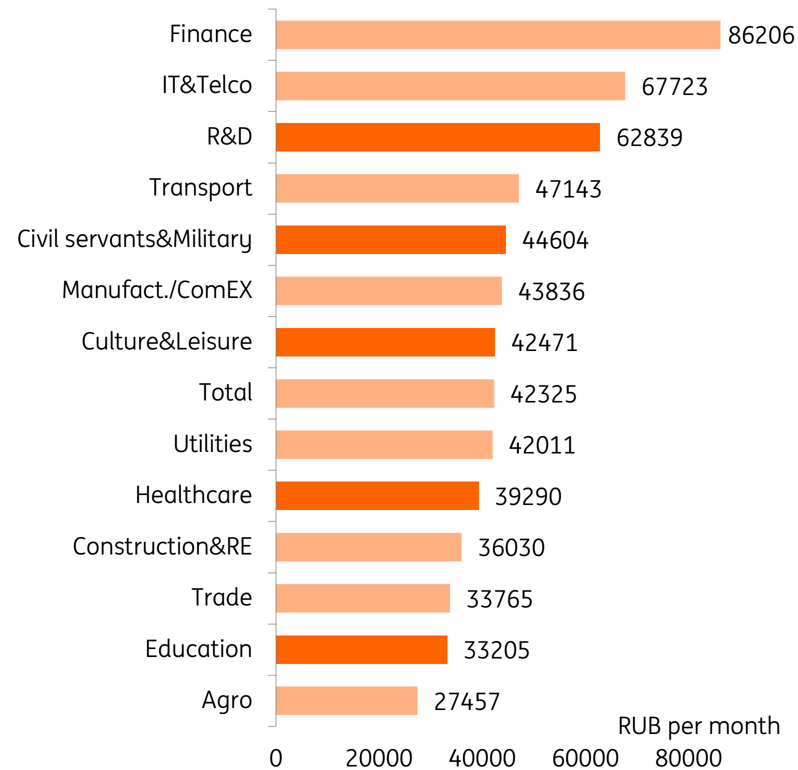
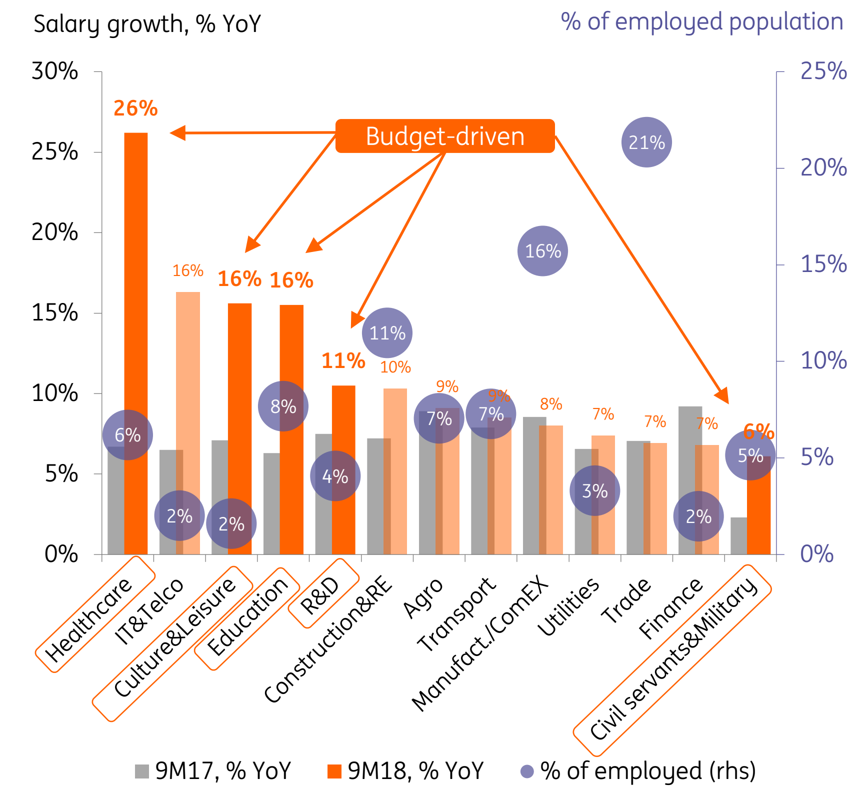
… due to low confidence in income growth

9M18 monthly average salary by sector



Nominal salary growth by sector

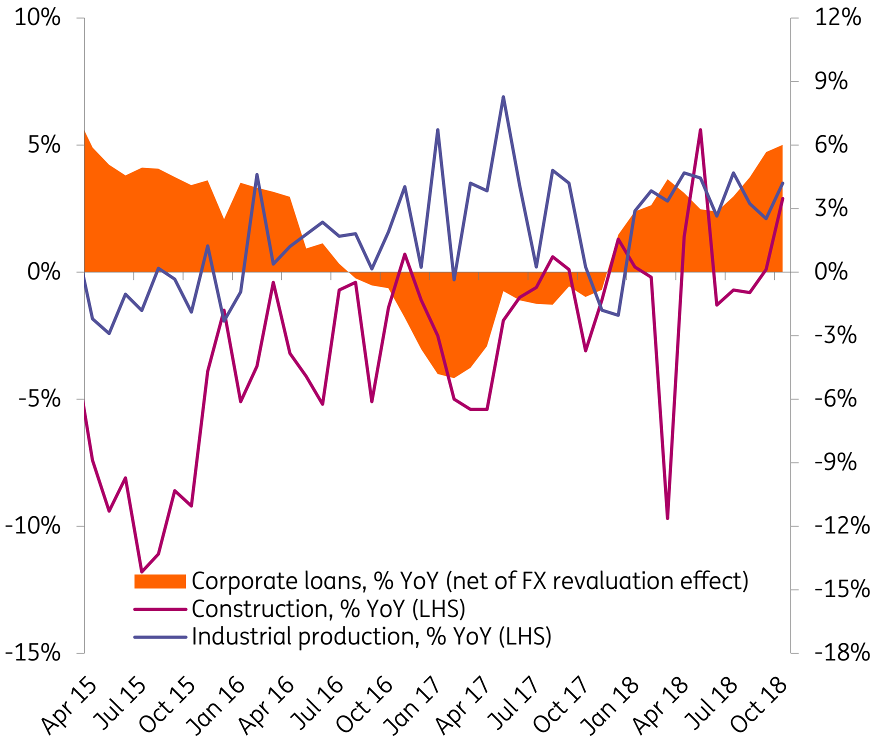


- Acceleration in the salary growth is seen predominantly in the lower-income, budget-dependent sectors (education, healthcare, etc.) accounting for 25% of Russia's 73 mln employees. Increase in their consumer confidence is limited as the electoral cycle is over
- The remaining 75% of employees (with exception of IT&telco, accounting for 2%) do not see faster salary growth

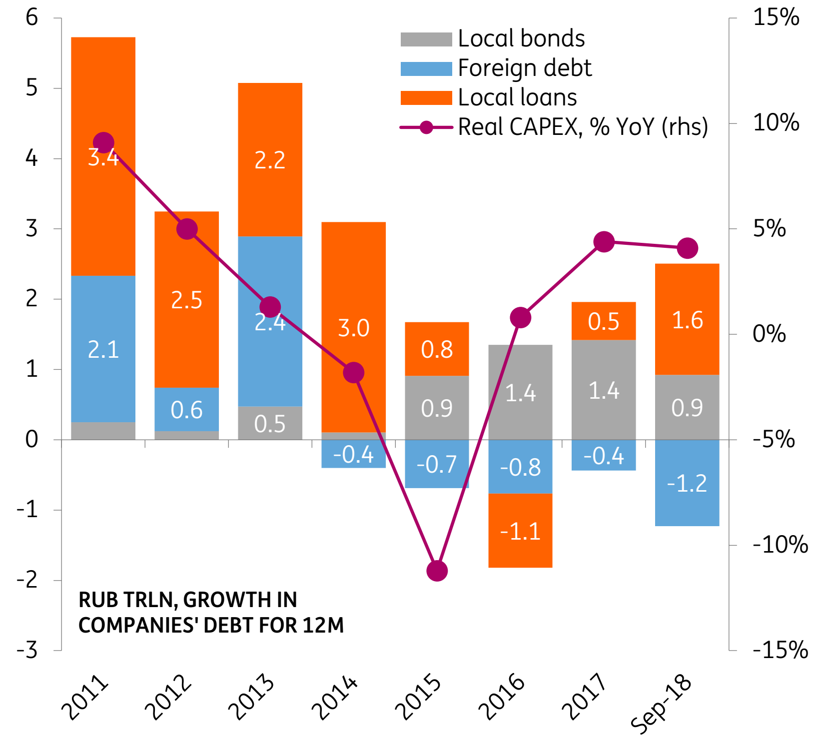
Sources : Rosstat, Bank of Russia, ING

Investment demand looks constrained

Corporate activity (industrial output, construction) moderate, recovery in local loan growth seen since 2018…



…which reflects substitution of foreign debt; local corporate bond market continues to grow from low base

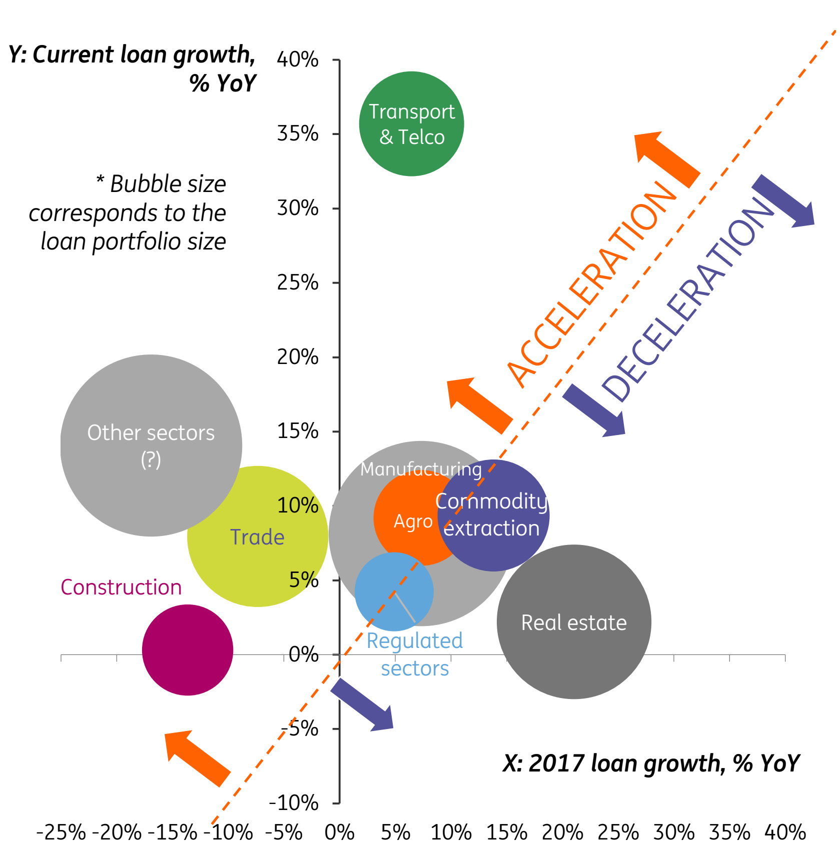


- As large investment projects related to the World Cup 2018 and construction of infrastructure are completed, the investments activity is slowing down. Demand for borrowed funds seems to be limited: in 2017-18 the rise in the corporates' debt burden made up RUB1.3-1.5trln per year against RUB3-6trln in 2011-13.
- Companies decrease the external debt burden and replace it with local bank loans. Domestic bond market is growing from a low base, but growth has slowed in 2018 due to deteriorating external conditions.

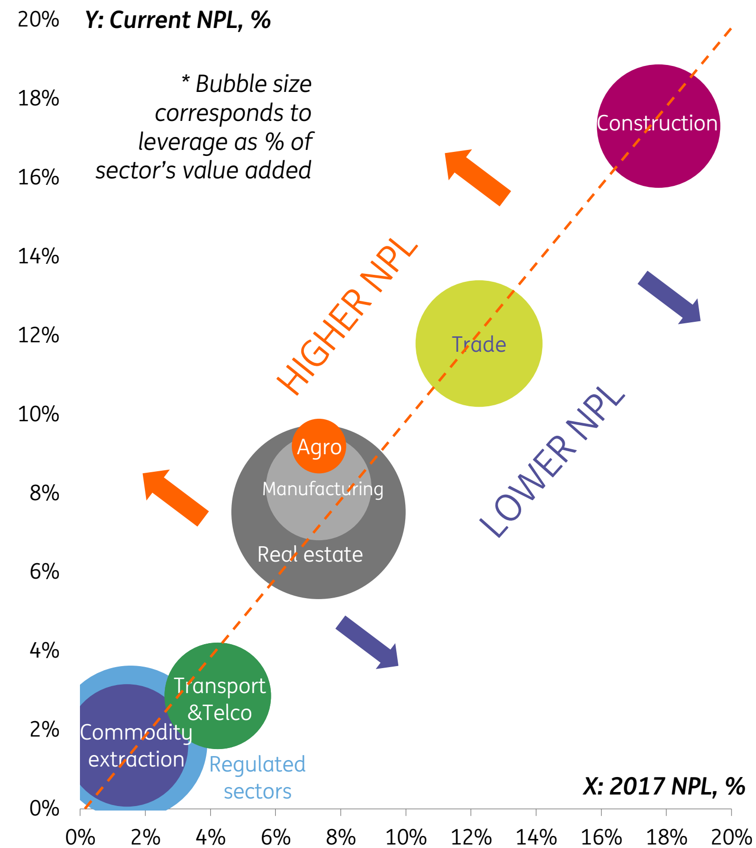
Source: Rosstat, CBR, ING

Lending recovery uneven by sector

Corporate loan growth by sector and book size



Sectors by leverage and NPL levels

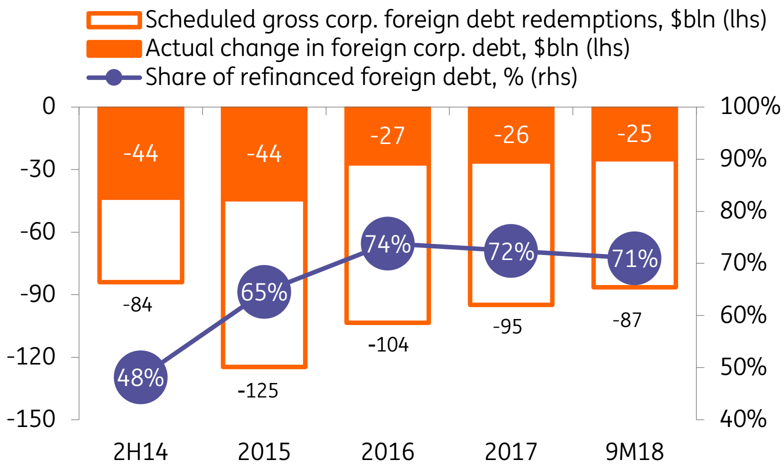


- With exception for transport and telcos (7% of portfolio), pick up in local lending is driven by sectors with high NPL/leverage (construction, trade, agriculture – 24% of portfolio) or unidentifiable (other, 21% of portfolio)
- Sectors with the highest quality (industrials, 41% of portfolio) are either deleveraging (oil exporters) or showing stable demand for local loans

Sources : Bank of Russia, Rosstat, ING

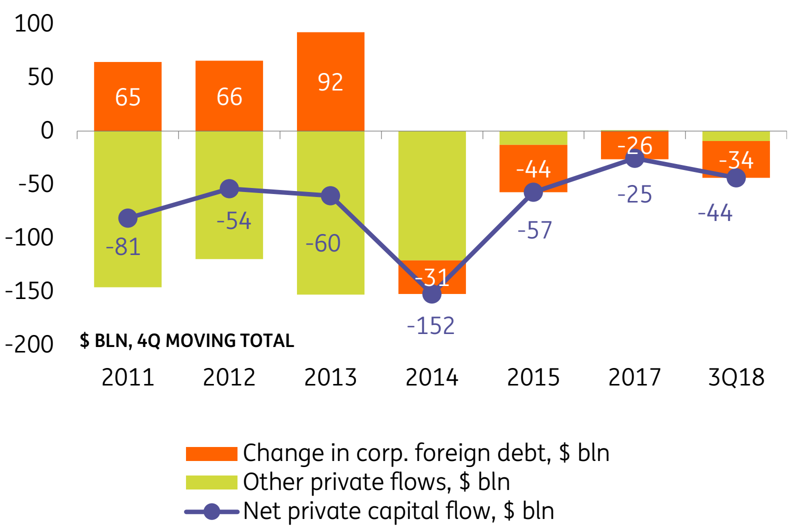
USD/RUB: with current account surplus sterilized…

Corporates have intensified the external debt repayments…

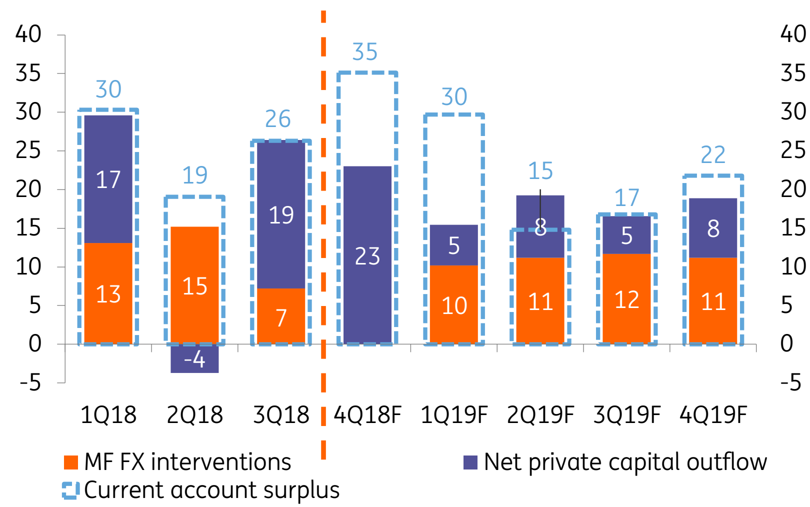


- Since 2017, the share of rolled over corporate foreign debt is decreasing due to low investment demand. In 3Q18 it was only 40% on external risks.
- In 3Q18, net foreign debt redemption accounted for $15 out of $19 bln net capital outflow
- As a result, current account surplus is being routinely sterilized even in the absence of FX interventions
- Suspension of MinFin FX purchases on the open market till the end-2018 was a forced balancing measure
- At Urals around $65/bbl current account to be fully sterilized by FX interventions and foreign debt redemptions in 2Q-4Q19

… promoting larger private capital outflows….



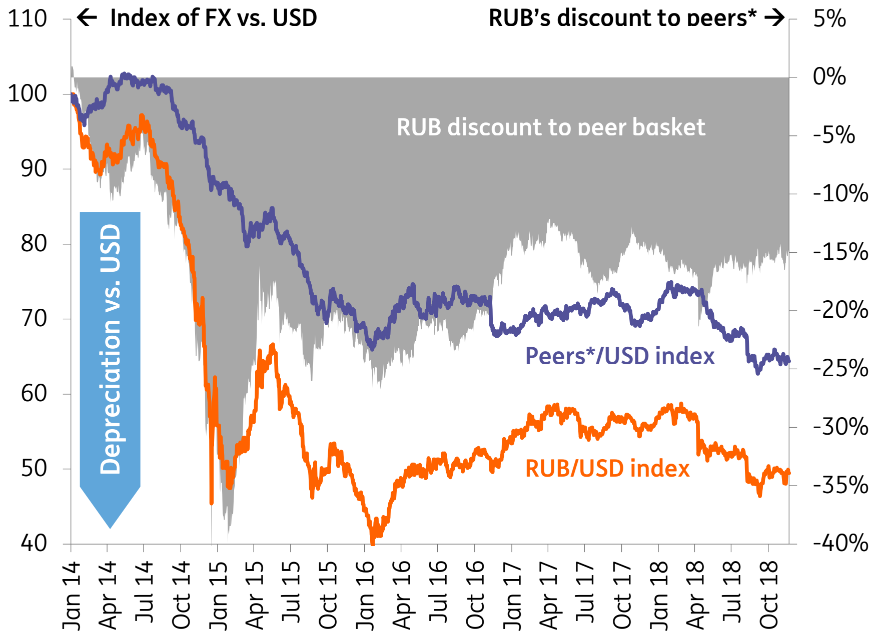
… and does not allow the rouble to take advantage of the growing current account surplus



Source: Rosstat, Minfin, CBR, ING

...RUB depends on the portfolio flows

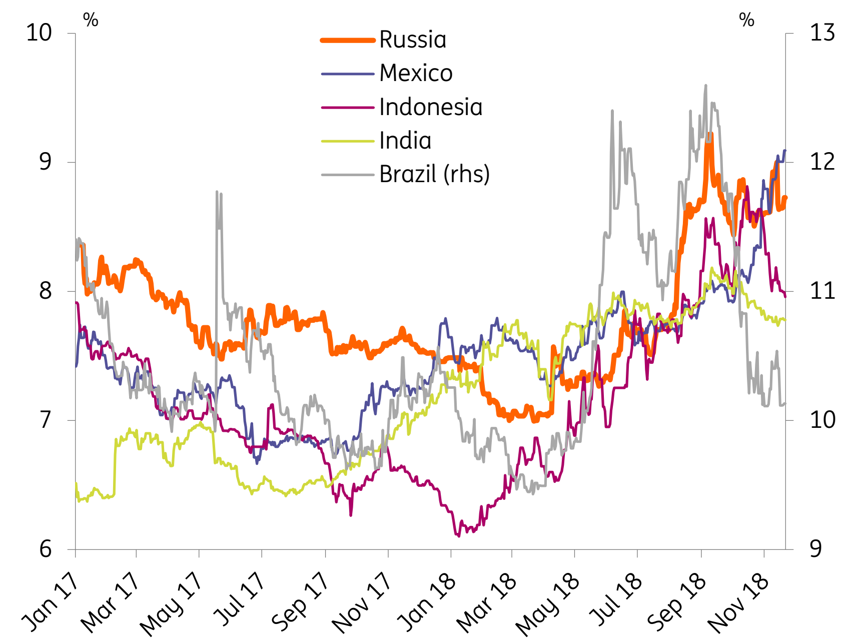
USD/RUB dynamic stays in line with the EM/commodity peers...



USD/RUB discount to peers*
USD/RUB (lhs)
USD/peers*, (lhs)

** equal weight FX basket of S. Africa, Brazil, Mexico, Turkey, Malaysia, Norway, Colombia*

...reflecting global capital flows in EM amid rising Fed rates, mounting US-China trade conflict

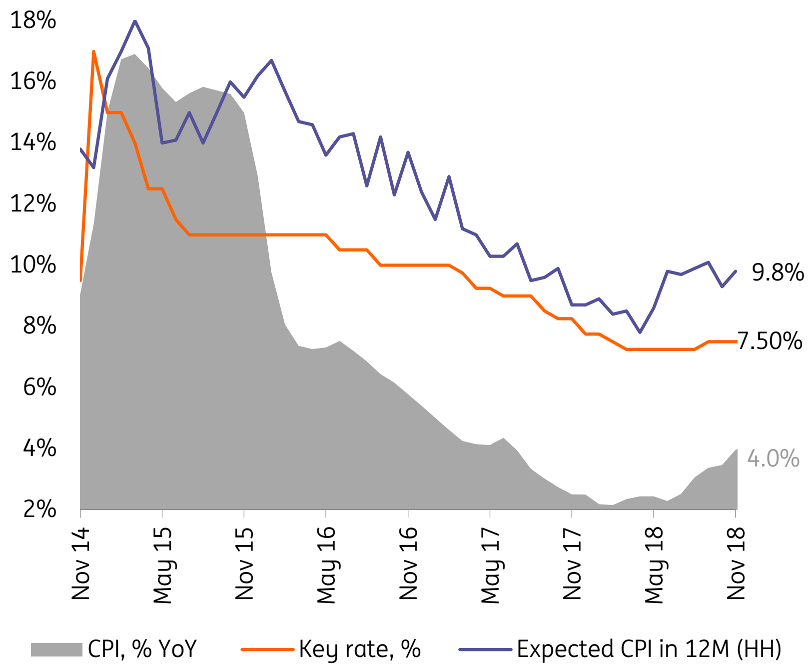


- YTD, rouble weakened by 12% to USD, in line with the peer currencies (-9%) amid EM risk-off. Since 2Q18 non-residents outflows from OFZ made up approximately RUB600bn leading to the increase in the OFZ yields by 150-200bp, also in line with peers. The ruble's discount to the peers (mostly, geopolitical) is stable at around 15%.
- **Risks related to the extension of sanctions against the new sovereign debt might be not fully priced-in by the markets. Non-residents are holding US$27bn worth of OFZ. In case of new sanctions, they can reduce their positions by up to 30% (as it occurred in 2014). Each US$5bn of capital outflows correspond to weaker fair value of the rouble by 1USD/RUB, but market reaction can be sharper.**

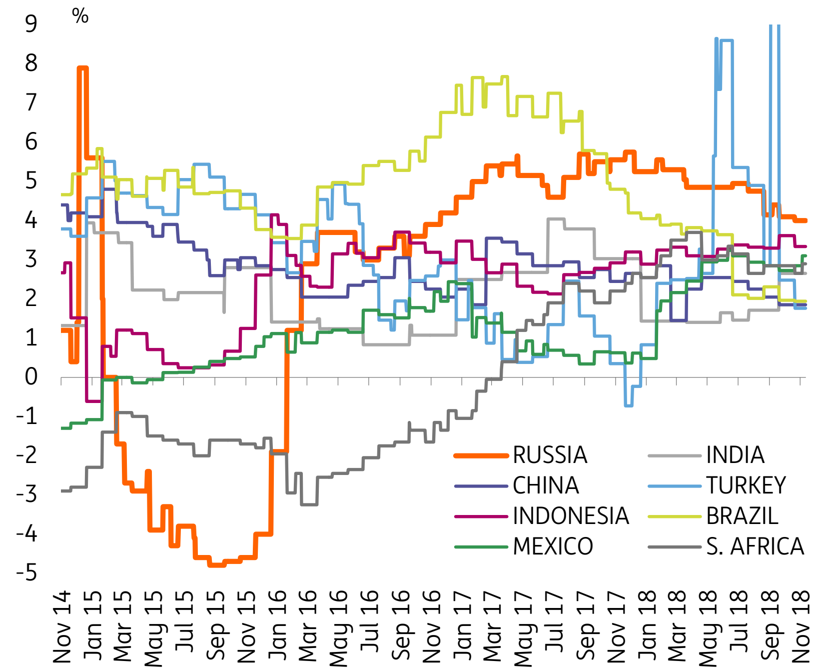
Source: Bloomberg, ING

Inflationary pressure mounts

CPI growth is on the rise, inflation expectations are weakening



Real interest rates in Russia are the highest among peers



Arguments in favor of unchanged CBR rate:

- Households' CPI expectations moderated
- Freeze in gasoline prices reached till Mar-19
- Russian real rates highest among EMs
- GDP and consumption growth weakening
- CPI risks related to VAT hike accounted for

Potential triggers for further hikes:

- If weekly CPI remains at ~0.15% per week, then FY18 CPI exceeds the CBR guideline of 4.2% YoY
- Further risk-off towards Russia (USA-China, USA-Russia tensions) could weaken RUB. 10% RUB depreciation adds up to 1 pp to CPI trend

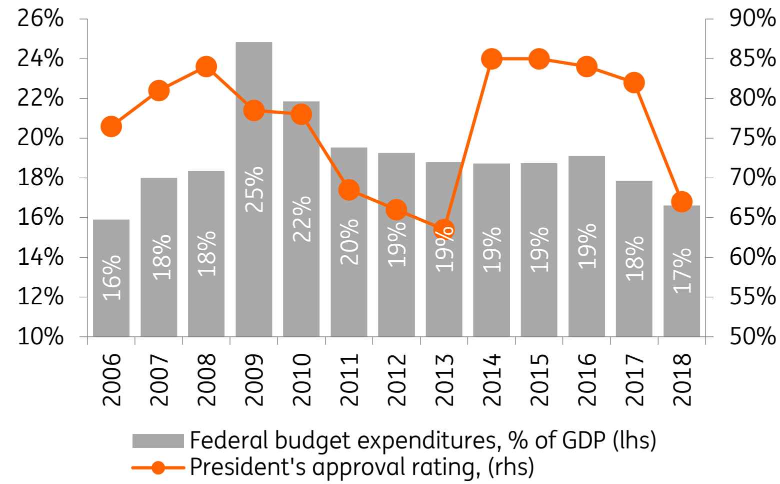
Source: Rosstat, CBR, Bloomberg, ING

Budget: will it remain conservative?

Official budget draft for 2019-21

	2018F	2019F	2020F	2021F
Avg USD/RUB	61.7	63.9	63.8	64.0
"Base" Urals, $/bbl	40.8	41.6	42.4	43.3
Base oil and gas revenues, RUB trn	4.7	4.9	5.2	5.4
Non-oil and gas revenues, RUB trn	10.1	11.7	12.3	13.0
Expenditures, RUB trn	16.8	18.0	19.0	20.0
Budget balance under base Urals	**-2.0**	**-1.4**	**-1.6**	**-1.7**
Sources of funding, RUB trn	2.0	1.4	1.6	1.7
Gross outlays of the NWF, RUB trn	1.1	0.0	0.0	0.0
Net OFZ placements, RUB trln	0.7	1.7	1.8	1.6
Other	0.2	-0.3	-0.3	0.1
Actual Urals, $/bbl.	69.6	63.4	59.7	57.9
Additional oil revenues->NWF, RUB trn	**4.1**	**3.4**	**2.8**	**2.6**
Final budget balance	**2.1**	**1.9**	**1.2**	**1.0**
...% GDP	*2.1%*	*1.8%*	*1.1%*	*0.8%*
Local state debt, % GDP	9.8%	10.9%	12.1%	12.7%
State savings, % GDP	4.8%	7.7%	10.4%	12.1%
Breakeven Urals, $/bbl	53	49	50	51
Revenues' sensitivity, RUB trn				
+10 $/bbl Urals =	1.4	1.5	1.6	1.8
+10 USD/RUB =	1.4	1.3	1.2	1.3

Budget expenditures and popular support

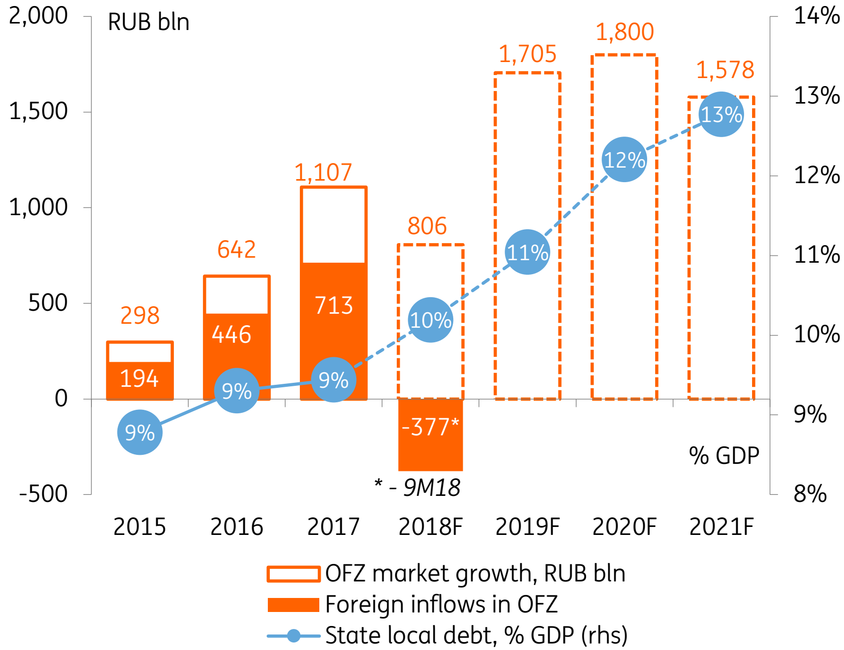


- **Budget draft looks conservative:** it implies expenditures of 17% of GDP – lowest since 2017 – amid decreasing political ratings.
- Extra outlays could be financed without breaking the budget rule in case of weaker rouble compared to the planned 64/USD. **Each 10 USD/RUB increases revenues by RUB1.2-1.3trn.**
- **Easing of the budget rule** – an increase in the base oil price, for example, by **10$/bbl – allows either to raise the spending by RUB1.5-1.8trn per year due to non-replenishment of the National Welfare Fund**, or decrease the level of the local borrowing by this amount.

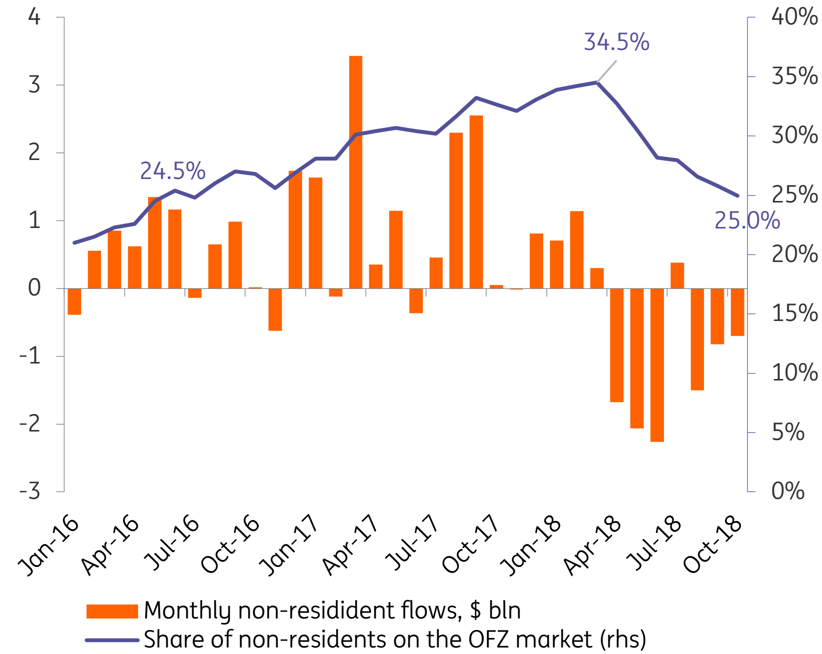
Source: MinFin, Levada Center, ING

Local banks: resource for the MinFin?

In 2015-17 non-residents accounted for 2/3 of the OFZ market growth, further prospects are under question



OFZ market has saw foreign capital outflow of ~$1 bln per month since April

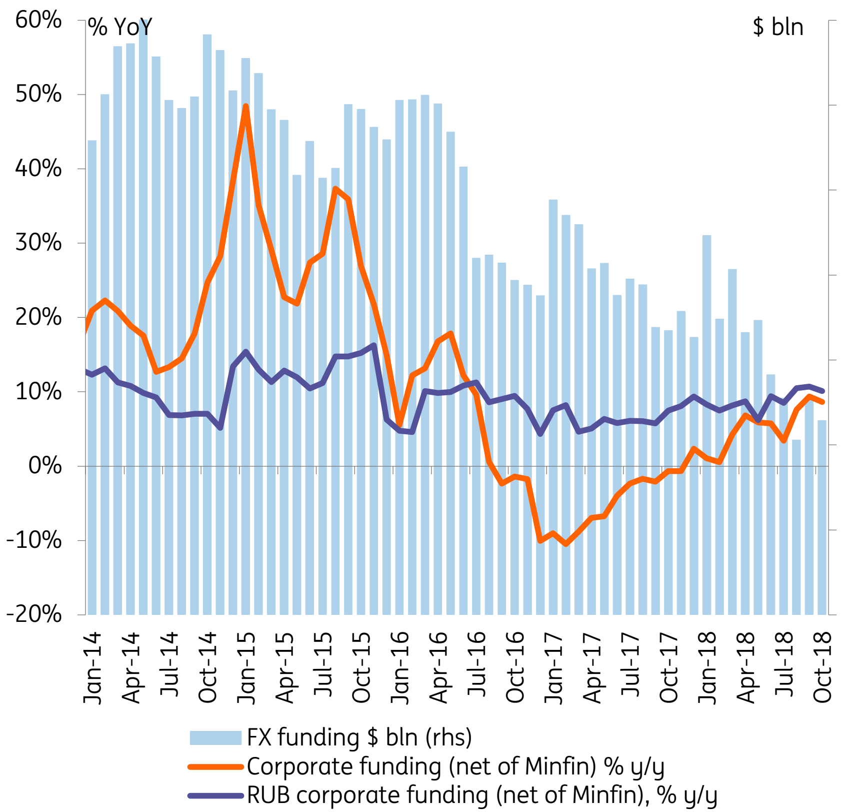


- In case of further capital outflows from the EM and/or imposition of sanctions against the new sovereign debt, the MinFin will not be able to rely on non-residents as buyers of OFZs. The borrowing plan might be reduced in the event of depreciation of the rouble and/or in case of softening of the budget rule (see the previous slide).
- The backup plan for the MinFin is to consider local banks as the key OFZs' buyers that now have a structural liquidity surplus of about RUB3trn, but now it is shrinking by RUB500bn per month due to the CBR's suspension of the FX purchases on the open market.

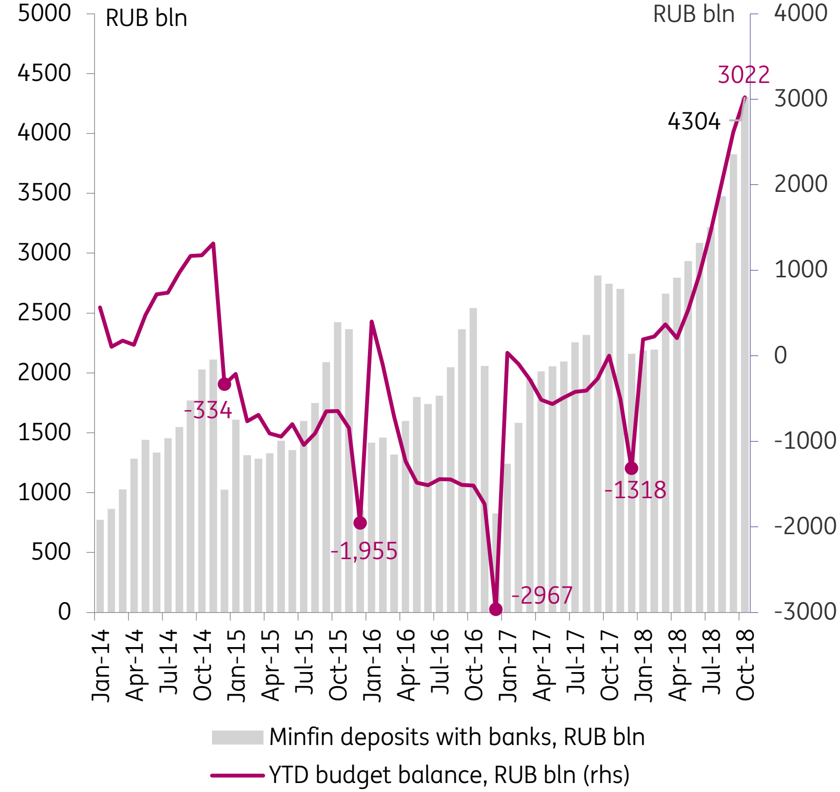
Source: MinFin, CBR, ING

Corporate funding – growing dependence on MF

Corporate funding net of Minfin deposits with banks



Russian banks' liabilities with Minfin

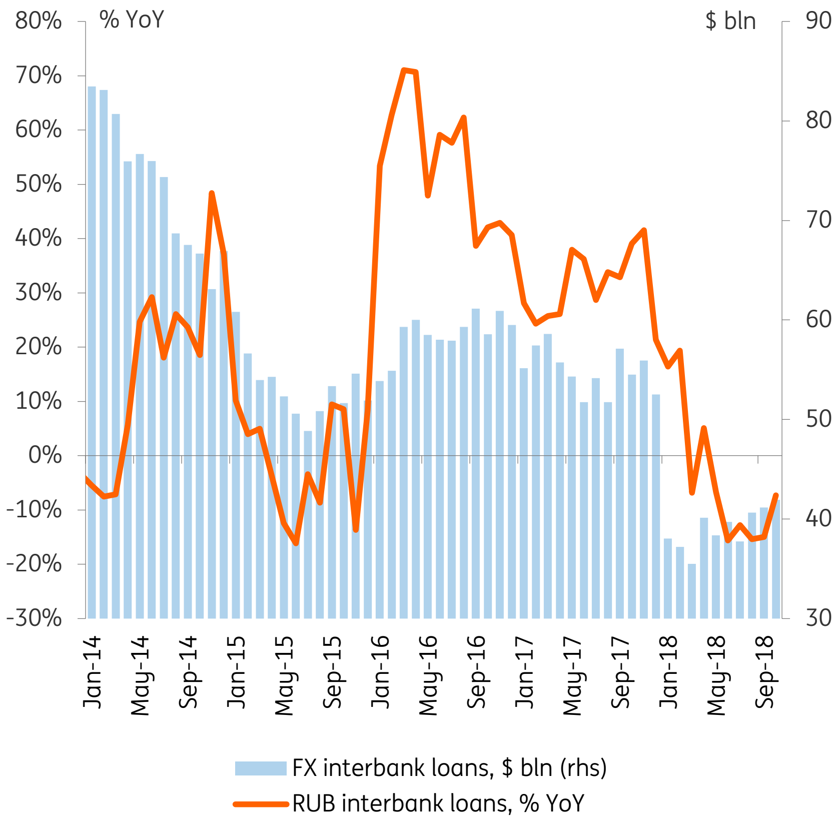


- Corporates are gradually reducing exposure to FX savings, replacing it with RUB accounts. Corporate funding growth outperforms lending due to constrained investment demand
- Banking sector's dependence on Finance Ministry's deposits is growing, reflecting large budget surplus. Currently, Minfin holds RUB4.3 trln on bank deposits, alleviating the negative effect of RUB3.0 YTD budget surplus and the halt to FX purchases on rouble liquidity

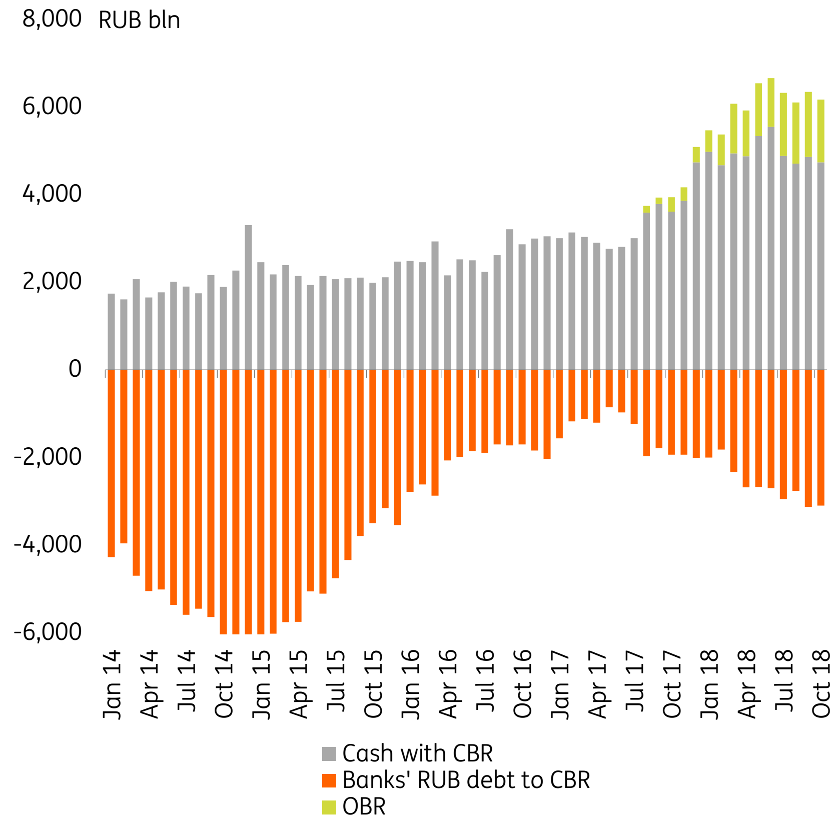
Sources : Bank of Russia, Bloomberg, MinFin, ING

Interbank market – shrinking, CBR role grows

Interbank market (liabilities)



Banks' balance with the CBR



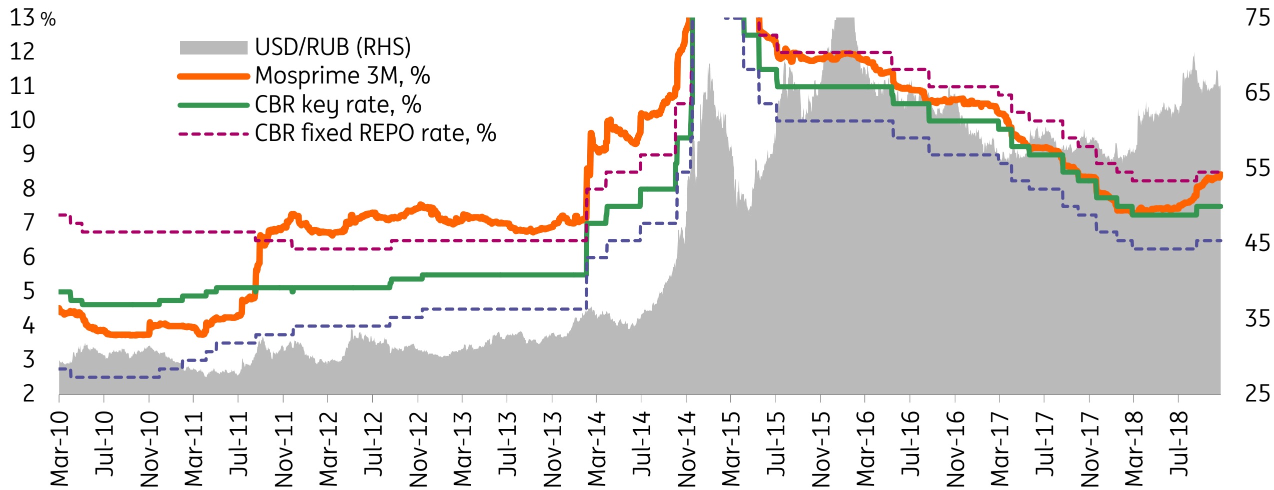
- Local interbank market is shrinking on both FX and RUB sides, reflecting fragmentation of the banking sector, uneven access to liquidity by various groups
- Banks have generally positive liquidity balance with the CBR, however their dependence on the CBR liquidity is also increasing, reflecting bailouts

Sources : Bank of Russia, ING

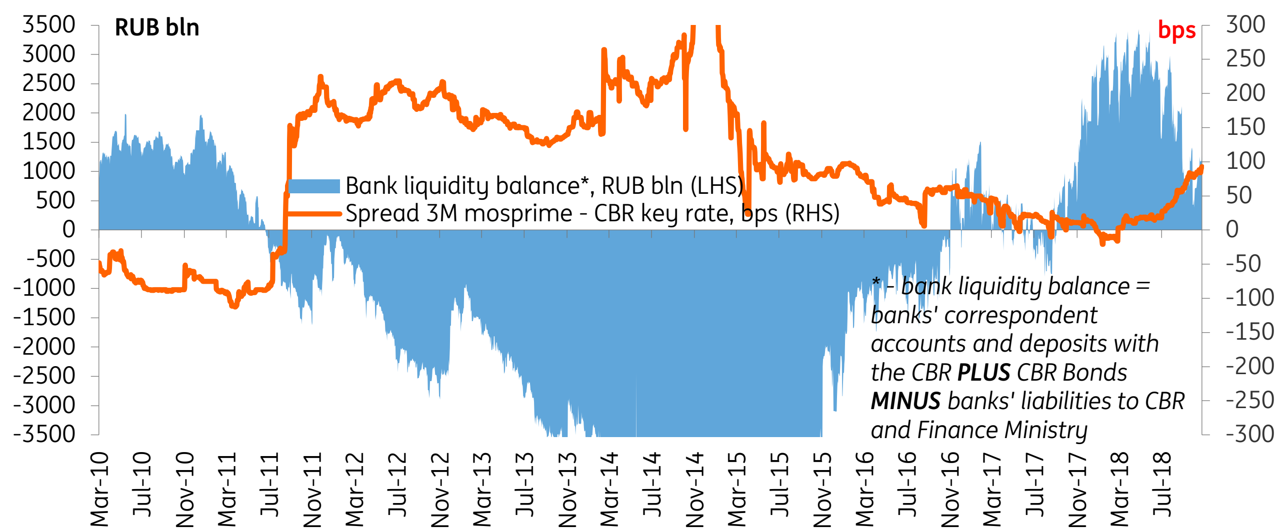
Interest rates: upward pressure

- Since mid-2018 interbank rates see upward pressure amid accelerated net capital outflow, increase in the CBR key rate and expectations of further tightening, and the halt in FX purchases by the CBR in favour of Minfin
- The banks' broad liquidity surplus with CBR and Minfin has shrunk by RUB2 trln to since mid-year to RUB1 trln currently, reflecting material increase of MF deposits with banks
- Further IR performance to depend on whether CBR reserves resume growth (whether it recommences FX purchases)

CBR interest rate corridor, Mosprime 3M and USD/RUB



Banks' liquidity balance and interest rate spread



Sources : Bank of Russia, Bloomberg, ING

Russia: Annual indicators

Annual indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity													
Real GDP (%YoY)	5.2	-7.8	4.5	4.3	3.7	1.8	0.7	-2.5	-0.2	1.5	1.6	1.0	1.5
Private consumption (%YoY)	10.6	-5.1	5.5	6.8	7.9	5.2	2.0	-9.4	-2.8	3.4	2.5	1.0	1.5
Investment (%YoY)	10.6	-14.4	5.9	9.1	5.0	1.3	-1.8	-11.2	0.8	4.3	3.0	1.5	3.0
Industrial production (%YoY)	0.6	-10.7	7.3	5.0	3.4	0.4	1.7	-0.8	1.3	1.0	3.0	1.5	2.5
Prices													
CPI (average, %YoY)	14.1	11.7	6.9	8.4	5.1	6.7	7.8	15.6	7.1	3.7	2.9	5.3	3.6
CPI (year-end, %YoY)	13.3	8.8	8.8	6.1	6.6	6.5	11.4	12.9	5.4	3.4	4.0	4.8	4.0
Wage rates (nominal, %YoY)	27.4	9.1	12.8	11.7	16.4	9.3	8.3	4.2	7.8	7.2	10.3	5.0	4.0
Fiscal balance (% of GDP)													
Consolidated government balance	4.9	-6.3	-3.4	1.4	0.4	-1.2	-1.1	-3.4	-3.7	-1.5	2.5	1.3	1.3
Consolidated primary balance	5.3	-5.6	-2.9	2.8	1.0	-0.5	-0.4	-3.0	-3.2	-0.6	3.6	2.5	2.6
Total public debt	6.5	8.3	9.0	9.4	9.8	10.6	11.8	12.5	13.3	12.6	12.9	13.7	14.7
External balance													
Current account balance (US$bn)	104	50	67	97	71	33	58	69	26	33	110	80	90
Current account balance (% of GDP)	10.4	5.6	5.9	6.7	4.2	2.1	5.3	6.5	1.8	2.1	6.7	4.9	5.4
Foreign exchange reserves ex gold (US$bn)	413	417	443	454	487	470	339	320	318	356	383	467	532
Debt indicators													
Gross external debt (US$bn)	480	466	489	539	636	729	600	519	512	518	459	436	418
Gross external debt (% of GDP)	48.2	52.1	43.1	37.2	37.7	45.2	55.0	49.3	36.8	33.0	28.8	26.8	25.1
Lending to corporates/households (% of GDP)	40.0	41.5	39.2	38.6	40.7	46.0	53.2	54.7	50.7	50.0	52.5	53.7	55.5
Interest & exchange rates													
Central bank key rate (year-end, %)	n/a	6.00	5.00	5.25	5.50	7.50	17.00	11.00	10.00	7.75	7.50	7.50	6.50
3m interest rate (Mosprime, average, %)	11.1	11.5	4.1	5.5	7.2	6.9	10.5	13.8	11.2	9.4	7.7	7.9	6.8
3m interest rate spread over US$-Libor(ppt)	655	1036	325	409	662	668	1030	1382	1142	968	802	815	678
2yr yield (average, %)	7.5	9.3	5.9	6.7	6.9	6.2	9.0	11.6	9.2	7.7	7.1	7.6	6.6
10yr yield (average, %)	7.6	11.2	7.6	8.6	8.2	7.5	9.5	11.1	8.9	7.9	7.9	8.1	7.1
USD/RUB exchange rate (year-end)	29.4	30.2	30.5	32.1	30.6	32.9	58.3	72.9	61.2	57.6	63.0	65.0	67.0
USD/RUB exchange rate (average)	41.4	43.4	40.8	41.7	40.3	45.3	72.7	79.3	61.9	58.6	62.2	64.6	66.6
EUR/RUB exchange rate (year-end)	41.1	43.2	40.9	41.8	40.3	45.1	70.5	79.5	64.6	69.1	72.5	81.3	87.1
EUR/RUB exchange rate (average)	60.9	60.7	54.7	58.3	52.0	60.3	95.9	87.2	65.3	66.8	72.2	78.2	85.2
Brent oil price (annual average, US$/bbl)	59	94	36	78	96	111	113	108	45	55	75	66	69

Sources: CEIC Database, Bloomberg, Rosstat, ING

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