

Russia not quite so bad

We have been turning more positive on Russia during the autumn and there are several factors that give us comfort looking into 2016.

The first, and perhaps most important, is that inflation is expected to half from the current 15% by the mid of next year and according to some economist reach 4% by the end of it. The drop might seem dramatic, but two thirds of the current inflation is a translation effect stemming from the ruble losing half of its value during last winter, suggesting that underlying inflation adjusted for this is around 5%. This price drop will be accompanied by a series of interest rate cuts, several hundred basis points. This, in turn, will lead to a rebound in consumption, bank lending and most likely also bond inflows

The second point is that we believe there is a possibility that European sanctions will be lifted in 2016, at least partially. The sanctions may be temporarily prolonged when they expire in January but probably not for more than six months. The situation in Eastern Ukraine has stabilized and it seems like all parties are moving towards implementation of the Minsk II agreement, which is a pre-requisite for lifting the sanctions. Some of the financial sector sanctions are likely to be removed first, which would enable the large Russian state-owned banks to re-enter the Eurobond market, decreasing hard currency borrowing costs significantly.

The third point refers to macro in general and the ruble in particular. The currency movement over the past 1.5 years - a result of oil prices, sanctions and macro in that order - has been extraordinary and is the main reason the equity market underperformed and financial stability was maintained. We believe the ruble may appreciate slightly due to an expected modest rebound in oil prices, a partial removal of sanctions and a slight macro improvement. The economy is in recession and will continue to operate much below potential but we believe growth bottomed out in the second quarter. The direction has changed and the risks may therefore be on the upside, especially as expectations are so low. The point is that when the downside risks are deemed smaller than the upside, investors and companies may start investing again.

The fourth point is about companies. We have repeatedly argued that there is a big discrepancy between macro headlines and realities



Russia has bottomed out economically and inflation is expected to fall sharply in 2016, which should be accompanied by massive rate cuts and a rebound in consumption. Photo: East Capital

on the ground. A combination of important substitution and relative strength has supported a number of domestic oriented companies in Russia while many of the exporters were “protected” by the weaker ruble. We have seen how market leaders like Magnit, Aeroflot and M Video have grown their EBITDA by 30-60% in the first half of this year even as the economy was contracting by almost 5%. And retailers like Lenta and Detsky Mir grew their sales by 30-40% in the second quarter when the economy was bottoming. There are obviously companies that struggle but the above examples are not only anecdotal, corporate profits have overall been very strong this year.

Finally, Russia is reforming and this realization should help the market and the economy in the longer term. Even though we would like to see more growth and efficiency-enhancing structural reforms, there have been at least three major improvements lately. First, Russia has amended its pension system and the government now supports the resumption of contribution into private pension funds. Goldman Sachs estimates that pension investments into Russian equities will increase by USD 60bn or 55% of the current free float by 2020. Second, Russia continues to improve the business climate and just moved up another three notches in the World Bank doing business survey. Russia retains its position as the best ranked BRIC economy at 51st place after being 123rd five years ago. Third, the anti-corruption drive seems to have been re-started. This is a more intangible process but graft is not only getting exposed but also taken to court. The Governor of Komi was recently arrested and accused of fraud and criminal conspiracy. Earlier this

year, the Governor of the Sakhalin region was arrested for bribery. High-level cases regarded as a deterrent is the classical modus-operandi of Russian anti-corruption work, but there is also a lot of activity with regards to petty corruption. The number of people facing corruption charges has increased more than 5 times over the past two years and more than 4000 officials are under investigation.

The two most important factors for the market are probably the likely partial lifting of sanctions in 2016 and the expected rapid decline of inflation and interest rates in the next 12 months. The economic and political situation will not look particularly great in the beginning of 2016. But it will look decidedly better than it did a year ago and that is what financial markets tend to trade on. To put it differently, the Russian financial market tend to perform when sentiment is shifting from bad to not quite so bad.

Jacob Grapengiesser
Partner, based in Moscow



Marcus Svedberg
Chief Economist

