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A March blip or was the Russia rally premature?

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Russian equities bounded out of the starting gate after the January holidays and by end-February the main indices were the best performing in the world, having appreciated by greater than 20%. The ruble, which gave up more than 50% of its value against the US dollar in 2014, rebounded by more than 12% in February. Commentators became fond of citing Mark Twain's "reports of my death have been greatly exaggerated" as optimism elbowed out the concerns that hung heavy over the markets and the economy in December.
But as can be seen from the table of key market indicators below, the fickleness of sentiment was seen again in early March and much of the previous two months' gains have already been given back. So the big question for investors, "is the recent pull-back just a blip in a sustainable market rally or, was the January-February move premature?" To answer that question, let's look at the reasons for the optimism.

Reasons to be cheerful

Despite the dangerous start to the Minsk-II deal, there was much greater effort put into achieving the agreement than was seen previously and that has raised hopes it may hold better this time. The bottom line is that President's Putin and Poroshenko, as well as the EU, need this deal to work because all face serious domestic problems that need to be dealt with. Also, from the Russian side, while the situation is not ideal it, ie. a frozen conflict, is an acceptable outcome for now. The de-escalation of fighting has also raised hopes that the EU will not renew the financial sector sanctions, or may gradually start to ease them in the coming months. The US is most unlikely to ease back to the extent that the EU may, until after the November 2016 presidential election is over, but investors hope for some move from Washington also so as not to cause a rift with the EU.

The price of crude oil gained by a fifth during January and February and that, along with the better news from eastern Ukraine, contributed to the ruble's 12% rally in February. Another reason for the much more stable ruble market is because of changes made by the Central Bank of Russia (CBR) to key personnel in the Monetary Policy Dept. and also the administrative changes which, eg. forced some of the big state exporters to bring more foreign currency home earlier and also discouraged the state banks from facilitating trading against the ruble. The Finance Ministry also converted almost $10bn of the Reserve Fund's holdings into rubles in late February.

The early indicators for the economy certainly show the expected sharp decline in some sectors, but more towards the mid-range expectations than at the extremes touted by some economists late last year. The retail and construction sectors are taking a big hit and the high cost of debt service is one of the main reasons that continue to hammer investment spending. But set against those areas of weakness the import substitution story remains intact and is providing some partial offset for the declines elsewhere. The big surge in state budget spending, which is unsustainable for many months, has also helped restrain the decline for now.

The CBR continues to push the message that the current spike in inflation will be short lived, perhaps peaking at under 20% in the spring, and that has allowed it to cut the benchmark key rate by 300 basis points since the start of the year. That also feeds into the net optimism in markets.

The other reason for the markets rally is of course just plain speculation. After last year's circa 50% fall in the dollar-denominated equity indices (RTS and RDX), the valuation of Russian equities hit the lowest among the major emerging markets. How wide is that valuation gap is still unclear because of the likelihood of earnings downgrades in vulnerable sectors, such as the banks, some consumer focused sectors, real-estate, transport, etc. However, many traders and risk-averse investors take the view that the risk premium had simply become too large and they are now being paid to take additional risk and wait. Investors also recall the situation in late January 2009 when the coverage of Russia was almost equally dismal and the number of reasons why the investment story was more likely to worsen greatly out-weighed the reasons for optimism. Yet this was exactly the right time to buy. From January 22, 2009 until early June that year, the RTS Index rose from 498 to 1,000.

Although there are key differences this time, ie. the geopolitics, many risk-tolerant investors have bought over the past two months in anticipation of a similar bounce.

But, as we see in the performance table, there has been a partial reversal of the January-February gains in early March. Part of the reason for that is external, for example the strong rally in the US dollar is always negative for sentiment in emerging markets and the price of Urals crude failed to hold onto the $60 per barrel level as traders became more skeptical that meaningful supply cuts will soon come. Internally, the assassination of Boris Nemtsov naturally led to questions over political stability while the economic reports, even though they show a moderate decline, is still a reason to pause until the full extent of the decline is known, probably later in the second quarter. A first-half GDP contraction of 5%, which then gives way to stability and a modest fourth quarter recovery and a full-year decline of between 3% and 4%, is Macro-Advisory's base case for this year.

If that is indeed the trend, then that should translate into more sluggish market trends, perhaps with greater volatility than we saw over the past few months, until mid to late second quarter or early summer, but then the start of a more sustainable, albeit gradual, rally through the second half.

Performance Trends: Equities, Currencies, Debt, Commodities

	Index/Price*	January & February	Year to Mid-March*
RTS Index	816.8	22.3%	11.3%
MICEX Index	1,619.5	20.1%	10.6%
RDX USD Index	978.5	23.7%	10.1%
MSCI EM Index	938.8	3.5%	-1.9%
MSCI World Index	1,722.7	3.7%	0.8%
S&P 500	2,053.4	2.2%	-0.7%
Copper, US$ p/lb	$266.40	-4.7%	-5.7%
Brent, Fwd, US$ p/bb	$53.99	20.2%	3.7%
Gold, US$ p/oz	$1,156.84	2.6%	-2.1%
RUB/US$ - spot	62.307p.	2.3%	1.2%
RUB/EUR - spot	65.580p.	4.3%	9.8%
US$/EUR	$1.053	7.5%	13.0%
Bond Yields	**31-Dec-2013**	**28-Feb-2015**	**16-Mar-2015**
UST - 10 Yr Yield	2.99%	2.01%	2.13%
Russia '28 – Eurobond	5.65%	7.50%	7.25%
Russia '30 – Eurobond	4.13%	5.74%	5.36%
OFZ - 9 Yr	7.67%	13.15%	12.76%

Source: Bloomberg

** prices at mid-session March 16 – US$ except where indicated*

There are a number of key factors that will determine whether we get that hoped for trend or something better or worse, and these include the following.

Investor sentiment will remain sensitive to newsflow from eastern Ukraine. Nobody pays too much attention to the statements coming from either Kyiv or Moscow, but investors will react to what they see on BBC or CNN. If the heavy-weapons stay silent and the number of clashes (inevitable) remains low, then confidence about at least an easing of sanctions will continue to grow. Over the nearer term, the reports from the gas talks will provide a good indicator of whether the pragmatism we now hope for, in relations between Moscow and Kyiv/EU, is holding or whether relations are deteriorating.

Easing the financial sector sanctions in the coming months will also be important if the economy is to stabilize in the second half and forecasts for even a small recovery in 2016 are validated. The critical sanction for Russia is the block on state banks accessing debt with a maturity past 30 days. That particular official sanction was expanded to a reported total block by all Western credit and trade institutions to all Russian entities. The impact of that move was: a) to almost kill off activity on the Moscow forex market, and b) means that Russian banks and companies must pay down approximately $100bn through 2015, albeit only $60bn in foreign currency to third-parties, with the remainder expected to return as re-financing for major Russian companies from off-shore subsidiaries.

More important than sanctions is the oil price. Higher average oil will lead to a strengthening of the ruble, lower inflation and interest rates, and a recovery in the economy even if sanctions are not materially eased. A lower average oil price will keep negative pressure on these indicators, and on the economy, even if sanctions are eased.

The momentum in the oil price through January and February was positive on the back of optimism that either US oil supply will soon start to fall or that pressure is growing within Opec for a major supply cut. That optimism has, so far, proven to be ill-founded and, as of mid-March, the price of Brent and Urals is tracking back towards $50 per barrel. Without those cuts, which realistically don't seem very likely until the price tracks much lower, the price of Urals crude is more likely to fall towards the 2009 low of $40 per barrel in the coming months. The current strengthening of the US dollar is also a negative factor for the oil price, as the two have always had a close negative correlation over the past four or five decades. A low of $40 per barrel implies a ruble-dollar rate in the mid-70s, even with the CBR's better management. Clearly equities or debt will not rally against such a weakening trend in the ruble or for the oil price.

On the domestic side, the earnings and dividend season, which starts in the second quarter, will also be key drivers of market sentiment. If major companies are able to give even moderate guidance about current activity and profit trends, then that will give more comfort to those buying because of the cheap valuations. A boost to dividends from companies with net cash would also provide a very positive message about the level of optimism beyond the current crisis.

The bottom line is that while there is justifiably more reason for optimism than was the case even three or four months ago, it is still far too early to blindly buy. The old adage of not chasing prices but equally not to be afraid to buy on bad days is still the best advice.