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2015 looks likely to be Russian economy's "Annus Horribilis

Chris Weafer of Macro-Advisory
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In a memorable speech delivered in late 1992, Britain's Queen Elizabeth II described the year just ending as an "Annus Horribilis" as she referred to a year filled with misery and stress for the royal household. In economic terms, the year just ending in Russia may be similarly described. But better not to use that portrayal just yet. For the economy and companies operating in Russia, 2015 is looking increasingly likely to be more deserving of the dubious title. But for stock market investors, despite the miserable macro backdrop inevitable for the first half of 2015, this coming year may yet end up being described as an "Annus Mirabilis".

Whether you are optimistic that sanctions against Russia will start to ease in mid-2015 and the price of Urals crude recover towards $90 per barrel, or you are pessimistic and assume some sanctions expansion, or extension, and lower crude prices, the one fact which both sides have no choice but to agree on is that most macroeconomic indicators for the economy will worsen through the next three quarters and will look a whole lot worse by the time we get to next summer. Where there can be more of a debate is about whether there will be meaningful recovery from next autumn, offering hope that the current slump will start to end as the next election season starts in 2016, or whether Russia's economy faces several more years of stagnation.

For investors in Russia's capital markets that is a key question. If on the side of the optimists, looking at the start of a recovery from next summer, then one should start to add to Russia market exposure from early in the New Year. One factor we have all learned over the past 16 years is that if you wait for solid evidence of economic recovery or an end to crisis in Russia, then you miss the first 30-40% of the rally. During the last economic crisis, the RTS Index hit a low of just under 500 in late January 2009, but then doubled over the next three months (and quadrupled over the next two years), while the country's macro indicators did not start to show a recovery until the autumn of that year.

Tough times

As mentioned, regardless off one's view of the economic outlook in the autumn, the next three quarters are going to be tough for all and downright miserable for many. The latest update from the Federal Statistics Service showed that GDP rose 0.7% over the first three-quarters of 2014. Not too bad given the battering that the ruble and capital flows have endured. The weak ruble and some sanctions have had a positive impact on demand for domestically produced goods, in particular in the food sectors, while the 33% increase in defense spending also boosted manufacturing. That has helped compensate for the much slower growth in retail sales, in the service sectors and the decline in investment spending.

But that trend is already starting to decline further. Retail sales in September were boosted because of a one-off rise in non-food sales as people used some of their depreciated rubles to buy goods at risk of scarcity or which might be priced higher over the winter. Some food items are certainly in both of those categories. Russia imports only about 35% of overall food consumption these days, down from nearly 50% in 2008, but that previous high percentage remains in the supermarkets and hypermarkets. Russia never has enough in adequate food storage facilities so higher prices and some shortages are inevitable as the summer/autumn supply ends. Consumer inflation, which reached 8.5% by mid-November is set to breach 9% by year end and will very likely hit 12% or higher by the spring. Interest rates, pushed higher in 2014 as the Central Bank of Russia tried to control inflation and the ruble, are not going to start falling until there is clear evidence that inflation has started to fall. Again, probably coming into next summer rather than earlier.

High interest rates have eaten into household disposable income at a time when nominal wage growth is slowing. Public sector workers, accounting for almost 20% of the national workforce, may expect a wage increase of 7.5% in 2015 or anywhere between a 3-5% real decline. High interest rates and a more difficult debt access market is also one of the reasons why investment by companies continues to fall. On top of all that is the prevailing low level of confidence by not only consumers and business owners, but also by those Russians with money to invest and by foreign investors. Both categories will keep their wallets firmly shut for Russia until there is solid evidence that the crisis has ended.

Over the first half of 2015 we may see Urals crude in the $75-80 per barrel range, inflation at 12%, the ruble trading in the range RUB55-60 against the US dollar (RUB68-75 against the euro), retail sales growth at less than 0.5% and a continuing slump in investment spending. That may translate into either zero GDP change or a small decline, with only the spending from the military-industrial complex and the modest positives from the weak ruble and sanctions providing some support to the headline number.

But that is where the bad news could end. At Macro-Advisory we are optimistic that full-year GDP growth in 2015 will reach between 0.5 and 1.0%, with most of the recovery back-ended to the second half. We expect inflation to peak in the second quarter and then to fall slowly to a year end rate of 8.0%. We believe that while the ruble may trade in the mid-50s against the US dollar and the high 60s against the euro, the year-end rates should be a whole lot better. The table shows our base case assumptions for 2015 -2017 and those based on a pessimistic scenario, which assumes low oil for longer and tougher sanctions. We dismiss as most unlikely the optimistic case proposed by Russia's Finance Ministry in its recent 2015-2017 budget submission.

The factors that will determine whether we end up with a pessimistic or base case result will chiefly be;

Sanctions: The only sanctions that have hurt the economy are those directed against the financial sector and they have hit hard since September. Interest rates are higher, the forex market is tight and access to capital is expensive. If the EU does not extend these sanctions when they end on July 31, there will be some improvement but only limited. If the US does not similarly drop its sanctions against Russia's state banks at the same time, then EU banks will remain closed to Russia regardless of the official EU position. A unilateral EU move would help some areas of trade finance, but the US sanctions will be key to a full easing.

Oil: Opec producers are suffering budget strains just as Russia is. But the bigger producers, eg. Saudi Arabia, are willing to put up with that for some time while pursuing some important internal Opec objectives and slowing US shale production. Ultimately, the price may be affected by a sharper slowdown in the global economy, but if International Monetary Fund/World Bank growth numbers and the International Energy Agency's demand outlook prove correct, then we should see Urals back above $90 per barrel by mid-2015.

Policy Actions: Government actions have been more reactive to the unfolding crisis this year. There has been a lot of discussion over what may be done and how financial reserves may be deployed. We have not yet had a clear response but hope to see that coming up to the next St. Petersburg Investment Forum in the spring. Hardly much before then. Already we know that the government's latest development slogan is "Import Substitution" and while encouraging for long overdue changes in such areas as agriculture, food production, pharmaceuticals and some manufacturing sectors, it is still all too vague to be able to assess the medium-term impact.

Confidence: This is a tough ingredient to call. So much is wrapped up in consumer, business and investor – domestic and foreign – confidence. That's because it is a mixture or perception and reality. The only position we know for sure is that it is a whole lot easier to lose confidence than it is to recover it. This is one reason why, even under an optimistic view of Russia, sanctions and oil from mid-2015, a return to the targeted 4-5% annual growth will take several years.

Russia is not a market that, beyond blind luck, rewards either the brave or the foolish, or those intransigent in their optimism or pessimism. It is however a market which rewards those who take the time to look past the headlines and who are prepared.

Russia - Macro Outlook			Base Scenario Assumptions			Pessimistic Scenario Assumptions		
	2013	2014E	2015E	2016E	2017E	2015E	2016E	2017E
Growth, real % YoY	1.3%	0.5%	0.9%	2.0%	3.5%	-0.5%	0.5%	2.0%
CPI - year-end, % YoY	6.5%	9.0%	8.0%	6.0%	4.5%	8.0%	6.0%	4.5%
Gross fixed investment, real % YoY	-0.3%	-3.5%	0.3%	2.0%	4.0%	-3.0%	0.0%	2.5%
Retail sales, % YoY	3.9%	2.0%	1.5%	2.5%	3.5%	0.5%	1.0%	2.5%
Unemployment, % EOP	5.6%	5.0%	5.0%	4.9%	4.9%	5.0%	4.9%	4.9%
Budget, balance % of GDP	-0.5%	0.1%	-1.0%	-1.0%	-1.0%	-2.5%	-2.0%	-2.0%
Current account, % GDP	1.6%	4.0%	3.5%	2.0%	1.5%	3.5%	2.0%	1.5%
RUB/US$, year-end	32.9	46.0	41.0	37.0	36.0	55.0	48.0	46.0
RUB/EUR, year-end	45.3	58.0	52.0	48.0	46.0	69.0	60.0	60.0
Urals, US$ p/bbl, average	$108.0	$100.0	$90.0	$90.0	$90.0	$75.0	$80.0	$80.0

Source: State Statistics Agency, Central Bank, Macro-Advisory estimates

Chris Weafer is Senior Partner at Macro-Advisory, which offers bespoke Russia-CIS consulting.