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Russia Macro Update

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Key Points

- Survived sanctions and weaker oil relatively well
- Sanctions forced the government into addressing legacy problems
- Economy is stable and Russia's financial position is strong
- But the economy and Russia are at a dangerous junction with several possible ways forward
- The government will be forced to focus much more on the domestic economy in this term – it has no choice
- There is no intention to make it more difficult for foreign companies or investors to work in Russia
- Companies and investors will continue to make good profit in Russia … but will, as always, have to be adaptable to changing risk and opportunities.

Russia Today: Some Positives

- Economy is stable and should deliver growth of 1.5-2.0% this year and next
- Balance Sheet is in good shape. In 1H18 the trade surplus was $90 bln, current account surplus $60 bln and the budget reported a surplus of $15 bln
- The Finance Ministry does not need to borrow externally
- The federal budget will balance at $53 p/bbl (average) this year and may balance at $44 p/bbl in 2021
- Despite the administration's decline in opinion polls, the country is stable with no material political concerns evident
- Foreign companies are, on average, reporting increased profits this year
- The May Decrees (the government's proposed spending programme, announced by Putin in May this year) should open up new business opportunities

Russia Today: Some Negatives

- Investment spending has slowed because of sanctions concerns
- Sanctions from the US may get much worse
- Current stable growth may descend into stagnation without an increase in investment spending and higher FDI
- The Central Bank has been forced into a more hawkish position
- Higher inflation and debt service costs will hurt households and SMEs more
- Opinion polls show that people are starting to be less tolerant
- There is a question mark over the funding for the May Decrees and participation by foreign companies

Economy

- On track to deliver 1.5-1.8% growth this year and, probably, the same in 2019
- Most sectors of the economy are showing modest growth:
  - Construction is lagging a little
  - Consumer is benefiting from small real disposable income growth
  - Agriculture is again growing with exports and import substitution
  - Manufacturing is mostly boosted with the higher oil price and output
- The weak ruble has a very positive impact on the trade balance and the budget
- The negatives are:
  - Higher than expected inflation, albeit modest
  - Weaker ruble exchange rate
  - Higher than expected average lending rates

GDP Trend

- Stable but still too low

Quarterly GDP Change, % YoY

Source: State Statistics Service

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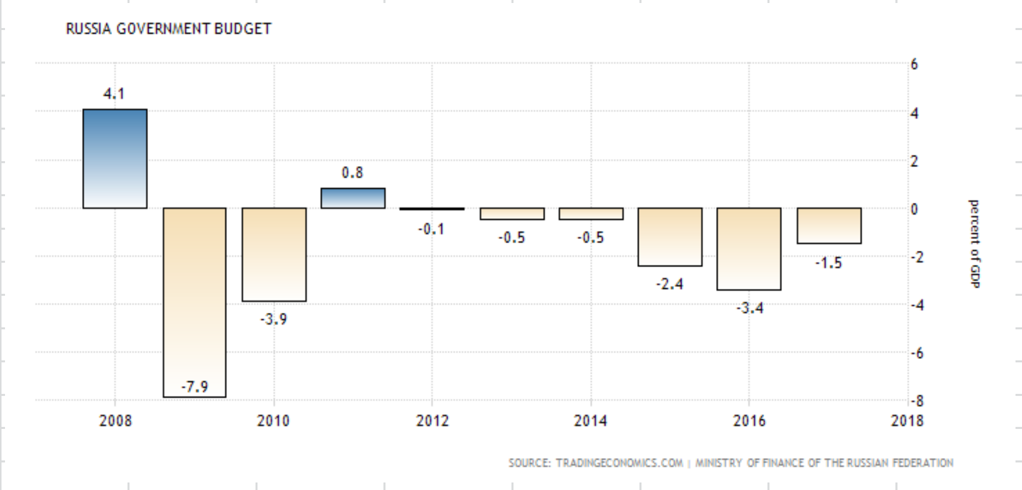
Budget is Returning to Surplus

- ❑ Budget will balance with $53 p/bbl oil this year
- ❑ With $75 p/bbl average the surplus should be over $25 billion
- ❑ The price of oil is more likely to rise this winter than to fall

Federal Budget Balance as % of GDP



Source: State Statistics Service

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Balance Sheet is Improving

- ❑ Trade surplus of $90 bln and Current Account surplus of $60 bln in 1H
- ❑ MinFin does not need to go to external markets this year or next
- ❑ Central Bank Reserves are rising and overall debt burden is falling

Total National Debt as % of GDP

Source: State Statistics Service

What Could Improve Growth?

- The May Decrees set out the policy priorities for the new government – details are expected in October
- The cost to the state (budget) will be RUB8 trln ($120 bln) over the six years
- Funding is expected to come from:
  - Bond sales to raise RUB3 trln
  - Infrastructure fund RUB3 – 3.5 trln
  - Tax reforms to raise an additional RUB1 – 1.5 trln
- The tax debate is intensifying with lobbying by all vested interest groups.
- Other than the VAT rise, there should be no other personal or corporate tax changes in 2019 – later if the oil price stays high or rises

Spending Specifics

- The government is working on mechanisms to attract private sector funding
- The total cost of the May Decrees is set at RUB25 trln ($375 bln)
- 13 separate project areas, including:
  - Road improvement costing $135 bln
  - Infrastructure development costing $28 bln
  - Improving demographics costing $56.8 bln
  - Digital economy costing $20.8 bln
  - Healthcare improvement costing $21.3 bln
- Many of the opportunities to participate will be limited to those companies that have localized "sufficiently"

Ruble Outlook

- The most important drivers of the ruble exchange rate are sanctions events and the perception of further sanctions risk
- But, it is important to understand that the government prefers a weak ruble and is not intervening to prevent ruble weakness. Its only concern is about volatility and uncertainty
- The benefits of a weak ruble include:
  - Improves the competitiveness of domestic producers and service providers
  - Reduces the oil price breakeven for the budget
  - Helps boost exports, especially in agriculture commodities
- It is understood that the weak ruble is hurting some sectors, such as Pharma, which are import dependent and also making it more expensive to import new equipment. But this is considered collateral damage over the medium term

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Ruble and Sanctions Effect

- The ruble-dollar rate traded in the 56-58 range in 1H17 as sanctions risk was considered to be low
- The CAATSA Act (August 2nd) moved the ruble-dollar rate to the 58-60 range
- The April 6th sanctions moved the rate into the 62-64 range
- The recent sanctions appears to have moved the range to 66-68
- Fear of new sanctions is already moving the exchange rate to a higher range (68-70)

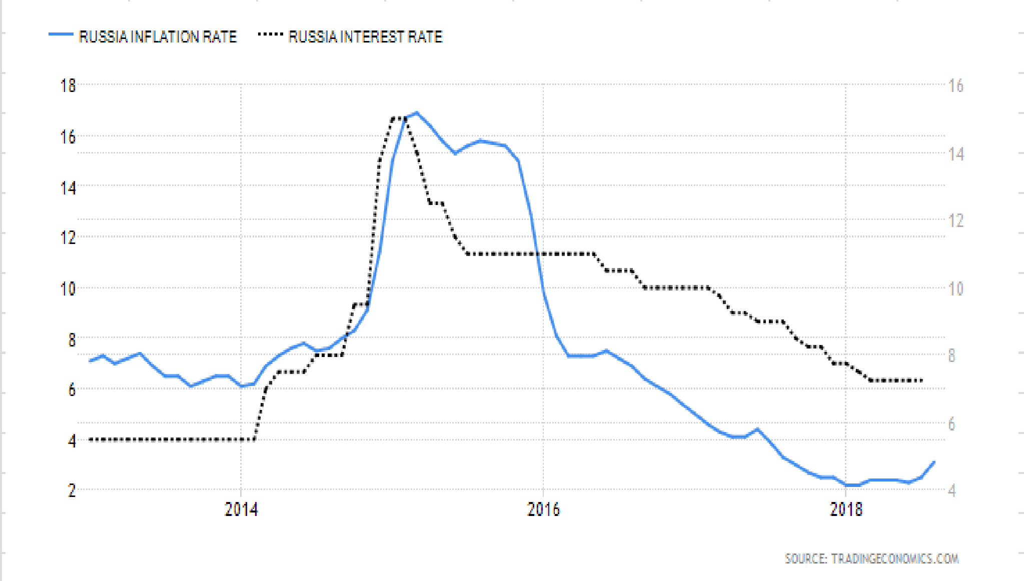
Ruble-US Dollar Exchange Rate: Recating to Sanctions News & Fears

Source: ExchangeRates

Weak Ruble = Higher Inflation

- Inflation forecasts are rising, but still below 5% YoY in 2019
- Central Bank has become more hawkish

Inflation (Blue, LHS) and Key Rate (Black, LHS)



Source: State Statistics Service

Medium Term Forecasts

- Growth: 1.7% in 2018, 1.8% in 2019 and 2.0% on 2020. The caveat being that further sanctions tightening will cut those forecasts lower.
- Ruble: R68/$1 and R77/EUR1 at end year. R72/$1 and R80/EUR1 by end 2019 – the greater risk is for a weaker exchange rate but that will depend on additional sanctions
- Inflation 3.6% by end this year and rising to 4.6% by end 2019
- Interest Rate 7.25% at end 2019 and 6.75% by end 2019, but only if the ruble stabilizes at the forecast rate and sanctions pressure eases by mid-next year
- Budget 2.0% budget surplus this year and next (approx. $30 bln each year) assuming current spending plans and tax assumptions are unchanged
- Assumption: Brent average $72 p/bbl this year and $77 p/bbl in 2019

The Latest Sanctions

- Russia has 90 days (November 20th) to show that it is no longer using chemical or biological weapons

- Next stage sanctions are at the discretion of the Executive Branch (Trump).

- But if Russia deemed not to have complied with the sanctions demand, then the Executive Branch must choose at least three of the six stated options (next slide)

90-Day Options

- Opposing loans from multilateral development banks (e.g., the World Bank or IMF)
- A prohibition on US banks making any loan or providing any credit to the Russian Government
- Additional restrictions on exports of goods or technologies to Russia
- Restrictions on the importation into the US of articles (which may include petroleum or any petroleum product) that are produced in Russia
- Downgrading or suspension of diplomatic relations
- Prohibition for air carriers owned or controlled (directly or indirectly) by the Russian Government from flying to or from the US

Sanctions Came As a Surprise

- Moscow was shocked by the latest US sanctions because they are at the initiative of the Executive Branch and not Congress, especially after a “relatively positive” Helsinki summit

- There have been indications that the Treasury Department is looking favorably at removing Rusal, EN+ and GAZ from the SDN List. OFAC has just extended the deadline for US investors exiting positions in these companies for a third time to late October

- The optimistic interpretation is that this move was:
  a) made known to Putin in advance
  b) aimed at trying to diffuse the momentum in Congress for new and far more dangerous sanctions legislation
  c) a ploy by Trump to diffuse criticism of him/Republicans being soft on Russia ahead of the mid-term elections

- The pessimistic view is that Trump has little interest in a Russia relationship or, if he had, he has abandoned it in the face of recent criticism

Sanctions From Hell Are Possible

- Helsinki infuriated Congress. Several bills have been consolidated or newly introduced and are now looking for support on Capitol Hill

- The most extensive of the new bills is the Defending American Security from Kremlin Aggression Act of 2018, or DESKAA. It is sponsored by three Democratic and three Republican senators and is expected to replace the DETER Act. The sponsors refer to it as the *"sanctions from hell"* legislation. The key provisions are:
  - Ban on US investors from buying any new Russia sovereign debt
  - Ban on US investors, banks or oil companies working in energy projects worldwide valued at or greater than US$250 million and which are supported by Russian state or parastatal entities
  - Sanctions on persons that sell, lease, provide goods, services technology, financing or support (including construction, modernization or repair of infrastructure) valued at greater than US$1 million or more than US$5 million in a 12-month period, to any oil projects in Russia
  - New sanctions on political figures, oligarchs and others facilitating illicit and corrupt activities on behalf of President Putin
  - Requiring the Treasury Department to publish a report on the net worth and assets of President Putin
  - Sanctions against individuals engaged in malicious cyber activities
  - Extension of cap on Russian uranium imports

Moscow's Reaction

- We have become accustomed to a sort of "good-cop, bad-cop" routine from Putin and Medvedev with regard to sanctions since the CAATSA legislation was signed last year
- Putin's position is that Russia will not retaliate in any way that causes more harm to the Russian economy or the Russian people. Prime Minister Medvedev has said the US sanctions amount to a form of economic warfare.
- Trade statistics for 1H18 show that while trade with the EU has declined (ex oil and gas), trade with the US increased by almost 12% over the same period in 2017
- Changing the Kremlin's position would take a real escalation in the seriousness of US sanctions against Russia, i.e. to the extent that they would have a real and obvious negative impact on people.
- The Duma autumn session starts. The bill to criminalize compliance with western sanctions had a first reading before the vacation break and will return for a second reading

Indicators to watch

- OFAC statements or actions with regard to the removing Rusal/EN+/GAZ from the SDN list
- Indications of bi-partisan support for the various bills now circulating in Congress
- Statements indicating the level of US opposition to the Nord Stream II pipeline
- The terms of the 2nd draft of the bill proposing to criminalise compliance with US sanctions within the territory of the Russia Federation

Accelerating Localization Efforts

- First Deputy Prime Minister and Finance Minister has approved proposals to create an action plan aimed at minimizing the negative impact of foreign sanctions
  - To create by end-August a working group on countering sanctions that would develop specific measures to support sanctioned companies
  - The Finance Ministry will be given authority to develop, on its own, support measures in the financial services sector
  - Various Ministries and the Federal Anti-Monopoly Service (FAS) are to conduct a feasibility study on amending existing legislation to reduce the economy's dependence on foreign patent holders
  - An effort to reduce the use of the US dollar in foreign trade
  - The elimination of fines on companies for failure to exchange foreign currency earnings if they are under sanctions
  - Examine ways to improve access for sanctioned companies to domestic financial markets
  - Limit unfair competition from foreign companies including through import restrictions
  - Proposed prohibition on state companies from purchasing certain imported goods
  - Restrict access to information on companies that are under threat of sanctions
  - Exempt sanctioned companies from certain reporting requirements, such as the ownership structure

Domestic Politics

- The late July polls show that the boost that Putin received from the Crimea referendum and the "economic warfare" with the West, has now gone.
- The high rating was always unsustainable. The catalyst for this drop appears to be anger at the pension reform proposal and the poor trend in the economy
- Putin will not want to see this approval rating slide much lower as it could endanger his position. Putin's recent comments were a mixture of compromise and determination. Very likely we will hear of more changes if the protests continue.

President Putin & Prime Minister Medvedev - Approval Ratings

	Jan '14	Dec '14	Jun '15	Dec '15	May '16	Nov '16	Dec '16	May '17	Dec '17	Feb '18	Apr '18	May '18	July '18	Aug '18
Vladimir Putin														
Approve	62%	85%	89%	85%	80%	86%	84%	81%	82%	76%	82%	79%	67%	70%
Disapprove	37%	14%	10%	14%	19%	14%	15%	18%	17%	22%	17%	20%	32%	30%
Dmitry Medvedev														
Approve	57%	60%	66%	61%	54%	52%	53%	46%	45%	41%	42%	n/a	31%	29%
Disapprove	42%	39%	33%	38%	45%	47%	46%	53%	54%	57%	57%	n/a	69%	71%

Source: Levada Center

Push-Back Against Pensions

- This issue has dominated the political agenda since the World Cup. The Duma has given a first reading to the necessary bill to raise the pension age, with some unexpectedly vocal dissent.

- Putin's typical approach to any controversial issue is to wait until the infighting stops before making a pronouncement. But given the importance of this issue he clearly felt that he had to intervene and take a public position

- As a way to test the level of discontent, and to act as a "pressure-release valve," the go-ahead was given for protests to be held in the country's largest cities

- It is worth noting that there were full reports about the demonstrations on prime-time TV news and this is not usual

- Polls show a meaningful increase in the percentage of people willing to "participate in economic and political" protests. 28% of respondents said that they are now willing to personally participate in protests. This is the highest figure during Putin's presidency

Longer-Term

- Macro conditions and the business environment beyond 2020 will depend on what happens next with sanctions, the oil price and public opinion
- The only way that the economy can push up to the targeted 4-5% annual growth is with a sustained increase in investment and FDI
- Public opinion is expected to be much more important between now and 2024 – especially if/as Putin wants to remain influential indefinitely
- Moscow is expected to target improved relations with the EU and also pursue a policy of political diversification by making greater efforts to engage with governments in the Middle-East, Asia and South America
- Localization will remain a key factor for foreign businesses. But the is still changing so companies will need to remain vigilant and flexible
- Industries with strongest growth will be those that benefit from the weak ruble, the May Decrees, consumer trends, technology improvements

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Upcoming Events

September 9th	Regional elections
September 11th	Far East Economic Forum
September 14th	Central Bank Policy meeting
Early October	May Decrees – specific details
November 6th	US mid-term elections
November 20th	Possible 2nd stage of “biological weapon” sanctions
Mid-November	Inaugural Russia-China Energy Forum, Beijing

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Macro-Forecasts

Russia: Macro Trends & Medium Term Forecasts

	2012	2013	2014	2015	2016	2017	2018E	2019E	2020E
GDP, RUB bln, nominal	66,865	70,499	77,200	84,320	90,222	95,004	99,184	105,235	111,970
GDP, US$ bln	2,150	2,210	2,000	1,360	1,347	1,635	1,526	1,503	1,600
Growth, real % YoY	3.4%	1.3%	0.7%	-2.8%	-0.2%	1.5%	1.7%	1.8%	2.0%
CPI - year-end, % YoY	6.6%	6.5%	11.4%	12.9%	5.4%	2.5%	3.6%	4.6%	4.2%
CPI- average, % YoY	5.1%	6.8%	7.8%	15.6%	7.2%	3.8%	2.7%	4.3%	4.4%
Gross fixed investment, real % YoY	6.0%	0.9%	-1.0%	-11.0%	0.8%	3.5%	3.0%	2.9%	3.5%
Industrial production, real % YoY	3.4%	0.4%	1.7%	-3.2%	1.1%	1.0%	1.5%	2.8%	3.0%
Agricultural output, % change YoY	-3.6%	3.1%	1.2%	3.5%	4.8%	2.4%	3.0%	3.5%	3.5%
Central Bank Key Rate, %			17.0%	11.0%	10.0%	7.75%	7.25%	6.75%	6.00%
Bank average lending rate, %	9.1%	9.5%	11.3%	16.0%	13.0%	10.5%	9.5%	9.3%	8.5%
Retail sales, % YoY	5.9%	3.9%	2.5%	-10.0%	-5.2%	1.2%	2.5%	3.5%	4.0%
Real disposable income, % YoY	7.3%	4.8%	-1.0%	-6.5%	-5.9%	-1.7%	1.0%	2.5%	2.5%
Unemployment, % EOP	5.7%	5.6%	5.3%	5.6%	5.4%	5.2%	5.1%	5.1%	5.0%
Budget, balance % of GDP	0.0%	-0.5%	-0.5%	-2.4%	-3.4%	-1.4%	1.9%	2.1%	2.4%
Current account, % GDP	3.7%	1.6%	3.0%	5.3%	1.9%	2.4%	5.6%	6.3%	6.9%
RUB/US$, year-end	30.8	32.9	61.4	73.5	61.3	57.7	68.0	72.0	68.0
RUB/US$, average	31.1	31.9	38.6	62.0	67.0	58.1	65.0	70.0	70.0
RUB/EUR, year-end	40.3	45.3	72.0	79.7	64.5	69.7	77.0	80.0	75.0
RUB/EUR, average	40.0	42.3	51.5	67.0	74.0	68.0	74.0	78.0	77.0
Brent, US$ p/bbl, average	$110	$108	$100	$54	$45	$55	$72	$77	$85

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

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