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Can Russia remain stable with oil at $30?

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Investors in Russian equity and debt enjoyed, on average, a relatively better year than peers in other major emerging markets. The rouble-denominated Micex gained 17 per cent in the year up to Christmas week, while the dollar denominated RDX added only 0.3 per cent – the difference being accounted for by the 16.5 per cent year-to-date fall in the value of the rouble versus the dollar. Over the same period, the MSCI EM Index lost 17 per cent and the MSCI World Index was off 4 per cent. The yield gap applied to Russian sovereign debt, and that on issues from the biggest corporations, contracted substantially despite the cut to sub-investment grade by two rating agencies earlier in the year.

Valuations started 2015 excessively cheap because of political and economic fears that proved unfounded. The conflict in eastern Ukraine did not spread further and sanctions were not added to. Domestically the government's response to falling oil revenues and tough macro conditions was pragmatic and effective. For sure nobody can say that 2015 has been a good year for Russia; what we can say is, "it could have been a lot worse".

As we stare into 2016, valuations are no longer excessively cheap but, on average, equities and debt are trading with a bigger risk premium, ie discount, than usual. Investors are more hopeful about the country's ability to survive the crisis but are still a long way from believing in a sustainable recovery.

The big issue coming into 2016 is the falling oil price and the question over how this may endanger the economic stability that the Kremlin and government officials have been lauding over the past few months. That stability is perfectly safe with $50 average oil but what happens if the price of Urals drops to $30 a barrel or even lower? While one can justifiably argue that such a low oil price should be a catalyst for a supply reaction, which should see a higher price in the second half of the year, the trend between now and spring looks more dangerous for oil producers.

One of the main reasons why Russian asset prices performed relatively well in 2015 is because of the pragmatic and generally effective actions by government agencies to counter the effects of sanctions and the weak oil price. Budget discipline held firm and the many demands of the big state companies to tap the sovereign wealth funds were rejected. But the biggest positive was the 180 degree turn in the central bank's rouble policy; after 15 years of regularly spending financial reserves to support the rouble, in 2015 it was allowed to fully free-float against the oil price.

This meant that the central bank's financial reserves remained close to $360bn from mid-March; the finance ministry has been able to contain the budget deficit at 2.5 per cent of GDP; some sectors of the economy, such as agriculture, received a boost as consumers switched to cheaper domestic products; and the current account is likely to have run a surplus of $60bn because of the big collapse in the value of imports.

With $30 oil the story will certainly change. One may argue that low oil for longer is actually good for Russia because it will force the government to start addressing issues, such as improving the investment and business climate, that have been avoidable during the period of high oil. That's a valid long-term assumption which doesn't provide much comfort for investors over the medium term. Oil at $30 a barrel will mean the rouble is likely to trade in the 75-80 range against the dollar. That will be even better for domestic producers but it will make it tougher for the central bank to achieve its inflation and interest rate targets. Consumer and business confidence will also stay very low and this will delay spending and investment decisions. The finance ministry will again press for more tax revenue, which will likely lead to windfall taxes on hard currency exporters by mid-year. All of which suggests the economy will remain in recession for the first half of 2016 at least.

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