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For investors in Russia, just two things matter

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As always, there is a great deal of noise around the Russia story and that makes it difficult for investors to identify the core issues with the greatest impact on risk. There is a lot of concern and speculation over the next steps in eastern Ukraine and the possible consequences for sanctions. Russia is also viewed as being among the most exposed to any deterioration in China's growth outlook and from the yuan devaluation. On top of which is the daily battering from the sliding oil price.

There can be no argument that Russia is in a very precarious and even dangerous position. The 4.6 per cent preliminary estimate for GDP contraction in Q2 confirms that. But, cutting though the noise and discarding extrapolations and exaggerations, there are two core issues which investors should now be most focused on and which will provide guidance as to whether investment risk is deteriorating or improving.

The factors which matter most are A) the volume of global oil supply and, B) whether a new round of talks starts concerning eastern Ukraine, i.e. specifically aimed at replacing the Minsk-II agreement. More than anything else, any indication of a cut in the former or progress in the latter would justify a reduction in the risk premium and an improvement in asset valuations. However, in the absence of either event Russia will remain under economic siege and capital markets will continue to be thrown around by multiple external contagions against a weakening domestic backdrop.

A great deal has been written about Russia's vulnerability to China. In reality that exposure is very indirect. China is one of Russia's biggest trade partners but this trade is almost all oil and other US dollar priced industrial materials. China's stock market decline, yuan devaluation and wobbly growth indicators have contributed to weakness in the oil market, which directly hurts Russia, but that is not even the major cause of the oil price decline. The basic problem is that the market is over-supplied by approximately 1.5m barrels per day as OPEC's major producers dig their heels in over market share and, so far, the lower price has not forced US shale producers to cut back. Until that over-supply issue is addressed the oil price outlook remains weak. History shows that the demand side of the equation only reacts modestly to GDP growth fluctuations but even a small usage decline will exacerbate the supply problem as indeed may the return of Iranian oil if the current supply situation is unchanged.

But, even though the price of Brent crude is down 17 per cent so far this year and is off 61 per cent since the start of last year, this does not endanger Russia's credit position. The reason is because of the 180 degree turn in rouble policy. For the previous 15 years, until the start of this year, the policy was for a strong rouble and the Central Bank occasionally spent a lot of money trying to defend the currency. The policy today is for a weak rouble because of the demonstrated benefit to domestic manufacturing and service sectors and because it helps keep the budget deficit in check. The weak rouble policy, which is also incorporated into the long term import-substitution and export growth industrial policy, also leaves Russia in a relatively better position than many of the OPEC producers in that, with, for example, a full year average oil price of $50 per barrel and a rouble-dollar rate at 70, the breakeven oil price for the budget is approximately $75 per barrel. That is down from $113 per barrel breakeven in 2013. The OPEC producers are all at a much higher breakeven level because of their dollar currency pegs.

Of course, while the weak rouble policy helps the country survive the crisis the combination of weak oil and weak rouble hurts economic and investment activity and will extend the period of recession or, at best, stagnation over the medium term. That would mean a further round of earnings downgrades across most sectors and it would continue to pile up problems in the banking sector.

The government's approach today is best described as damage limitation. There is a lot of discussion about long term recovery and growth strategies and the fact that these are now focused more on basic industries is at least encouraging. But the reality is that no money will be allocated to these programmes until financial sector sanctions start to ease and access to international capital markets returns. Since last August no Russian entity, sanctioned or not, has been able to access new credits and the hope is that even a modest easing of the sanctions regime may be viewed as passing the risk high-water mark and allow non-sanctioned companies back into the market.

That is probably the critical action required to allow the Kremlin to move from a survivalist to a recovery strategy. For that to be possible the current Minsk-II deal, to which the EU has linked its sanctions regime and which is impossible to achieve by the set sate of December 31, will need to be supplanted with a new deal avoiding that tight deadline.

In terms of the big picture for the economy and investment risk, the monthly oil supply report and indications of whether new peace talks are possible rank well above all other events and concerns. The rest is just noise.