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Is the ruble a basket case or over-sold?

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At mid-session on the first trading day of December, the ruble had declined by 60% against the US dollar since the start of the year (over 70% since the start of 2013), and was down 45% against the euro (55% since January 2013). The obvious questions are: why has the ruble fallen so quickly and by so much? Does this collapse jeopardise Russia's financial stability and raise the risk of a default? And, how much further can the ruble fall or is this another of those attractive buying opportunities that seem to be available in Russia every seven years?

Is the fall justified?

By most standard measures the ruble's collapse has been extraordinary. That scale of decline is usually associated with an economy with huge debt obligations, a non-fundable budget and a current account deficit. Russia ticks none of those boxes. Total foreign sovereign debt is only at 3% of GDP, and total private sector foreign debt is at 33% of GDP and falling as a result of the fact that Russian companies are not able to refinance maturing debt on foreign markets. Despite spending approximately $70bn in a futile defence of the ruble this year, the Central Bank of Russia (CBR) still has $420bn in foreign exchange reserves, a total which includes $180bn split between two readily available sovereign wealth funds. At the end of the third quarter the trade surplus was over $150bn, up over 10% from the previous year, the current account surplus was just short of $60bn, ie. double that of 2013, and the federal budget surplus was equal to 2.1% of GDP.

There is no reason for a currency crisis when looking at the nation's balance sheet and cash flow. The reason why the currency has fallen so much is because the ruble is a high-beta petro-currency, with the beta coming from the fact that foreign investor and domestic business sentiment has been deteriorating since early 2013. The exchange rate of the ruble fell 9% against both the dollar and the euro in 2013, even though the price of Urals oil held steady close to $108 per barrel and a crisis over Ukraine was a long way in the distance. The reason for the decline was the slowly eroding confidence in the economy and in the government's ability, or its willingness, to address some glaring policy errors.

So the ruble came into the sanctions period already weakened. And even though the exchange rate actually slightly improved though this past summer, the last sanctions update that effectively cut off all Russian enterprises from accessing Western debt and credit markets proved to be a real killer for the Moscow forex interbank market. How much of the decline in the ruble came from the sanctions expansion is hard to calculate, as it happened at the same time as the price of oil started to slip off the cliff-edge.

So, to use a sporting metaphor to describe the ruble decline, it was a case of Strike 1 from the weakening economy through 2013; Strike 2 came from the sanctions and the further hit on confidence; and Strike 3 (you're out) came with the oil price collapse.

How vulnerable is the economy?

When considering the risk posed to the economy one has to combine the impact from both the ruble and oil price decline. If you look only at either in isolation, then the conclusion inevitably is that Russia Inc. is in a crisis and sinking fast. But that is not the case when you combine the two negatives. To a large extent one problem helps balance the other. This was an expensive lesson learned in the 2008-09 crisis, ie. don't waste reserves trying to defend the indefensible. Although the fact that the CBR has used $70bn from reserves this year before finally giving up trying to defend the ruble suggests that lesson was poorly learned in 2009. Still, better late than never.

It means that while the price of Urals crude has fallen 37% since the start of the year, and the country loses approximately $100bn in lost revenue over a full year, in ruble terms the budget is better off. That is because the ruble loss has been greater than the oil price decline and results in an increased budget surplus in local currency terms. Given that almost all of the budget expenditures are in rubles, then this is a meaningful increase and allows the government some spending options, eg. to raise public sector salaries and pensions or to fund investment projects.

Much has been made of the fact that Russian enterprises must pay down over $25bn in foreign debt obligations his month and at least $100bn through 2015. Here also the suggestion is that the collapsing oil price and ruble will make this difficult in the extreme. This is actually not the case for 2015. The reason is because Russia keeps its entire sovereign savings, including the two sovereign wealth funds, in foreign currencies, which are mostly dollars and euros. So there is no increased risk here unless the CBR were to start using reserves to again try to control the currency or the government were to start doling out the reserves cash to the state companies to fund their investment projects. So far the evidence is that this is not at all likely, as the Kremlin is more focused on preserving the country's investment grade credit rating.

Real damage is to growth and investment

The real damage from the collapsing ruble and oil price is to investment and growth. Russia is an uninvestible country for all but the bravest of hedge fund investors right now, and will remain in this category until both the ruble and oil stabilize at minimum. Russians with spare cash are just as risk-phobic these days as are foreign investors, and the longer this situation lasts the greater will be the long-term negative legacy from this crisis, and the longer it will take to return to even modest annual growth.

The weak ruble piles pressure on inflation and interest rates, as well as hurting domestic business and consumer confidence. While the initial reaction to a falling currency is always to rush out and buy some items which may cost more later, that tends to be a one-off hit and the aftermath is a long period of much weaker activity. That is what Russia is facing this winter and through at least the first half of 2015, if not into 2016.

Time to buy or keep clear?

The country is not facing a balance sheet or budget crisis, but is already in an investment crisis. The economy is also looking at a long period of growth stagnation. But arguably the current value of the ruble and the rating of Russian sovereign debt and the equity market more than fully discounts all of that. In fact, the current valuations not only reflect the current problems, but anticipate a much worse situation to come. Is this a time to buy?

One factor in favour of that argument is that Russia has always been a country to buy when the reasons not to become so overwhelming that to do so would be akin to throwing a dice on a roulette wheel. This was the case in late 1998 and early 1999, and again in January 2009 when the RTS Index fell to 498 before doubling over the following three months. Between July 2008 and June 2009, the ruble fell 60% against the dollar as oil collapsed and the economic indicators were stuck in a downward spiral. The ruble then rallied 20% over the second half of that year as oil started to rally.

Is it different this time? There are good and bad differences this time. The good difference is that the CBR has stopped burning through reserves, while the weaker ruble has protected the budget, the spending power of sovereign savings and has helped provide a boost to domestic industries as imports become more expensive. It means that there is no default threat this time and the economy can avoid a big growth decline as happened in 2009.

The bad difference is that the oil price decline is only Strike 3 and the other two problems remain serious and unresolved. The political backdrop, in particular, adds a very unpredictable factor to this crisis and that is almost enough in isolation to keep the risk premium high and investors wary of otherwise cheap valuations.

Inevitably, after such a major collapse in the ruble and in the oil price there will be a trading opportunity from the increased volatility. But for the start of a steady rally three events need to occur;

Oil price: The price of Brent needs to find a floor at least, before investors will return to Russia and allow the risk premium to shrink. The good news is that the Opec producers are in just a tough position and pressure will increase within the organisation to agree some supply cuts over the winter months. The major Opec producers, led by Saudi Arabia, were unable to get a broad consensus from the other member states to pro-rata cut production to balance the market. But all Opec countries now have a much higher oil price requirement to balance their respective budgets, so there is a more limited time period that they can live with the current, or lower, oil price. Some states, especially Venezuela, are in a particularly precarious position and may soon be a much more serious economic and social disruption which, in turn, may lead to a decline in oil output.

East Ukraine: So long as the newsflow from and concerning the region stays bad, investors will worry both about the continuing impact of sanctions on the economy and liquidity, plus the threat of even tougher sanctions to come. The best news for investors would be an agreement between all parties to return to the Minsk talks. That would be a buy signal for Russia risk

Policy response: The Kremlin is increasingly faced with two choices – either turn to greater isolationism from the West or to more aggressively push reforms in an effort to counteract the negative events of this year, and also to address the reasons for the slowdown evident from early 2013.

President Vladimir Putin is scheduled to make a major policy speech on December 4 and his annual press Q&A is set for December 18. We hope for some clearer guidance on which way he is leaning at either or both of those events. These are the two events to which investors should pay greatest attention in deciding whether to throw the dice or wait.