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The oil price is all that matters regarding Russia

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The key takeaway concerning the economy and the ruble from President Vladimir Putin's press conference on December 18 is that the Kremlin does not have any strategy or plan to try and pull out of this slump or to halt the decline in the ruble. The message seems to be one of trying to weather the worsening storm, which he said will get much worse over the next half year and may not start to ease for up to two years. The government will deal with outbreaks of the crisis, such as this week's ruble collapse, on a case-by-case basis while crossing its fingers that the price of oil will soon start to rally. Given that the US and the EU have both moved to tighten sanctions again this week, and even despite there having been a calmer period with more encouraging comments from all sides involved in the eastern Ukraine crisis, there is realistically no hope of a substantial easing of the financial sector sanctions through the first half of 2015 and maybe not until 2016. Kicking the injured while on the ground seems to be a more satisfying political course than engaging in talks. That really leaves only the oil price as the source of hope that the worst case scenarios for the ruble and the economy can be avoided.

The one factor that gives some substance to that hope is Russia is by no means the only country to be now hurting from the oil price fall. It is, however, the only one getting all the publicity and subject to speculation of imminent disaster. It is also the only one of the oil-dependent economies which allows its currency to free-float and take a battering. While I have said that the Kremlin is not publicly disclosing any specific strategy, the one choice it appears to have made is to allow the ruble to fall, and to fall much further if oil goes down below $60 per barrel. It is a kind of "lesser of two evils" strategy. The weak ruble protects the country's budget revenues and provides a soft stimulus for domestic manufacturers. It allows the country to survive the crisis at the expense of growth and investment flows. Both of which are being sacrificed over the medium term in order to try to remain in a relatively better shape to recover after the crisis. Hence, trying to limit the decline in financial reserves in order to protect the country's investment grade rating is a better strategy than burning though the money while oil remains weak.

The oil price is key to how Russia survives this crisis and to how long it lasts. If the price of Urals crude were to rally back to $90 per barrel, then we could expect to see the ruble back at RUB50, or lower, against the dollar, and there would be little talk of an imminent financial crisis. Over the short term, it is difficult to see what might cause that rally. Much more likely the price of crude will drift below $60 per barrel and down to the low $50s. But, as we have highlighted in several previous columns, all of the Opec producers now need a much higher oil price average than was the case in 2008. At the current oil price, Saudi Arabia, the United Arab Emirates and Kuwait are dipping into their financial reserves to cover their respective budget deficits. Their currencies are pegged to the dollar so they don't have the issue of inflation or higher interest rates to deal with, but the longer oil stays low the greater will be the cost to them. Venezuela was already on the brink of an economic collapse even before the price of oil fell, and the African producers are also not in good shape to live with low oil for long.

It is ridiculous to assert that Saudi Arabia is colluding with the US to hurt Russia and Iran. The gap between the Kingdom's budget requirement and today's price is costing it $200mn in lost revenue every day. That's a sizeable favour to grant! Pressure within OPEC to reach a compromise over Saudi's demand for pro-rata cuts is already growing and any assumption that the group will simply do nothing indefinitely as oil slides to $50 per barrel, or lower, is unrealistic. Venezuela's economy, and a sizeable portion of its 2.5mn barrels of daily production, is at risk over the near term and any decline in output would in any case help prop up the oil price.

Yes, apart from the oil price, there are several reasons why the ruble has been hit so hard over the past few months. But oil is the critical driver. Since October 1, the ruble has lost 50% against the dollar while the oil price is not far behind with a 44% drop in the same period. Oil weakness and sanctions came on top of an already weakened base in the economy that has been evident since early 2013. The previous growth drivers, i.e. consumer spending and manufacturing sector growth, which had sustained the booming economy for the past dozen years, had become exhausted. Lower wage growth, rising inflation and high interest rates all took their toll. The economy would have been weaker in 2014 even regardless of the sanctions and oil.

Lack of confidence

This week we saw a new, and potentially dangerous element if not calmed very soon. That is the sharp drop in public confidence in the Central Bank of Russia (CBR), which led to a frenetic few days when the CBR seemed to panic and the ruble briefly reached towards 80 against the dollar. The way the widely reported bridging loan was extended to Rosneft on the evening of December 15 most certainly added to the market volatility.

The currency seems to be now settling closer to the RUB60 level against the dollar. At that level, it has lost 83% against the US currency and 60% against the euro. The impact of that fall, and the continuing uncertainty, is that inflation will push much higher in the first few months of 2015 with headline inflation number expected to hit 14-15% from 10% today. The CBR’s benchmark key rate is now at 17%, having started the year at only 5.5%, and the likelihood is that the rate will go higher still in the next quarter as the CBR tries to tame inflation and provide support for the ruble.
We heard that message again from President Putin during his press briefing. He made clear that he is opposed to the use of financial reserves to try and support the currency and is also opposed to mechanisms which may be interpreted as a form of capital controls. In effect, it means that the CBR has relatively few options and one of those will be to continue using interest rates to try to attract support for ruble assets.

What that means is the economy is very likely to fall off a cliff in the first and second quarters of 2015. While we see GDP contraction of between 3% and 5% as probable for the full year (depending on where oil trades), a much steeper fall in the first half is now inevitable. Consumers, especially in Moscow, has been busy taking ruble cash out of ATMs all week and have been buying appliances and other imported goods which will soon see big price rises or even shortages after the New Year. That will provide a big boost to the retail sector in December, but will mean the sector will be a wasteland through the next six months. High prices, high interest rates and low nominal wage growth makes that a certainly. The high cost of debt will also severely cut capital investment in 2015.
The one compensating factor is that the weak ruble, in the absence of higher oil revenues, continues to protect the budget and will, for example, allow the government to boost pensions and some public sector worker salaries by the rate of inflation in 2015. It will also help boost local demand and growth in the manufacturing sectors.

But the bottom line is the oil price. If it falls further, the financial squeeze on Russia will tighten and the ruble will fall, along with equities and debt prices. If oil starts to rally, then the pressure eases and the crisis is a whole lot more manageable, ie. including the sanctions impact. For investors it is therefore a straightforward decision: buy Russia if oil goes up and disregard all of the other noise, but stay away so long as oil trends lower.