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ITI Capital: What's wrong with Russian rouble and what should we expect till the end of the year?

KEY TAKEAWAY

We believe that the rouble is oversold technically and fundamentally by ₺10-12 assuming brent oil mid-range \$40-43/bbl. The rouble's geopolitical premium is close to its all-time highs. Otherwise, the rate would not have exceeded ₺70/\$, but would be even lower, given expected recovery of the global economy, demand for hydrocarbons and domestic demand.

The Central Bank will try to stabilise the exchange rate and may take bolder steps to strengthen the rouble if the rate rises above ₺80/\$.

Therefore, we recommend selling dollars against the rouble to short term target of ₺75/\$, since in the medium term, until the end of the fourth quarter, the role of the key factors that drive the rouble-dollar premium, mainly sanctions risks, may increase following the US elections, even with Trump's victory. Thus, the rouble is projected to trade in the ₺72-81/\$ range in 4Q20, our baseline estimate for the rest of the year is ₺72/\$ if Trump wins and the sanctions are suspended, which is least likely, according to our scenario published in "The rouble on the swings of geopolitics: hold on tight!" note.

WHAT'S HAPPENING TO THE ROUBLE?

- The dollar continues to increase its edge over the EM currencies, which have on average lost 20% since this year.
- The rouble has fallen by 22% against the dollar year-to-date, becoming the third-weakest currency after the Turkish lira (-24%) and the Brazilian real (-29%). It was only in September that the rouble retreated by 7%, posting the biggest decline since 2014, when the US and EU imposed sectoral sanctions on Russia. Back then, legal entities were added to the blacklist, while U.S. persons were barred from dealing in Russia's companies' new debt with a maturity of more than 30 days.
- The main reason behind the Turkish lira decline is the strong demand for dollars amid increased macroeconomic instability, the country's dollarization level is approaching 60% and foreign currency reserves fell by \$5 bln year-to-date. The country faced a FX-liquidity crisis and the Central Bank was forced to raise rates for the first time since August 2018, by 20 bps to 10.25%. The Brazilian real decline was driven by a spike in covid cases and lack of state funds to fight the pandemic. Since then, the covid infection rate has stabilised at just below 30,000 cases per day and has been declining over the past month, as the economy reopened. Meanwhile, the fiscal and monetary stimulus to Brazilian GDP ratio has increased to 12% and 4% respectively.

- The weakening of the rouble was driven by a streak of bad news that increased the likelihood of new sanctions by the US and EU. The New York Times reported late in June that American intelligence officials have concluded that a Russian military intelligence unit offered bounties to Taliban-linked militants for killing coalition forces in Afghanistan. In addition, Biden's approval rating has been growing in the US (according to polls, Biden maintains a 10-pt lead over Trump), which is still important. In early August, companies made \$4 bln-worth roubles conversion into dollars for dividend payments, the Belarusian political conflict escalated in early August, and Alexei Navalny was hospitalized on 20 August.
- Since then, the external environment has deteriorated, and the escalation of the conflict in Nagorno-Karabakh recently emerged as yet another negative factor. Its blow to the rouble will depend on the scale of the conflict and Russia's help to Armenia, given Turkey's help to Azerbaijan (war by proxy).

KEY RISKS AHEAD OF ELECTIONS PRICED IN

- We believe that nearly all risks of tougher sanctions against Russia ahead of the US elections are priced in already. A new risk factor was the escalation of the conflict in Nagorno-Karabakh, but the risk of Russian military intervention (as in Belarus) is very low too, within a few percentage points.
- Even if Russia provides limited military assistance to Armenia (primarily arms supplies as part of bilateral commitments), this would not have any tangible impact on the country's economic or financial situation.

RISK PREMIUM AND USDRUB



Source: ITI Capital, Bloomberg

INFLUENCE OF NON-RESIDENTS AND LOCAL PLAYERS ON THE ROUBLE AND OFZ

- From the beginning of June to 25 September, the Russian rouble lost around 12% and the longest government bonds fell from local highs by around 9%. Total share of non-resident OFZ holdings fell by 4% to 26.3%, according to the National Settlement Depository (NSD) data.
- The main phase of the rouble's decline against the dollar began at the end of August and continues to this day (the rouble suffered nearly half of its losses over the period). The share of non-residents in the OFZs dropped by 2% in less than a month, triggering a ₴60 bln outflow, or a ₴35 bln net outflow. This period is marked by increased non-residents' activity, while previously the market was dominated by local players, according to our estimates.
- According to our research, it's unlikely that non-residents accounted for the bulk of sales during this time. We analysed the NSD's daily statistics on the foreign investments in OFZ, one of the most popular instruments among non-residents. The data suggests, there were no significant changes in investments in absolute terms throughout the summer. In June, the total inflow was ₴18.6 bln, followed by a ₴5.4 bln outflow in July, and a ₴14 bln inflow in August.
- Total share of foreign OFZ holdings was steadily declining due to the Finance Ministry's proactive measures in the primary market, as it rushed to ramp up borrowing in the domestic market to cope with lower budget revenues. Thus, it

becomes clear that until recently, the rouble and OFZ markets were primarily driven by local players.

- Regular selling in non-residents OFZ-holdings has accelerated in the second half of September (-₽42 bln since 17.09.2020). Obviously, increased geopolitical risks contributed to the capital flight. It is also worth noting that RUBUSD suffered the heaviest losses from the end of August to 24 September, when it dropped 6%.

WILL THE CBR SAVE THE ROUBLE?

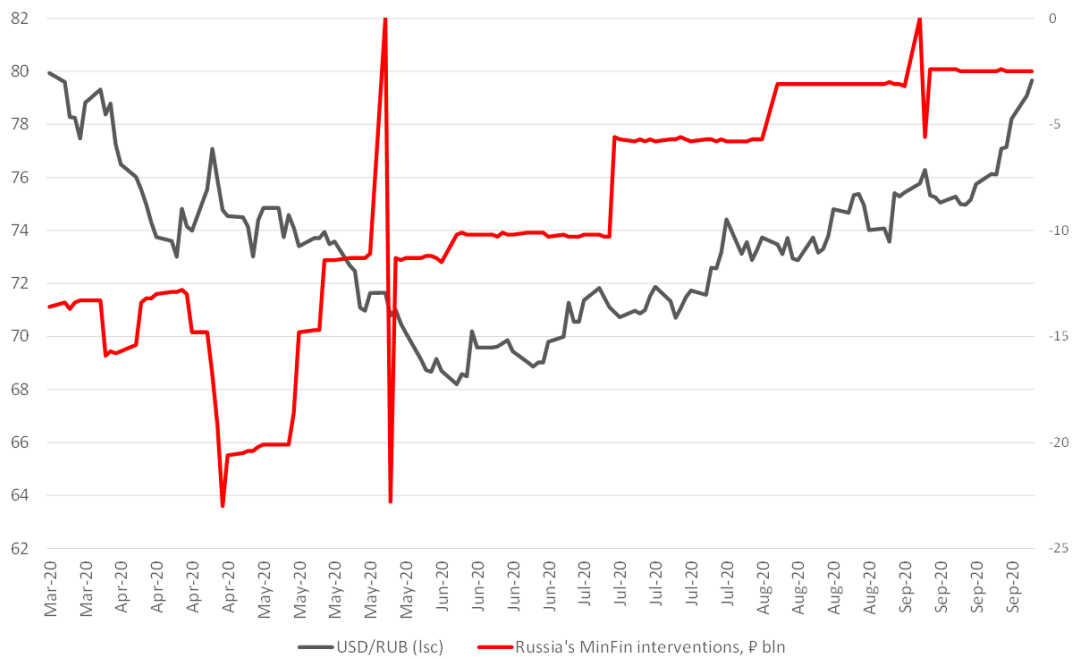
- If the rouble continues to weaken (that is drops below ₽80/\$), we expect the CBR to stabilise the rate by encouraging exporters to sell FX-revenue, as it did in back December 2014, when the regulator sold more than \$20 bln-worth of currency over several weeks. The CBR can also adopt a tougher stance on the monetary policy, which, coupled with FX-sales and termination of current purchases by the Finance Ministry, will be the most effective way to stabilise the exchange rate.
- Measures taken by the Central Bank on 29 September. The Bank of Russia said it would sell additional foreign currency worth ₽2.9 bln a day in October-December. We believe that this is a drop in the bucket, given that the current interventions stand at ₽2.5 bln per day and will eventually increase to ₽5.4 bln (\$70 mln), which is 1.6% of the current FX-trading on MICEX TOM+TOD. We believe that sales will work if they amount at least to 5% of the daily trading volume, i.e. ₽20 bln per day, which, according to the budget rule, is only possible if funds from the Sberbank sale are used, that is if Urals trade below \$12/bbl, and Brent below \$16/bbl. This was roughly the case in late April and early May when Brent traded above \$20/bbl.

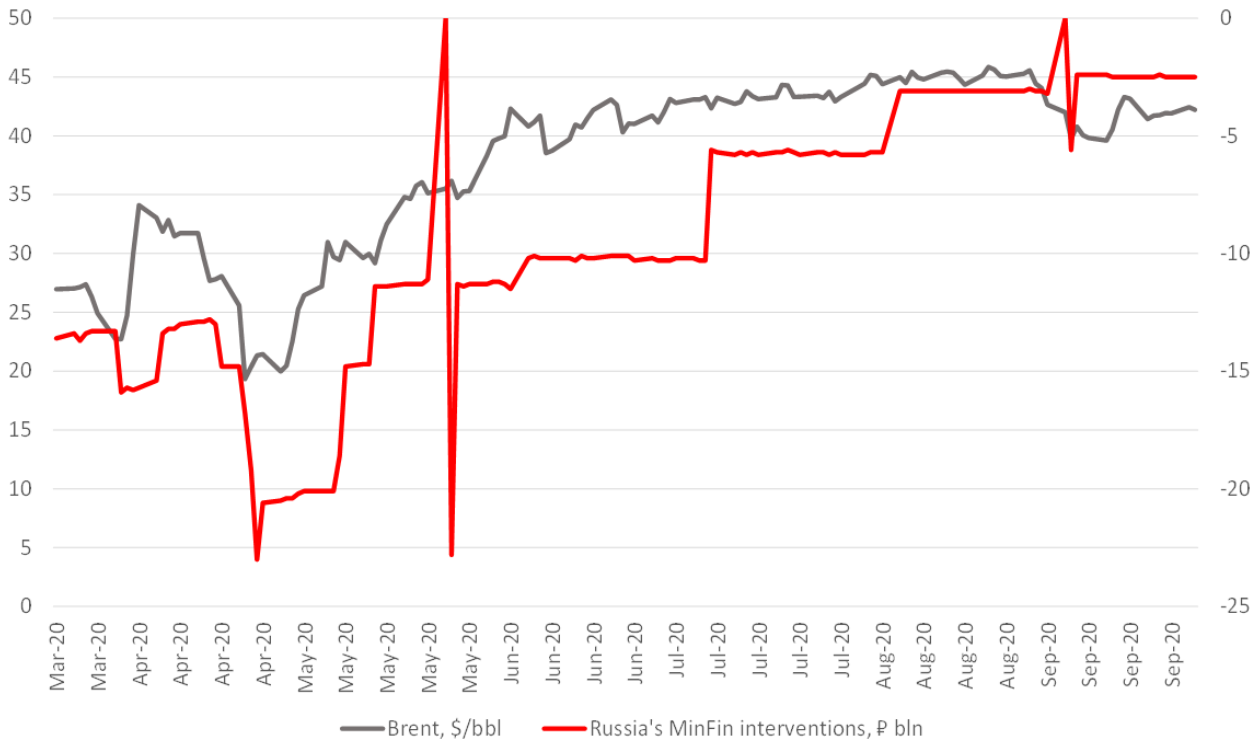
KEY FACTOR FOR THE ROUBLE: US ELECTIONS

- If Biden wins, which is currently the baseline scenario, Russia is likely to face tougher sanctions. At least, further implementation of the CAATSA law that targets Russia seems very likely. The bill was adopted by Congress (in 2017) and signed into law by Trump. This will imply risks of additional restrictive measures against Russian entities and individuals, but most likely excluding state assets. The probability of much stricter financial penalties (through CAATSA or additional measures) is seen at 40%, and the rouble could decline to 81/\$ in this scenario.
- Adoption (and implementation) of the DASKA bill, providing for a complete ban for U.S. investors on transactions with any Russian sovereign debt, would be a way heavier blow to investors. Several powerful U.S. government agencies, including the U.S. State Department and the Treasury, have expressed opposition to the bill's provisions arguing that they would harm cooperation with Russia on strategically important issues. In our view, the Democrats' victory per se (in the absence of new triggers for serious bilateral tensions with Russia) would not accelerate the adoption (let alone implementation) of the DASKA bill, which will clearly not happen this year. If US officials remain tough on Russia, the rouble is likely to trade close to current levels after the elections, and its further strengthening rouble will largely depend on higher oil prices and accelerated development of effective COVID-19 vaccines.
- If Trump wins the November elections, we do not expect any significant change in U.S. policy toward Russia, although additional sanctions pressure (through further

implementation of CAATSA, for example) cannot be ruled out. However, Trump's victory will most likely strengthen the dollar's position against other currencies, which will prevent the rouble's spikes. In the absence of financial sanctions, the rouble could strengthen to \$72/\$ under a particularly favourable set of circumstances.

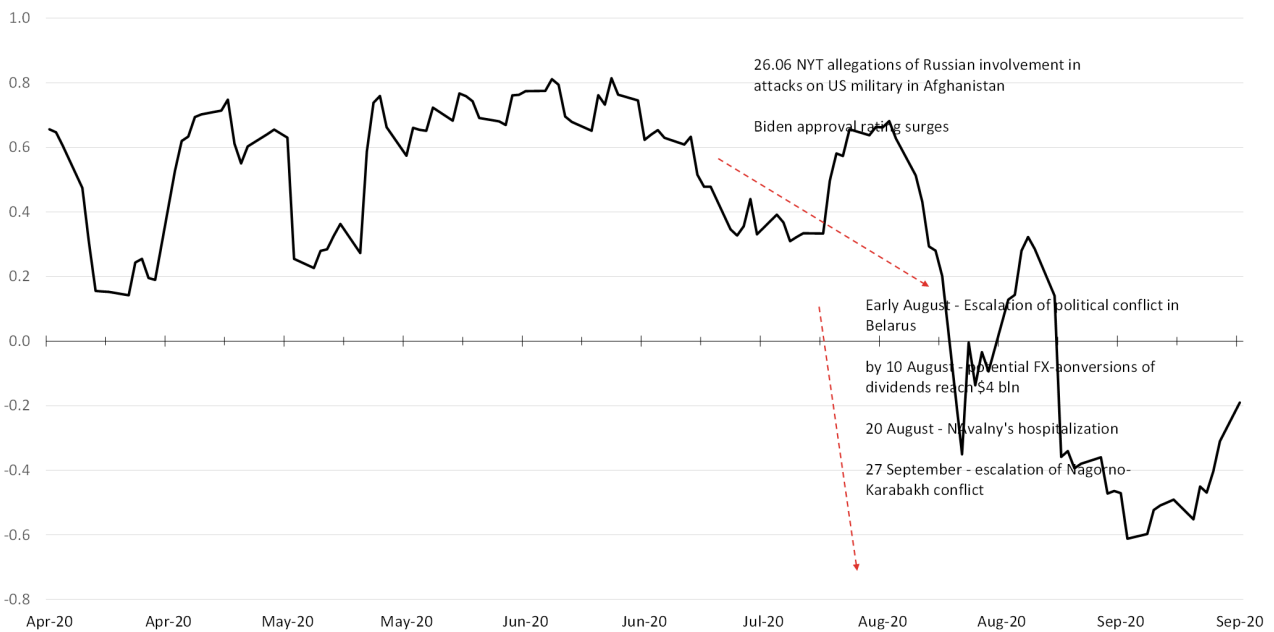
RUSSIA'S MINFIN INTERVENTIONS UNDER THE BUDGET RULE IN 2020





Source: CBR, Bloomberg, ITI Capital

USDRUB AND OIL CORRELATION AND KEY FACTORS IN 2020



Source: Bloomberg, ITI Capital

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