Russian Macro and Fixed Income

The new investment opportunities

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Russian macro update: healthy resilience and positive outlook

- GDP growth slowed from the 1.9% y-o-y in 2Q18 to 1.3% y-o-e in 3Q18, which we think is still a decent performance given the base effect (+2.2% y-o-y in 3Q17). The average growth rate for 9m18 reached 1.5% y-o-y.

- We forecast acceleration in GDP growth in Q4 to over 2% due to higher industrial production growth rates. For the full year 2018 we expect the real GDP growth to be just under 2% .

- Industrial production growth accelerated to 3.7% y-o-y in October from 2.1% in September. This was due to pickup in manufacturing growth, which we expect to remain strong in 4Q18.
- Current account surplus for 10M18 rose to $88bln, implying that in October it was $12.1bln, thanks to higher oil prices, stronger exports and weaker ruble. We expect current account surplus for the full year 2018 to reach $104bln (over 6.3% of GDP).

- Inflation is likely to decelerate in November, it can be as low as 3.5% y-o-y, as in October, hence we expect it to be below 4.0% y-o-y by the year-end. This implies that we can expect CPI growth of just 0.8-0.9% in November-December.
- CBR recent monetary and fiscal policies have helped to absorb external shocks. On September 14 the Central Bank hiked policy rate by 25 basis points to mitigate the growing inflation risks. Besides, in late August the bank suspended FX purchases (a total of $30bln) till the end of the year to reduce the exchange rate volatility.

- Budget surplus for 10M18 reached over 3trln rubles thanks to a 39% buildup of budget revenues as a result of higher oil prices and weaker ruble. We expect budget to remain in surplus in 2018 (2.5% GDP), for the first time since 2013.

Latest developments and important notes

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- ***Russian total external debt, including corporate and financial sectors' obligations, has shrunk to a nine-year low of $467bln, which is almost equivalent to Bank of Russia's international reserves ($462bln)****. As of October 2018, Russia's total external debt is down by $51bln year-to-date to $467bln, thanks to redemptions by non–financial sector borrowers ($27bln).*

- ***Total external debt redemptions in Q4 2018 will be an equivalent of the same period last year***, but in Q1'19 will be lower by 42% yoy.

- ***New US sanctions on Russia are expected to be postponed till late January or early February 2019*** according to our estimates.

- ***Implied FX volatility is the key indicator of CBR monetary policy and FX purchases***

- ***Oil price growth reduces the share of investments in the Russian GDP structure due to higher FX purchases making it harder to reach*** 25% level, targeted by the government by 2024.

- ***Capital outflows in October from the private sector reached almost $10.3 bln***, it is the highest monthly outflow since early 2015, which brought the 10m18 outflow figure to $42.2 bln out of which $27bln are corporate redemptions, purchases of foreign assets and $7bln net outflows by non-residents for 10months of 2018.

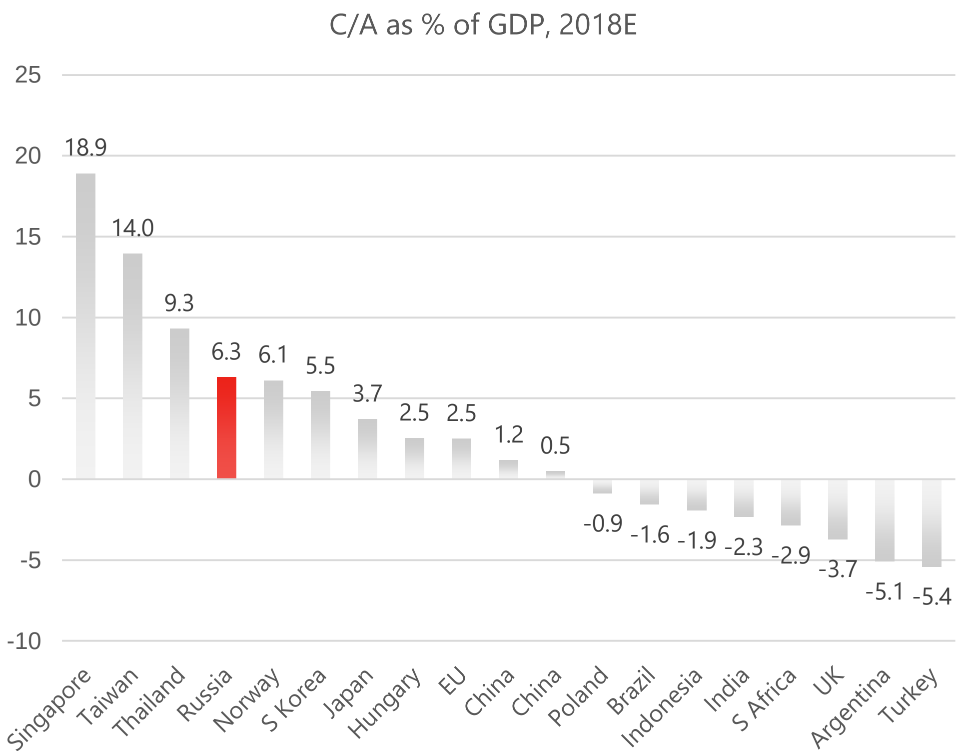
- ***Public investment buildup, which is an important driver for the economic growth***, is to continue. In 2018 public investment can increase by 30-40% from 1trl ruble last year.

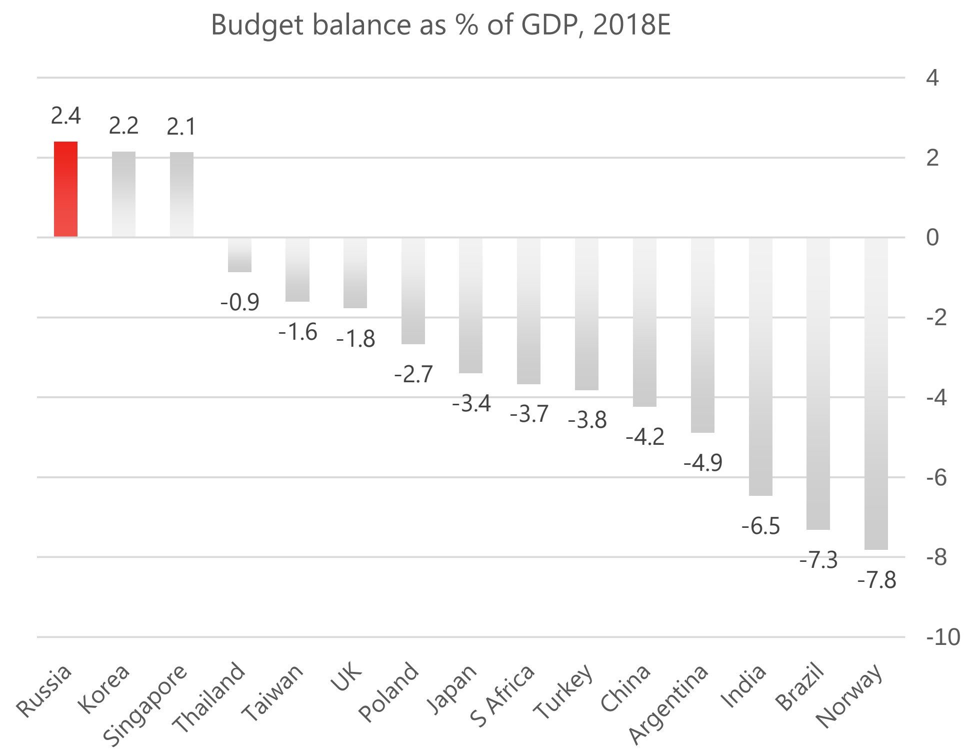
- ***Russia is moving up in the World Bank's Doing Business ranking***. The biggest improvement was observed in the category Dealing with Construction Permits – in this category Russia has climbed from 115th place all the way up to 48th

- ***Vladimir Putin approval ratings are nearing the 18-year lows*** – in October they plunged to 66% from 80% in January. It indicates that now a majority of the country's population believes that Russia is heading in the wrong direction.

Russian macro: Defensive play in EM

Despite risks of new sanctions, rising geopolitical tensions and EM sell-off, the Russian economy is now more resilient than some of its EM peers. This resilience is due to this year's strong current account and budget surplus, low dollarization levels (<25%), low external debt (<30% of GDP) and moderate inflation (<4%).

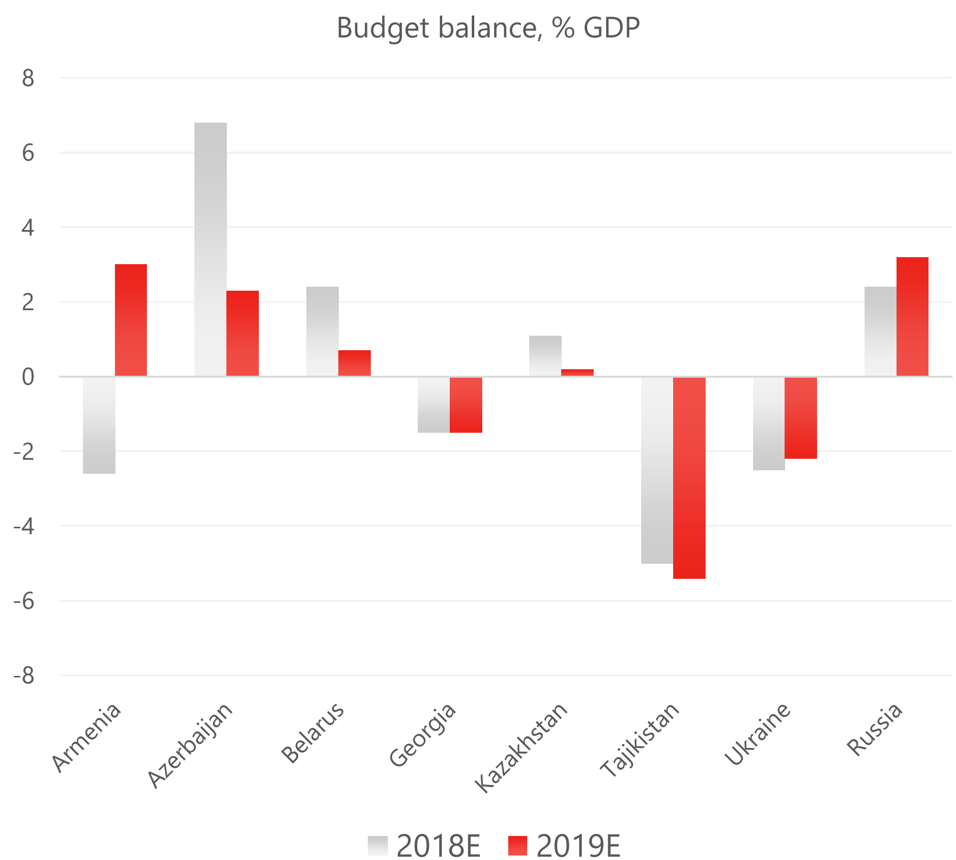


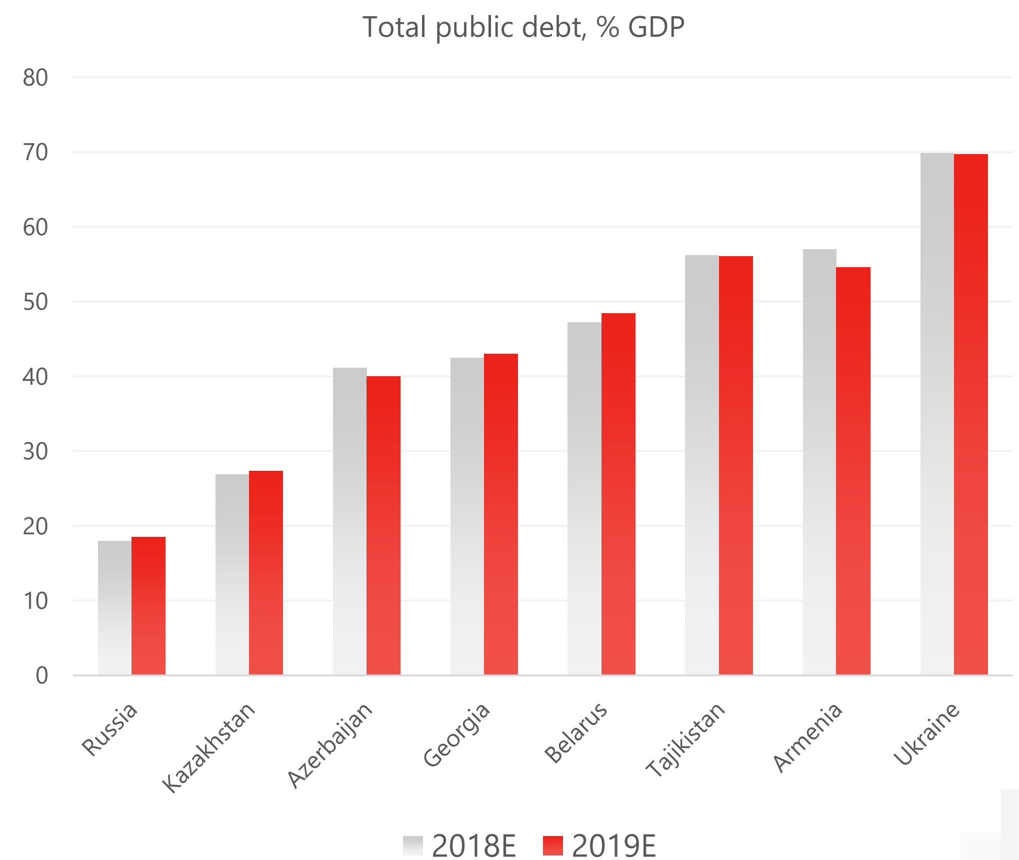


Source: ITI Capital, IMF

Public Debt and Budget Balance

Russian public debt is estimated to be 18% GDP – it is the lowest level in the CIS space and one of the lowest in the world. The budget surplus is currently estimated to stand at 2.4% GDP, by the year-end it can reach near 2% GDP and is expected to break through the 3% mark in 2019.





Source: Finance ministries, National statistics agencies, ITI Capital

Russia and CIS Macro Summary

Real sector	Nominal GDP, $bln		GDP per capita, %		Population, mln		Real GDP growth, %		Budget balance, % of GDP		Total public debt, % GDP	
	2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E	2018E	2019E
Russia	**1 640**	**1 680**	**11,9**	**12**	**144,5**	**144,8**	**1,8**	**2**	**2,4**	**3,2**	**18**	**18,5**
Kazakhstan	167,1	175,7	9	9,6	18,5	18,7	3,7	3,5	1,1	0,2	26,9	27,3
Ukraine	126,4	129,1	2,5	2,8	42,2	42,1	2,7	3	-2,5	-2,2	69,8	69,7
Belarus	58	57,6	6	6,2	9,4	9,4	3,8	3,5	2,4	0,7	47,2	48,4
Azerbaijan	43,4	46,1	4,2	4,25	9,6	10,1	1,2	2	6,8	2,3	41,1	40
Georgia	16,1	17,1	4,1	4,2	3,7	3,7	4,3	4,5	-1,5	-1,5	42,5	43
Armenia	12,5	13,4	4,1	4,2	3	3	5	4,5	-2,6	3	57	54,6
Tajikistan	7,4	8,1	1	1	9	9,2	8	7	-5	-5,4	56,2	56

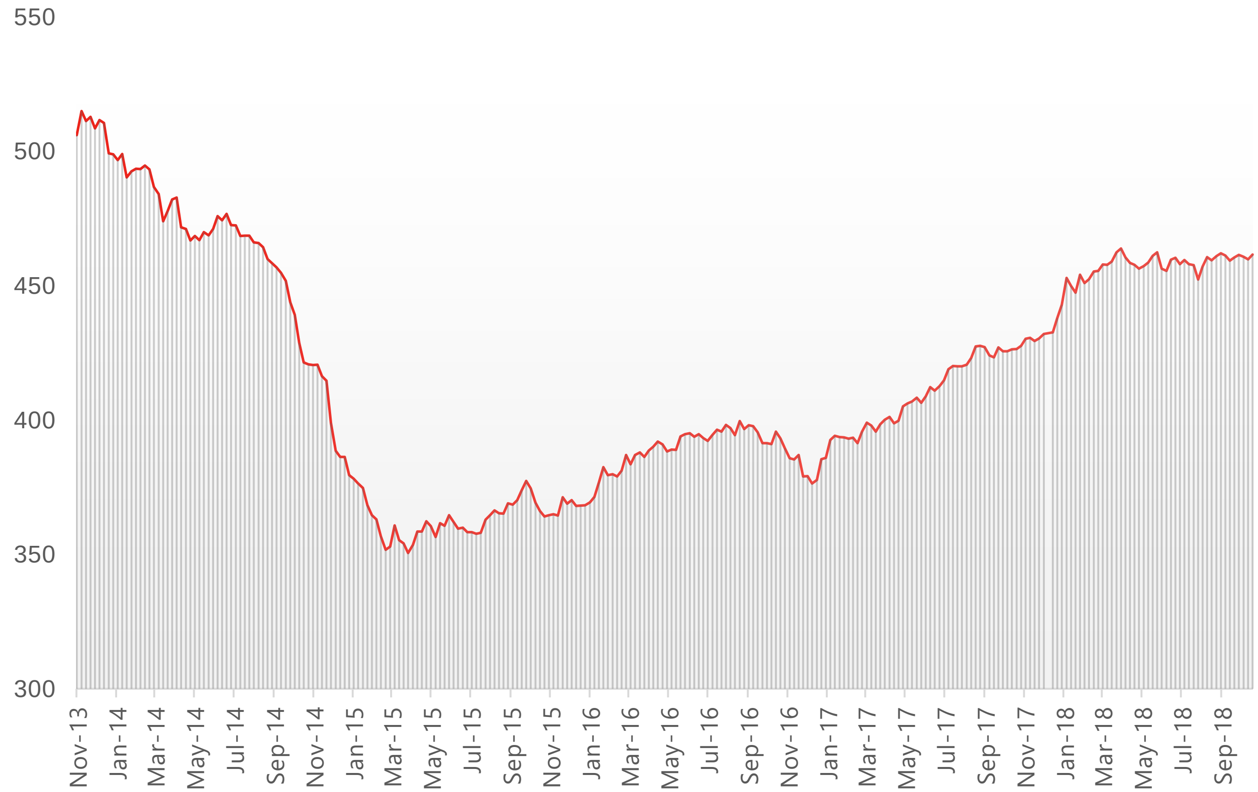
External indicators	Current account, % GDP		External debt, % GDP		Total reserves, $bln		Sov Eurobonds, Z-spread, bps	Credit rating
	2018E	2019E	2018E	2019E	2018E	2019E	Current	Current
Russia	**6,3**	**6,4**	**30**	**26,3**	**465**	**555**	**159**	**Ba1/BBB-/BBB**
Armenia	-3,8	-2,9	86,8	83	2,3	2,3	244,6	B1/-/B+
Azerbaijan	8,2	2,4	-	-	5,5	5,5	181,6	Ba2/BB+/BB+
Belarus	-2,5	-3,5	68,1	68,7	6,5	7,1	359	B3/B/B
Georgia	-9,4	-9,5	112	109	2,8	2,8	72,2	Ba2/BB-/BB-
Kazakhstan	-1,3	-2,9	101	98	90,7	92	88	Baa3/BBB-/BBB
Tajikistan	-0,4	-1	77,7	78,7	1,1	1	542	B3/B-/-
Ukraine	-1,7	-1,1	92,3	91	20	19	485	Caa2/B-/B-

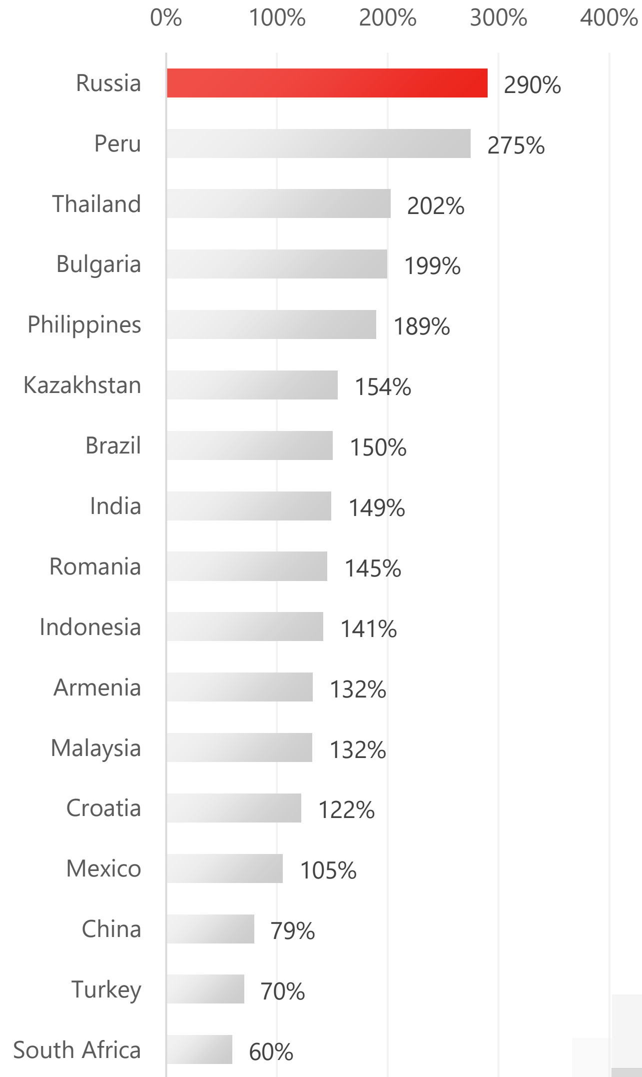
Monetary policy	Key rate		FX rate, aop		Inflation, YoY, eop	
	2018E	2019E	2018E	2019E	2018E	2019E
Russia	**7,5**	**7**	**64,5**	**67**	**3,7**	**4,3**
Armenia	6	6	482,2	484	3,5	3
Azerbaijan	10	9	1,7	1,7	4,5	7
Belarus	9,5	9	1,99	2,2	5,5	5,5
Georgia	7	6,5	2,6	2,6	2,5	3,5
Kazakhstan	9	8,5	345	355	6	5,5
Tajikistan	14	10	9,2	9,5	4,5	5,5
Ukraine	17,5	14	27,1	30	11,5	8

Source: National statics agencies, IMF, ITI Capital

Solvency ratio: Assessing Reserve Adequacy

Russia's reserve adequacy ratio (total reserves/foreign short-term liabilities) is 290% - the world's highest. The country's total reserves, including gold, have grown in the past four years by over $100bln, thanks to MinFin FX purchases, increased gold and euro exposure, repayment of FX liabilities to CBR.

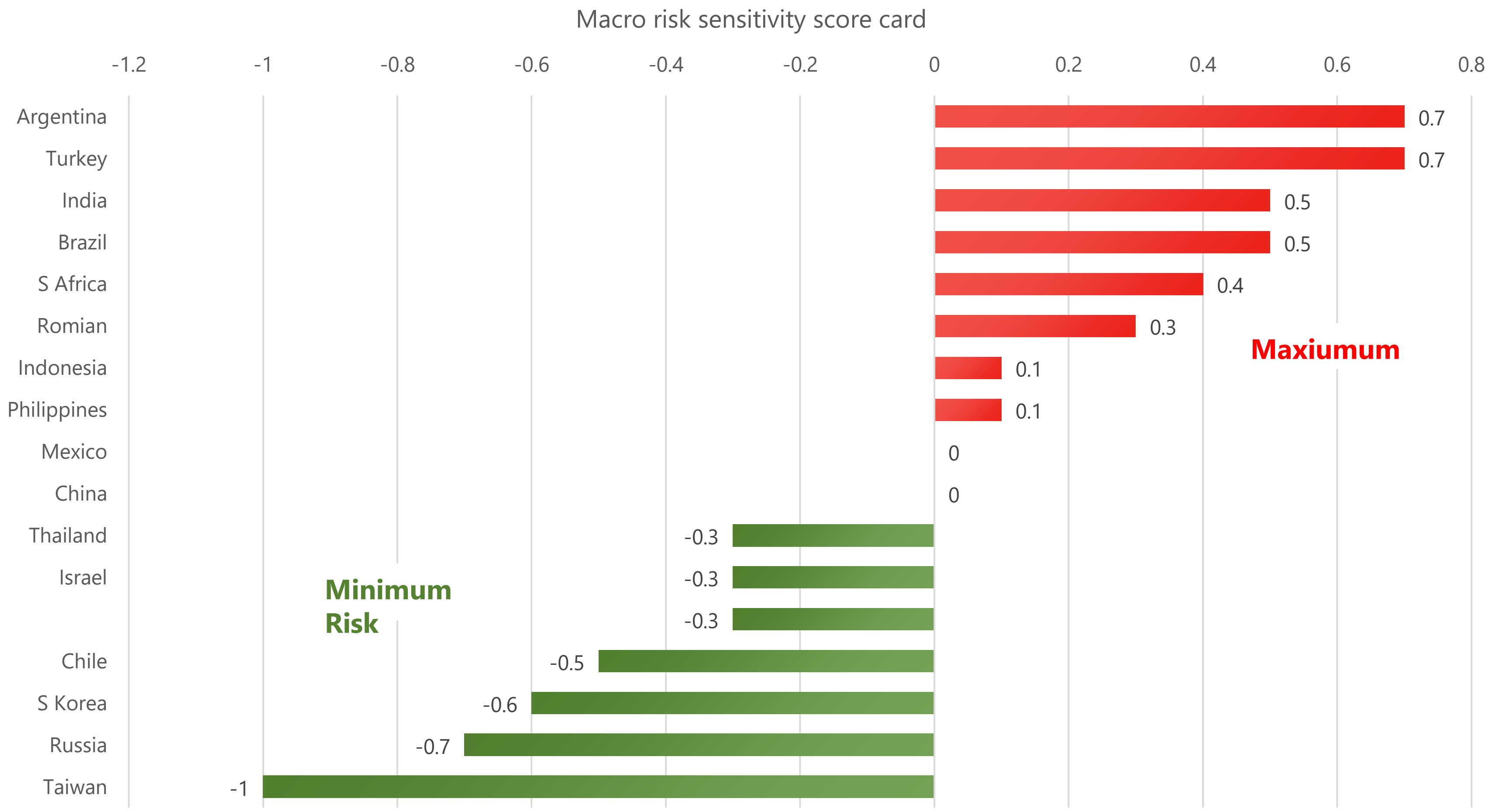




Source: IMF, CBR, ITI Capital

Macro risk assessment

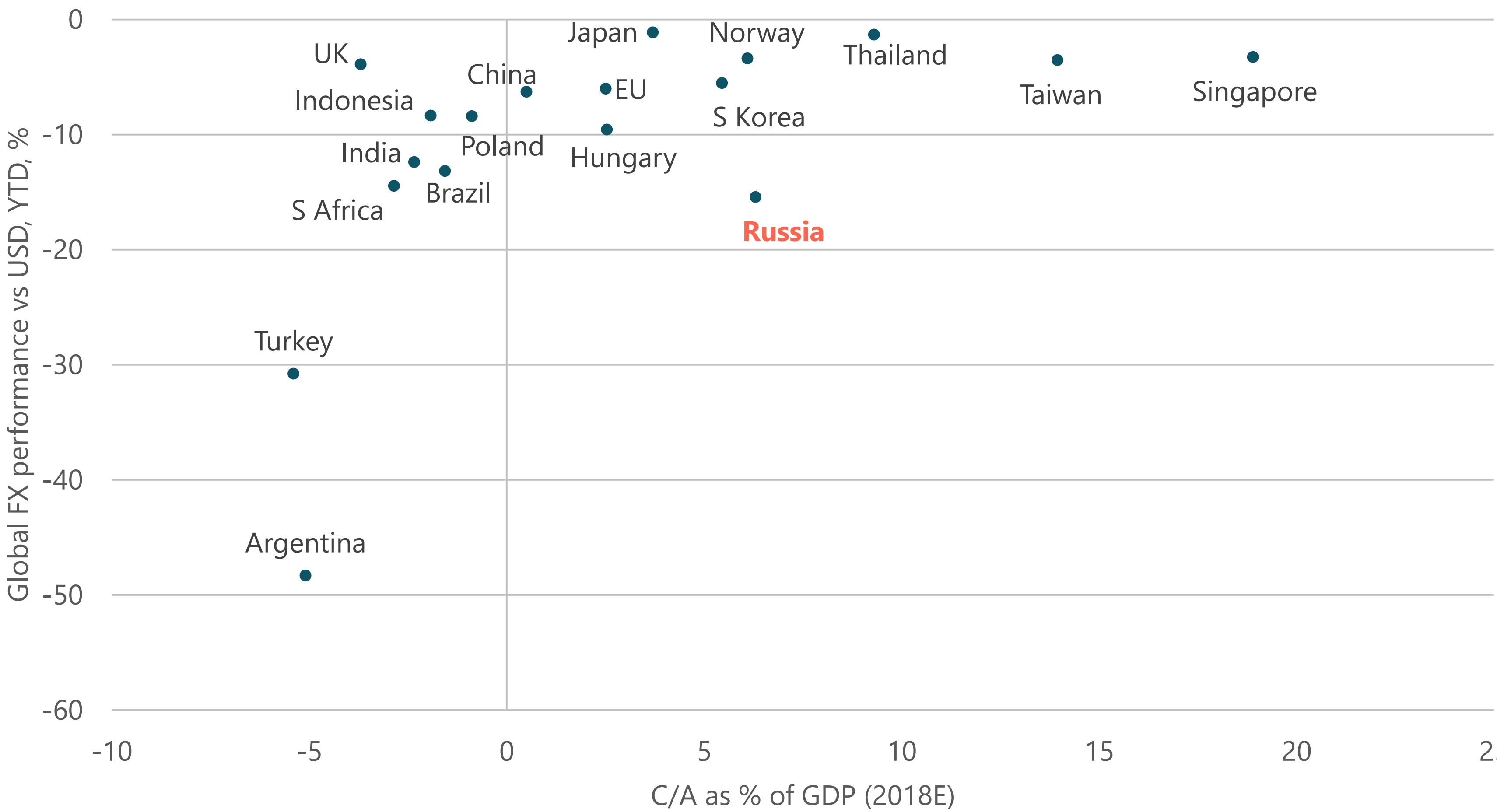
Russia's macro risk assessment, based on level of inflation, current account, fiscal balance, public debt percentage of GDP, reserve adequacy ratio and higher rating in the World Bank's Doing Business ranking, is one of the lowest in the world.



Source: IMF, CBR, ITI Capital

Russian ruble is ignoring fundamentals

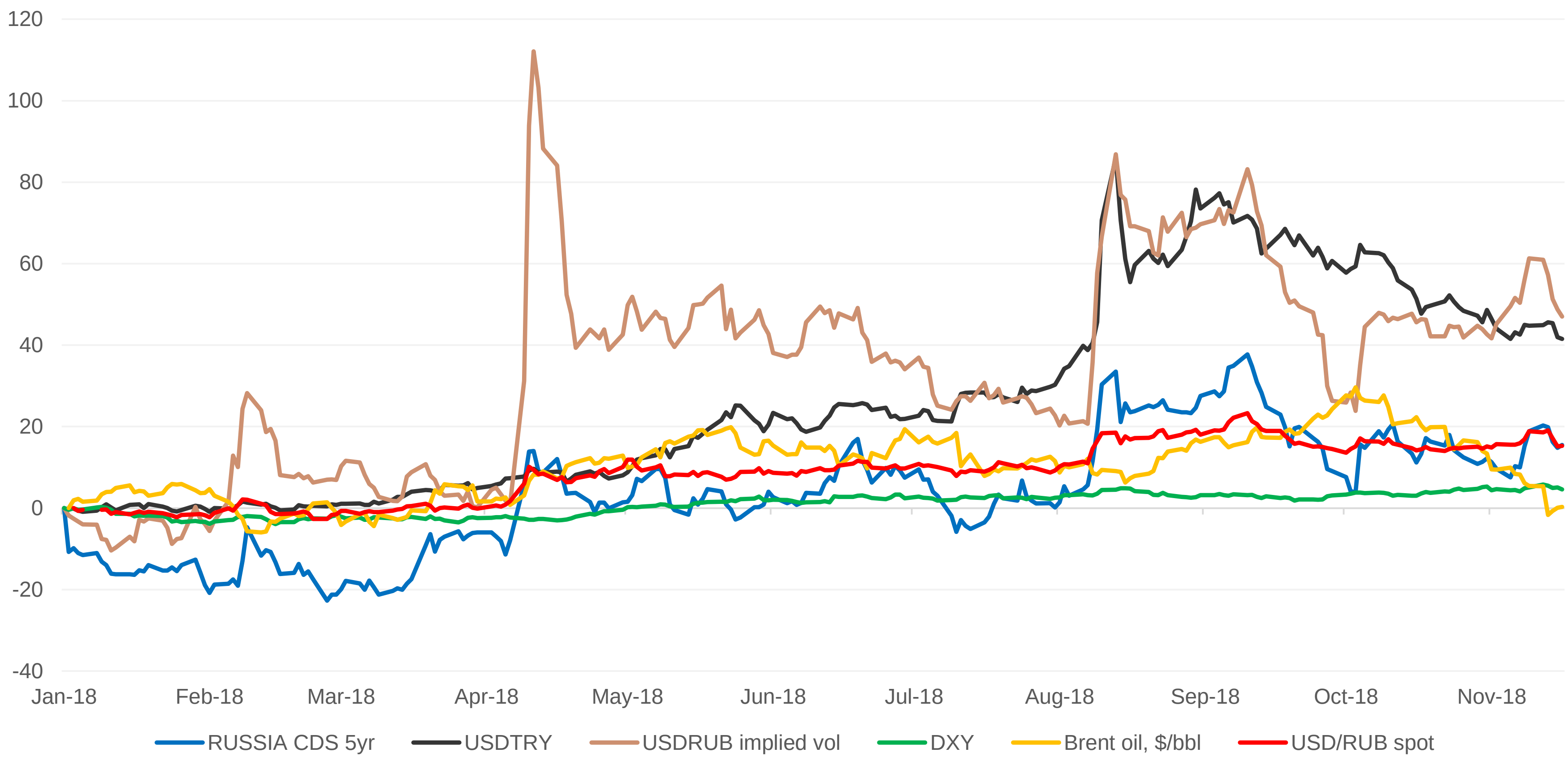
Based on macro risk assessment and the current account balance, Russian ruble should have be trading 10% stronger vs US dollar – its underperformance was a reflection of additional risk premium.



Source: ITI Capital, IMF, CBR

Russian FX performance could have been worse

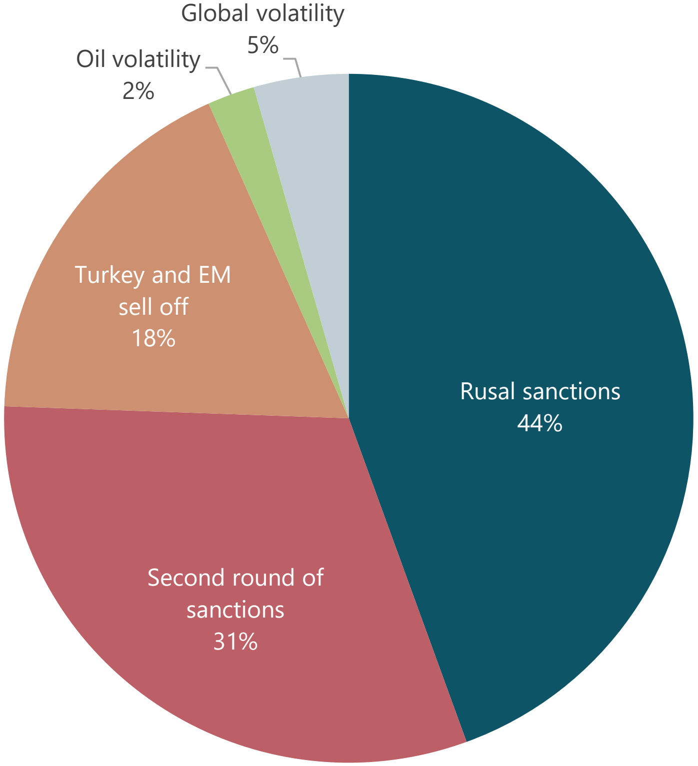
Russian ruble was severely pressured by three major developments: the SDN sanctions, imposed on Rusal in April; the second round of US sanctions, announced in August; the high EM volatility.



Source: ITI Capital, Bloomberg

Structure of Ruble volatility

The key factors behind the higher ruble volatility and additional risk premium

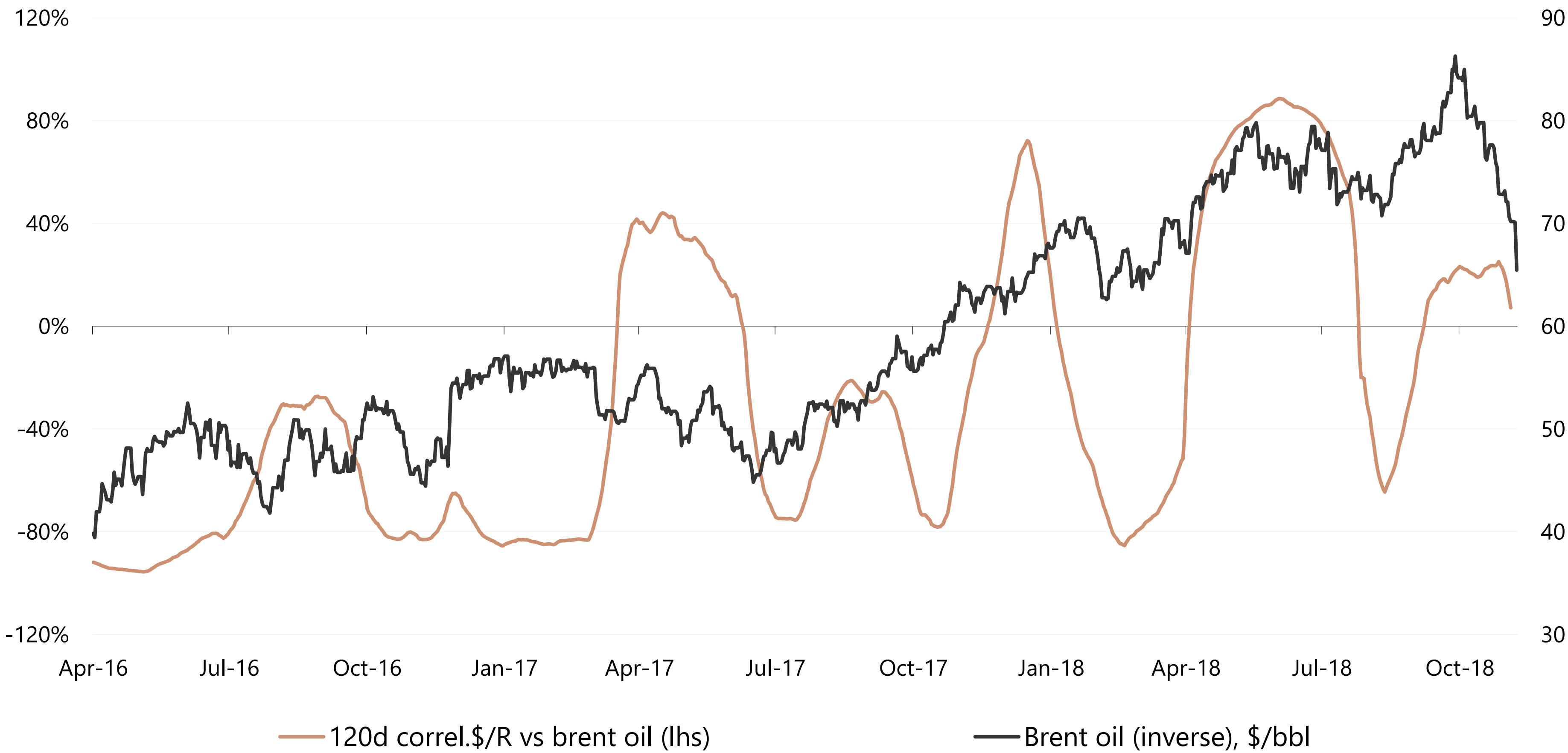


Global equities	30d correlation, %
USA vs EM	21
USA vs EU	-7
Europe vs EM	67
EM vs Russia	51
MSCI World vs MSCI Asia	65
FX market	
USDRUB vs EM FX	-54
USDRUB vs USDTRY	45
USDRUB vs USDBRL	37
USDRUB vs USDZAR	38
USDRUB vs EUR	-16
Oil	
USDRUB vs Brent oil	-20

Source: ITI Capital, Bloomberg

USDRUB vs Oil correlation

Correlation between USD/RUB and oil prices is very low because of high volatility: the current 120-day correlation has sunk below 10% and tends to go still lower.



Source: ITI Capital, Bloomberg

EM Currencies vs Oil Prices

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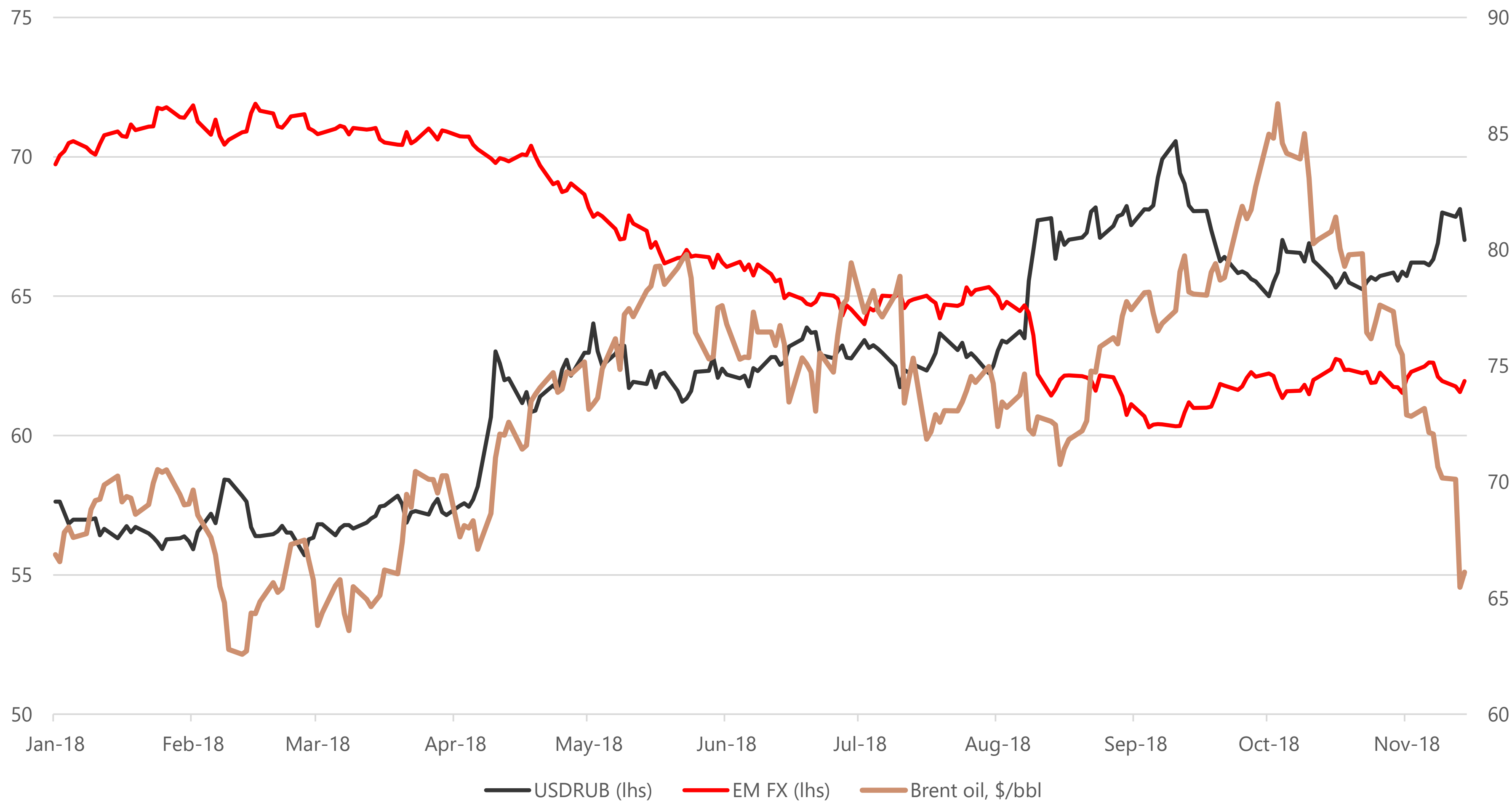
Russian ruble's weak correlation with the oil prices is not unique – other EM currencies tend to ignore Brent as well.

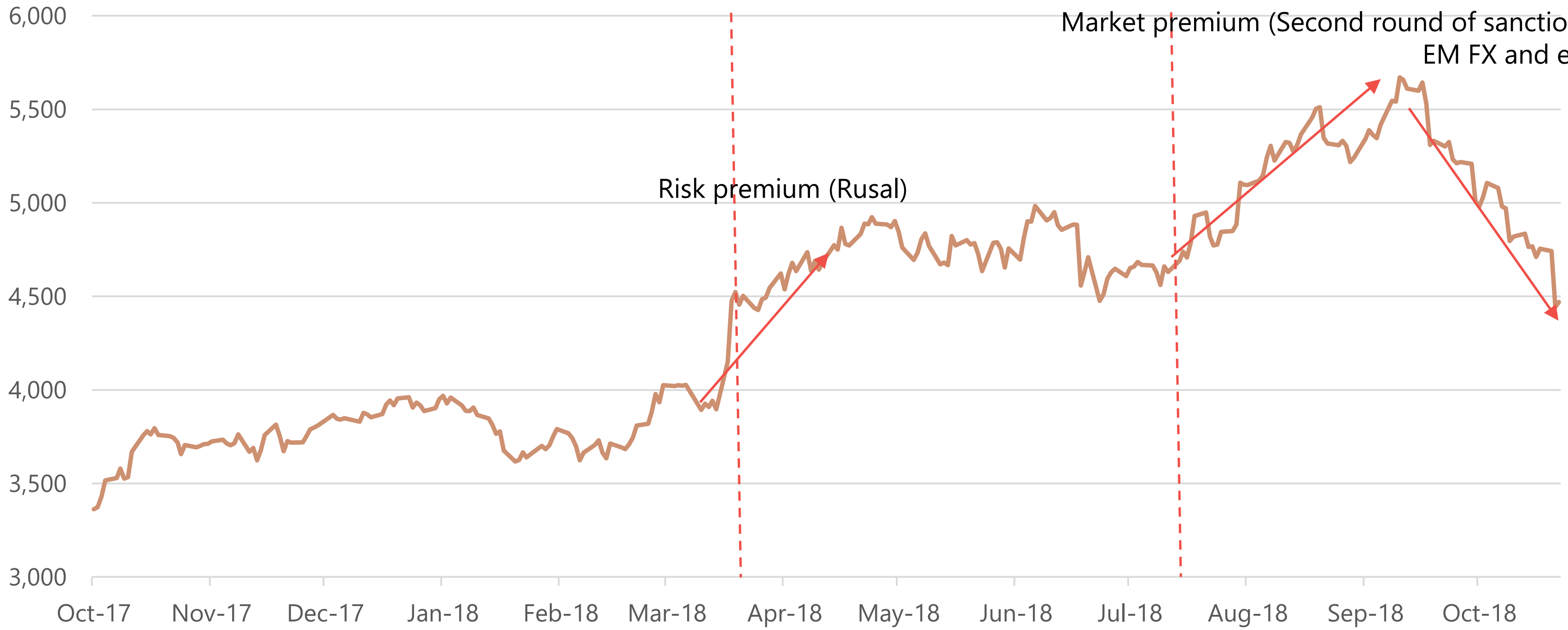


Source: ITI Capital, Bloomberg

Oil Price in Rubles Reaches Fair Levels

Despite ruble's weakness, Brent is now trading at fair levels in the Russian currency – thanks to the postponement of the new round of sanctions. That implies that the ruble's exchange rate is approaching a fair level. Improving market efficiency of ruble will support correlation.

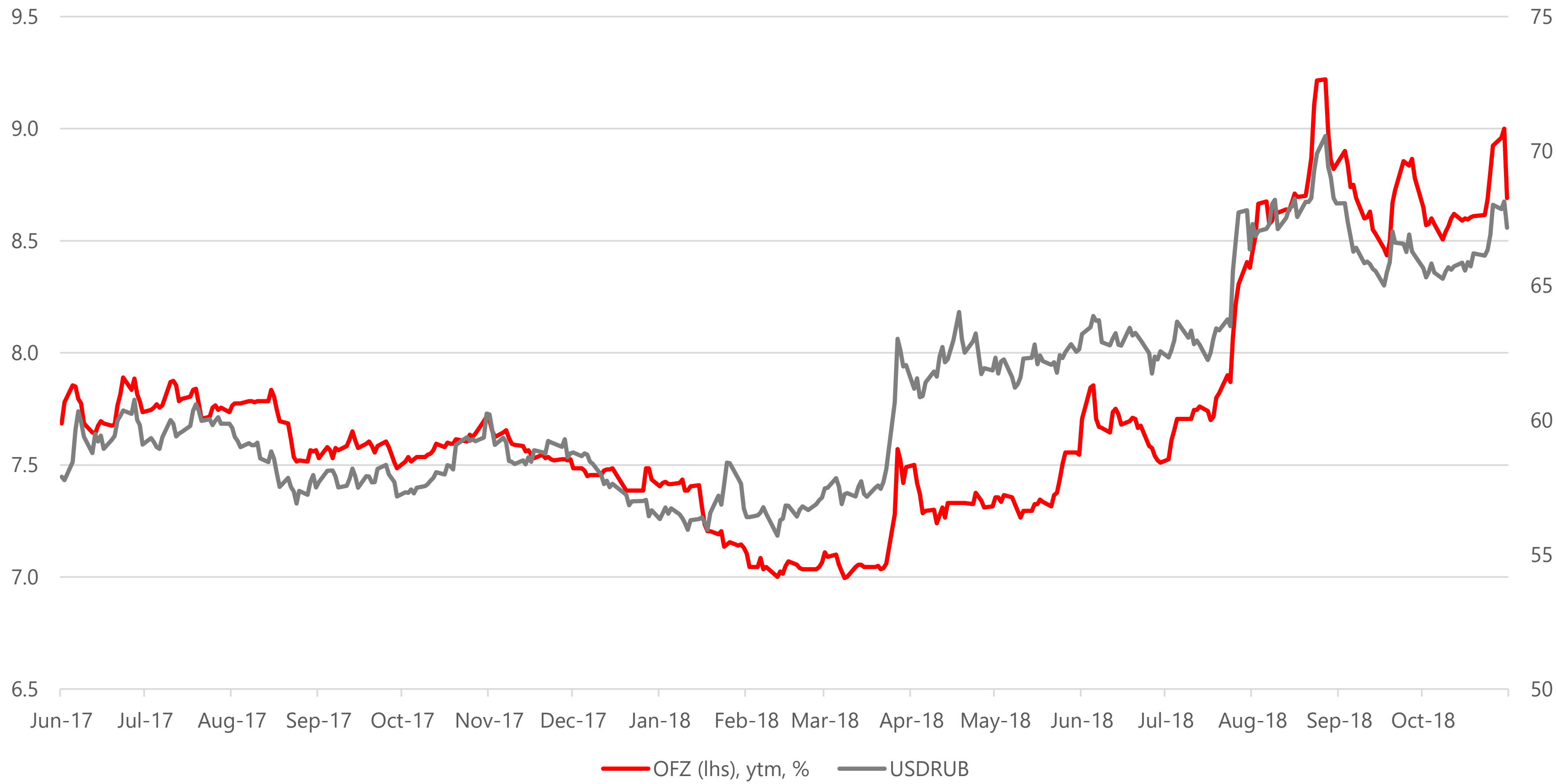
Scenario analysis									
Brent oil, $/bbl	45	50	55	60	65	70	75	80	85
USD/RUB	77	73	70	68	67	66	64	62	61
EUR/RUB	87,8	83,2	79,8	77,5	76,4	75,24	73,0	70,7	69,5



Source: ITI Capital, Bloomberg

Ruble Weakness Spurs Government Bond Yield Higher

Long-term Russian government bond (OFZ) yield grew by 2 percentage points from the 1Q18 lows, reaching a peak in early September.



Source: ITI Capital, Bloomberg

Russian Government Bond (OFZ): Capital Outflow Slowdown

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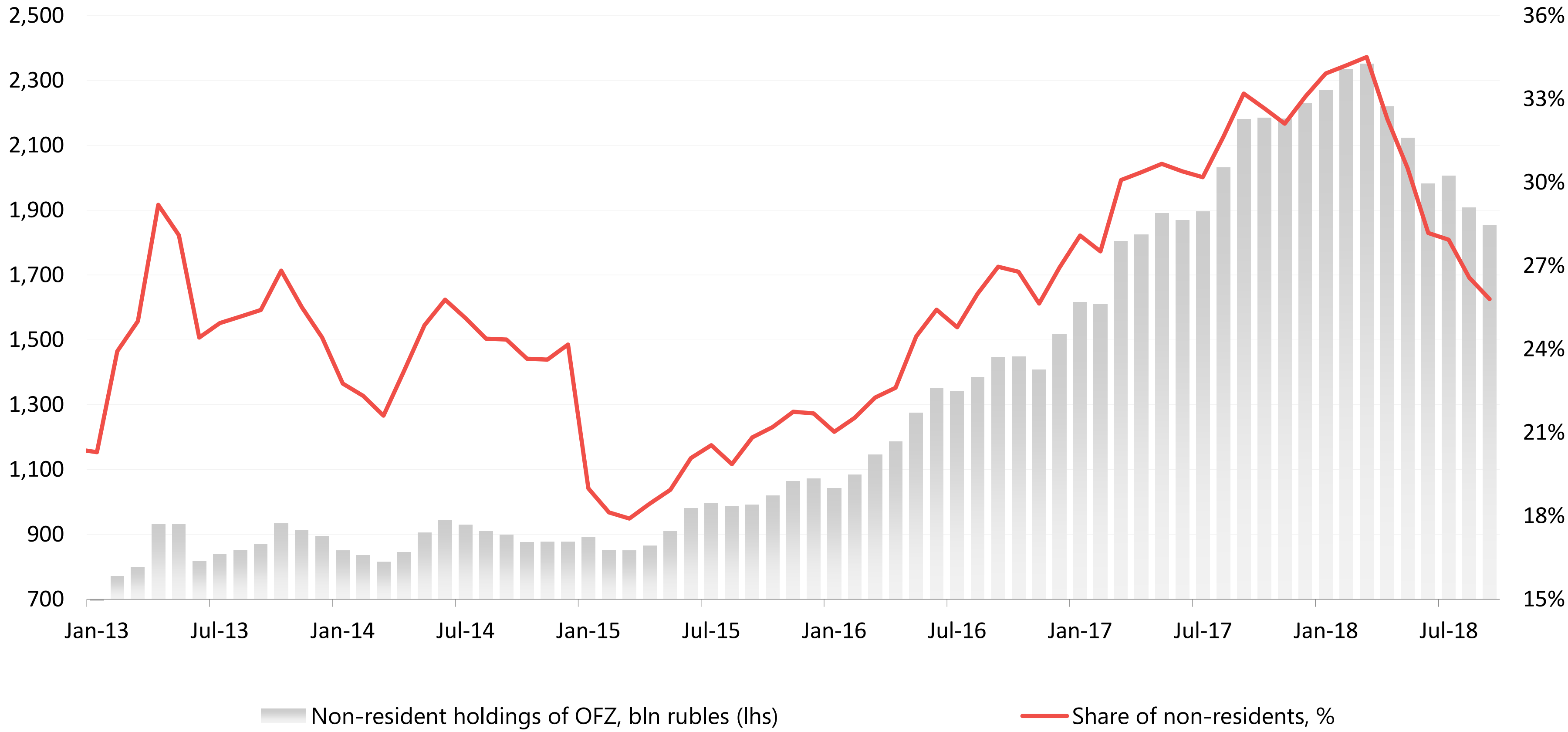
The foreign Capital outflow from the OFZ market has slowed down – since September the foreign investors' total portfolio has decreased by just a little over 50bln rubles.
Their share in the market currently stands at just above 25%, with the aggregate holding down to the two-year low of 1.8trln rubles ($27bln), the lowest since July 2016.



Source: CBR, ITI Capital, Bloomberg

OFZ Yield Curve: 90-100bp Slide In The Offing

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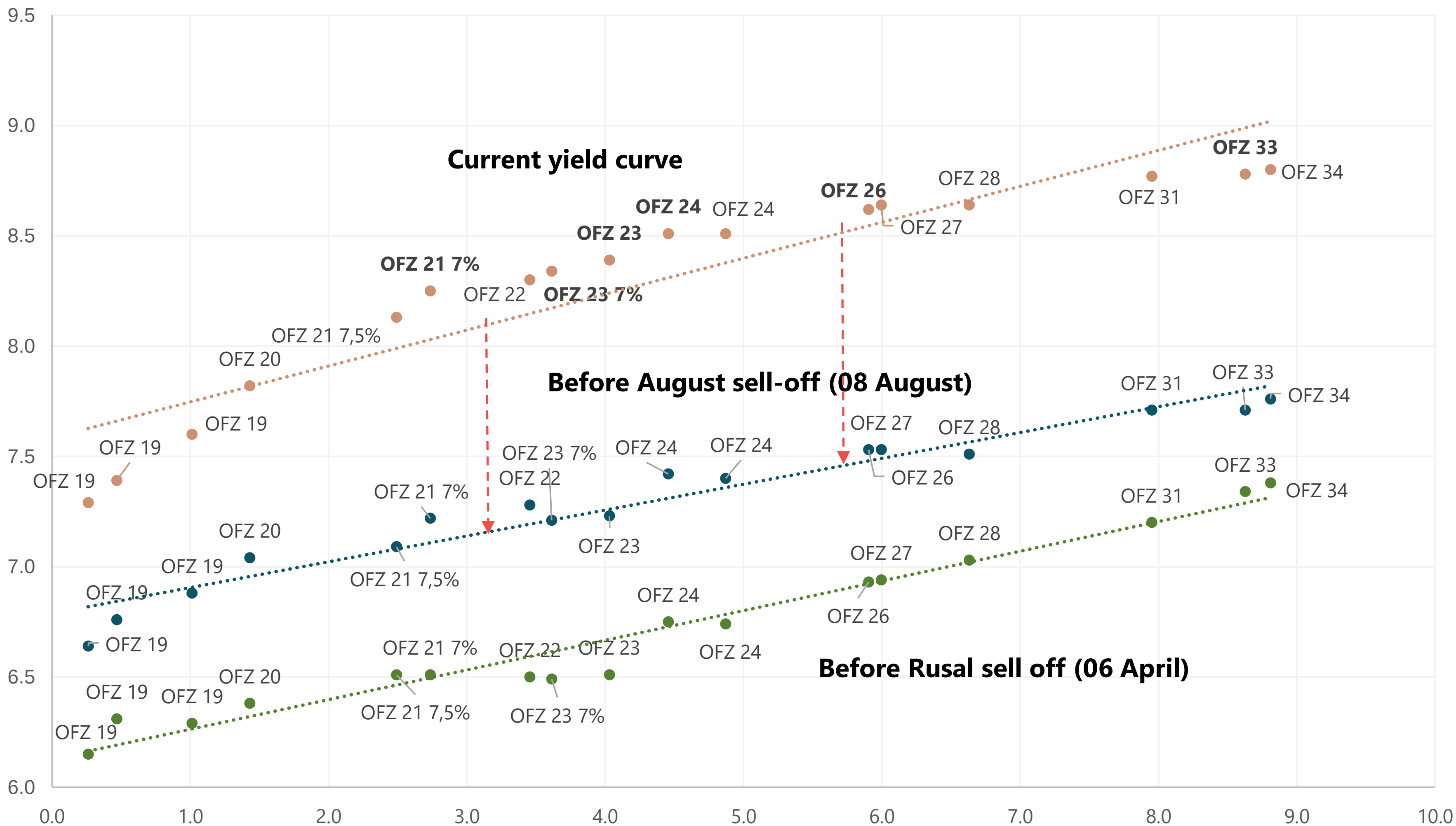


Source: ITI Capital, Bloomberg

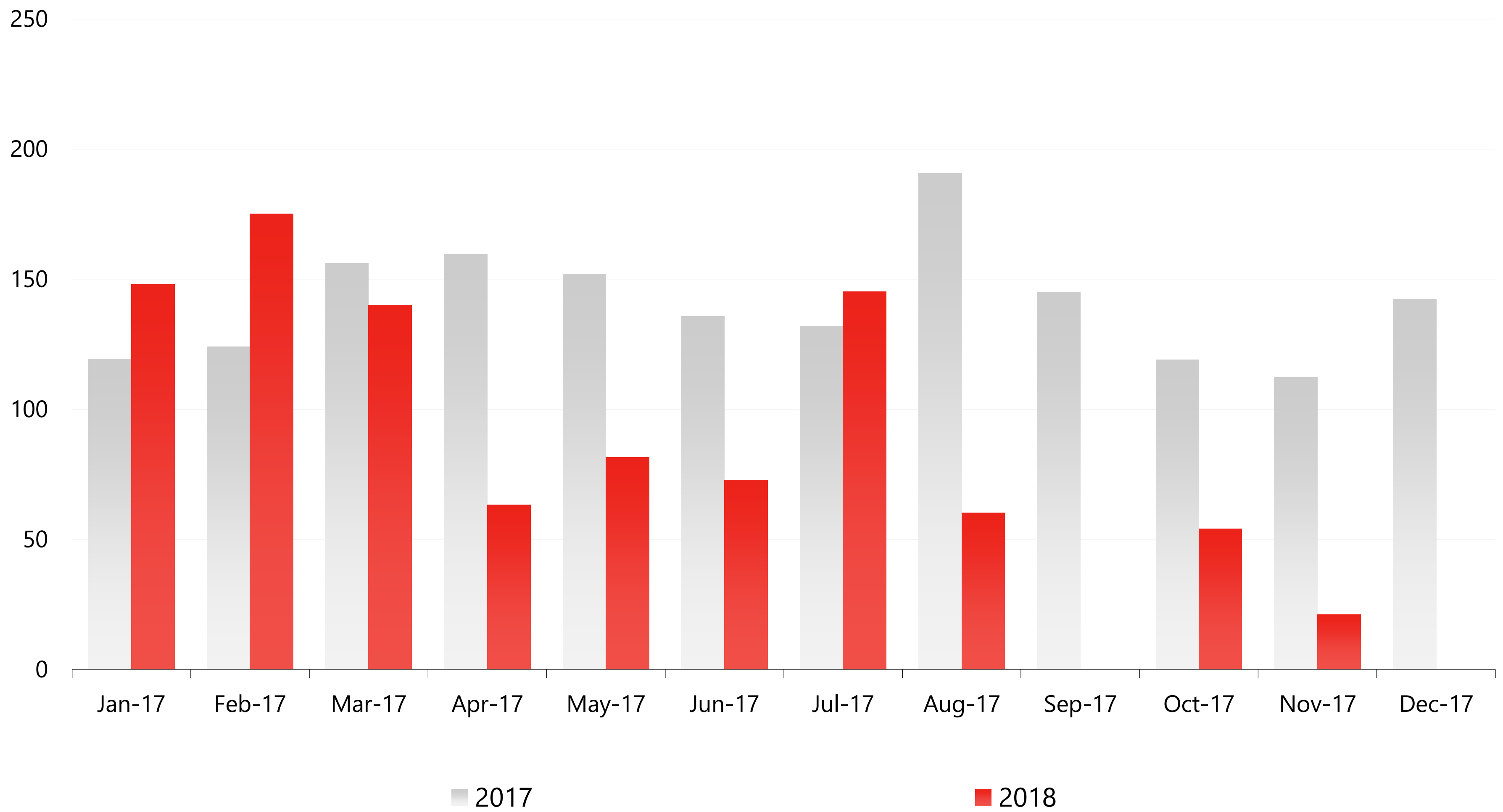
OFZ: Trade recommendations

Ticker	Name	Outstandi ng, $mln	Coupon	maturity	PX_LAST	YTM, %	Mod.durati ons,yrs	Price upside, % (Before August selloff)	Price upside, % (Before April selloff)	Yield upside, b.p (Before August selloff)	Yield upside, b.p (Before Rusal selloff)
EJ8422747 corp	OFZ 23	250 000	7	16.08.2023	95,203	8,39	4,03	4,6%	7,8%	-116	-188
AN4153895 corp	OFZ 24	350 000	7,1	16.10.2024	94,398	8,51	4,87	5,0%	8,5%	-111	-165
AP6275485 corp	OFZ 21	323 198	7	15.12.2021	97,083	8,25	2,73	2,7%	5,0%	-103	-188
AR4276549 corp	OFZ 24	203 106	6,5	28.02.2024	92,152	8,51	4,45	4,6%	7,8%	-109	-164
LW5541799 corp	OFZ 26	350 000	7,75	16.09.2026	95,886	8,62	5,90	6,5%	10,5%	-109	-146
AM3604130 corp	OFZ 22	350 000	7,4	07.12.2022	97,421	8,3	3,45	3,6%	6,8%	-102	-189
AM8549157 corp	OFZ 33	350 000	7,7	23.03.2033	92,68	8,78	8,63	9,1%	12,7%	-107	-105
Average								**5,2%**	**8,4%**	**-108,1**	**-163,6**

OFZ-28 spread over US Treasuries

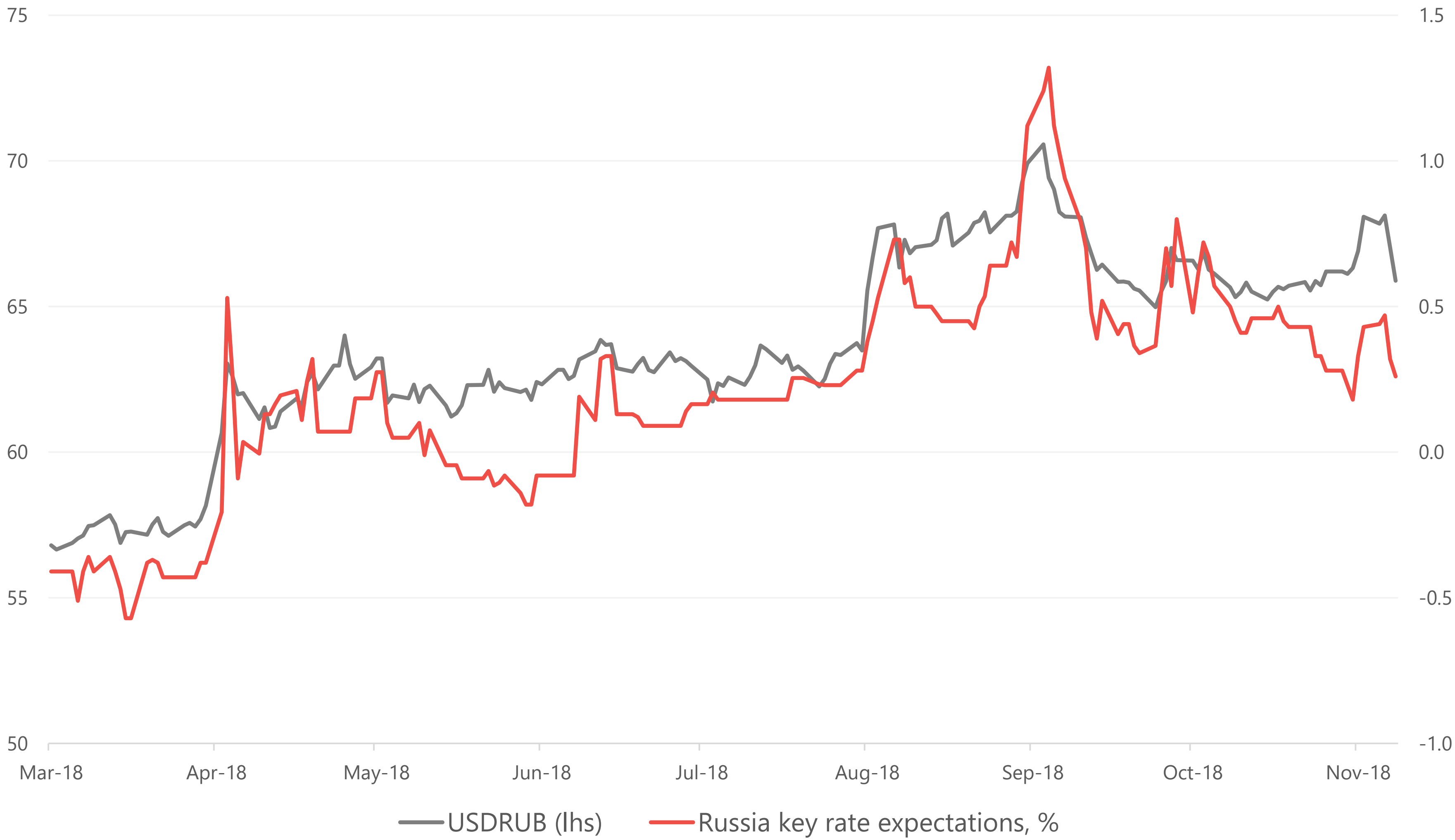
Source: ITI Capital, Bloomberg

OFZ total issuance, bln rubles



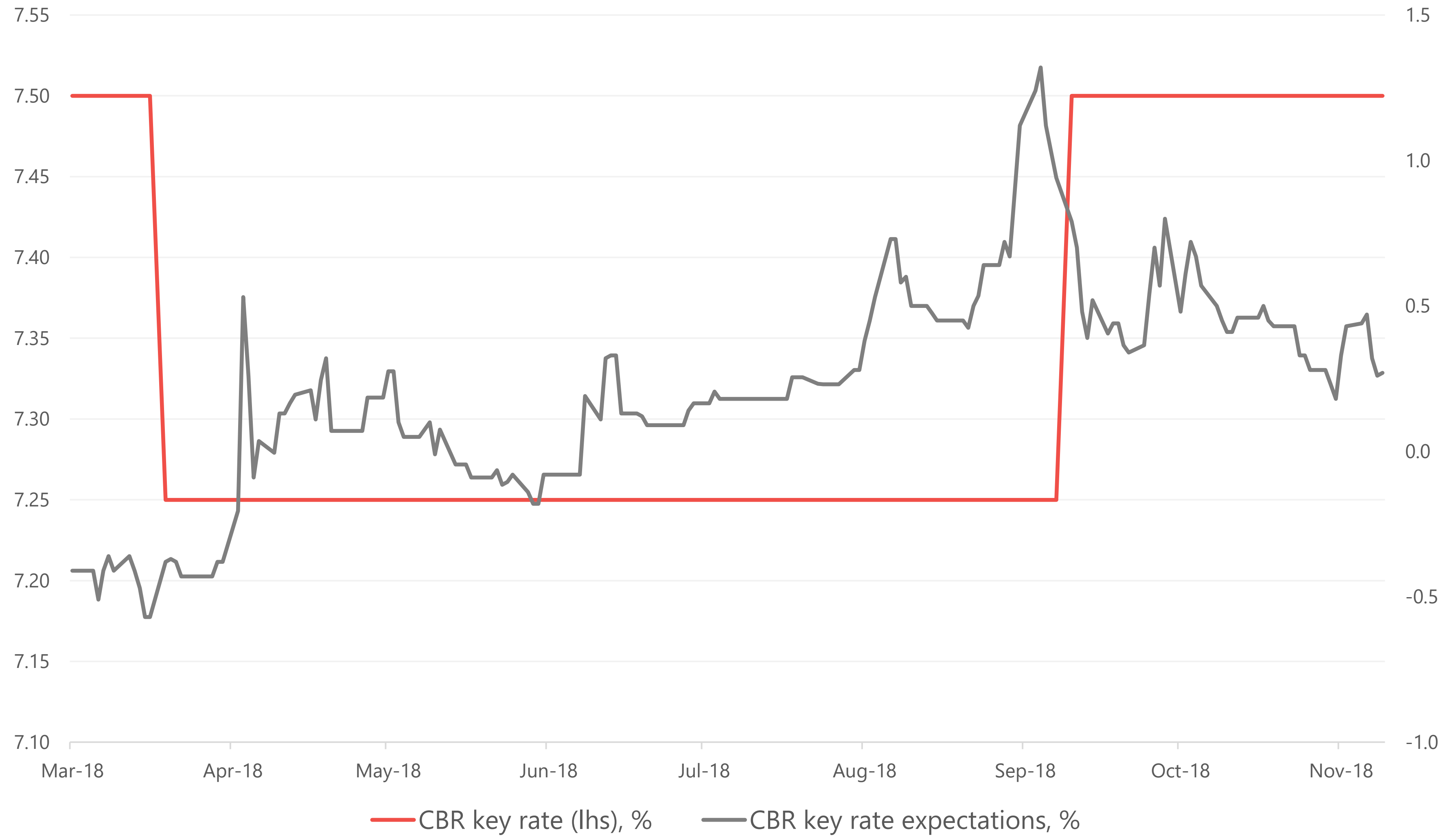
Source: Ministry of Finance RF, ITI Capital, Bloomberg

Russian Policy Rate Expectations Driven by FX Market Volatility



Source: ITI Capital, Bloomberg

Bank of Russia Policy Rate: Actual Levels and Expectations



Source: ITI Capital, Bloomberg

Local Rates Range-Bound, %

Source: ITI Capital, Bloomberg

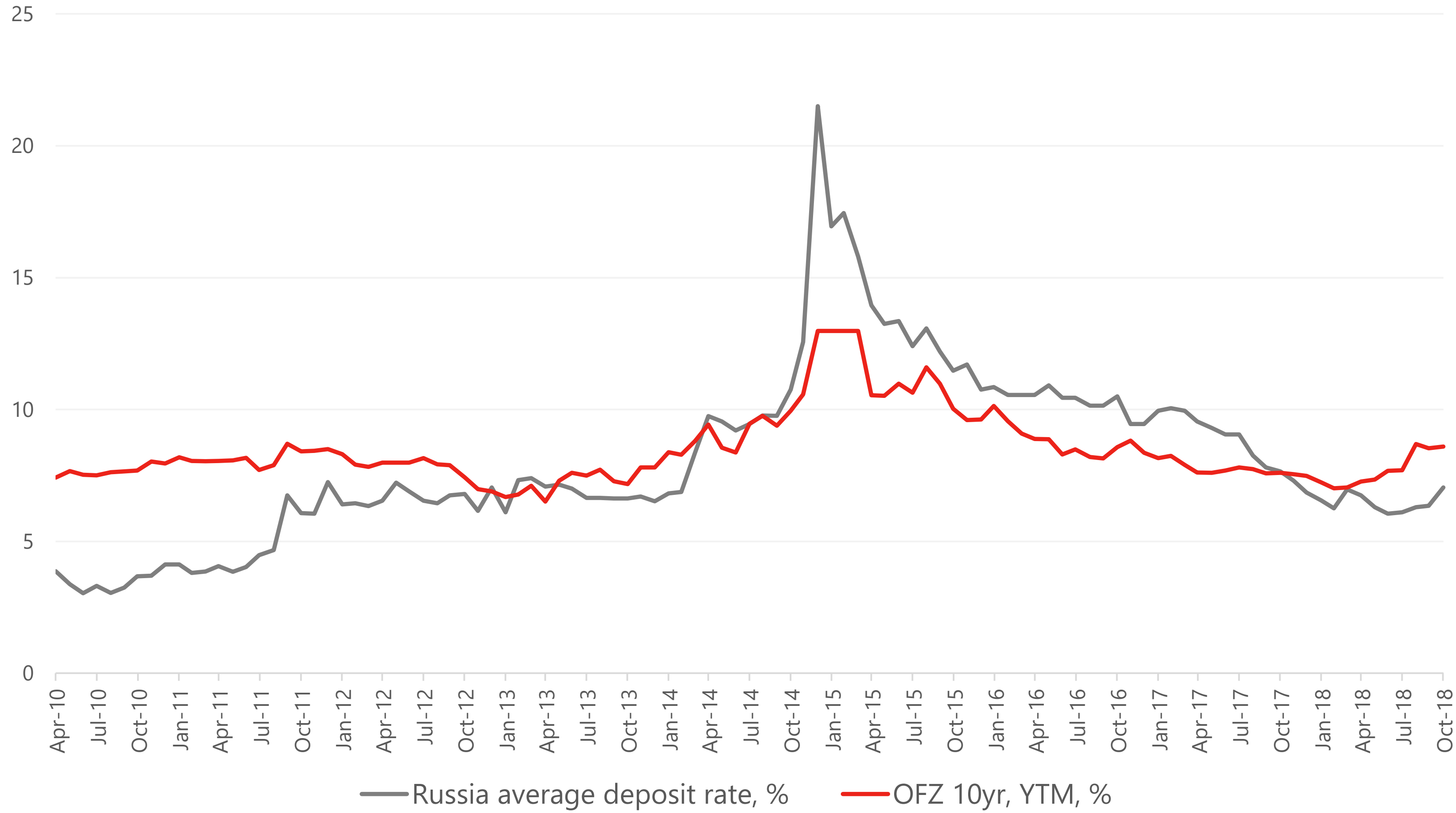
Market Indicators of Russian Policy Rate

One of the most important policy rate indicators is the USD/RUB implied volatility.

Source: ITI Capital, Bloomberg

OFZ Yields Exceed Average Deposit Rate

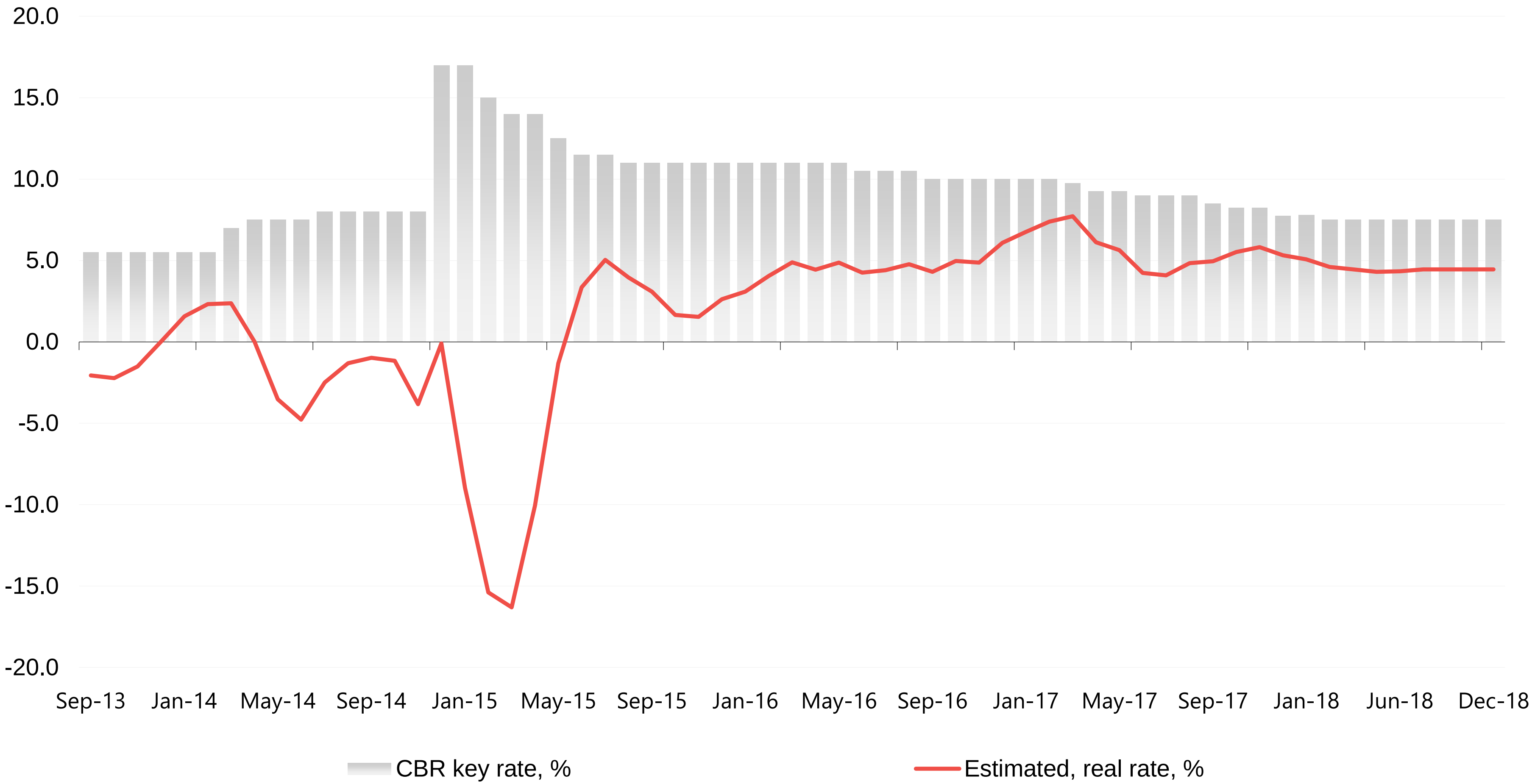
One of the reasons why local banks are buying the Russian government bonds is that the return on this investment exceeds funding costs, because the bond yield to maturity is higher than the average deposit rate.



Source: ITI Capital, Bloomberg

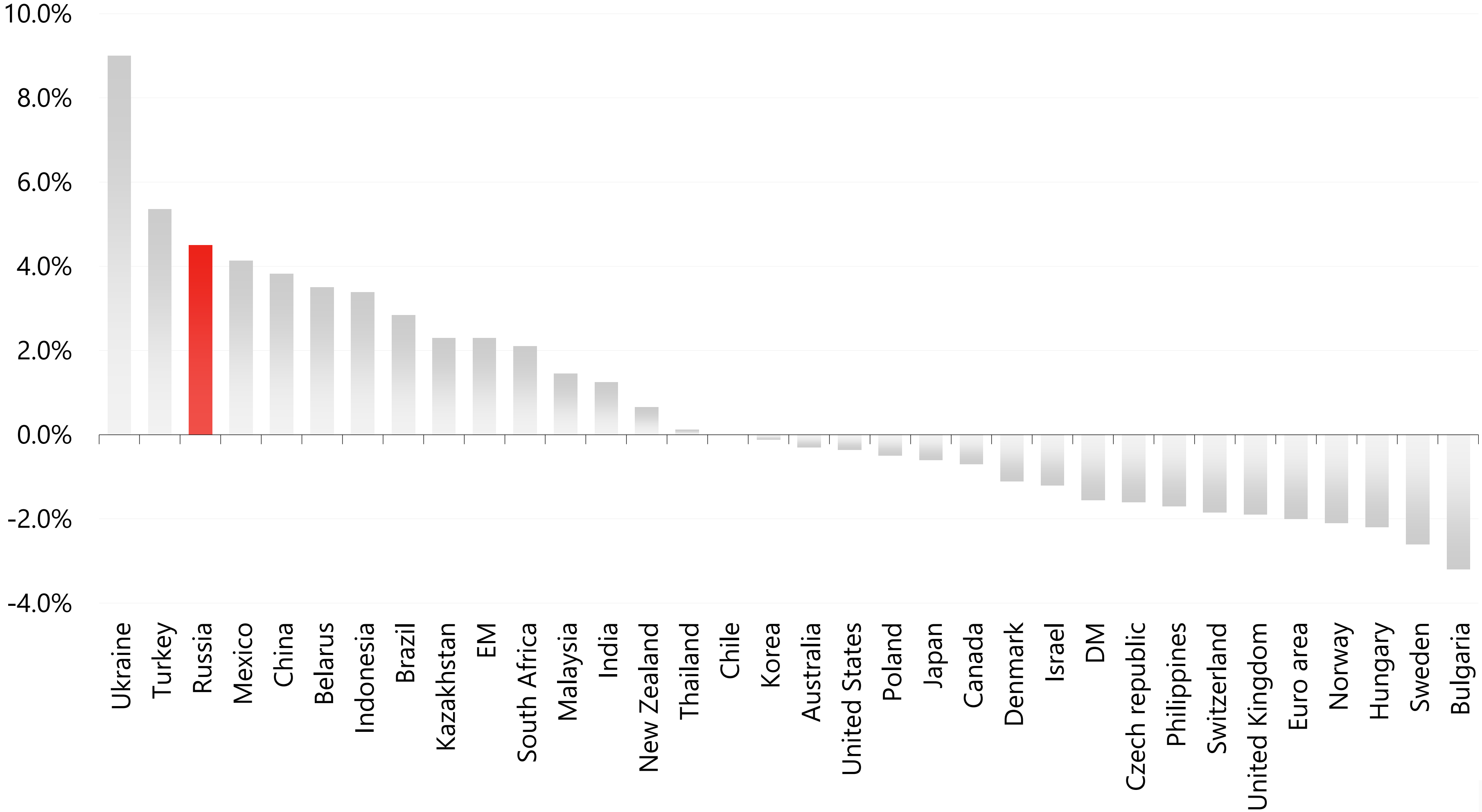
Carry Trade

Russia offers the best carry trade if its moderate inflation and stable economic growth are taken into account.



Source: CBR, ITI Capital, Bloomberg

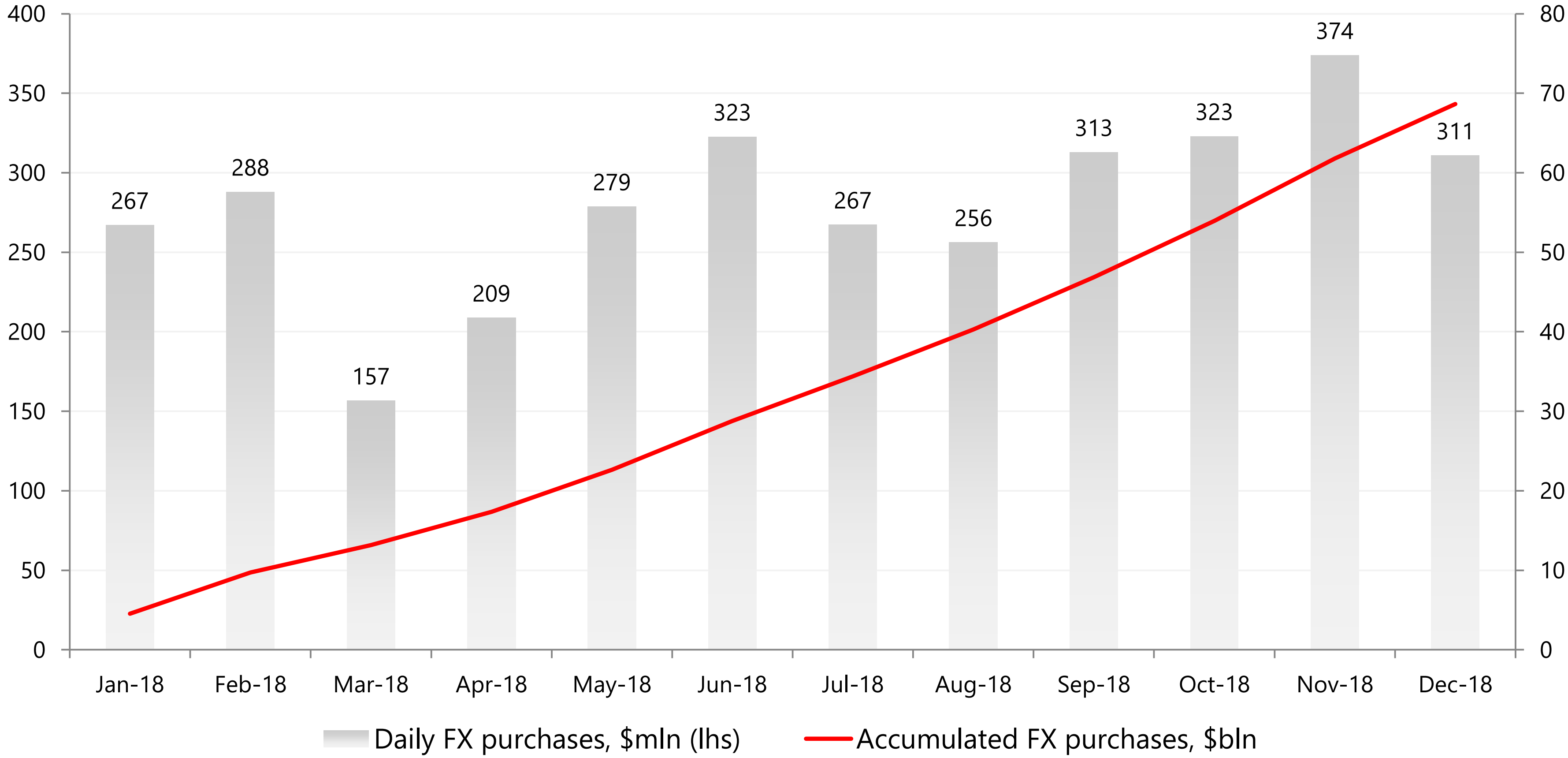
Superior Carry Trade with Moderate Inflation



Source: CBR, ITI Capital, Bloomberg

Finance Ministry's FX Purchases

Higher oil prices enabled Finance Ministry to step up FX purchases – the total volume could reach $70bn this year, but only $37bn were purchased on the open market.



Source: Ministry of Finance RF, ITI Capital, Bloomberg

Finance Ministry’s FX Purchases: Key Theme for 2019

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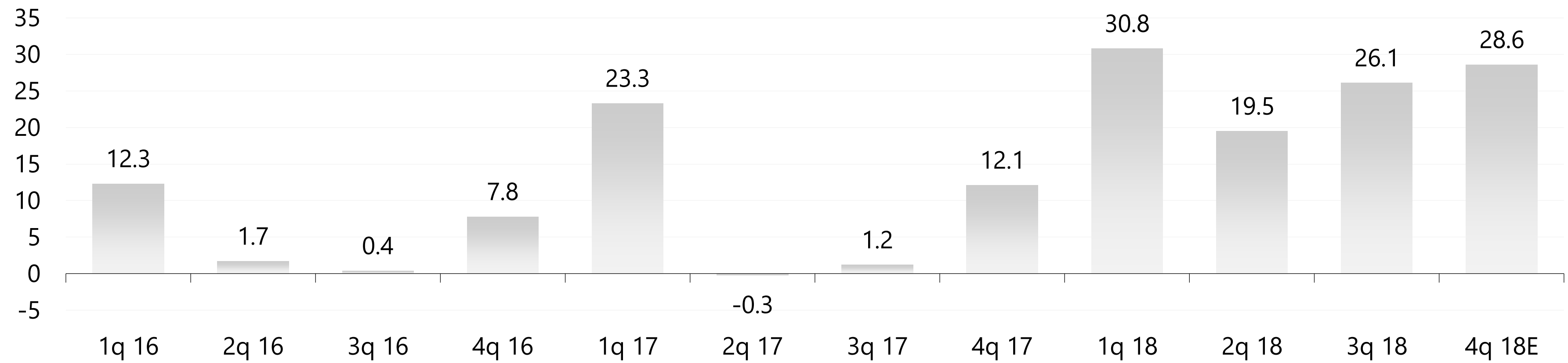
- Finance Ministry’s FX interventions coincided with a spike in FX volatility and drew much attention though their volumes were rather limited – just $250-300mln a day.
- We estimate the total volume to be just under $70bn, including December purchases, which still have to be announced – we think, in December the ministry is to buy around $6.8bln, or $310mln a day. So far the highest volumes were announced for November – almost $8bln ($374mln a day).
- In August Russia’s central bank had to suspend buying FX on the open market. By that moment it had purchased just $2.8bln out of the previously announced $5.8bln. Since then Finance Ministry’s demand for foreign currency has been satisfied at the expense of the central bank’s balances and it is supposed to be so till the end of the year. Thus, out of the total amount of Finance Ministry FX purchases just $37bln was bought on the open market and $33bln is to be bought off CBR’s balances.
- Open market operations involve Finance Ministry transferring rubles, received from corporate taxpayers, to the central bank, which then uses the money to buy US dollars on Moscow Exchange at market rates.
- Non-market purchase of FX means that CBR still gets the rubles from the Finance Ministry, but doesn’t spend them to buy dollars on the open market, i.e. the rubles do not end up on the balance of local banks selling FX to the central bank. So, the Russian lenders have to look for rubles elsewhere and this puts pressure on the available ruble liquidity. Bank of Russia records the FX purchase as an increase in FX liabilities to Finance Ministry, lowering ruble liabilities to local commercial banks, which use more liquidity from CBR deposits (the rubles deposited with the commercial banks).
- We expect the $33bn, purchased this year from CBR without recourse to the open market, will be bought in the open market in the next couple of years with the whole amount distributed evenly. It would mean additional purchases of $1bln per month in the open market. However, this scenario would be subject to the levels of FX volatility and the new US sanctions, which are expected to be imposed on Russia by the end of 1Q19.

Current account and FX flows, $bln

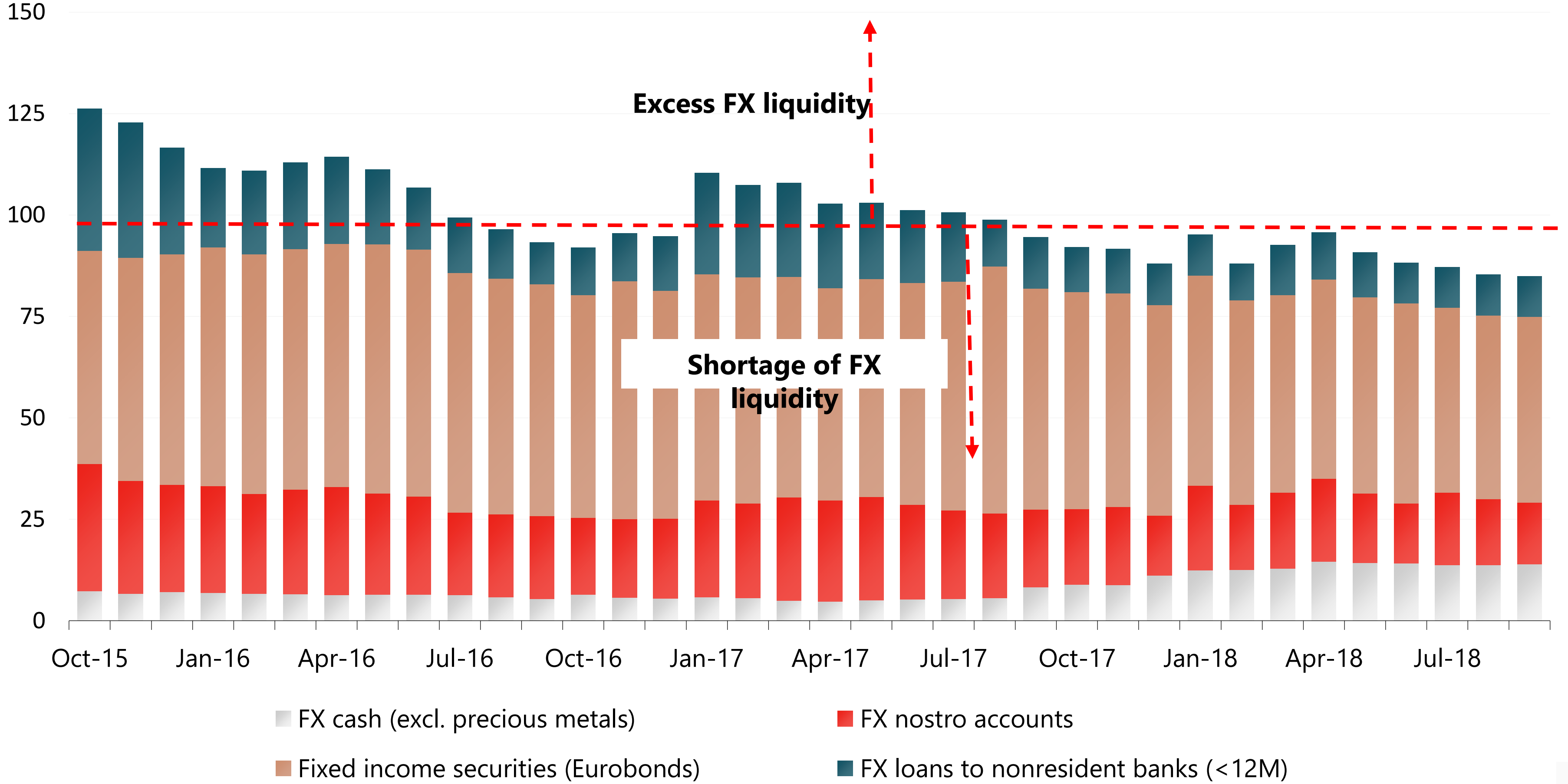
	Jan 18	Feb 18	Mar 18	Apr 18	May 18	June 18	July 18	Aug 18	Sept 18	Oct 18	Nov 18	Dec 18
Current account, $ bln	**13,3**	**7,8**	**9,7**	**7,0**	**6,0**	**6,5**	**8,0**	**9,0**	**9,1**	**12,1**	**8,0**	**8,5**
Net debt payments, $ bln.	**-2,0**	**-5,4**	**-2,9**	**-4,1**	**-6,2**	**-3,3**	**-9,9**	**-4,0**	**-4,0**	**-3,8**	**-4,8**	**-6,4**
Financials	-0,3	-2,6	-0,8	-0,8	-4,8	-0,9	-5,2	-2,0	-0,7	-1,9	-3,3	-0,7
Corporates	-1,6	-2,8	-2,1	-3,3	-1,4	-2,4	-4,7	-2,0	-3,3	-1,9	-1,5	-5,7
Minfin interventions	-4,5	-5,2	-3,4	-4,2	-5,3	-6,1	-5,6	-2,5				
OFZ outflows	0,7	1,1	0,3	-2,1	-1,6	-2,2	0,4	-1,5	-1,8	-1,0	-0,1	-0,2
Loans	0,5	0,5	0,5	0,5	0,5	0,5	0,0	1,0	-8,4			
Net FX balance	**12,0**	**3,5**	**7,1**	**0,8**	**-1,8**	**0,9**	**-1,5**	**3,5**	**3,4**	**7,3**	**3,1**	**1,9**
	1,4	-0,1	-0,8	-5,8	0,6	-0,3	0,2	-5,0	0,5	2,5	-0,5	1,0
Total debt, $ bln	**-15,0**	**-9,0**	**-5,2**	**-7,7**	**-8,1**	**-6,6**	**-15,4**	**-8,9**	**-10,3**	**-5,9**	**-6,7**	**-12,4**
Financials	-0,4	-2,9	-0,9	-0,8	-5,4	-1,0	-5,8	-1,3	-0,8	-2,1	-3,7	-0,8
Corporates	-14,6	-6,1	-4,2	-6,8	-2,7	-5,6	-9,6	-7,6	-9,6	-3,8	-3,1	-11,7
Share of refinancing, %	86,8%	40,0%	43,0%	46,9%	23,5%	49,9%	35,7%	54,9%	61,6%	35,6%	28,2%	48,7%
Brent Oil, $/bbl	66,87	69,05	65,78	70,27	75,17	79,44	74,25	77,42	82,72	80	70	70
USD/RUB	**56,2**	**56,3**	**57,1**	**63,0**	**62,4**	**62,7**	**62,5**	**67,5**	**67,0**	**64,5**	**65,0**	**64,0**



Source: CBR, ITI Capital, Bloomberg

Estimates of short term FX liquidity

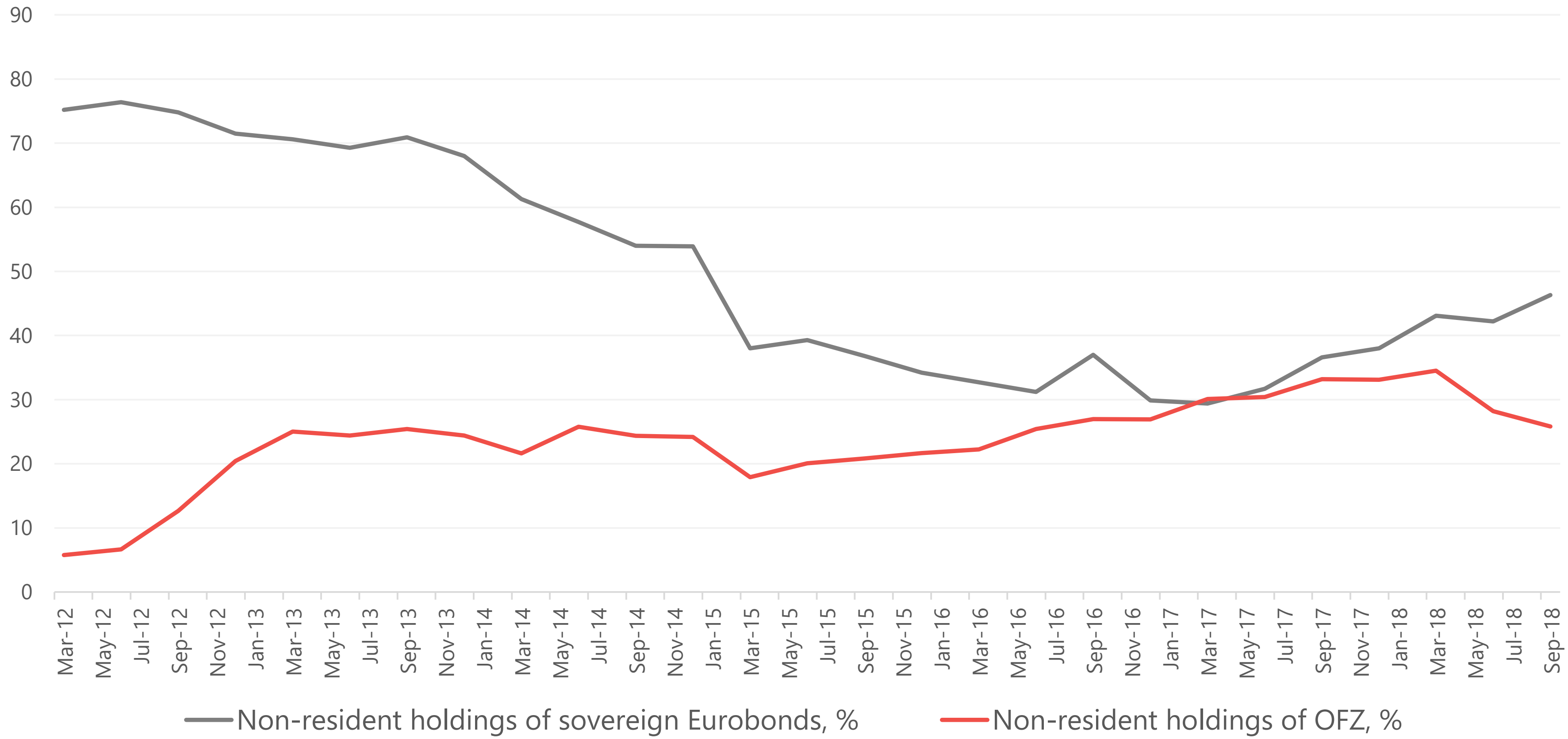
Major outflows from FX deposits in July and August pushed total commercial banks FX assets to seven-year low. In September, FX liquidity began to level off, which was reflected in contraction of USD/RUB 1-year swap basis.



Source: CBR, ITI Capital, Bloomberg

Non-resident holdings of Eurobonds

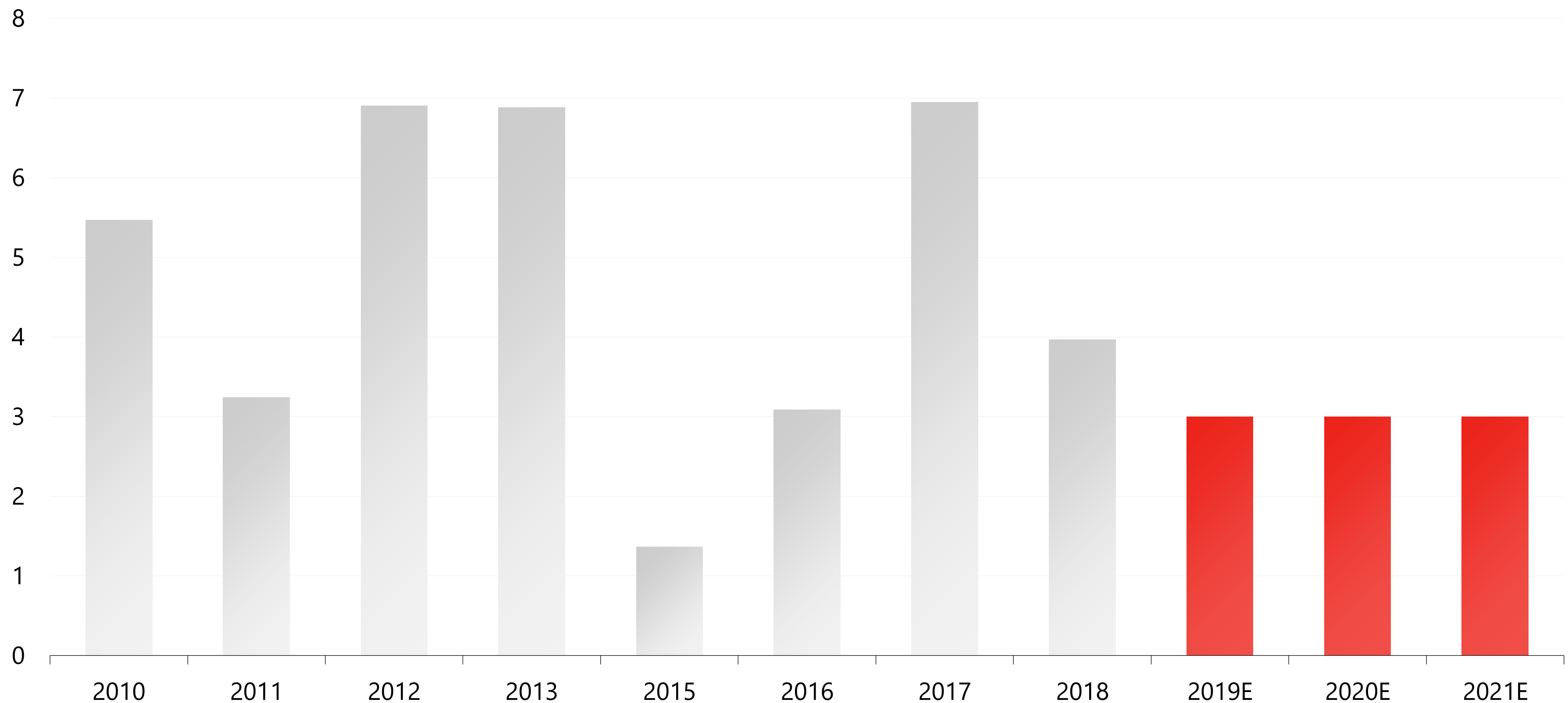
Non-resident holdings of Eurobonds have been rising, primarily due to shrinking supply as a result of redemptions and maturing, and is now close to 50%. Since April, when the US sanctions on Rusal were imposed, nominal non-resident investments in Russian Eurobonds have shrunk by just $0.5bln (by 3%; over the last quarter they were reduced by less than 1%).



Source: CBR, ITI Capital, Bloomberg

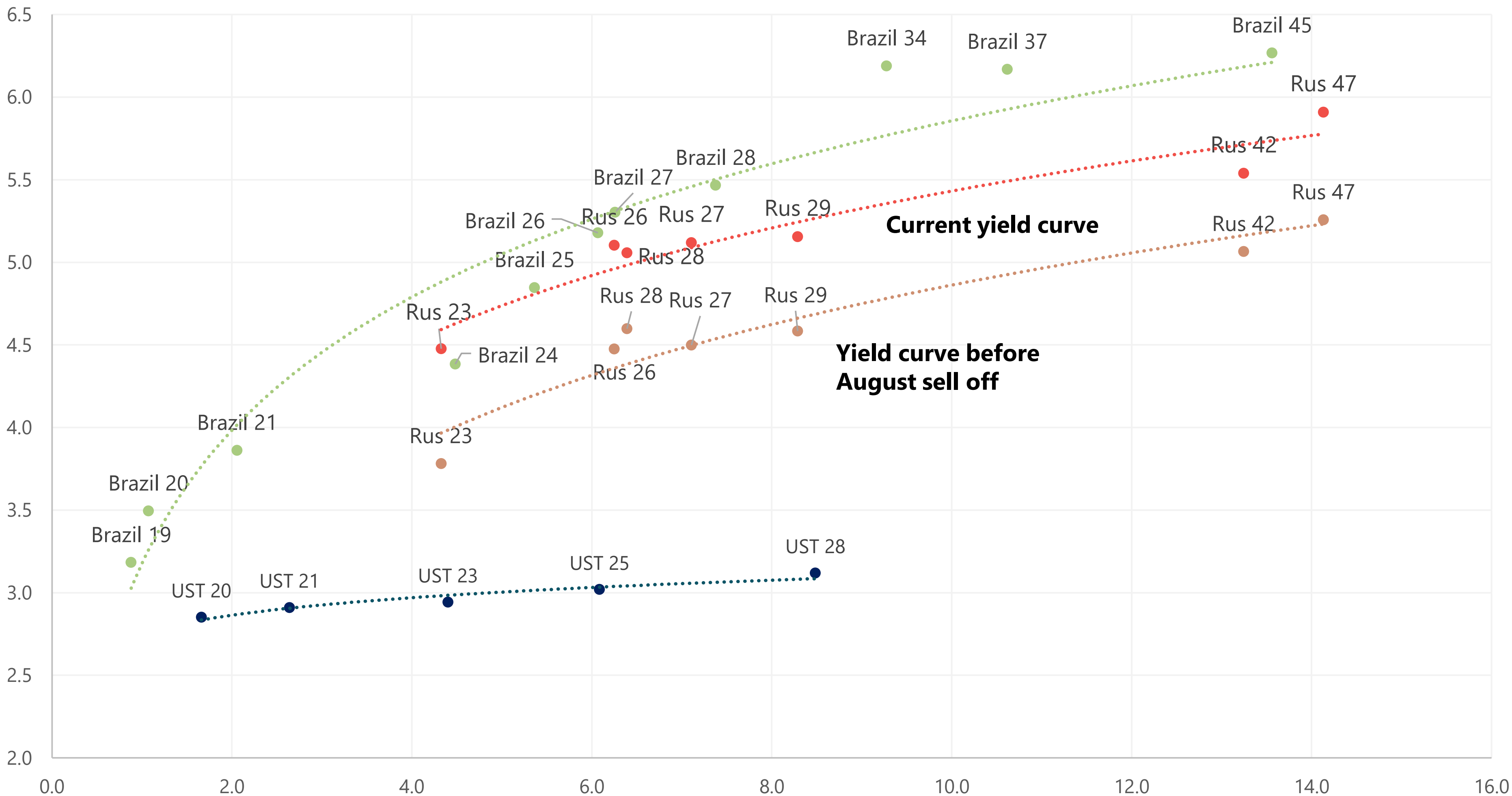
Sovereign Eurobond Issuance: Actual and Expected

Total issuance of Russian sovereign Eurobonds was the lowest in two years and will remain low due to sanction risks and higher budget surplus.



Source: Ministry of Finance RF, ITI Capital, Bloomberg

Russian and Latin American Sovereign Dollar Bonds Yield Curve



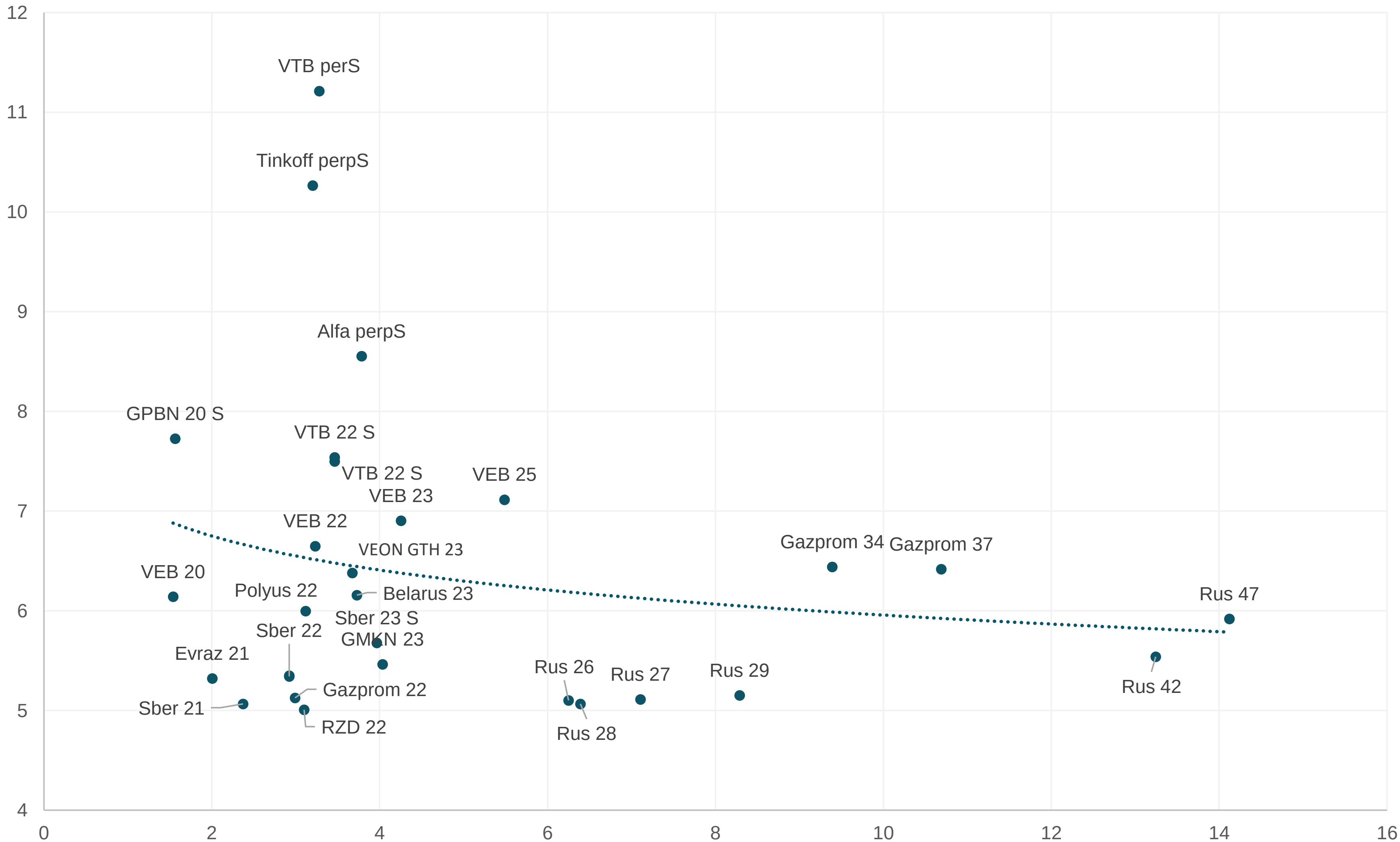
Source: ITI Capital, Bloomberg

Spread between Brazil and Russia 10-year Dollar Bond Yields

Brazil's composite sovereign rating (BB-) is two notches below that of Russia (BBB-), whereas the average spread of the former's two-year bond over the latter's stands at 20-25bp. We expect the spread to widen by at least 50bp, subject to sanction developments.

Source: ITI Capital, Bloomberg

Eurobonds with biggest upside



Source: ITI Capital, Bloomberg

Scenario analysis

We assume base-case scenario analysis, which involves positive developments over sanctions and easing geopolitical tensions. We expect to hear more guidance from US Congress before December 14th, after that date decisions can be made next year only. Our base-case scenario assumes a moderate year-end rally, which could lead to a recovery in Russia's oversold assets.

Scenario analysis (ITI Capital)

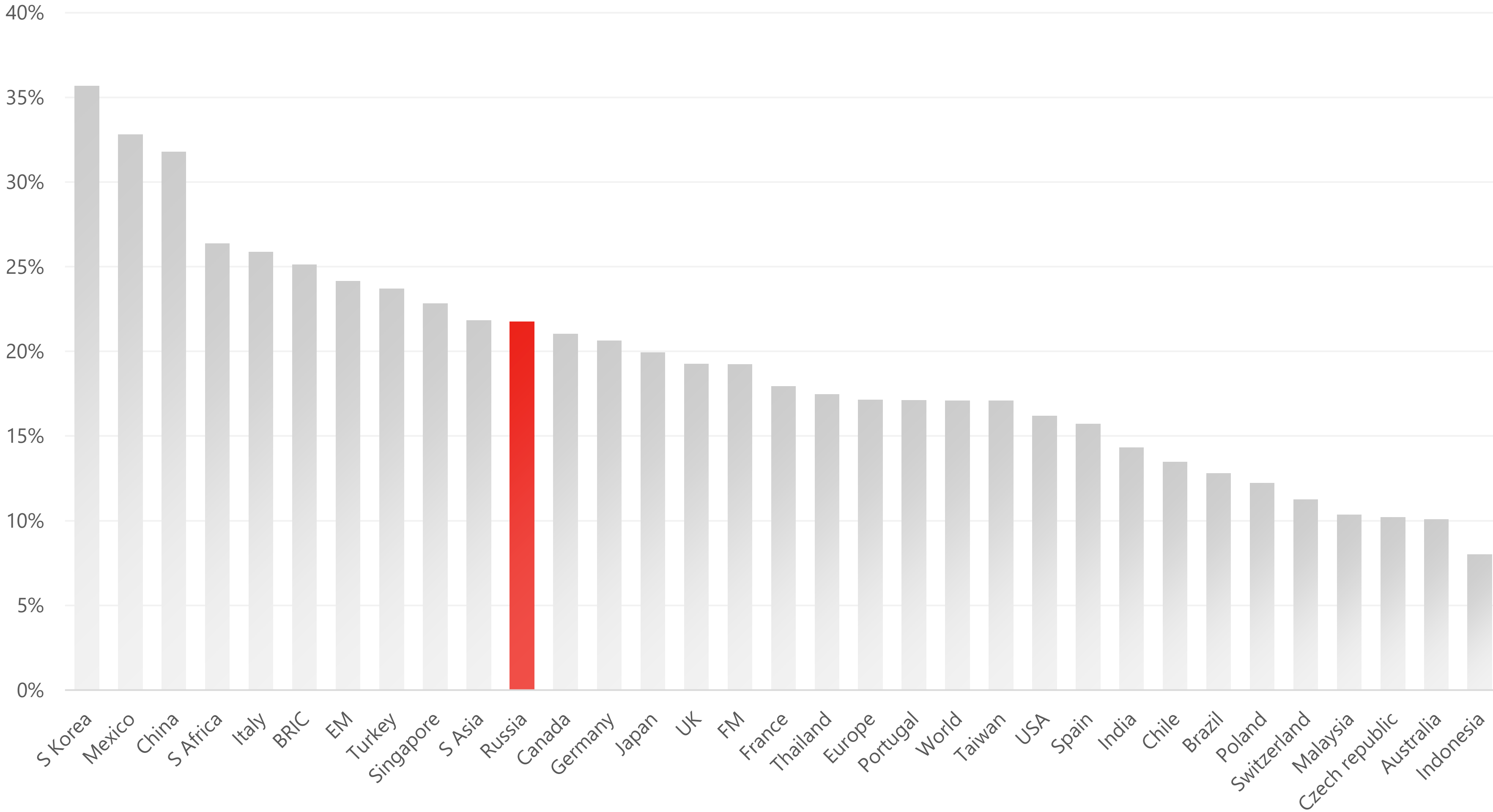
End of period 2018r	Probability, %	USD/RUB	Inflation, r/r	Oil, $/bbl	Russia CBR key rate, %	Sberbank equity, rubles
Base (neutral)	60	64,5	3,80%	75	7,5	220+
Light weight	35	71,5	3,8-4,2%	75	(+50 b.p.) till 8	170
Heavy/Tough	5	80+	3,8-4,2%	75	(+150 b.p.) till 9	140

End of period 2018r	Probability, %	$ Risk premium (long end of the curve), b.p	Risk premium (long end, OFZ), b.p	Non-resident share in OFZ, %	Eurobonds (VEB), price growth	Eurobonds (Non-financials)
Base (neutral)	60	(-30b.p.) till 180 b.p.	(-50 b.p.) till 8%	(+3%) till 28 %	4%	3-4%
Light weight	35	(+20 b.p.) till 235 b.p.	(+30 b.p.) till 9%	(-4%) till 21%	-3%	-1,50%
Heavy/Tough	5	(+140 b.p) till 350 b.p.	(+140 b.p.) till 10%	(-12%) till 13%	(-13%)-15%	(-4%)-5%

Source: ITI Capital, Bloomberg

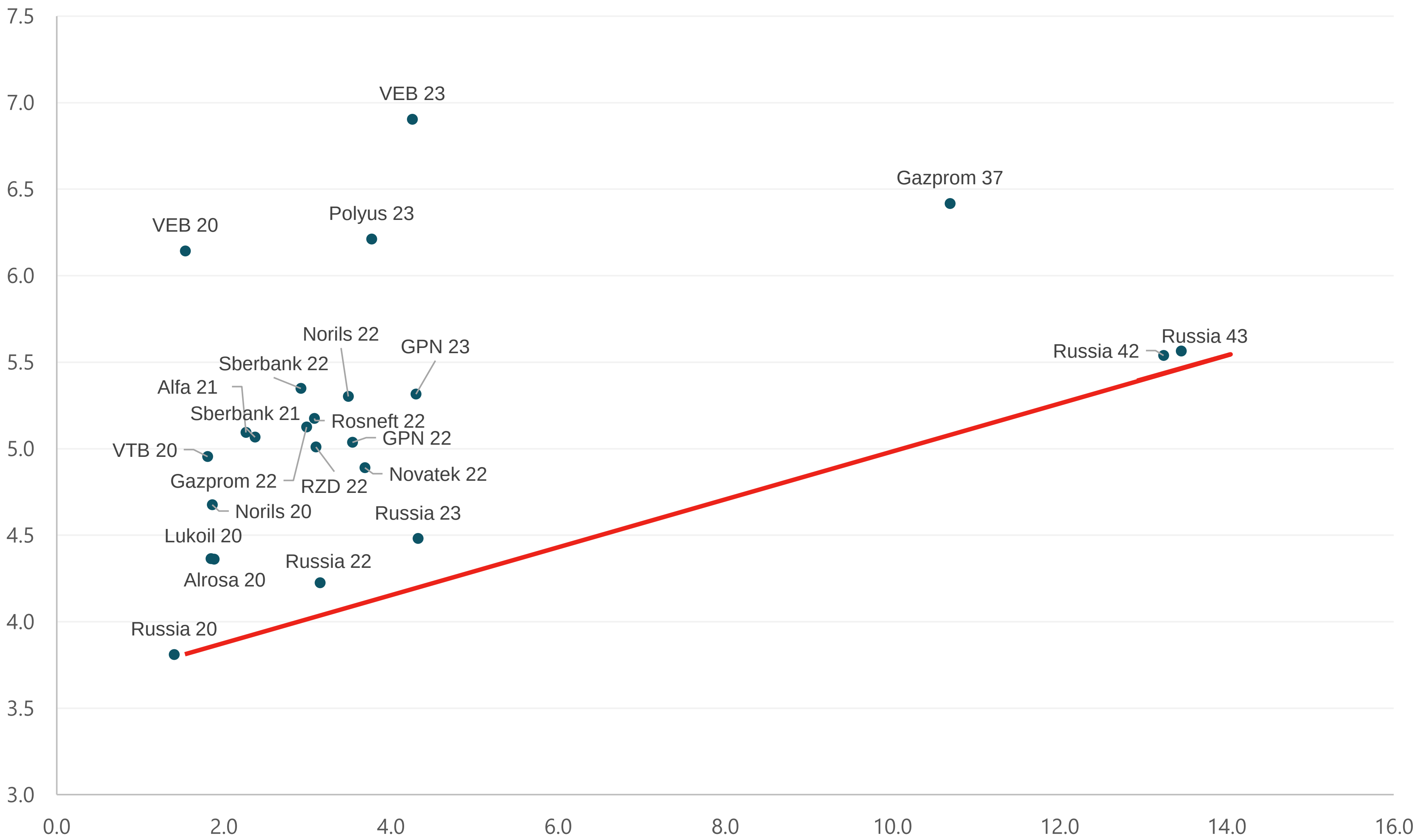
Global equities with biggest upside

Russian equities is one of the most oversold with 12m consensus upside of 22% in USD.



Source: ITI Capital, Bloomberg

ITI Funds Eurobonds



Source: ITI Capital, Bloomberg

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