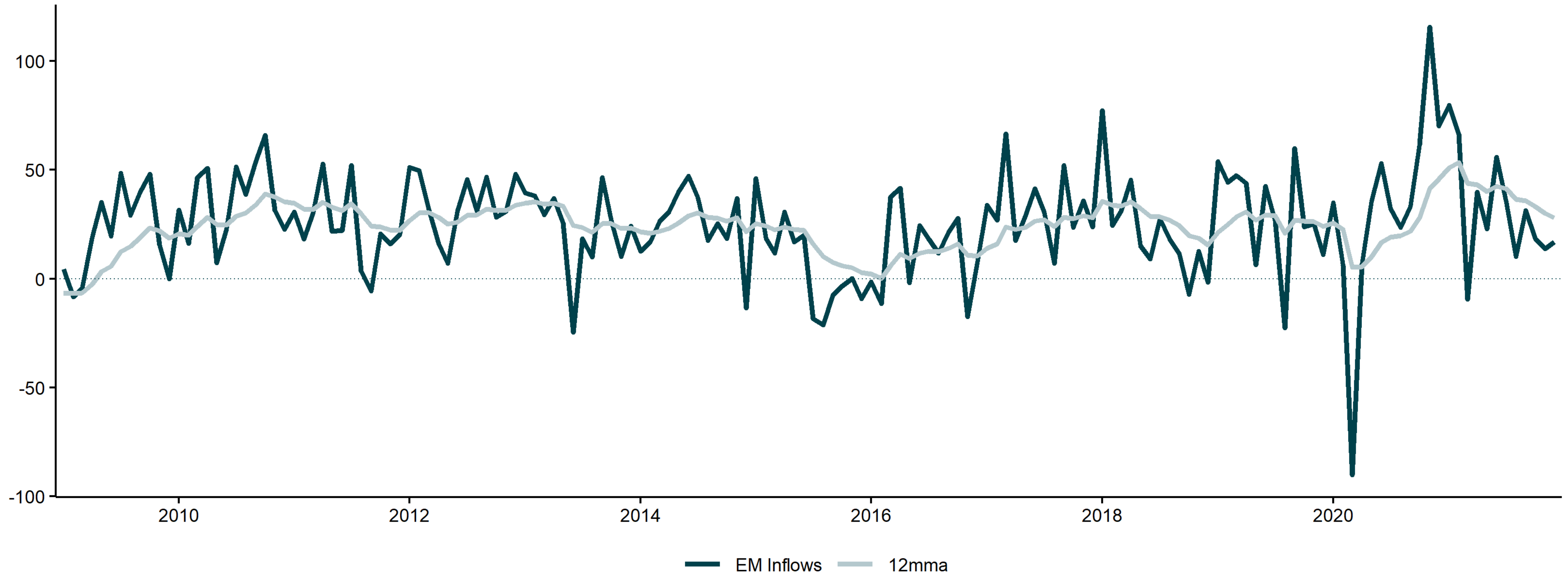
Russian and Ruble outlook altered

Capital inflows into EM beginning to fade

Net portfolio inflow into emerging markets, USD bn

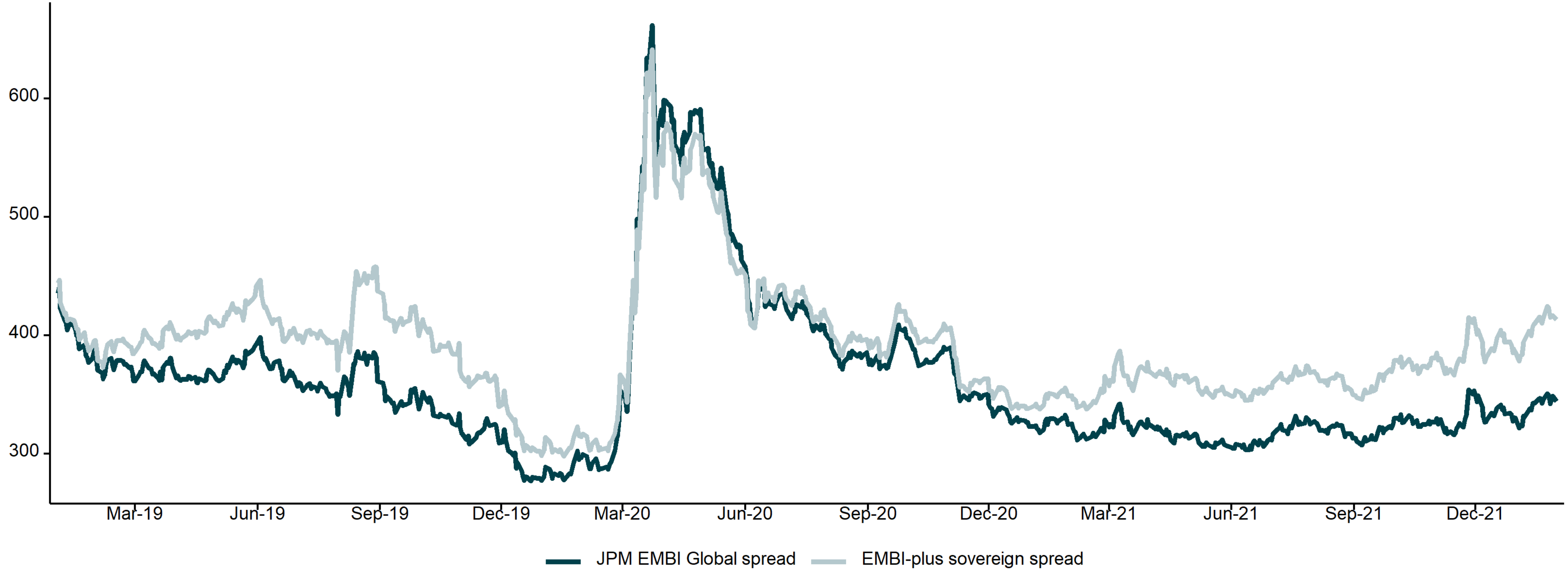


Source: IIF, Commerzbank Research

- There was record net capital outflow from EM in March 2020 when the pandemic broke out.
- Outflow stopped soon after and inflow resumed, until recently when Fed tightening (and now ECB tightening) began to be priced in.

EM spreads gradually widening again

JP Morgan EMBIG global & EMBI-plus sovereign spreads, bps



Source: Bloomberg, Commerzbank Research

- EM sovereign spreads widened to their most since Lehman following the corona outbreak.
- Risk sentiment improved later, but is slightly deteriorating as the Fed rate hiking cycle draws near. EM currencies, which are anyway affected by idiosyncratic factors, tend to become hotspots (e.g. Turkey in the past).

Ruble outlook: observations

- Geo-politics has gone into circular loop of escalation. Next rational step of each side warrants the next step of the other side – towards escalation. Opposite direction since after Biden-Putin summit of summer 2021. There seems to be no way out this time barring a full-fledged Treaty, which will ensure, in advance, the reciprocation by the other party.

- Sanctions the main tool for the US and EU. But, President Vladimir Putin will not care about sanctions. In fact, he would benefit from any economic hardship which will result and 'confirm' that the main challenge in this era is an outside enemy.

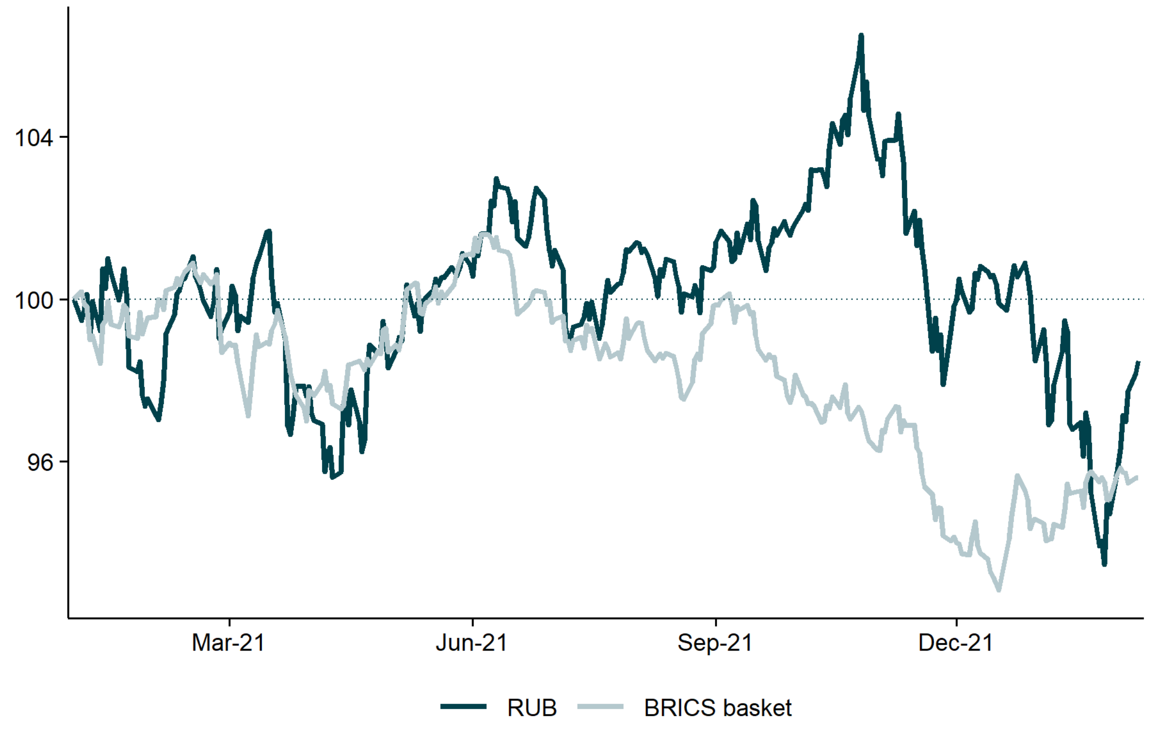
- But because Putin does not care, this does not mean that the west will forget about sanctions, or that the sanctions will not have effect. As FX analysts, we do not judge, we try to price-in the impact. E.g. look back at US sanctions on Turkish exports after arrest of Pastor Brunson, which ultimately triggered the 2018 Turkish lira crisis.

- So, why are markets complacent?

- Naïve views in financial markets, e.g. the ultimate agenda is to get Nord Stream 2 fast-tracked.

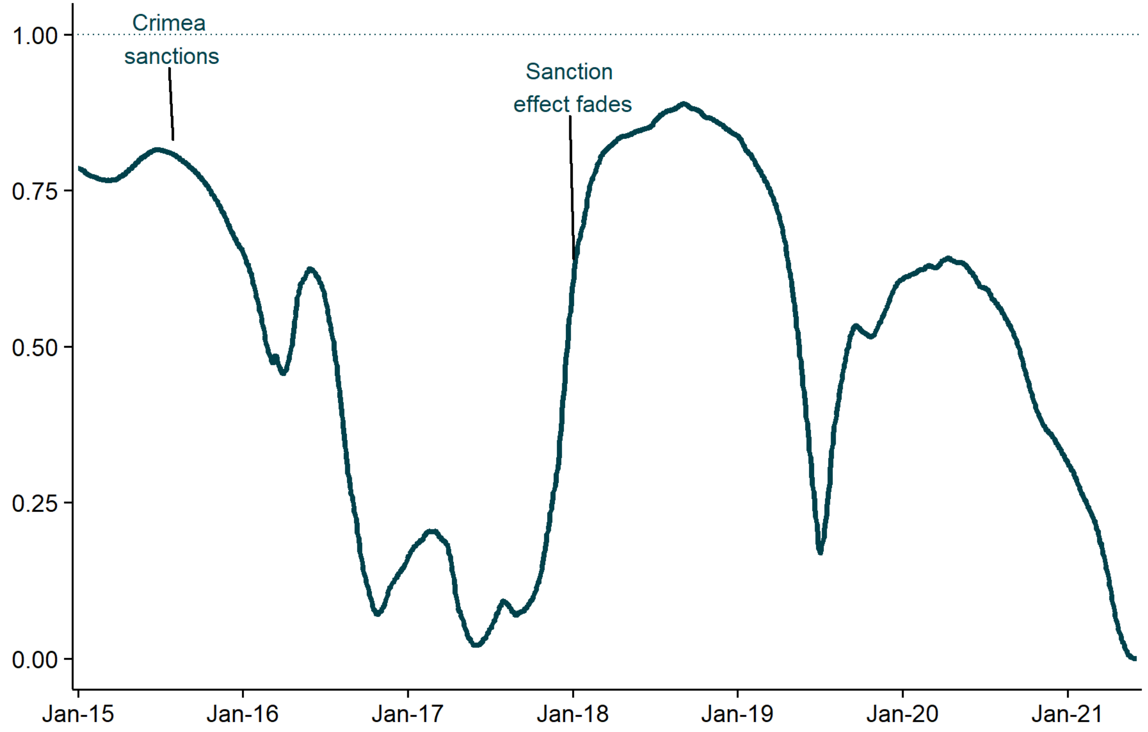
RUB movements: how much is global, how much local?

USD-RUB vs. BRICS basket, rebased: lower=weaker ccy



Source: Bloomberg, Commerzbank Research

Proportion of USD-RUB variation explained by peer group movements



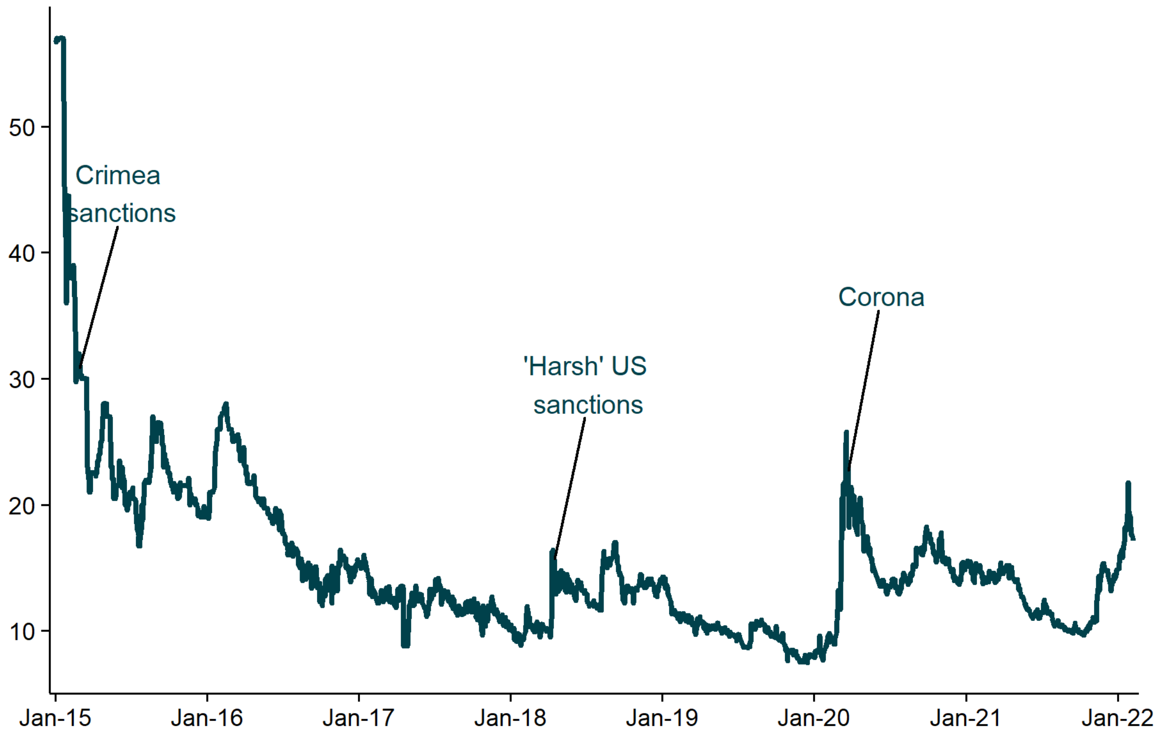
Source: Commerzbank Research

- RUB was correlated with broader EM through pandemic.
- Then outperformed when CBR began to hike more aggressively.
- Recently underperformed heavily as geo-politics deteriorated.

- Rolling regression of RUB on BRICS index shows that aside from massive idiosyncratic moves, global peers explain c.70% of RUB movements.
- Right now, RUB has become fully idiosyncratic with near-zero correlation.

RUB volatility and risk premia escalating

USD-RUB ATM 3 month option volatility



Source: Bloomberg, Commerzbank Research

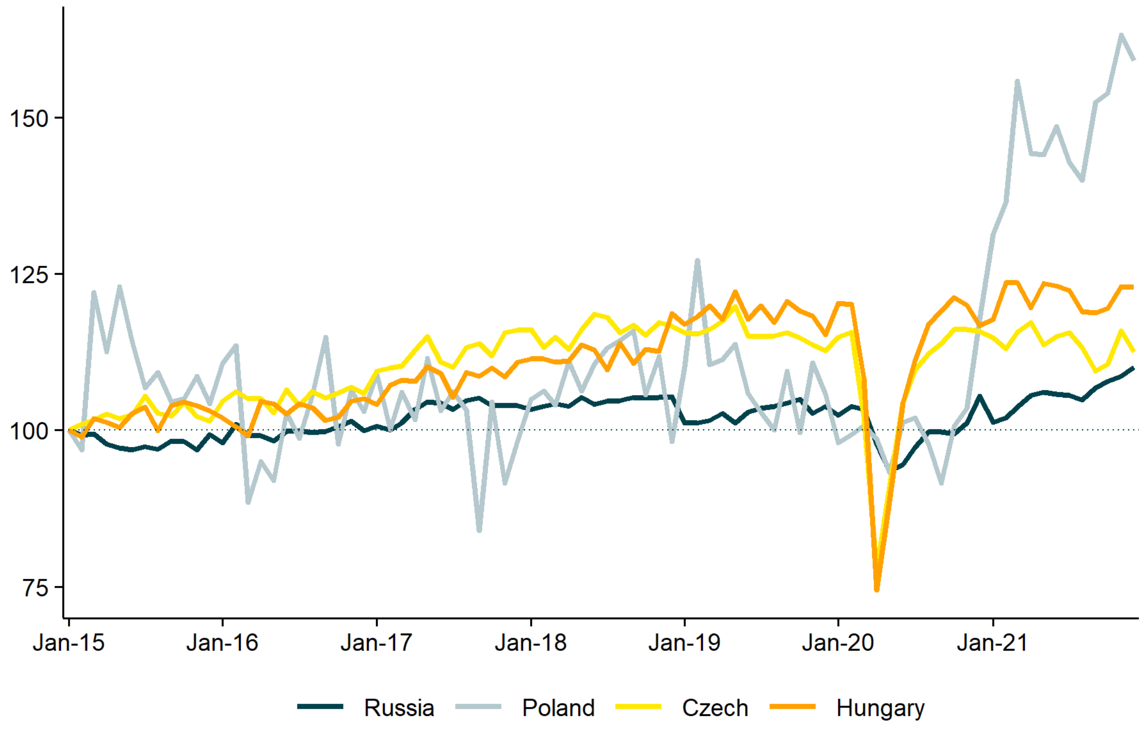
5-year CDS spread, bps

Source: Bloomberg, Commerzbank Research

- RUB volatility jumped to a high level over the past month, but not particularly high given the underlying qualitative change of risk.
- Widening of CDS spread also reversing, showing complacency.

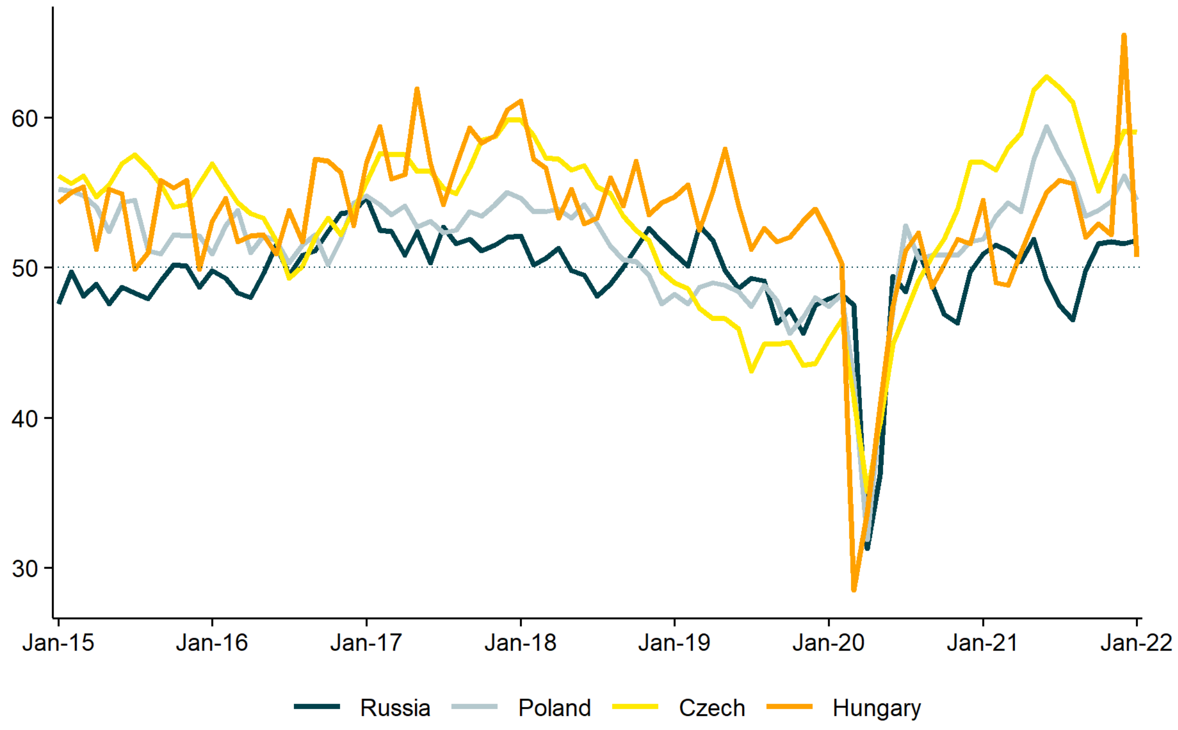
Industrial output rebounding after pandemic

Industrial output, swda levels



Source: Bloomberg, Commerzbank Research

PMI Indices, sa



Source: Markit, Bloomberg

- Industrial output trend recovered in EMEA countries, but the punchiest rebound could be coming to an end.
- In the long-term, Poland was an outperformer, Czech Republic and Russia grew the slower.

- PMIs rebounded strongly during 2021, but they are not very indicative of absolute growth rates; readings above 55-60 in some countries do not imply the same growth rate as in normal times.

Russian economic outlook: key topics

- GDP growth averaged 4.7%y/y for Jan-Nov, against CBR's 4.0-4.5% forecast for 2021. Given the volatility of output during the pandemic rebound, we can call this ‘in line’.
- Unrealistic complacency in the market. We would fade interim constructive market developments.
- As base-case, we do not anticipate military conflict involving NATO, or especially ‘nuclear’ sanctions involving 1) SWIFT 2) oil and gas or 3) technology (semiconductors etc.). But these obviously remain as risk scenarios.
- Our forecasts discount incidents of hybrid warfare, which will be difficult to trace and prove – but no de-escalation – which will ultimately trigger a subset of sanctions, probably on the capital markets side, and probably targeting Nord Stream 2 (revival of Cruz bill recently defeated in US Senate).
- Still, USD-RUB could easily shoot up to 82.00 and above from geo-political uncertainty in coming months. We forecast USD-RUB to trade at 80.00 by the end of the year.
- Kremlin has expressed support for CBR's monetary policy, while saying inflation is at an "unacceptable level". Putin has cited the example of Turkey.

Russian economic outlook: now idiosyncratic

Macroeconomic forecasts

		2021	2022	2023
Real GDP (yoy)	Avg.	4.2	1.6	1.5
	Q4	4.5	1.0	1.8
CPI (yoy)	Avg.	6.7	11.2	6.3
	Dec.	8.3	11.0	4.3
Key rate	Dec.	8.50	14.00	10.00

Exchange rate forecast (month-end)

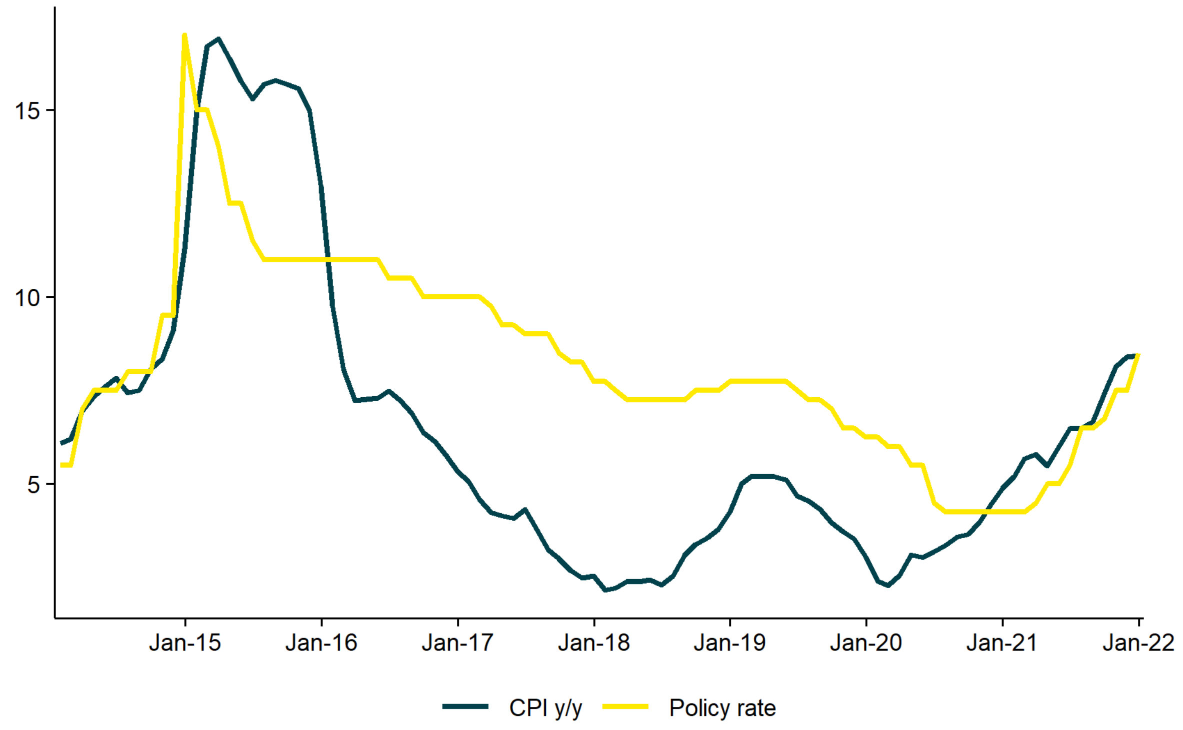
	Mar-2022	Jun-2022	Sep-2022	Dec-2022	Mar-2023	Jun-2023	Sep-2023	Dec-2023
EUR-RUB	86.24	88.00	89.38	88.00	87.36	88.92	89.32	89.32
USD-RUB	77.00	80.00	82.00	80.00	78.00	78.00	77.00	77.00

Source: Commerzbank Research

- Unrealistic complacency in the market.
- The USD-RUB exchange rate has calmed down somewhat in recent days after breaching the 80.0 level briefly in January, but this should not be taken as an indication that the risks are behind us. While we would like to be optimistic about the likelihood of quick de-escalation, our base-case remains for significant turbulence and overshooting of the ruble exchange rate over the coming month(s), which is likely to trigger equally sharp monetary tightening by the Russian central bank in order to stabilise the financial system.
- We have revised our USD-RUB forecast for H2 2022 from 74.0-76.0 range to 80.0-82.0 range to reflect increased geo-political risks. Our forecast does not price-in worst-case scenarios such as full-scale war and extreme western sanctions such as SWIFT disconnection (USD-RUB would rise to easily above 100.0 in those scenarios). Nevertheless, we want to be pro-active compared with the market which appears entirely complacent.
- We forecast USD-RUB to ultimately calm down in subsequent quarters, but only after interim turbulence, and at the cost of high interest rates and economic recession.

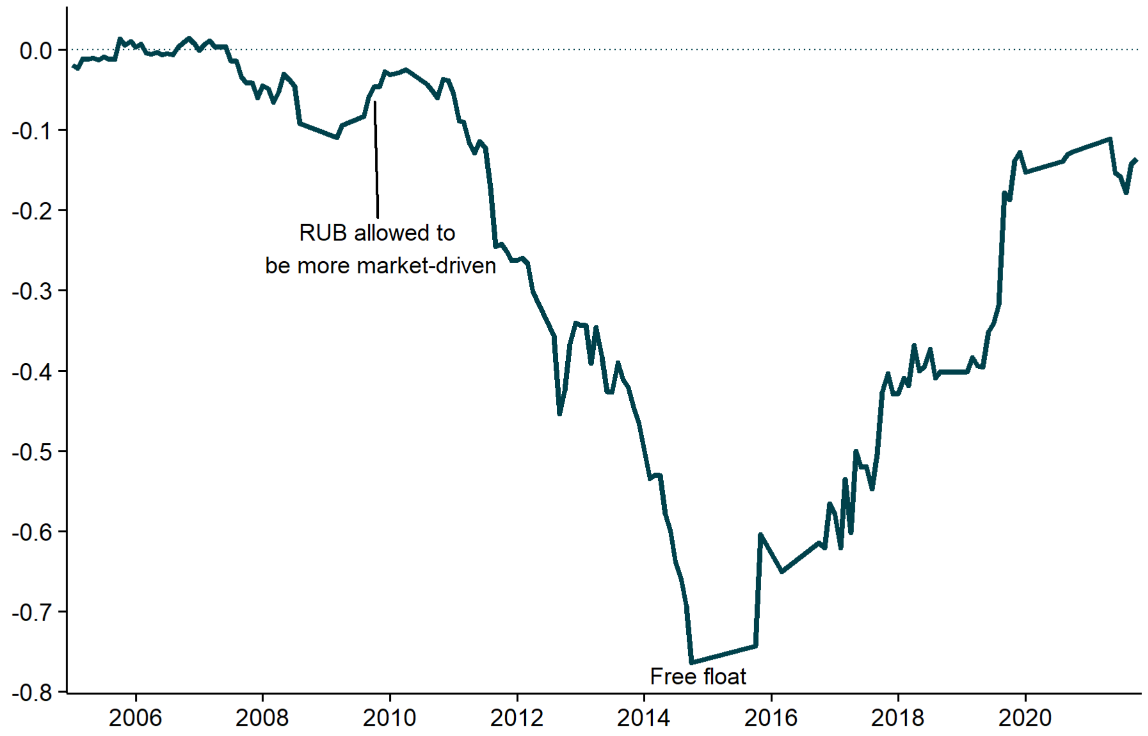
CBR action after Crimea sanctions saved the day

CPI inflation and CBR base rate after Crimea, in %



Source: CBR, Commerzbank Research

Elasticity of exchange rate to oil price movements (negative because higher oil price lowers USD-RUB



Source: Bloomberg, Commerzbank Research

- During 2014, sharp ruble depreciation warned CBR that very high inflation was around the corner; CBR hiked rates to 17% quickly, which ultimately stabilised the financial markets and brought both the exchange rate and inflation back to convergent paths.

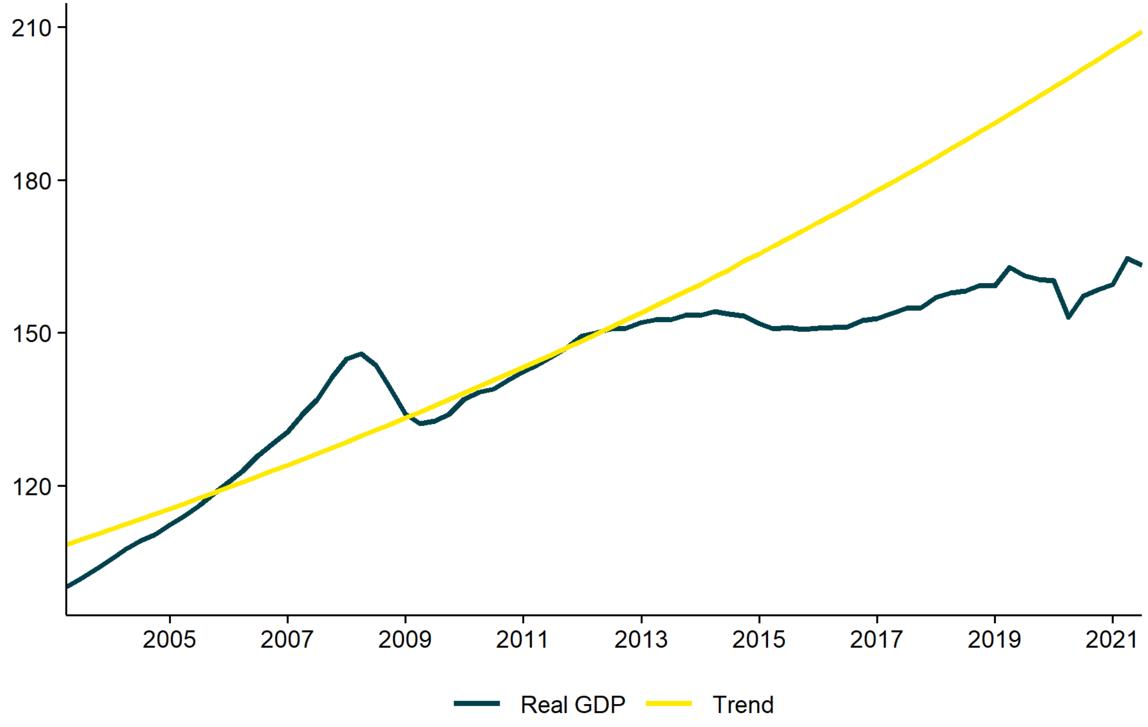
- CBR's inflation targeting credibility became so good that RUB lost sensitivity to oil price – the market assumed that if the oil price were high and RUB strong, CBR would simply hike interest rates less (or cut more), which would fully neutralise the impact.

Impact of sanctions on Russian economy - 1

Real GDP timeline, y/y

Source: Rosstat, Commerzbank Research

Real GDP after Crimea sanctions vs. earlier 2003-2014 trend-line



Source: OECD, Commerzbank Research

- Russian GDP growth dipped after Crimea sanctions, but appeared to rebound later.
- Subsequent sanctions (e.g. 2018) hardly had any impact.

- We should view the impact more broadly than via balance sheets of sanctioned entities.
- Real GDP *level* began to fall further and further below earlier pre-Crimea trend-line.

Russia: Direct impact of sanctions (official version)

- Various restrictions, including economic sanctions, introduced by other countries cost Russia $6.3bln in 2018, according to the estimates of the Economic Development Ministry presented on Tuesday.

- These restrictions include anti-dumping duties, licensing, quotas, technical barriers, sanitary and phytosanitary measures and also economic sanctions.

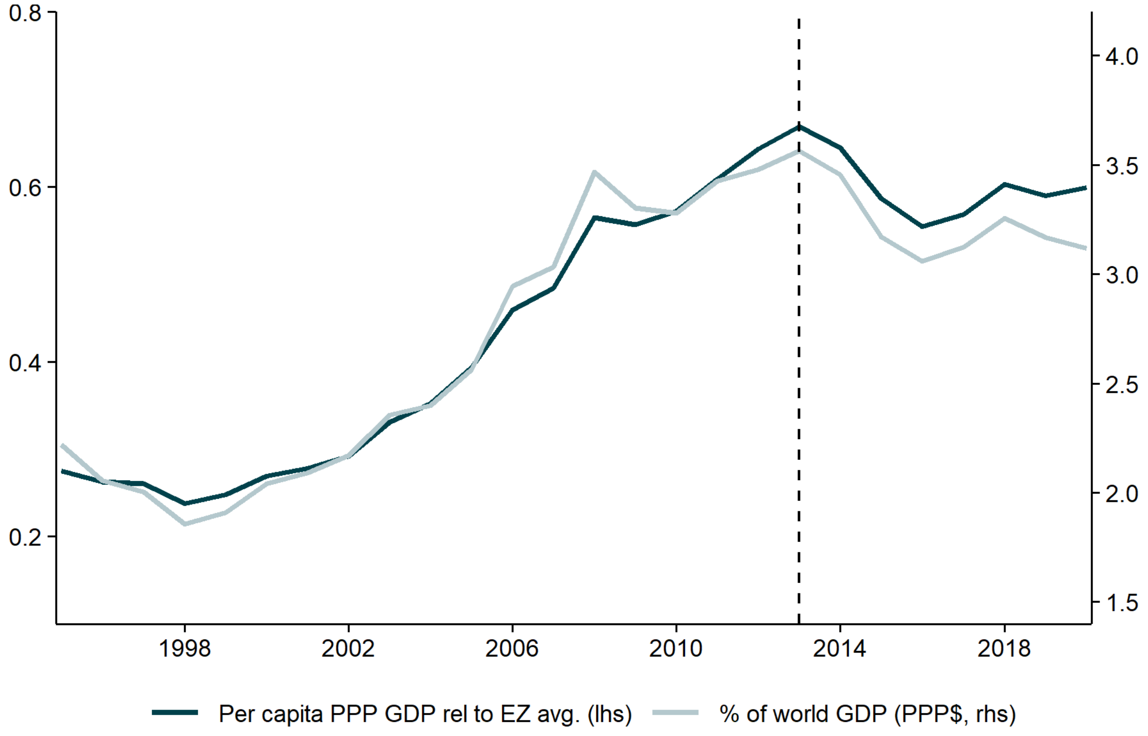
- Russia suffered the biggest loss ($2.42bln) due to restrictions introduced by the EU countries. US sanctions cost Russia nearly $1.17bln, and Ukraine's restrictions were the third hard-hitting to the tune of $775mln, the ministry said.

- A more realistic estimate probably is that the economy is 10%-15% smaller now, as a result of sanctions, than it would otherwise might have been. A similar proportion has been lost to lower oil price too.

Source: Russian Economic Development Ministry; http://tass.com/economy/1045324

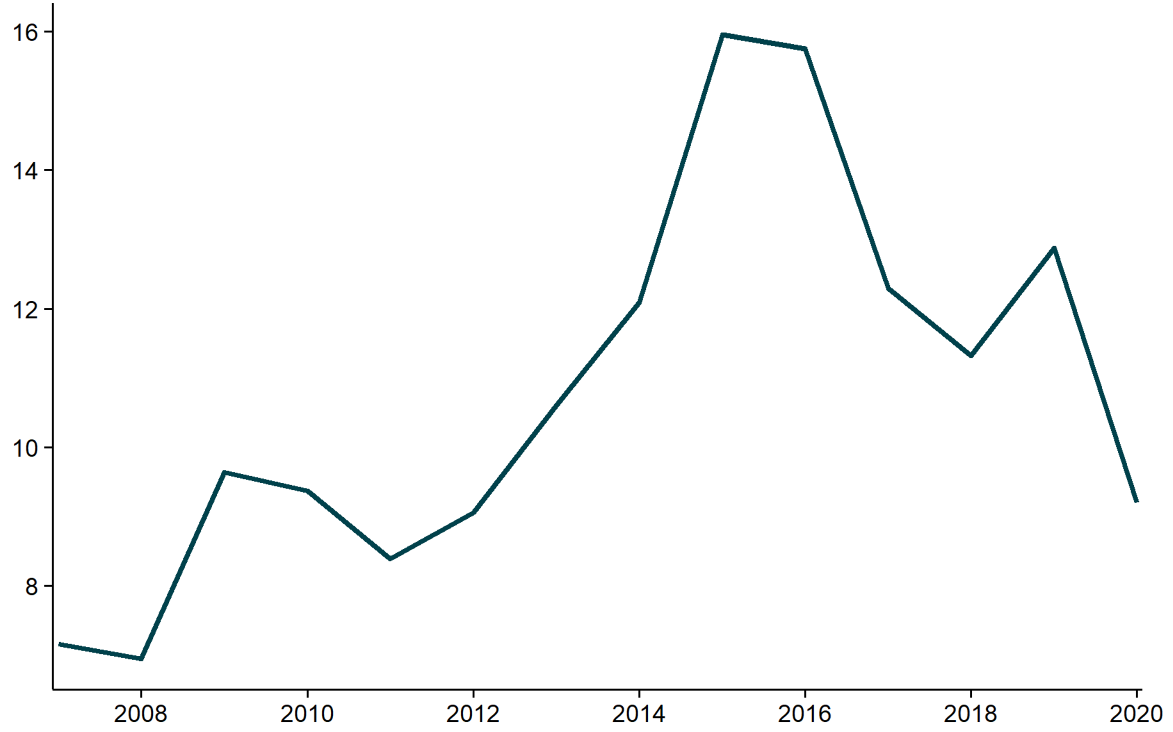
Impact of sanctions on Russian economy - 2

Per capita PPP GDP relative to EZ avg. and Russia's % share of world GDP



Source: World Bank, Eurostat, Commerzbank Research

Share of high-tech exports within manufactured exports, %



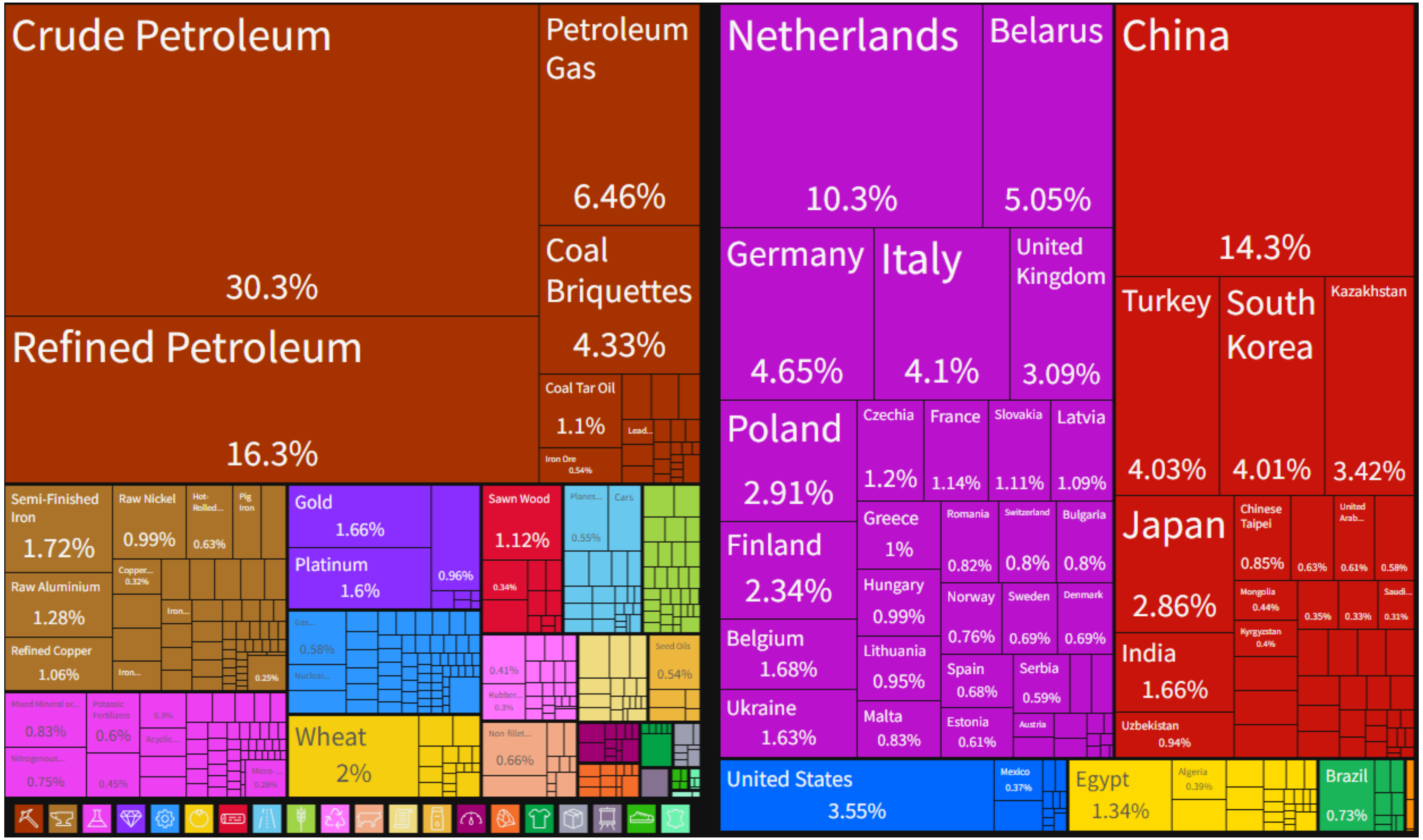
Source: World Bank, Commerzbank Research

- Outperformance changed to steady underperformance after Crimea.
- Picture complicated by oil price collapse at the same time, but opposite chart confirms persistence of underperformance across different oil price.

- Similar trend can be tracked in individual sectors as well: for example, high-tech exports require more foreign collaboration and import of technology. Russia's high-tech exports as percentage of manufactured exports shows that export diversification towards more value-added products stalled.

Russia’s hydrocarbon dependence

Composition and destination of exports, % of total



- % labour force in non natural resource industries = 10%
- In global league tables, Russia is ranked as competitive in 103 commodities; China in 513.
- Less than 10% of manufactured exports qualifies as high-tech.

Source: EBRD

Source: 2019 annual data; https://oec.world/en/profile/country/rus

Reducing exposure to the US and US dollar

In which currencies and locations CBR's FX reserves are stored, % total

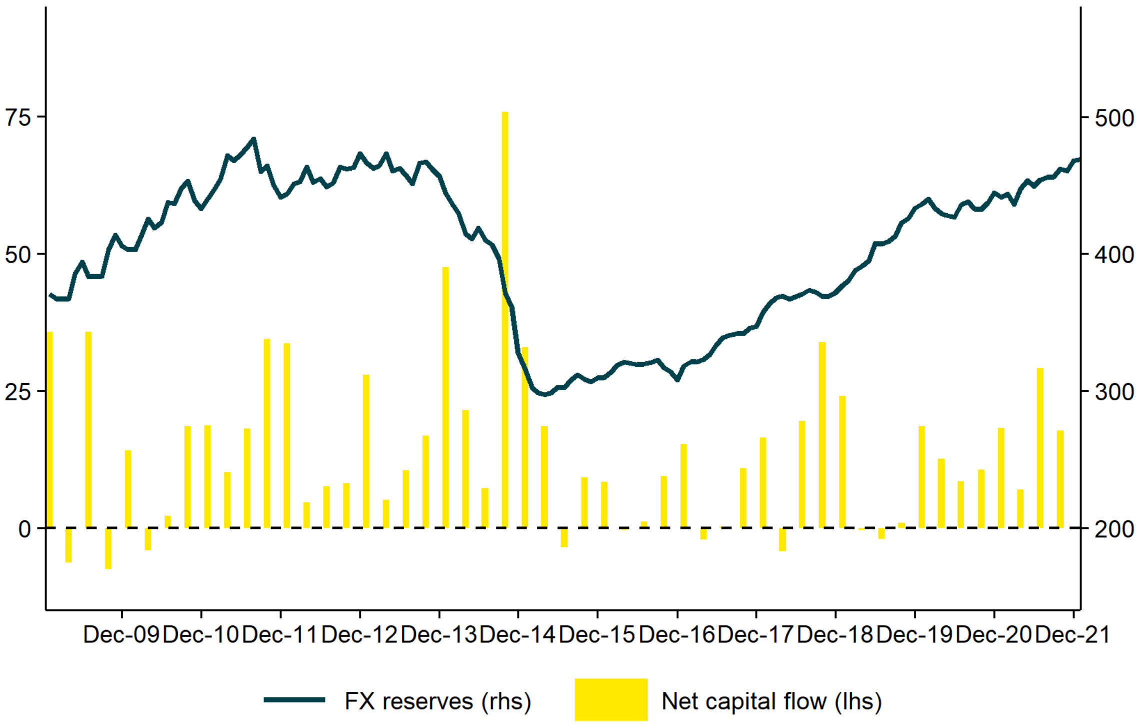
	Dec-2018	Dec-2019	Jun-2020	Dec-2020	Jun-2021
By currency					
Euro	31.7	30.8	29.5	29.2	32.3
Dollar	22.7	24.5	22.2	21.2	16.4
Yuan	14.2	12.3	12.2	12.8	13.1
Pound sterling	6.0	6.5	5.9	6.3	6.5
Gold	18.1	19.5	22.9	23.3	21.7
Other	7.3	6.4	7.2	7.2	10.0
By countries					
USA	9.7	7.9	7.1	6.8	6.6
France	14.2	12.4	10.4	10.2	12.2
Germany	14.2	11.0	11.8	10.8	9.5
China	14.1	13.8	14.2	14.2	13.8
Japan	7.5	13.2	12.3	12.7	10.0
UK	6.6	6.4	4.1	4.4	4.5

Source: CBR

- USD assets steadily reduced, now less than gold. Increasing geographical exposure to China, Japan, decreasing to US and EU.
- Almost eliminated US Treasury holdings. USD transactions in trade lower from 80% pre-Crimea to less than 60% now.

External balances and reserve assets improving

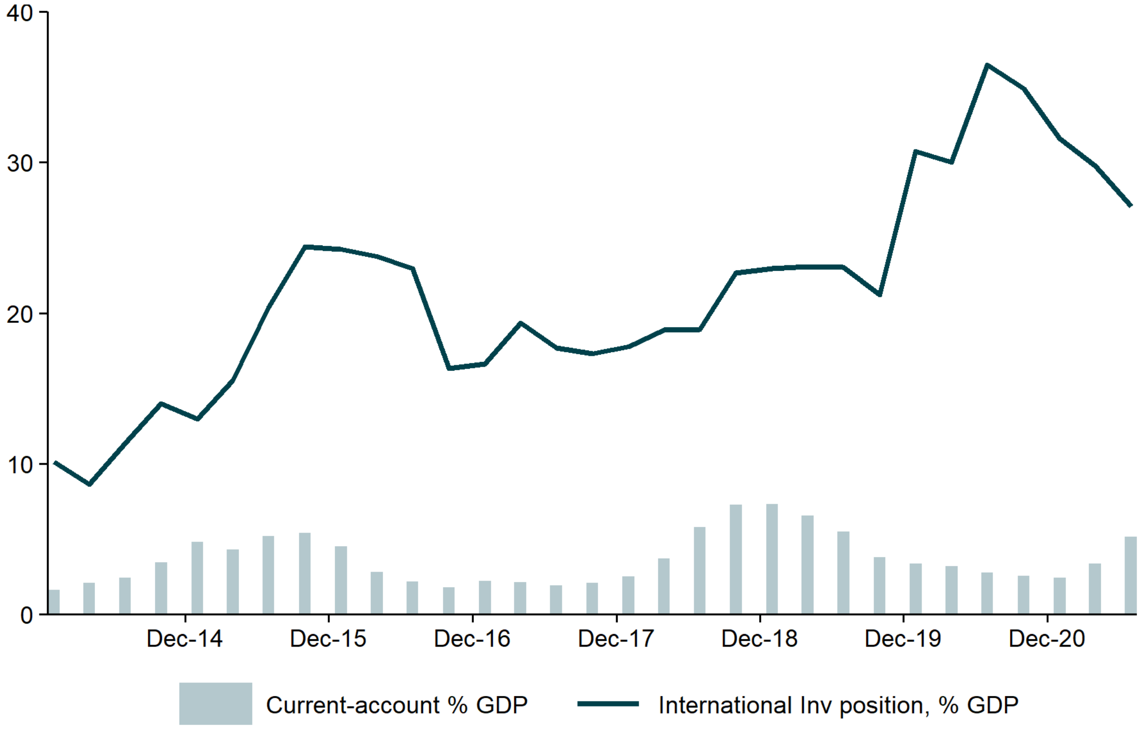
FX reserves and net BoP capital inflow/outflow, USD bn



Source: CBR, Commerzbank Research

- Capital outflow occurred after Crimea.
- Flows are now strong because of high oil price and is pushing up FX reserves.

Current a/c and net international investment position, % GDP

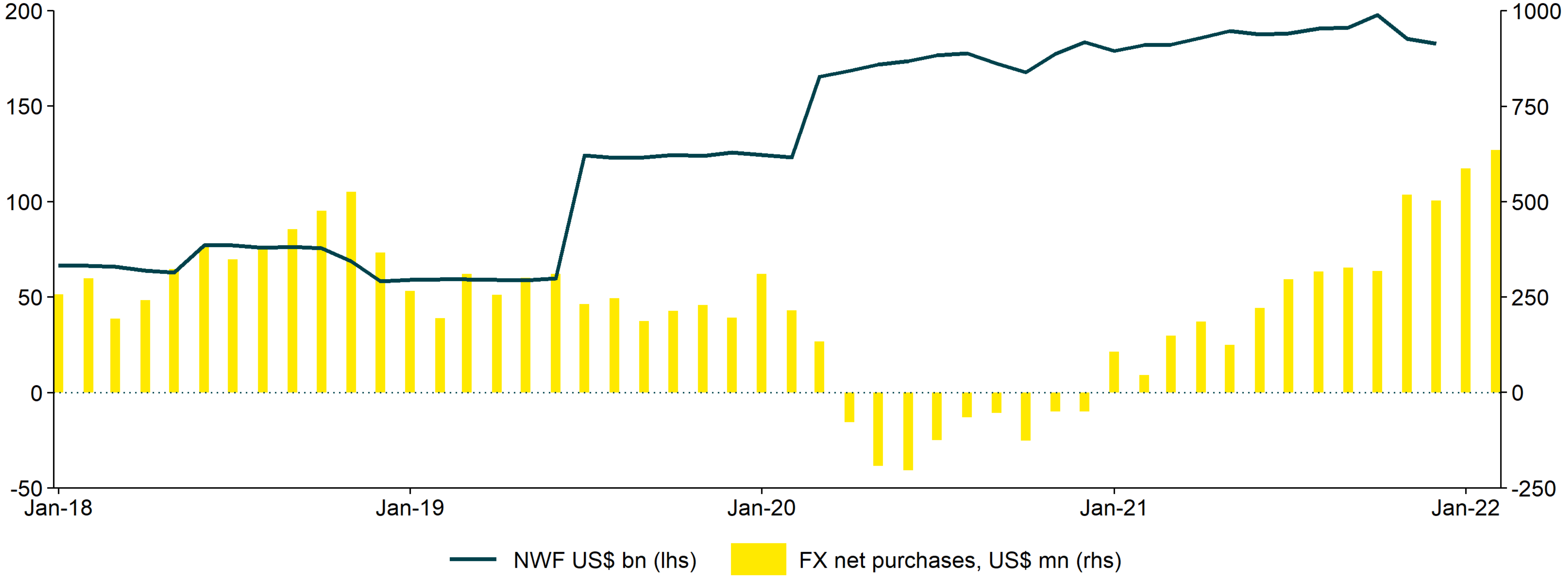


Source: World Bank, CBR, Commerzbank Research

- Current-account remained in surplus on 12m rolling basis, even in low oil price years.
- External debt peaked in 2014 in absolute terms and in 2016 as percentage of GDP. Net foreign assets are positive, but dipped after pandemic.

CBR stops FinMin FX purchases

National Wealth Fund, USD bn and Finance Ministry's FX purchases (net), US$ mn

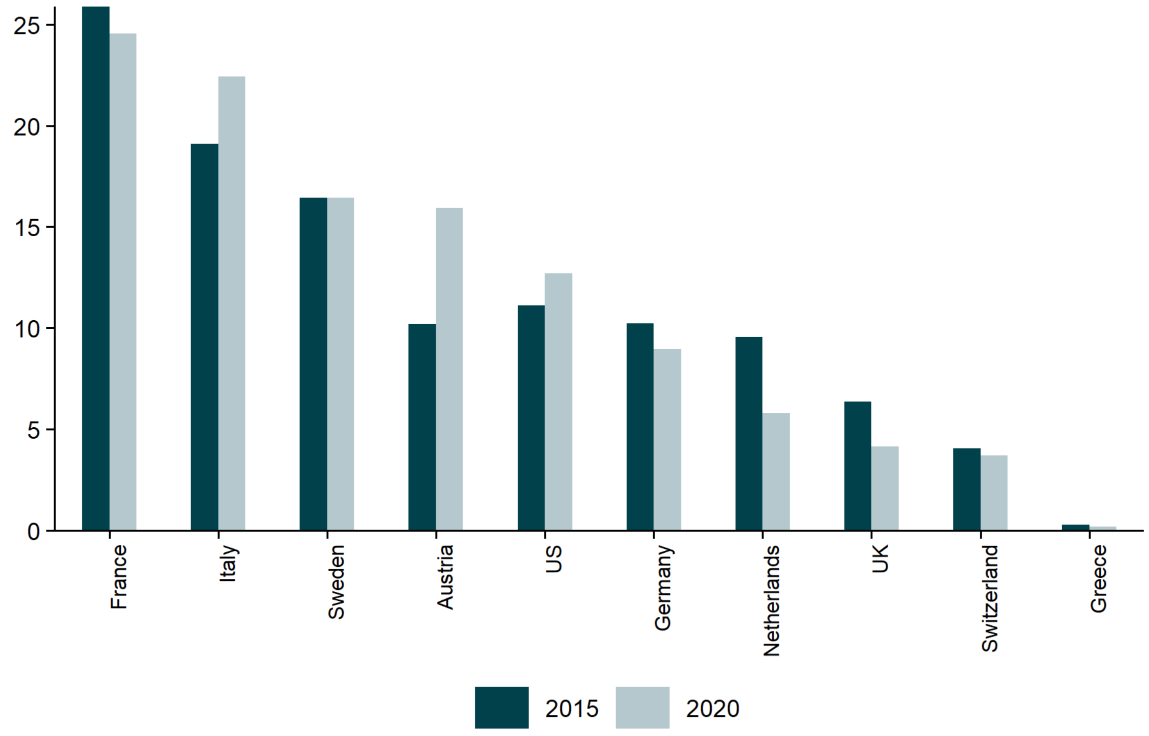


Source: Finance Ministry, Commerzbank Research

- Oil price has been averaging at a high enough level that the FinMin was buying up increasing volumes of FX surplus from the market. This will enlarge the NWF in 2022. The NWF has increased steadily since 2020 and surpassed 12% of GDP.
- Now CBR stopped purchases to increase dollar supply and support RUB. We view this as RUB-neutral though.

Banks’ cross-border exposure

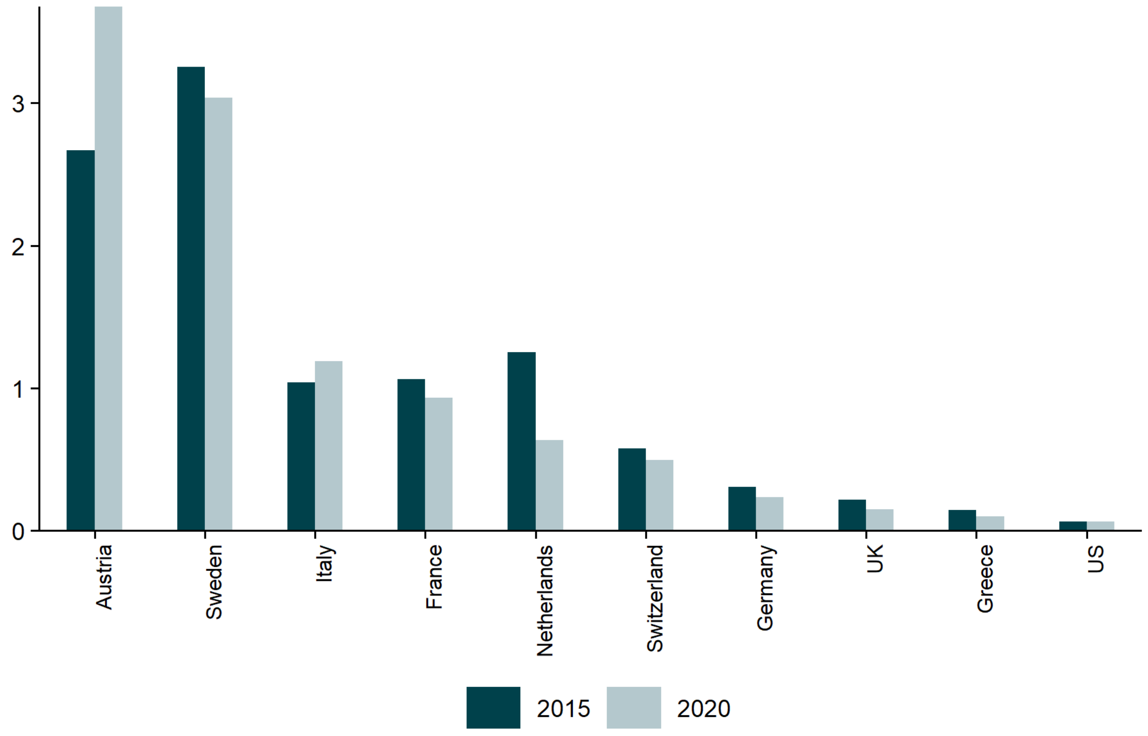
Banks’ cross-border exposure to Russian banks, USD bn



Source: BIS, Commerzbank Research

- European banks have significant cross-border lending exposure to Russia. France and Italy largest in absolute value.

Banks’ cross-border exposure to Russian banks, % of lender’s GDP

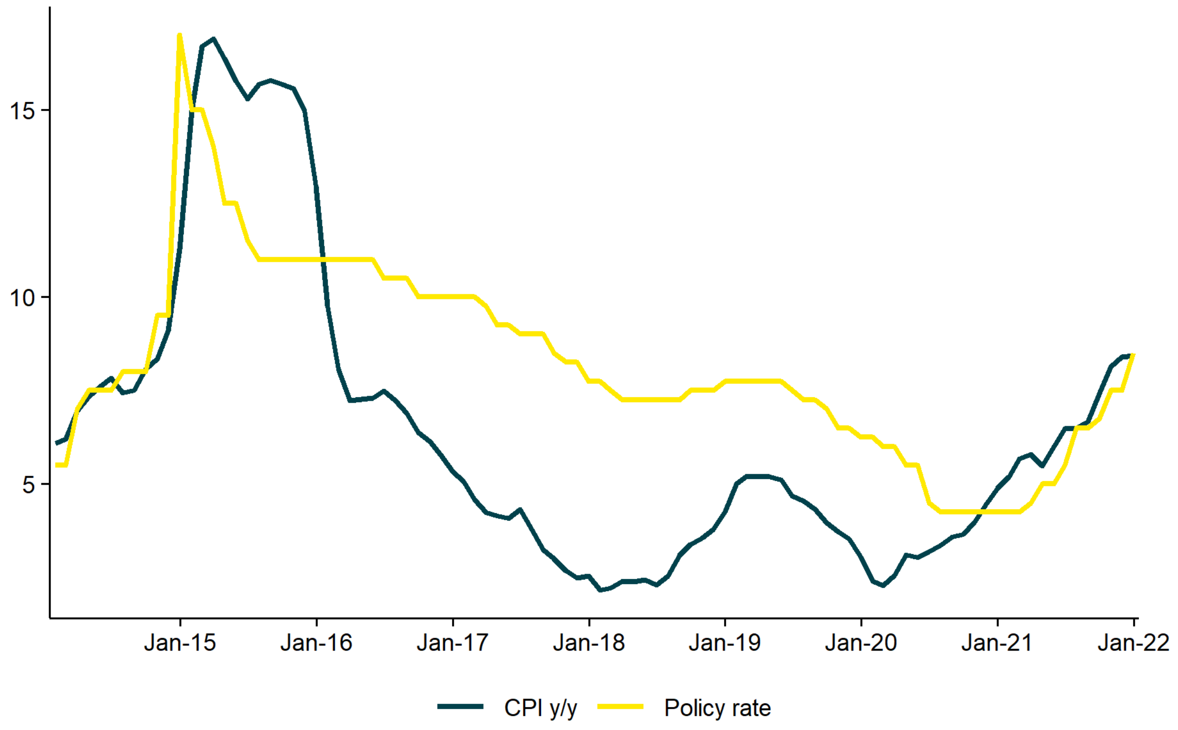


Source: BIS, Commerzbank Research

- Austria, Sweden the largest as % GDP. Austria, Italy have increased exposures now compared with 2015.

CBR action after Crimea sanctions saved the day

CPI inflation and CBR base rate after Crimea, in %



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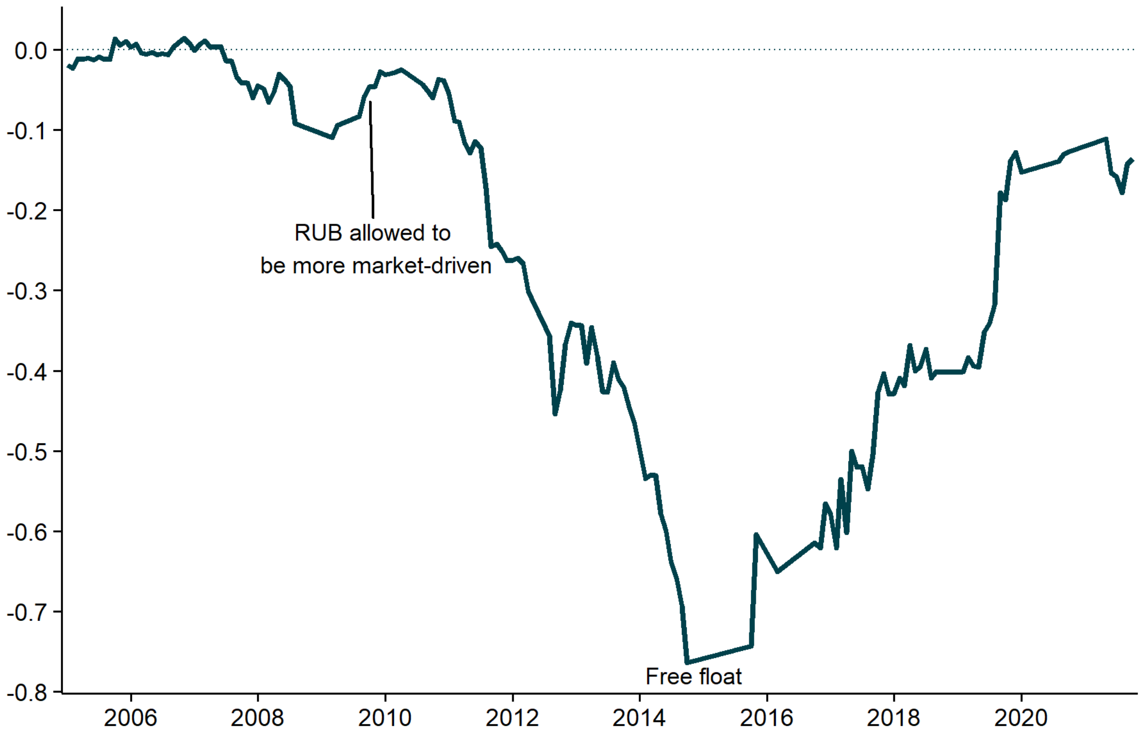
Elasticity of exchange rate to oil price movements (negative because higher oil price lowers USD-RUB



Source: Bloomberg, Commerzbank Research

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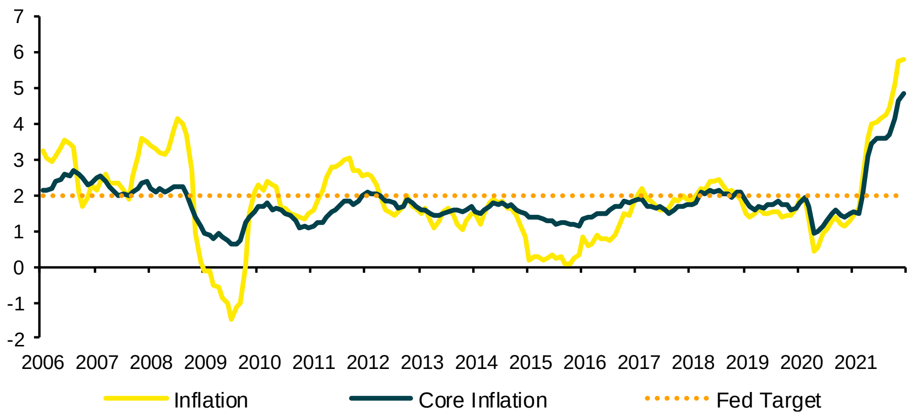
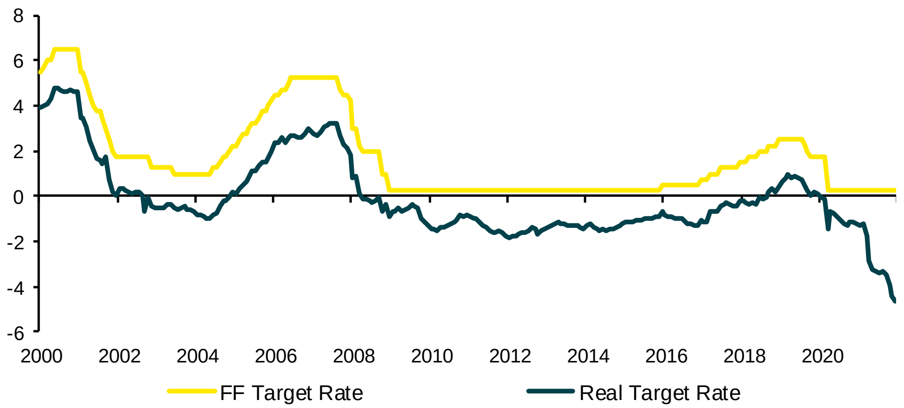
USA: Fed's lift-off imminent

PCE Deflator, annual rate of change in %



Source: Global Insight, Fed, Commerzbank Research

Real rate: Fed funds target minus PCE inflation

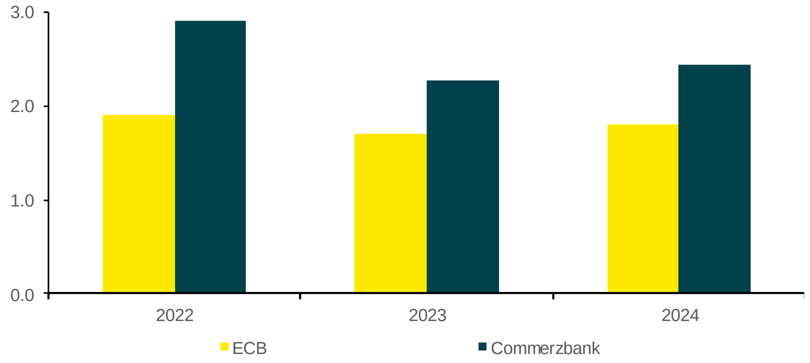


Sources: Global Insight, Commerzbank Research

- As expected, the Fed decided at its January meeting to end its bond purchases at the beginning of March. It is also becoming apparent that it will reduce the portfolio it holds again from the middle of the year by not reinvesting maturing funds. The pace of balance sheet reduction is likely to be slow at first, but will be gradually increased.
- At the same time, the Fed signaled a first rate hike at its next meeting in mid-March. The reason is high inflation, while at the same time there is almost full employment.
- Fed Chairman Powell repeatedly pointed out that we are in a different situation than in the last interest rate cycle from 2015, with growth and inflation higher and the labor market better.
- We have therefore adjusted our forecast and expect six (previously four) interest rate hikes of 25 basis points each this year. This would be a faster pace than in 2015/18.
- We therefore expect monetary policy to be tightened at each of the seven remaining meetings this year (six rate hikes plus a decision to reduce bond holdings once).

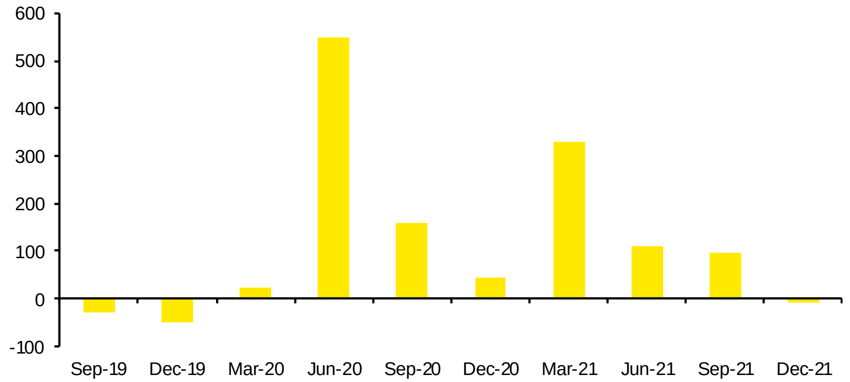
ECB: Initiate policy change in March

Core rate euro area in % (HICP exl. energy/&food), ECB and Commerzbank forecasts



Source: ECB, Commerzbank Research

Net allotment TLTRO in €bn



Source: ECB, Commerzbank Research

- The ECB has announced it will reassess monetary policy at the March meeting on the basis of updated inflation and growth forecasts. The ECB stressed that there will be no interest rate hikes before the end of net asset purchases.
- We do not expect the data published up to the March meeting to signal a decline in the EZ inflation rate, i.e. it will remain well above the ECB's December forecast. Therefore, the ECB Council is likely to decide on an accelerated reduction of bond purchases at the upcoming meeting. We expect monthly net APP purchases of €30 billion in the second quarter and €10 billion from July. This would be a clear signal that rate hikes by late summer will be on the table.
- We believe that the ECB is currently noticeably underestimating underlying inflation (top left chart), as the core rate is expected to reach a new all-time high of 3% from spring onwards. As a result, the ECB should ultimately also adjust its medium-term inflation expectations from the current 1.8% to at least the target value of 2%.
- The conditions for an interest rate hike set by the ECB in its forward guidance would then be met. Given the high inflationary pressure, we expect the ECB to raise the deposit rate from the current -0.5% by 25 basis points in both September and December. We do not expect any further rate hikes in the coming year. The many doves at the ECB will probably regard a fall in inflation to around 2% due to base effects as a late confirmation that the rise in inflation is only temporary after all.
- As a result of the monetary policy normalisation we expect, we guess that the ECB sees also no need for new TLTROs. Another argument against new TLTROs is that commercial banks are likely to voluntarily repay a large part of the TLTRO funds in advance from June 2022. The allowances of the tiered rate system could still be increased, but the impact would be muted if the deposit rate is raised to 0% by the end of the year.

Fixed Income Forecasts

	14-Feb	2022 Mar	Jun	Sep	Dec	2023 Mar
Euro area						
ECB deposit rate	**-0.50**	-0.50	-0.50	-0.25	0.00	0.00
3m OIS	**-0.57**	-0.57	-0.57	-0.57	-0.56	-0.47
3m Euribor	**-0.52**	-0.56	-0.55	-0.30	-0.06	-0.06
2y Bunds	**-0.39**	-0.40	-0.20	-0.10	0.00	0.10
5y Bunds	**0.00**	-0.10	0.15	0.25	0.30	0.35
10y Bunds	**0.22**	0.20	0.30	0.40	0.40	0.40
30y Bunds	**0.42**	0.35	0.40	0.40	0.40	0.35
Swap Spread						
2y	**61**	40	40	40	40	40
5y	**64**	45	50	50	50	50
10y	**61**	45	50	50	50	50
30y	**34**	30	35	35	35	35
UK						
Repo rate	**0.50**	0.75	1.00	1.25	1.50	1.50
3m OIS	**0.44**	0.70	0.95	1.20	1.45	1.40
10y	**1.50**	1.40	1.60	1.70	1.80	1.90

	14. Feb	2022 Mar	Jun	Sep	Dec	2023 Mar
USA						
Fed Funds Rate	**0.25**	0.50	0.75	1.25	1.75	2.00
3m OIS	**0.40**	0.41	0.67	1.18	1.65	1.91
3m Libor	**0.51**	0.46	0.74	1.25	1.75	2.01
2y Notes	**1.52**	1.10	1.40	1.60	1.90	2.10
5y Notes	**1.84**	1.60	1.90	2.10	2.20	2.30
10y Notes	**1.92**	1.90	2.10	2.20	2.30	2.30
30y Bonds	**2.22**	2.10	2.00	2.10	2.10	2.15
Swap Spread						
2y	**22**	20	20	20	20	20
5y	**10**	10	10	10	10	10
10y	**8**	5	5	5	5	5
30y	**-21**	-15	-15	-15	-15	-15
Japan						
Target rate	**-0.10**	-0.10	-0.10	-0.10	-0.10	-0.10
3m OIS	**-0.03**	-0.10	-0.10	-0.10	-0.05	-0.05
10y	**-0.13**	0.20	0.25	0.20	0.15	0.10

Thank you for your time!

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