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Russia Macro-Politics: *Breaking Bad in EM*

Yossarian: ""They're trying to kill me"
Clevinger: "No one's trying to kill you".
Yossarian: "Then why are they shooting at me?"
Clevinger: "They're shooting at everyone"
Yossarian: "And what difference does that make?

Joseph Heller*, Catch-22*

Buckle up for the roller-coaster ride. Fair to say that concern bordering on fear is now the dominant sentiment in global markets. We see that in the weakness of emerging market currencies over the past couple of weeks and now in the developed market equity indices. Over the short term it is impossible to call the direction of equities or EM currencies because momentum and fear has triumphed over valuations and economics as decisively as Seattle in the Super Bowl. We have seen these episodes many times since 2008 and it is always foolish to say "it's different this time". That remains to be seen over the next few weeks. Critically investors hope to see some coordinated calming from the world's major Central Banks. Until that happens volatility will remain and both equities and currencies, MICEX and the ruble included, will overshoot on the downside.

We are sticking with the forecasts issued in November;

Rub-US$:	36.0 at year end
US$-Eur:	$1.30 at year end
Rub-Eur:	47.50 at year-end
MICEX:	+10-15% gain for the year
Eurobond 28:	5.8% YTM at end year
OFZ 10yt:	9.0% YTM at year end
GDP Growth:	+1.9% for 2014 (provisional - very likely to change in the spring)

Russia's economy grew 1.3% in 2013. That is down from the 3.4% growth recorded in 2012 and the over 3% consensus growth rate expected at the start of this year. The main culprits for the lower growth were lower investment spending (-0.3% vs. +6.0% in 2012) and slower retail sales growth (+3.9% vs. +5.9%). High average lending rates and falling confidence contributed to both numbers but the key reason was the fact that liquidity injected into the banking system by the Central Bank stayed in the financial markets rather than filtering into the real economy.

Expect a small pickup this year. We have a real GDP growth forecast of +1.9% for 2014 based on a recovery in investment spending (+1.6%), 4.0% retail sales growth and government spending. It is also hoped that the Central Bank will resolve the problem of injecting liquidity into the financial markets which the stays there. Clearly that money needs to be made available for investment and at lower rates than currently charged. (*see forecast table and comments in the Macro section later*). In reality the 2014 growth number may end up at a repeat 1.3% of up to 3.0% depending on policy actions and the global backdrop.

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That may change in the spring. But, there are many uncertain variables in the equation, e.g. external currency contagion, China growth and the knock-on to the oil price, capital flows and consumer/business confidence. The reality is that the possible range for this year is between 1.3% and 2.6%. The picture should be clearer in the 2nd Qtr.

Some sectors continue to grow well. The best growth this year should come in the technology/media sector, in transport, in healthcare, in retail and consumer sectors (the boom is over but above the EU average growth is continuing) and, with a longer term horizon, agriculture and food production. Utilities and other industries which contribute to inflation may again be subject to tough regulation as the recent ruble weakness makes it much harder for the Central Bank to lower the inflation rate towards it's year end target of 5.5%. The commercial real-estate market is heading for a yield shake-out this summer.

Budget and balance sheet look safe. While there is a question mark over the GDP growth outlook, the budget execution and the country's balance sheet should not see much strain. We forecast a 1.0% budget spending deficit this year based on an average Urals oil price of $95 p/bbl. That oil number is on the conservative side as continuing supply outages, including what now looks like at least a one year delay for the restart of the Kashagan field in the Caspian, should keep the average price above $100 p/bbl.

Will China Break Bad? The main concern for Russia, the oil price and the ruble is that China reports a sharper fall in growth than currently expected or runs into a banking/credit crisis. There was a particularly good article about the threat to the banking system in Sunday's Telegraph which highlighted the $15 trillion credit growth along with the risks in the Trust structures and the shadow banking industry. Clearly if China "breaks bad" all bets are off for commodity dependent economies and currencies. The article is at http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10611931/The-15-trillion-shadow-over-Chinese-banks.html

Ruble finally capitulated. Through January the MICEX Index lost 3.2% while the dollar based indices were hit much harder. The RDXUSD Index fell 10.8% (*see separate section later with full tables showing stock, index, currency, commodity moves in January and over the past 13 months*). The reason for that gap was the 7.1% drop in the value of the ruble against the dollar. We issued a separate note on the ruble fall and the outlook from here (*Ruble Slide: 2 Fast 2 Furious*), the summary of which is included later in this note. We stick with our forecast that the ruble will end the year at 36.0 against the US dollar with the ruble–euro rate a function of where the dollar trades against the euro. A year end US$-Eur rate at $1.30 would imply a year-end Rub-Eur rate of 47.5. The note highlights the fact that medium to longer term a weak ruble is a positive driver of economic change in Russia. But the transition can be painful and we expect the Central Bank to try and restore stability to the market when the global EM backdrop calms down (see comments later in this note). Near term further weakness is possible because of the fear/momentum combination even though the economics don't justify it.

Yields on ruble bonds look set to expand. The yield on Russia's sovereign Eurobonds is expected to drift within a narrow range and to take their lead from the trend in the global bond market and US Treasuries. The outlook for the local ruble bond market is less safe as the weakening ruble erodes value for foreign holders which must then be compensated for with a higher yield. Foreign holders now account for over 25% of the ruble OFZ market.

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Politics continues to be a non-event in Russia. The independent Levada Center's monthly approval rating poll shows that 65% of people approve of the president and 34% disapprove. The numbers are unchanged from 12 months earlier. The stability in Russia provides a very stark contrast to the TV pictures from Bangkok, Kiev, Istanbul and, from time to time, Rio.

Defence Minister Shoigu remains the second most trusted politician in Russia. Levada's poll also shows that the population is almost equally split between those who consider the country is headed in the right direction and those who do not.

All eyes are on Sochi. The Sochi Olympics loom large over the country and the political leadership. Only after the event is completed will we be better able to assess the impact in terms of politics, economics and the foreign perception of Russia.

Warnings aplenty. Former Finance Minister Alexey Kudrin, now a member of the President's council of economic advisors, revised his role as the harbinger of doom when he said on TV channel NTV "This year and next year will be the worst years since 2000, not including the crisis year of 2009. They are not just bad, this is not a temporary, momentary deterioration. For itself, Russia has fallen into a new trend, which is connected with the outdated old model of growth and the absence of main support points for a new model. A new model is not being formed actively, and until that happens, we are in a medium-term or perhaps longer-term stagnation period,"

Other news

First Russian IPO of 2014. Retailer Lenta is set to hold the first IPO of the year and is reported to be targeting a $1 bln via a London listing. A brave decision given the difficult EM and Russia backdrop. But, as always, it will come down to the valuation. If the IPO valuation is low enough to accommodate the risks then it will get sold.

Another step in opening the capital markets. It is reported that Euroclear was given clearance to enter the corporate and municipal bond market from yesterday, Feb 3rd. According to newswire reports Clearstream will get access to corporate bonds before April. Foreign bond investors who were allowed into Russia as part of the liberalization of the OFZ ruble bond market last year, own approximately 26% of the total issuance.

Merger of Russia's two main courts nearly complete. The Federation Council approved during bills aiming to reform the judiciary by merging the Supreme Court with the Supreme Commercial Court. The result is that The Supreme Court will be granted power to supervise and resolve economic disputes that currently fall within the jurisdiction of the Supreme Commercial Court. The new entity will have 170 judges and St. Petersburg will serve as the official residence of the Supreme Court.

The current Russian judicial structure has two branches. General jurisdiction courts consider civil lawsuits, crimes and cases involving administrative offenses. This branch of the system is headed by the Supreme Court. Commercial courts, headed by the Supreme Commercial Court, hear economic disputes between legal entities pertaining to civil, administrative and other relationships.

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Russia relevant Books

Title: **The Putin Mystique**
Author: *Anna Arutunyan*

The book looks at the reasons why Putin is popular in Russia. The author's view is that Russian people have been seduced by the president, for reasons largely inexplicable, and also because they are scared of him. She does give too much space to rehashing familiar stories of people who "crossed" Putin, such as Khodorkovsky, Browder, the female band, etc, and her view of the president is never in doubt.

Reading the book, one can't help making the comparison with Bulgakov's The Master & Margarita, i.e. how Professor Woland and his group created illusions and manipulated people and events. Over the New Year holidays I watched Vladimir Bortko's ten-part series of The Master & Margarita. If you have not seen it, you have a treat waiting. It is available with English subtitles via Amazon.

Title: **Russia vs the EU…The Competition for Influence in Post-Soviet States**
Author: *Jakob Tolstrup*

The timing is perfect given the events in Ukraine and Russia's plan to expand the Customs Union into a much larger Eurasia Union. The author mainly focuses on Ukraine, Belarus and Moldova but not exclusively. Lots of examples of the "competition" between the EU and Russia and interesting analysis.

Title: **Why Russians Don't Smile**
Author: *Luc Jones*

Don't be put off by the title. This is not another Russia-bashing book. It is a guide to working and living in Russia written by somebody living in Russia almost as long as me and whom I have known throughout that period. Luc aims the book at expats who have recently located to Russia and need a guide about life and living in Russia; at foreigners who don't visit Russia and want a better understand of what it is like to do business and work here; for Russians who would like a better view of how foreigners perceive them as people rather than Russia as a country. Lots of helpful hints, contacts, do's and don'ts, etc. And the best part is it is free. Contact Luc for a free PDF download of the book at luc.jones@antalrussia.com

Moscow Times Op-Eds

Two Op-Eds in January. See later in this note my two most recent Op-Eds carried in the Moscow Times . "***Still Betting on Oil Conflicts***» was published on January 14th. This piece looks at what is holding the price of Brent/Urals near $108 p/bbl, a level it has been close to almost consistently for the past three years. Conflicts in African producing countries and in Iraq, the continuing Iranian sanctions are all significant reasons keeping the oil price close to the level at which the Russian budget balances. This long period of oil price stability is unique in the history of oil and any oil economy is making a big bet if it continues to rely on high oil revenues indefinitely rather than using this period to push diversification at a faster pace.

"Two sides to every weak ruble" was published last Friday, January 31st. This piece looks at the reasons for the ruble weakness seen since the middle of last year and especially since mid-January. Contagion is of course one explanation but is not the only one. Central Bank actions have also undermined the ruble. What's the outlook for here and what are the benefits from a weak currency?

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EM and Russia: Breaking Bad or overdone concerns?

Fear is now the dominant sentiment in EM. To say that investors are running scared of emerging market (EM) exposure is a big understatement. The MSCI EM Index fell 6.6% over the past month compared to a drop of 3.7% for the MSCI All World Index (tables later); all of the EM currencies with even a small free float extended last year's losses, and there is a flashing red question mark over growth projections across the entire EM universe. The MSCI EM Index has under-performed the MSCI All World Index by over one-third in recent years and the consensus view is that there is further under-performance to come.

The argument to buy. The optimists point to the cheap relative valuation for the MSCI EM (PE at 10.1 times vs. 14.9 times for developed markets) while the IMF forecasts 2014 growth of 2.2% for developed economies (DM) compared to more than double that (5.1%) for EM (IMF table below). They will also point to the fact that not all EMs are in the same at-risk category as some, such as Russia, still have a positive current account, large financial reserves and either a budget surplus or a small deficit.

The argument to sell. The pessimists, however, expect big growth downgrades and fiscal deterioration as a consequence of the US Fed's winding down of the QE programme, which will suck liquidity back to US dollar assets and cause both a growth and funding crisis across the EM asset class.

We stick with our original view. My view is that it is too early to have confidence in either side of the argument. I am sticking with my forecast of a 10-15% gain for the MICEX Index for the full year albeit mostly in the 2nd half. But, over the short-term, it is clear that the risk in the equity market is for further deterioration.

ETFs are a huge risk factor. Negative momentum is leading to a pick up in ETF switching/redemptions and this could get much worse before finding a support level. I have consistently highlighted the risk inherent in the huge build up of ETF money in EM funds over the past four years, i.e. up to 70% of the total. ETFs offer easier and cheaper access to an asset class but sentiment and momentum are much bigger drivers here than fundamentals. So while EM ETFs were a big driver of EM performance up to last year, the danger is that as fear now becomes the dominant sentiment we could see an even sharper spike in EM switching/redemptions and the risk of a cliff-face fall for equities.

Through the month of January;

- The MSCI Emerging Markets Equity Index lost 6.6% while the US S&P 500 lost 3.6%, mostly over the last few days of the month. That follows a loss of 5% and a gain of 30% for each respectively through 2013.
- In Russia the MICEX Index fell 3.2% (+2% in 2013) and the RDXUSD Index of Russian DRs fell 10.8% (-1.1% in 2013).
- EM Equity Funds reported total outflows of $10.5 bln for the month with $1.2 bln of that coming from Russia equity funds.
- The ruble lost 7.1% against the US dollar and reached a new record low against the euro (47.4) after losing 4.7% through the month.
- The yield on the domestic ruble priced OFZ (10yr) reached 8.3%.
- The yield on Russia's benchmark Eurobond 28 moved from 5.65% at the start of the month to 5.66% at the end of January.

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- The government confirmed that the economic growth in 2013 was only 1.3% (from +3.4% in 2012) with declines in investment spending and consumer activity accounting for the decline.
- At the same time, the Central Bank missed its inflation target and, at end December, the annualized rate of CPI was 6.5%.
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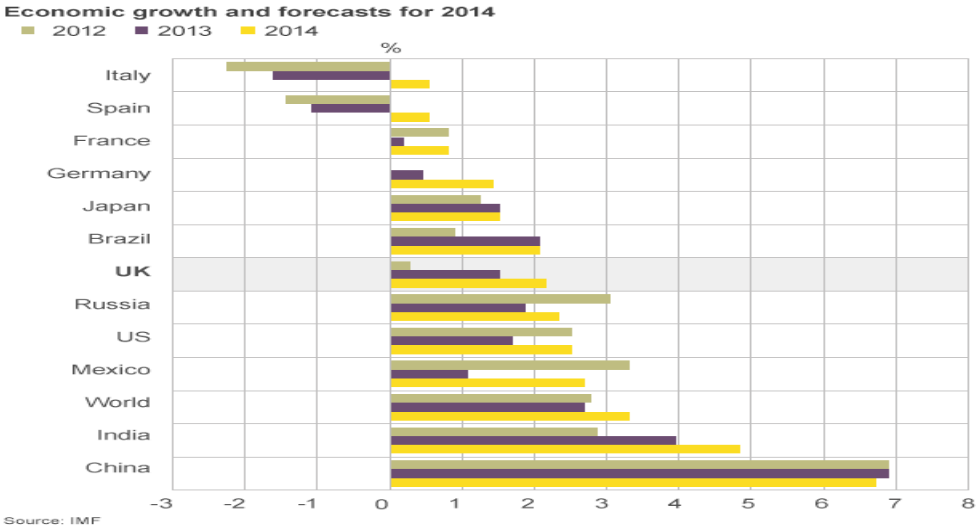

Macro update: After a poor 2013 an uncertain 2014

On Friday the Federal Statistics Service confirmed that GDP growth for 2013 was 1.3%. This is well down on the 3.4% recorded in 2012 and almost one-third the growth rate originally expected for last year. In numerical terms the critical reasons for the worse than expected outcome was the negative trend in capital investment (-0.3% versus +6% in 2012) and the slower growth in retail spending (+3.9% versus +5.9% in 2012). The twin cause of those weaker numbers was A) debt service costs remained too high and B) confidence slipped all year. The higher than expected inflation rate and the weakening trend in the ruble did not help either.

One month into 2014 the picture is not at all clear. There are a wide range of forecasts for growth in 2014, ranging from 1.3% to 3.0%. The Economy Ministry is hoping for +2.5% while we have taken a middle ground position with +1.9%. The Deputy Economy Minister has already said that the estimate for January is for +1.0% growth. There is a hope that the Olympics may provide a boost but that hope is fading as the audience is expected to be relatively small and the event very localised.

Important determinants of the actual result will include;

Bank lending rates	whether the current high rates for SMEs and consumers can be reduced
Liquidity ring-fence	part of the problem of high rates and the difficult access to loans is because the liquidity injected by the Central Bank stayed within the banking system (to bet against the ruble!). This needs to change
Inflation	price growth can be brought below 6%, which will be difficult as the ruble weakens
Ruble volatility	an uncertain or weakening currency will delay inward investment, probably boost capital flows and lead to spending delays
Stimulus	the government may debate some industry supports, e.g. tax breaks, in the spring. Or introduce other spending & investment incentives. There have been some good proposals made by the Economy and Finance Ministries to help boost investment in the SME sectors but, so far, very little follow through
Regions	Moscow's economy is already very strong and comparable to the EU average. Future growth needs to come from the regions. Rating agency S&P recently said that only 20 of Russia's over 80 regions are in a good fiscal position.
Infrastructure	The R.D.I.F. has been successful in raising investment commitments from the likes of Abu Dhabi ($5 bln in 2013). There now needs to be a step up in infrastructure spending across the board and especially in the regions. The 2018 FIFA World Cup, to be staged in eleven Russian cities, may act as a catalyst for this spending increase.
External	The big unknown right now is how the investors will deal with emerging economies and the impact on risk assessment plus capital flows as a result of the US Fed's QE rundown. If there, for example, a material impact on Chinese growth this will hurt commodities demand and prices and, by extension, Russia.
Confidence	Declining confidence amongst consumers and businesses was a significant contributory factor in the slowdown experienced in 2013. Confidence will need to be rebuilt to ensure better economic activity in 2014. Government actions and the external environment will also play a part in this.

Key macro forecasts. Based on the data recently released by the government agencies, we have updated the 2013 historic information and slightly tweaked our 2014 forecasts. The details are in the table below (no change to key numbers). The reality is, however, that forecasts at this stage are definitely going to change in the spring when the 1stt quarter numbers and any government policy changes are clear. The external environment, especially Chinese growth and the US dollar trend will also have an impact on Russia's macro execution and these also will be clearer in the spring.

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Headline Economic Indicators & Forecasts

	2009	2010	2011	2012	2013(E)	2014(F)
GDP, Nominal, $ bln	$1,219	$1,478	$1,950	$2,010	$2,060	$2,160
Growth, real % YoY	-7.8%	4.5%	4.3%	3.4%	1.3%	1.9%
Industrial Production, real % YoY	-9.3%	8.2%	4.7%	2.6%	0.3%	0.5%
Gross fixed investment, real % YoY	-14.4%	5.8%	10.2%	6.0%	-0.3%	1.6%
Retail sales, % YoY	-5.5%	4.4%	7.2%	5.9%	3.9%	4.0%
Budget, balance % of GDP	-5.9%	-4.0%	0.8%	0.0%	-0.5%	-1.0%
CPI - Year end, % YoY	8.8%	8.8%	6.1%	6.6%	6.5%	5.7%
PPI - Year end, % YoY	13.9%	16.7%	12.0%	5.1%	2.8%	4.0%
Lending, average, %	15.3%	10.8%	8.5%	9.1%	10.0%	9.0%
Deposit, average, %	8.6%	6.0%	4.4%	5.5%	5.0%	4.5%
Real disposable income, % YoY	1.9%	4.3%	0.4%	4.2%	3.3%	2.0%
Real wage growth, % YoY	-2.7%	4.4%	4.1%	8.6%	5.5%	4.0%
Nominal monthly wages (Rub p/m)	18,800p.	21,100p.	23,500p.	26,700p.	30,000p.	33,000p.
Unemployment, %	8.4%	7.5%	6.6%	5.7%	5.6%	5.3%
Trade balance, $ bln	$111.6	$151.7	$198.2	$193.3	$177.0	$155.0
Current Account, $ bln	$48.6	$70.3	$98.8	$74.5	$33.0	$20.0
FDI, gross $ bln	$36.5	$43.5	$52.9	$55.0	$78.0	$60.0
Capital Inflow/Outflow, $ bln	-$56.9	-$33.6	-$80.5	-$56.8	-$62.7	-$60.0
Foreign public debt, $ bln	$44.3	$46.6	$49.3	$70.0	$76.0	$85.0
Foreign private debt, $ bln	$425.4	$442.1	$492.6	$567.8	$660.0	$700.0
Foreign public debt, % of GDP	3.6%	3.2%	2.5%	3.5%	3.7%	3.9%
Total foreign debt, % of GDP	38.5%	33.1%	27.8%	31.7%	35.7%	36.3%
Foreign exchange reserves (ex gold),	$417	$444	$454	$487	$475	$475
Rub/$, year end	30.0	30.9	31.4	30.8	32.9	36.0
Rub/Eur, year end	43.8	40.8	41.5	40.3	45.3	47.0
Average Urals, $ p/bbl	$61	$78	$109	$110	$108	$95

Source: Federal Statistics Service, Central Bank of Russia, Macro-Advisory estimates

2013 in Summary

- GDP growth in 2013 was only 1.3% according to data released from the Federal Statistics Service late last week. It was hoped that a figure of 1.4% might be achieved given the slight uptick in the December Industrial Production number.

- Industrial output expanded 0.8% y-o-y in December, bringing the annual growth total to +0.3%. Growth was recorded in, e.g. defence, pharmaceuticals and energy sectors, while contraction occurred in the metallurgical sector.

- Investment fell 0.3% for the year, from growth of 6% in the previous year. This was one of the major factors behind the disappointing overall growth number. The decline in the pace of retail sales, to +3.9% from +5.9% in 2012, was also a significant factor.

- The federal budget finished the year with a spending deficit of Rubles 310 bln ($9.3 bln). That was better than the figure of 0.8% to GDP previously cited by the Finance Ministry. Slightly lower year-end spending accounted for the difference.

- The 2013 current account surplus was $4.7 bln in 4Q13 and $33 bln for the full year. That is equal to .5% of GDP.

- The trade surplus totalled $177.3 bln last year, a decline of almost 8% over the previous year despite the price of oil and gas remaining almost unchanged year on year.

- Capital outflows totalled $16.6 bln in 4Q13 and that brought the full year total to $62.7 bln. That compares with an outflow of $56.8 bln for 2012 and brings the total since 2007, the last year of positive flows, to $423 bln. Of that total about 20% is capital exported by individuals.

- Direct investments into Russia reached $14.9 bln in 4Q13 and $78.4 bln for the full year. That was an increase of 83% YoY. A separate study by UNCTAD reported that FDI inflows to Russia jumped by 83% to $94bn in 2013. The report said that it expects a similar jump in 2014 as, e.g., the Russian Direct Investment Fund (RDIF) continues to attract international investment partners.

- According to data published by the Association of European Businesses (AEB) new car and LCV sales in Russia grew 4% YoY to 264,257 units in December and fell by 5% YoY to 2,777,447 units for the year.

- But in a sign that technology and higher margin consumer activity is still growing strongly in Russia, the total number of smartphone units sold in Russia increased 51% to 18.5 mln units last year.

- Household consumption accounted for 49.4% of GDP in Q3 '13 (Rub 8.844 trillion), up from 47.1% in the same period of 2012. State consumption rose to 18.7% (Rub 3.345 trillion) from 17.5% over the same period.

Other macro news

Duma wants to boost minimum wages. The LDPR party have submitted a bill to the Duma to raise the minimum wage to Rub 100 ($3) per hour from January 1. If passed the minimum monthly wage will be between Rub16,000 and Rub 17,000 ($400 - $500). The current minimum monthly wage is Rub 7,000.

GDP structure update. The share of GDP from gross capital formation declined to 27.3% from 30.3%, of which investment -20.6%, down from 21.1% and inventory changes amounting to 6.7% of GDP, down from 9.2% and the share of net exports declined to 4.2% of GDP in Q3 2013 from 4.6% in Q3 2012. Russian GDP in Q3 2013 amounted to 17.934 trillion rubles, 1.2% more than a year earlier in current prices and 9.3% more than in Q2 2013. The GDP deflator index for Q3 2013 compared with Q3 2012 was 108.4%.

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Politics update: Waiting for Sochi

A quiet start to the year. After the excitement and surprises of December, the first month of the new year was uneventful. On the domestic front the focus has been on preparations for the Sochi Olympics. It is only when the games are over may we again see some movement in domestic politics.

Externally it has all been about the events in Ukraine. Moscow is clearly reluctant to get further involved having agreed a deal with Yanukovich's government in December. President Putin and the Foreign Minister have been warning against EU or other western interference in what they argue is a purely domestic affair.

Note; I issues a separate briefing on Ukraine and the implications for the Russia December deal late last week.

Putin's approval rating is unchanged. The Levada monthly opinion poll for January shows that President Putin's approval rating was unchanged from December at 65%. It has been more or less constant for the past 15 months (see table below). Prime Minister Medvedev's approval rating has again slipped just below 50% as it did in November. There are no major conclusions to be drawn from the poll other than "more of the same"

More people would vote for Putin next Sunday. In a separate poll, Levada asked people for whom would they vote if the elections were to be held next Sunday. 68% of those who said they would vote would vote for Vladimir Putin. That is a 10% increase since December 2012. His closest rival would again be the leader of the Communist Party, Zyuganov, with an expected poll of 11%.

Fewer people object to a 4th term. 22% of people said that they would like to see Putin run for another term in March 2018 while 47%, down from 55% last year, said they would prefer somebody else. But only 12% said they could name a possible alternative to Putin today.

Approval Ratings for President and Prime Minister

	Jan '12	July '12	Nov '12	Dec '12	May '13	Nov '13	Dec '13	Jan '14
Vladimir Putin								
Approve	64%	67%	63%	65%	64%	61%	65%	65%
Disapprove	34%	32%	36%	34%	35%	37%	34%	34%
Dmitri Medvedev								
Approve	57%	59%	54%	57%	54%	46%	51%	48%
Disapprove	41%	39%	45%	42%	46%	53%	47%	51%

Source: Levada Center

Trust ratings. Levada also produces a monthly poll asking people which politicians or public figures they trust most. Here also there were no surprises with Putin topping the list (34%) followed by Defense Minister Shoigu with a 19% trust rating.

Trusted Politicians		Jan '12	Sept '12	Dec '12	Mar '13	Nov '13	Dec '13	Jan '14
Putin	President	41%	36%	34%	35%	32%	36%	34%
Medvedev	Prime Minister	28%	23%	19%	17%	11%	14%	13%
Shoigu	Defense Minister	11%	10%	14%	18%	19%	19%	19%
Zyuganov	Leader Communist Party	12%	8%	8%	9%	8%	9%	9%
Zhirinovsky	Leader LDPR	12%	8%	8%	9%	9%	8%	8%
Prokhorov	Businessman-Independent politician	4%	5%	4%	6%	5%	5%	5%
Patriarch Kirill	Head of Church	7%	6%	3%	3%	2%	4%	5%
Matveinko	Leader of the Federation Council	5%	4%	4%	4%	3%	3%	2%
Lavrov	Foreign Minister			4%	5%	5%	6%	6%
Sobyanin	Moscow Mayor			5%	2%	4%	5%	3%
Mironov	Founder member of A Just Russia	8%	4%	3%	4%	3%	3%	2%
None of the above		17%	22%	20%	20%	25%	20%	19%
No opinion		5%	10%	9%	6%	6%	7%	7%
Source: Levada Center								

Equal split in the view of the country's progress. 43% of people poll by Levada in January said that they approve the work of the government while 56% do not. 43% consider that the country is heading in the right direction while 41% disagree. Neither of these polls are materially different from the December poll.

Market update: Irrational fear?

All fall down. Given the scale of the collapse in emerging market assets through January a better title might be "irrational terror". Most of the losses came in the latter part of the month after the US Fed extended the pace of withdrawal from the QE programme. The MSCI EM Index lost 6.6% for the month compared to a loss of 3.7% for the MSCI All World Index. Even last year's major market winner, the S&P 500, was not immune as investors start to fear that a collapse in the emerging economies may sooner than later have negative contagion to developed economies.

RTS and RDX sharply under-performed MICEX. The worst performing EM indices were those that are US$ denominated or exposed and where the domestic currency is at least partially free floating. Hence, amongst the Russian Indices the MSCI Index only fell 3.2%, or broadly similar to the S&P 500 and to The Shanghai Composite. That is because the MSCI is a ruble index. The RTS and RDXUSD Indices, both US dollar denominated, fell 9.7% and 10.8% respectively with the extra loss as a result of the ruble collapse. So domestic market investors are relatively protected but foreign currency investors took a beating.

UX in Ukraine was ignored. It is interesting to note that the Ukraine UX Index only fell 2.2% despite the capital city all but paralysed with the protests. The reason of course is because there is almost no liquidity in that bourse so investors have simply been ignoring it. Similarly for the MSCI EM Frontier Index which, with a gain of 0.9% for the month was one of the few indices to report a positive move.

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EM Indices, Commodities and Currencies in January* & 13 Mths**			
	Index/Price*	January*	From Jan 1 '13
RTS Index	1,302.1	-9.7%	-14.7%
MICEX Index	1,455.2	-3.2%	-1.3%
RDX USD Index	1,528.0	-10.8%	-11.8%
Kazakhstan KASE	927.9	1.1%	4.3%
Ukraine UX	889.7	-2.2%	-6.4%
Turkey ISE	61,858.2	-8.8%	-22.3%
Shanghai Composite	2,033.1	-3.9%	-10.4%
India BSE	20,513.9	-3.0%	4.8%
Brazil Bovespa	47,639.0	-7.5%	-21.8%
MSCI EM Index	936.5	-6.6%	-11.2%
MSCI World Index	1,598.5	-3.7%	19.4%
S&P 500	1,782.6	-3.6%	25.0%
MSCI EM EMEA	297.6	-9.4%	-16.3%
MSCI EM LatAm	2,894.2	-9.6%	-23.8%
MSCI EM Asia	424.5	-4.9%	12.4%
MSCI Frontier Markets	599.6	0.9%	28.9%
Copper, $ p/lb	$319.70	-5.9%	-12.5%
Brent, Fwd, $ p/bbl	$106.40	-4.0%	-4.2%
Gold, $ p/oz	$1,244.55	3.2%	-25.7%
Wheat, US d/bu	$555.76	-8.2%	-28.6%
Corn, US d/bu	$434.00	2.8%	-37.8%
Sugar, US d/lb	$15.55	-5.2%	-20.3%
Rub/US$	35.181p.	-7.1%	-15.7%
Rub/Eur	47.437p.	-4.7%	-18.1%
US$/Eur	$1.349	2.0%	-2.2%
Bond Yields	Jan 1 '13	Dec 31st '13	January 31st '14
UST - 10 Yr Yield	1.77%	2.99%	2.71%
Russia - Eurobond '28	3.83%	5.65%	5.66%
Russia - Eurobond '30	2.55%	4.13%	4.29%
OFZ - 10y		7.67%	8.28%
Source: Bloomberg			
* prices at close January 31st - US$ except where indicated			
** from December 31st 2012 to January 31st 2014			

Best and worst DRs for January. The table below shows the best fifteen Russian/CIS DRs and the worst performing DRs through January and with the performance since the start of 2013 also noted. RusAl topped the list for the past month. There have been some statements regarding the completion of settlement with Interros EPAM is one of the beneficiaries of the weaker ruble as it has US$ revenues and ruble costs. Ukrnafta, up 12.7%, is moving speculatively on expectations of the outcome of the political stand-off in Kiev.

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QIWI was hit hard with fears of regulation. At the other end of the table QIWI, last year's top Russia DR performer, took a hammering as a result of proposed legislation introduced to limit or more tightly control electronic transactions in Russia. Tinkoff Systems (TCS) was hit with concerns over credit card distribution last year and although it rallied into late December that gain was more than lost in January as investors are again nervous. VimpelCom lost 25% after the company passed on the expected final dividend of last year and warned of a lower payout in the future. The steel names were hit on general global economic concerns.

Note: The table showing the performance of Russian DRs for the past thirteen months, ranked by best to worst, is at the end of this note.

Russian/CIS ADR/GDRs in January* & 13 months*							
Leaders				**Laggards**			
	Price*	**January***	**From Jan 1 '13**		**Price***	**January***	**From Jan 1 '13**
	$ p/s	**%**	**%**		**$ p/s**	**%**	**%**
RusAl (HK$)	2.74	19.1%	-44.1%	GlobalTrans	13.25	-16.7%	-19.7%
EPAM	40.90	17.1%	126.0%	PIK Group	1.93	-16.7%	-12.1%
Ukrnafta (Eur)	66.52	12.7%	4.2%	Severstal	8.12	-17.8%	-33.3%
AFI Development	0.78	8.9%	36.4%	CTC Media	11.46	-18.1%	47.3%
Highland Gold Plc (GBP)	63.50	8.5%	-34.2%	Kazakhmys (GBP)	178.10	-18.5%	-77.1%
Chelyabinsk Zinc	3.68	6.6%	38.8%	MTS	17.25	-20.2%	-7.5%
Alrosa	36.50	4.3%	4.3%	Magnit	52.75	-20.3%	30.7%
Phos Agro	10.20	4.2%	-25.0%	Ferrexpo (GBP)	152.00	-20.4%	-37.0%
Luxoft	37.39	1.1%	119.9%	Eurasia Drilling	34.60	-23.1%	-3.1%
X5 Retail Group	16.90	0.8%	-5.3%	Evraz Plc (GBP)	85.40	-23.7%	-67.0%
Ros Agro	6.50	0.7%	0.0%	Pharmstandard	7.54	-24.0%	-55.1%
Polymetal (GBP)	577.50	0.4%	-50.9%	Mechel	1.94	-24.2%	-72.0%
Raven Russia Plc (GBP)	0.79	-0.3%	24.8%	Vimpelcom	9.69	-25.1%	-7.6%
MD Medical	11.25	-0.4%	-9.8%	TCS Group	10.90	-30.6%	-37.7%
Avangard	11.55	-1.7%	1.9%	QIWI	36.09	-35.6%	112.3%
Source: Bloomberg							
** prices at close January 31st - US$ except where indicated*							
*** from December 31st 2012 to January 31st 2014*							

Debt

Modest move in Eurobonds. Despite the rally in US Treasuries last month there was a very modest expansion in the yield of Russian sovereign Eurobonds, e.g. the YTM on the '28's rose from 5.65% to 5.66% over the month. This was because of some contagion from the uncertainty in other EM asset classes but the indications of support from the ECB pulled prices better as the month closed..

OFZ's were hit hard with the ruble fall. The big hit came in the ruble bond market as prices fell with the weaker ruble. Bond investors do not believe that the Central Bank will be able to hold the ruble even with heavy interventions and so moved the YTM on the 10yr OFZ from 7.67% at the start of January to 8.28% at the close of the month. It is estimated that 25% of the local ruble dent market is held by foreign investors so, if those investors become more convinced that the ruble will move sharply lower against the dollar/euro basket then we could see a step up in selling as they exit.

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Commodities

US Keystone decision hit Brent. The price of Brent held steady for most of the month as traders ignored the volatility in equity and currency markets. But that changed on Friday as Brent lost $1.55 per barrel. The cause of that decline was the news that the US environment impact study on the Keystone Pipeline project concluded that it will have no material impact. That now clears the way for Washington to approve the project and that will allow for a ramp up in Canadian Sands production and further cut US requirement for imported Mid East oil.

Short-term price risk. That news, if unchallenged, plus the strengthening US dollar and growing concerns over emerging market economic growth, may well see Brent drift towards the $100 p/bbl level over the short-term. A steeper collapse is still unlikely given the continuing production and export outages in Libya, South Sudan and Iraq plus the growing concern over Nigerian supply.

Metals and grains drifting with sentiment. Elsewhere the rally in the value of the US dollar and the specific Chinese growth concerns were mainly responsible for the price drops across most industrial commodities (e.g. copper was off 5.9%). Agriculture prices are always hard to call in January so the fall in Wheat and the gain in corn is of little consequence so far.

Ruble slide: 2 fast 2 Furious

The ruble has fallen too far and too fast though January because of a mixture of external contagion and domestic Central bank actions.

The full year outlook remains weak. Baring some new external shocks the ruble should stage a modest rally against both the dollar and the euro over the near term. We are sticking with my end-year forecast of Rub/$ 36.0 and Rub/Eur 47.0, i.e. the latter because we assume the US dollar will rally to $1.30 against the Euro as the Fed accelerates its exit from QE.

Small rally possible his week. Short-term we may see the ruble rally to, circa, Rub/$34.0 and Rub/Eur 46.0 as against Friday's close or Rub/$35.18 and Rub/Eur 47.44 respectively.

China, taxes and Fx reserves. The reasons why I expect a rally this week are;

- Chinese New Year started on Friday and that means Chinese markets will be closed all week and newsflow from Asia light. It is the China growth number, rather than the Fed's tapering, which poses the greatest threat to the ruble.

- The monthly domestic tax payments start Monday and that always leads to a rise in the demand for rubles

- The Central Bank and the Economy Minister made it very clear on Friday that the ruble will now be defended with increased interventions. Russia's total Fx reserves are approx. $450 bln (excluding about $50 bln in gold bullion) so the government has the fire-power and, given the quiet Asian markets and domestic tax demand, this is a very good week to use some of that . My guess is that the promise of action will be good enough for now.

- Traders and speculators are unlikely to increase bets against the ruble this week because of the factors mentioned above. More likely some will close short-ruble bets and wait to see what happens when China re-opens on Monday week.

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One short-term risk is the oil price. Brent crude fell $1.55 p/bbl on Friday (to $106.4 p/bbl). If that slide continues this week then this will add some pressure on the ruble. My view is that the slide will be halted or will be moderate as the continuing supply outages in Africa and the Mid-East are far from a resolution and Nigeria's domestic stability is at increasing risk (see comment earlier).

A Miserable January for the currency

New Rub/Euro low. The ruble lost 7.1% against the US Dollar, 4.7% against the Euro and 5.9% against the basket since the start of the year (*see table in the markets section*). Most of those losses came over the past ten days as the US Fed's actions spooked investors across most emerging economies. The ruble has now established a new record low against the euro and is close to the record low against the US dollar of 36.73 recorded in February 2009.

Sentiment trumps economics. The problem is that in February 2009 the price of Urals crude was only $40 p/bbl, the economy was in recession and the Central Bank was rapidly burning through foreign exchange reserves to buy time for the country's biggest corporations to scramble out of foreign currency debt. Today the situation is quite different with Urals above $100 p/bbl, positive economic growth and only a modest decline in foreign exchange reserves. In pure economic terms the ruble should not have weakened so steeply has it has done. And that has left a legacy of fear that, despite the assurance from the Central bank and government Ministers that they will use whatever financial reserves are necessary to stabilise the ruble, we may see further falls.

The reasons for the decline include;

Global contagion is the obvious first explanation. Ever since the US Fed first muted its intention to start tapering the QE programme, emerging market investors have been jittery. It had been hoped that last summer's volatility and weakness would have conditioned investors to the Fed's plan but that turned out to be wishful thinking. The fed's announcement of acceleration in the programme completely pulled the rug from under emerging market currencies over the past ten days and the ruble along with the others. The specific concern is that QE injected cash into emerging market assets and now that cash will start to head back to US dollar assets thus starving developing economies of capital and leading to a lowering of expected growth rates. Russia is in better shape financially – *see table below* – than others and did not benefit from cheap dollar injections to the same extent as most others. But, for now at least, that matters little as the proverbial baby gets dumped with the bath water.

Central Bank actions. There has been a lot of discussion about this in recent days and many economists blame the Central Bank for at least exacerbating the situation. Though 2013, the bank was actively intervening in the foreign exchange market in support of the ruble so that it would not fall as much as peers in other emerging markets. But as the focus of greater concern has shifted to the weakening growth indictors in the economy in recent months, the Central Bank started to inject ruble liquidity to boost the banking sector. This was an attempt to cut customer lending rates and to ensure there are no liquidity issues in the banking system as the Central Bank accelerates the program of closing more small banks. Up to 400 licenses may be withdrawn, a long-held government objective, over the next 12 to18 months. But that daily routine has contributed to ruble weakness. As it continues, the expectation that there will be more weakness to come has grown among traders, thus exacerbating the situation.

Fiscal position may be undermined. The table below shows that the Russia is in a better position than countries which have also seen large currency weakness. Unlike Turkey, South Africa and Brazil, Russia has a current account surplus and a small budget deficit. Russia's sovereign debt levels are very small compared to almost all other emerging economy except

China. So on those traditional measures of vulnerability the ruble should not have fallen so much so quickly. The issue is, however, that the current account surplus has been shrinking through last year and, while the surplus totalled $33 bln for the full year, it was less than $6 bln for the 2nd half. The concern is that if this trend continues, then the current account may easily slip into a deficit in the 2nd or 3rd quarter of this year. The budget deficit, which last year was 0.5% of GDP, is set to expand to a 1% deficit this year.

The decline of the ruble has both positive and negative implications;

- The weak ruble is positive for budget tax revenues short-term. As the price of oil and gas holds up in US dollar terms the value of those exports rises in ruble terms. That is good for the hard currency exporters but also boosts ruble tax revenue.

- A weak ruble pushes inflation higher. Most of the consumer goods imported into the country are priced in euros, especially food stuffs and medicines.

- Medium to longer term the rising cost of imported product should encourage import substitution. That should be positive for domestic consumer product producers, e.g. auto manufacturers and those in the food industry.

- The weak ruble should help the export competitiveness of Russian manufactured goods as the products will be cheaper in export markets. The issue here is that this segment of the export mix is quite small at only 15% of the value of all exports. Russia's exports are dominated by oil & gas (66%), other commodities (15%) and defence equipment. But the lower ruble will help stimulate some greater efforts to export products.

- The best placed companies are those which export. or price their services in dollars or euros but who have a cost base in rubles. Companies with a high foreign debt service load with revenues in rubles are in the worst position (*see separate client note*).

What's next?

Finding a balance. The Central Bank needs to find the balance between the need to support the ruble, maintain fiscal stability and also to provide some stimulus to boost flagging growth. For investors and businesses it will be a case of watching what the Central Bank does and assessing any policy changes in the market place. Based on end week statements from senior government officials there does seem to be a greater determination to halt the slide and to partially reverse it short-term.

Contagion, and negative sentiment, are the main risks. Longer term the more important factor will be external contagion and the trend in the EM currencies. The Central Bank should be able to ensure the ruble performs relatively better than other currencies in. e.g. Brazil, South Africa and Turkey, because of the better balance sheet, but it will not be able to fight the directional tide.

Current Account may prove to be key. The real test for the ruble may come only in the spring when the Current Account may be negative and, if confidence remains low, capital outflow may be high. That combination, if it materializes, will press hard against the ruble.

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Selected Emerging Markets - Key Data Comparison				
	GDP '2014 (F) % growth	Consumer Inflation % YoY	Current Account % of GDP	Budget Balance % of GDP
China	7.3%	3.0%	2.0%	-2.0%
India	5.1%	10.5%	-3.3%	-4.5%
Indonesia	5.0%	8.6%	-2.8%	-2.4%
South Korea	3.6%	0.9%	4.1%	0.9%
Brazil	2.5%	5.7%	-3.0%	-3.6%
South Africa	3.0%	5.6%	-5.1%	-4.2%
Turkey	3.0%	7.6%	-5.9%	-1.5%
Russia	2.0%	6.5%	1.5%	-0.4%
Source: Bloomberg, JP Morgan Research, Macro-Advisory				

MT Op-Ed 1: Still Betting on Oil Conflicts

14 January 2014

Last week, the American Petroleum Institute called on the U.S. government to end the embargo preventing the export of domestically produced crude oil. The call comes against a backdrop of rapidly rising oil production, a trend that will make the U.S. the world's biggest oil producer within 12 months. Given how emotive this subject is and the fact that the embargo came into force as a direct response to the Arab oil embargo of 1973, it is unlikely that any such change is even possible for many years. Even after the rapid production increase in recent years, the U.S. still needs to import 9 million barrels every day to satisfy current demand. It is still a long way from energy independence.

Much continues to be written about the threat to the price of crude from the rapidly rising production in North America as both U.S. and Canadian producers exploit unconventional hydrocarbon reserves. A steady customer switch to cheap shale gas will also soon create the potential to export crude according to the "end the embargo" advocates. The export call is also supported by the major oil companies who claim that U.S. oil will help lower global energy prices. Others argue that the cost of the new production is rising and, along with rising budget requirements across the Middle East and Africa, the current price is actually a sustainable new norm as producers would need to quickly act to correct any supply imbalances.

One could write volumes about the pros and cons of that argument. Suffice it to say that the relative price stability seen over the past three years is unusual. The price of Brent crude has averaged $108 per barrel, almost consistently, since late 2010. The outlook for the first half of 2014 is not much different, although we have cut our forecast for the second half to under $100 per barrel as some of the current production outages are partially restored. At that price average, the federal budget is expected to run a deficit equal to 1 percent of gross domestic product for this year, and the ruble would come under more pressure.

But as much as strategists and economists would like to be emphatic in oil-price forecasting, there is still a lot of guesstimation involved. That is because, unlike with most globally traded commodities where one can build scenarios based primarily on supply and demand, the oil industry has an additional element that trumps economics: politics.

The demand side is the easiest of the four forecast model elements to forecast — that is, with the caveat being the assumption of growth forecasts issued by the World Bank and the International Monetary Fund are correct. In its October 2013 review, the IMF forecast global growth to reach 3.6 percent this year, up from 2.9 percent last year. On the back of that forecast, the International Energy Agency expects average daily oil consumption to rise by 1.2 million barrels to 92.4 million barrels. That is a similar increase to the one recorded last year. In theory, the supply side should also be relatively predictable. The pace of supply growth in the U.S. and Canada is reasonably clear, and the 1 million extra barrels expected in the former plus the 250,000 barrels expected in the latter should cover the expected global demand increase.

Kazakhstan's Kashagan field, located in the north Caspian, was expected to be producing an average of 200,000 barrels per day later this year and double that in 2015, but it has had to suspend operations again because of technical difficulties. The project has so far cost $50 billion, the same as the cost of building the facilities for the Sochi Olympics, and is a good example of just how difficult and expensive it is to bring major new oil sources on-line. The easy oil plays are ending. The next wave of oil will have to come from shale, the Caspian, the Arctic and from offshore Brazil. All of these projects will be technically challenging and carry an unpredictably high cost. But for 2014, the majority of new oil flows will come from North America.

Then there is the politics. The reason why the 1.3 million extra barrels produced in the U.S. and Canada last year did not depress oil prices is because they only compensated for production disruptions in Libya, Sudan, Iraq and the losses from the continuing Iranian sanctions. If there had been no internal conflicts in the Middle East or Africa and if Iranian sanctions had been lifted, then the price of Brent would more likely have plunged to $80 per barrel by the end of last year. Will the conflicts in Libya, Sudan and Iraq be resolved and oil exports restored? Given the news from those countries at present, any answer is no more than a guess.

And then there are potentially new conflicts. Kurdistan is planning to export 300,000 barrels of new oil per day via the newly built pipeline to Turkey's Ceyhan terminal. If that oil reaches the market, then it would be a price negative. But don't bank on it. Kurdistan is behaving as if it were a sovereign country instead of a province of Iraq, so this also has potential conflict written all over it. The news flow from Nigeria is also disconcerting, and many commentators see a risk to oil production if the Islamic militants currently active in the country's northern regions extend their campaign to the oil region.

Iran is also another big question mark. The country is capable of restoring at least 1 million barrels to daily production and exports once the sanctions are lifted. It can do so relatively quickly because the oil-production wells were placed in suspension rather than damaged. The timetable to possibly allow Iran to resume bigger export volumes in six months has now started as part of a deal reached last year. But at the same time, a bill to impose new sanctions is currently being debated by the U.S. Congress. The situation is far from clear, and while oil traders expect to see more Iranian oil exported in the fall or from early 2015 at latest, the return will more likely be a slow build up rather than a sudden deluge. The value of the U.S. dollar is also a factor because this is the traded currency for oil. Historically, there has been a close correlation between the trade value, or purchasing power, of the dollar and the price of oil. Since the U.S. Federal Reserve started its quantitative easing programs in mid-2009, the weakened dollar has provided support for crude oil. As the Federal Reserve is now starting to cut quantitative easing support, the value of the dollar may well start to rally from mid-year and into next year and act as a depressant for the price of oil.

All things considered, rapidly rising U.S. and Canadian oil production certainly poses a threat to the price of oil in the long-term, albeit with the caveat that cost requirements are also expected to rise. But how quickly and to what extent that threat actually starts to influence the global market will depend largely on politics in the Middle East and Africa. In any event, it is safe to say that from the oil market's viewpoint, an agreeable level of disruption and uncertainty will continue for some time. The oil-revenue assumptions in Russia's federal budget look safe for 2014.

MT Op-Ed 2: Two Sides to Every Weak Ruble

30 January 2014

On Thursday, the ruble-dollar exchange rate was at 35.4, while the buying rate of the euro was 48.2 rubles. That means the ruble has dropped almost 8 percent against the dollar and lost just more than 6 percent against the euro since the start of the year. Over the past 12 months, the picture is even worse, with the ruble having lost 16 percent against the dollar and 20 percent against the euro. The current ruble-euro rate represents a new record low for the Russian currency against that of its main trading partner, the eurozone. That means the cost of imported consumer goods will rise further, thus boosting the inflation rate. Russian tourists can expect to pay a lot more for foreign holidays this year, while expatriates will find their ruble-denominated salaries will not go as far in their home countries.

In February 2009, when the ruble posted its record low of 36.7 against the dollar and recorded its previous record low of 47.25 against the euro, the price of Urals crude had collapsed from the record high of near $140 per barrel, set in June 2008, to only $40 per barrel. During the 2009 recession, gross domestic product declined by 7.8 percent and the Central Bank burned through more than one-third of the country's foreign exchange reserves. Today the price of Urals crude is at $105 per barrel, a level it has been close to for most of the past three years. While economic growth has been disappointing, the trend is still positive.

So, what is going on?

The old formula of a strong oil plus positive growth equalling strong ruble is not working. There is clearly a new dynamic at work. For companies needing to pay for imported goods and services and individuals with savings, the critical question is: "Is it too late to panic, or might we see a further steep fall in the value of the ruble?"

I started this year with a forecast that the ruble would slowly slide ahead of the Central Bank's plan for a fully free-floating ruble in early 2015. I set an end-year forecast of 36 for the ruble against the dollar. I certainly did not expect to see that target almost reached over the first month.

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Looking purely at the economics, the worst of the slide should nearly be over. The problem is that fear of further weakness coupled with external contagion may, regardless of the economics, cause a steeper slide than warranted in the short-term. The immediate short-term risk factor is external contagion and whether the rising concerns over a full blown crisis in emerging markets will continue to spook investors into cutting exposure to all assets in that category. So while the current downward spiral across most emerging markets currencies may force a new record low for the ruble-dollar rate and pull the ruble-euro rate toward 50, I believe it is too late to start switching out of the ruble. The economics do not justify it, and the Central Bank has enough firepower to stabilize the situation once the rest of the world settles down. That unpredictable latter bit is the risk, of course.

When trying to understand the reasons for the weakness in the ruble, it is useful to take a step back and look at the context. The downward spiral in the value of emerging market currencies started last summer when the chairman of the U.S. Federal Reserve first muted the probability of unwinding the quantitative easing. or QE, program. That news led to the specific concern that capital would start to flow out of emerging economies and back into dollar assets. The presumption being that a significant amount of the QE cash made available by the Federal Reserve since 2009 had found its way into these economies. The Federal Reserve's latest decision to accelerate QE unwinding, which was made at Ben Bernanke's last meeting as chairman on Wednesday, is the reason why the ruble and other emerging market currencies fell further yesterday. Over the past 12 months, as the ruble lost 16 percent against the dollar, Brazil's currency has fallen 21 percent, South African's rand is down 23 percent and Turkey's lira fell 32 percent before its central bank intervened aggressively with a near doubling of interest rates earlier this week. All of this looks relatively good compared to the more than 60 percent hammering suffered by Argentina's peso.

The problem is that the ruble should not be in the same at-risk category as the currencies of Brazil, South Africa, Turkey, Argentina and many other big emerging economies. In contrast to those countries that are running sizeable current account and budget deficits, Russia has a current account surplus, and last year's budget deficit was less than 0.5 percent of GDP. To a large extent, it is a case of throwing out the baby with the bathwater. When calmer conditions prevail, the safer balance sheet currencies should stabilize or recover some of the recent losses.

So contagion is only part of the story, of course. Part of the explanation for why the stronger balance sheet has not protected the ruble is because of the actions of the Central Bank itself. Though 2013, the bank was actively intervening in the foreign exchange market in support of the ruble so that it would not fall as much as peers in other emerging markets.

But as the focus of greater concern has shifted to the weakening growth indictors in the economy in recent months, the Central Bank started to inject ruble liquidity to boost the banking sector. This was an attempt to cut customer lending rates and to ensure there are no liquidity issues in the banking system as the Central Bank accelerates the program of closing more small banks. Up to 400 licenses may be withdrawn, a long-held government objective, over the next 12 to18 months. But that daily routine has contributed to ruble weakness. As it continues, the expectation that there will be more weakness to come has grown among traders, thus exacerbating the situation. Many economists have recently started to highlight this combination as a major cause for ruble weakness and have called on the Central Bank to cease or change its interventions policy. That would at least ease one of the factors forcing the ruble lower.

While external contagion is the major short-term risk and the major unknown at this point, the more fundamental problem for Russia continues to be the slowing economic performance and the concern that a further weak result in 2014 would start to unravel the positive financial indicators. For example, Russia's current account surplus was $33 billion last year, of which only $5.3 billion was reported in the second half-year. There is a real fear that we may see a deficit in the 2nd or 3rd quarter this year — something Russia has not seen since the 1998 default. In that case, the ruble will face further downward pressure.

Despite the deteriorating current account, Russia, unlike many emerging market peers, faces no major debt or financing issues. And given the outlook for crude oil over the next 12 months, none should arise. There is also an optimistic side to the ruble weakness: It may force greater import substitution as consumers switch to cheaper domestic alternatives. The cheap ruble should also provide a competitive boost to the country's admittedly small export manufacturers. It is here that those who believe in silver linings wrapped around dark clouds will be looking.

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Russian DRs Leaders & Laggards from Jan '13*

Stock	13 Months*	Stock	13 Months*
Outperforming RTS Index		**Underperforming RTS Index**	
EPAM	126.0%	LSR Group	-15.7%
Luxoft	119.9%	Norilsk Nickel	-17.3%
QIWI	112.3%	Etalon Group	-17.4%
Yandex	70.6%	KazMunaiGas	-19.6%
CTC Media	47.3%	GlobalTrans	-19.7%
Chelyabinsk Zinc	38.8%	Rosneft	-23.0%
AFI Development	36.4%	Tatneft	-24.0%
Sistema	33.6%	Phos Agro	-25.0%
Magnit	30.7%	VTB	-26.6%
Megafon	25.3%	TMK	-27.8%
Raven Russia Plc (GBP)	24.8%	Novolipetsk	-28.7%
Halyk Bank	20.2%	RusHydro	-32.4%
Moscow Exchange (Rub)	12.4%	Severstal	-33.3%
Mail.Ru	8.0%	Highland Gold Plc (GBP)	-34.2%
Alrosa	4.3%	Uralkali	-36.8%
Ukrnafta (Eur)	4.2%	Ferrexpo (GBP)	-37.0%
KazkomertsBank	2.9%	TCS Group	-37.7%
Nomos Bank	2.6%	IRC (HK$)	-39.3%
Avangard	1.9%	Magnitogorsk	-40.1%
Novatek	1.9%	Hydraulic Machines	-43.1%
Ros Agro	0.0%	Transcontainer	-43.9%
Eurasia Drilling	-3.1%	RusAl (HK$)	-44.1%
MHP	-3.8%	Polymetal (GBP)	-50.9%
Cherkizovo Group	-4.1%	Pharmstandard	-55.1%
X5 Retail Group	-5.3%	Federal Grid	-58.3%
Integra	-5.8%	Evraz Plc (GBP)	-67.0%
MTS	-7.5%	RusPetro Plc (GBP)	-69.6%
Vimpelcom	-7.6%	Mechel	-72.0%
Polyus Gold Intl (GBP)	-9.2%	Kazakhmys (GBP)	-77.1%
MD Medical	-9.8%	Petropavlovsk Plc (GBP)	-80.5%
Global Ports	-9.9%		
O'Key Group	-10.3%		
Novorossiisk Seaport	-12.0%		
PIK Group	-12.1%		
Sberbank	-12.2%		
GazpromNeft	-12.2%		
Surgutneftegaz	-12.6%		
Gazprom	-12.7%		
LUKoil	-14.1%		

Source: Bloomberg

*** from December 31st 2012 to January 31st 2014*