COUNTRY TOOLKIT

JANUARY 2019

RUSSIA

FISCAL POLICY TO RESTRICT GROWTH IN 2019

Economy likely to suffer from external uncertainty and VAT rate hike

GDP growth likely decelerated to 1.4% yoy in 2018 and will edge down further to 1.2% yoy in 2019 due to geopolitics and fiscal reforms.

CBR may consider further tightening by 25bp to 8.0% owing to secondary inflation risks

Further policy tightening could help contain inflation risks in 1Q19 from food and gasoline prices and the consequent impact on inflation expectations.

Budget profile to strengthen on federal and general levels

The federal budget could maintain a surplus of 1.8% of GDP in 2019 the wake of a commodities recovery, while the general balance stay in the range 0.3-0.4% of GDP on stronger revenue outlook in the regions.

Inflation to top at 5.7% yoy

We update our inflation forecast to 5.7% yoy in 1Q19 from 5.0% yoy, with a gradual reversal to 4.6% by year-end.

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SOCIETE GENERALE
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FORECASTS – FISCAL POLICY TO RESTRICT GROWTH IN 2019

RUSSIA	4Q17	1Q18	2Q18	3Q18	4Q18f	1Q19f	2Q19f	3Q19f	4Q19f	2016	2017	2018f	2019f	2020f	2021f	2022f	2023f
GDP (%yoy)	0.9	1.2	1.9	1.3	1.3	0.6	1.4	1.3	1.4	3.4	1.5	1.4	1.2	1.4	1.8	2.0	2.0
Consumer expenditure	4.3	2.7	2.6	1.7	2.1	1.1	1.2	1.4	1.4	-2.7	3.4	2.3	1.3	1.7	2.2	1.9	2.0
Government expenditure	0.4	0.5	0.6	0.2	0.2	0.2	0.2	0.2	0.2	0.6	0.4	0.4	0.2	0.2	0.1	0.1	0.0
Investment	3.4	1.8	1.0	1.0	1.3	1.0	1.3	1.6	-2.0	3.4	4.3	1.2	0.0	-2.4	3.5	4.0	4.0
Exports	5.2	6.8	7.3	4.8	5.0	3.2	3.0	2.6	2.0	1.3	5.1	5.9	2.7	1.6	3.0	3.5	3.5
Imports	15.4	9.6	2.8	7.0	4.0	-1.0	-2.0	-3.0	-3.0	-4.7	17.4	5.7	-2.3	-8.0	3.5	3.5	5.0
Net trade*	-1.9	-0.2	1.3	-0.5	0.4	1.2	1.3	1.5	1.3	1.4	-2.3	0.2	1.3	2.4	0.1	0.2	-0.1
Nominal GDP (% yoy)	6.7	8.2	12.8	12.0	12.3	10.3	11.6	6.3	6.3	3.3	6.8	11.4	8.4	4.2	5.2	6.6	7.0
CPI headline (% yoy)	2.5	2.4	2.3	3.4	4.3	5.7	5.3	5.1	4.6	6.6	3.5	3.1	5.2	4.0	4.0	3.9	4.1
CPI core (% yoy)	2.6	2.5	2.9	3.2	3.4	4.2	4.0	4.0	4.1	7.2	3.3	3.0	4.1	3.9	4.0	3.9	4.1
Unemployment rate (%)	5.1	5.1	4.7	4.5	4.7	5.0	4.6	4.3	4.5	5.5	5.2	4.7	4.6	4.5	4.3	4.3	4.0
Employment (%yoy)	-0.3	0.9	1.4	1.4	0.6	-0.3	-0.3	-0.4	-0.4	0.1	-0.3	1.1	-0.3	-0.4	-0.4	-0.4	-0.2
Productivity (%yoy)	1.9	1.8	1.2	0.5	0.4	0.5	0.9	1.3	1.6	1.1	2.4	1.0	1.1	1.4	2.4	2.6	2.0
Nominal Wage (% yoy)	8.8	11.8	10.6	9.6	8.7	8.5	8.4	8.2	8.1	8.7	7.5	10.1	8.3	8.1	6.7	5.5	6.2
Real Wage (% yoy)	6.1	9.2	8.1	6.0	4.5	3.3	3.4	3.5	3.4	2.0	3.9	6.8	3.4	4.0	2.7	1.5	2.0
Savings rate (%)	7.2	6.6	6.1	6.2	6.4	5.5	5.6	5.2	5.3	10.3	7.6	6.3	5.4	5.6	5.3	5.1	4.9
Fiscal stance** (% of GDP)										1.2	0.7	0.3	0.0	0.0	0.1	0.2	0.5
Output gap (% of GDP)										-1.8	-0.7	0.0	0.1	0.0	0.1	0.3	0.5
Corporate profits before tax (% yoy)										47.0	-16.6	14.9	8.6	7.2	5.1	3.1	1.0
Current account (% of GDP)										2.1	2.6	6.1	6.1	5.0	4.4	3.7	3.2
Budget balance (% of GDP)										-3.6	-1.5	0.6	0.4	0.3	0.3	0.3	0.3
Public Debt (% of GDP)										16.4	16.2	13.9	14.5	15.7	16.8	17.3	16.5
Main Central Bank rate (%)	7.8	7.3	7.3	7.3	7.8	8.0	8.0	8.0	8.0	10.5	8.9	7.3	8.0	7.2	6.8	6.5	6.5
CBR Balance sheet (RUB tn)	34.8	34.1	33.6	33.0	34.5	33.9	33.4	32.9	34.8	34.8	34.8	34.5	34.8	35.3	36.2	36.8	38.6

Sources: Datastream, SG Cross Asset Research/Economics

* Net contribution to GDP growth

** The fiscal stance is defined as the change in the cyclically-adjusted budget balance

Source: Rosstat, SG Cross Asset Research/Economics

RUSSIA – SUMMARY OF KEY VIEWS AND RECENT PUBLICATIONS

Fiscal policy to restrict growth in 2019

- Uncertainty surrounding geopolitics likely restricted domestic economic growth in 2018 (SG forecast: 1.4%). However, if sanction risks dissipate, the fiscal impact would be in the driver's seat going forward. We see consumer inflation rising (SG: 5.7% yoy in 1Q19) following the VAT rate hike, with GDP then gearing down in 2019.
- We reiterate our 2019 GDP growth forecast at 1.2% yoy in anticipation of a negative loop in private consumption amid the upcoming 2pp VAT hike. At the same time, the proposed fiscal stimulus will unlikely bear fruit soon, due to weak fiscal multipliers.
- Inflation jumped to 4.3% yoy in 2018, well ahead of the VAT rate hike, driven by food and gasoline prices. These inflationary shocks paved the way for a spike in the CPI rate to 5.7% yoy in 1Q19. The nature of the price growth and timely measures by the CBR should help to restrain inflation to 4.6% yoy by end-2019 and bring it back to 4.0% in early 2020.
- The positive response from oil prices to the OPEC+ agreement on production cuts, coupled with weakness in the real effective exchange rate, will likely keep the current account surplus at c.6.0% of GDP ($96n). The MinFin will unlikely abandon the oil budget rule aimed at absorbing excess income flows.
- The CBR has elaborated on its hawkish approach since September 2018, with the key rate raised twice to 7.75% since then. We suggest that secondary effects from the VAT rate hike and realised cost-push shocks may be high enough during January-February to trigger another 25bp hike in March 2019. Nonetheless, the ongoing inflation rout will hardly be long-lasting, so a strong reversal of monetary policy is possible in 1Q20 (SGe:-50bp).
- While the federal budget surplus is set to post 1.8% of GDP amid a strong oil market in 2019, the general balance may gain momentum and preserve surplus in the range 0.3-0.4% of GDP. The MinFin managed to save c.RUB4.2tn in 2018 and aims to save RUB2.6-3.3tn in 2019-21 annually.

Recent SG reports:

OOM – New lessons learned as CBR hikes to 7.75%

OOM – CBR tweaks policy with 25bp hike

OOM – Russian VAT increase: inflation impact overestimated

OOM – April FX shock: not that shocking

EM Looking Glass – Short-term pain, long-term uncertainties

OOM – Russian presidential election promises – who will pay?

OOM – Russian inflation: breaking the trend

OUTLOOK – WHERE WE DIFFER FROM CONSENSUS

Annual	CPI % yoy						GDP growth % yoy						Unemployment					
	2018	2019	2020	2021	2022	2023	2018	2019	2020	2021	2022	2023	2018	2019	2020	2021	2022	2023
Consensus Economics	4.3	4.4	3.8	3.8	3.7	3.7	1.7	1.5	1.7	1.7	1.7	1.6	5.0	5.0	5.0	5.1	5.1	5.2
Bank of Russia	4.3	5.3	4.0	4.0	-	-	1.7	1.5	2.1	2.5	-	-	-	-	-	-	-	-
IMF (Oct'18)	4.3	5.8	4.8	4.8	4.8	4.6	1.7	1.8	1.8	1.6	1.3	1.2	5.5	5.3	5.1	5.0	5.1	5.2
Societe Generale	**4.3**	**4.6**	**4.0**	**4.0**	**4.0**	**4.0**	**1.4**	**1.2**	**1.4**	**1.8**	**2.0**	**2.0**	**4.7**	**4.6**	**4.5**	**4.3**	**4.3**	**4.0**

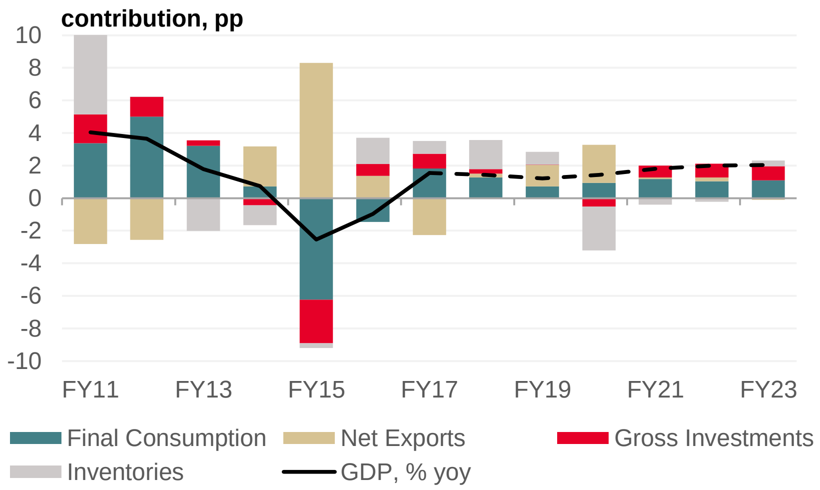
Quarterly	CPI				10Y					Bank Rate					USDRUB			
	1Q19	2Q19	3Q19	4Q19	1Q19	2Q19	3Q19	4Q19	1Q20	1Q19	2Q19	3Q19	4Q19	1Q20	1Q19	2Q19	3Q19	4Q19
Consensus Economics	5.2	5.1	4.9	4.4	-	-	-	-	-	7.75	7.65	7.61	7.52	-	67.9	67.0	67.2	66.9
Market*	5.3	5.0	4.9	4.6	-	-	-	-	-	7.60	7.60	7.55	7.50	7.40	68.2	67.9	67.5	67.0
Societe Generale	**5.7**	**5.3**	**5.1**	**4.6**	**8.60**	**8.65**	**8.50**	**8.30**	**8.10**	**8.00**	**8.00**	**8.00**	**8.00**	**7.50**	**66.2**	**65.5**	**65.7**	**66.5**

- The outlook for Russia has not been so varied among experts, authorities and global think tanks since 2015. Growth forecasts range from +1.2% to +1.8%, while inflation estimates range from 5.2% to 5.7%. **We are in the conservative camp (1.2% GDP growth, 5.7% CPI rate)**. We think inflation will have a stronger impact on real sector activity in 2019 than any other forecaster expects.

- The **long-term outlook is not unanimous either in terms of growth or inflation**. The IMF remains extremely pessimistic on the outlook for inflation in the medium term (4.6% CPI) according to the latest WEO release. However, there may be a modest impact from fiscal stimulus embedded in the figures that is hard to estimate currently. We think that the fiscal programme will be more beneficial for economic potential (**SG: GDP to accelerate above 2.0% after 2022**) and that the financial authorities will cope with related inflation risks (**SG: inflation to converge on 4.0% target from 2020**).

Source: Bloomberg, Bank of Russia, IMF, Consensus, Economics SG Cross Asset Research/Economics,

GROWTH – WEAKER ORDERS POINT TO SLOWDOWN

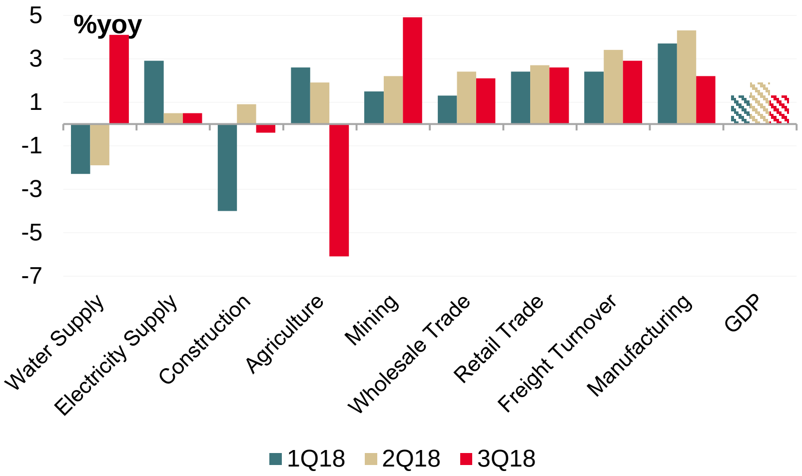


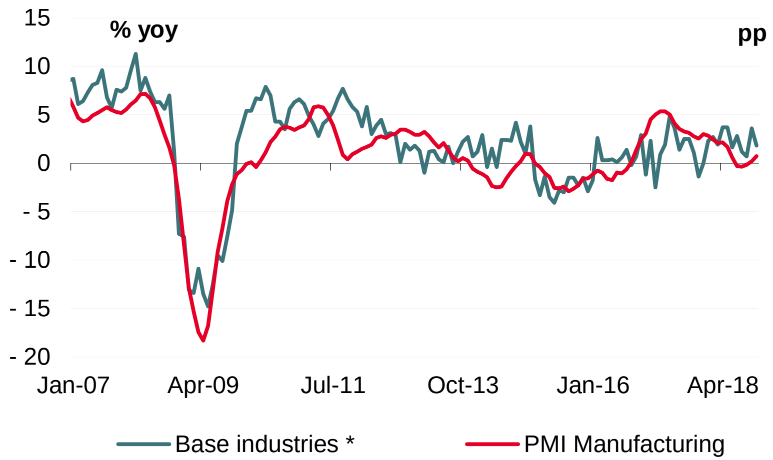
- **3Q18 GDP growth of 1.3% yoy** was a tad weaker than expected (consensus, SG: 1.4%) and down from 2Q18's 1.9% yoy. The deceleration came despite positive contributions from private consumption (contr. to GDP +1.1pp) and net exports (+1.1pp). Business investments also demonstrated healthy dynamics (+0.5pp), but a plunge in inventories outweighed all the optimism (-1.1pp). All the forward-looking indicators, including the PMI survey and REB (orders), demonstrate an unstable backdrop, which should filter into weaker business investment.

- **Our medium-term outlook sees a potential deceleration of the domestic economy** owing to a fiscal shock in 2019 (**SG: 1.2% yoy**) and probable external turbulence in 2020 (**SG: 1.4% yoy**) caused by a recession in the US economy. Moreover, the geopolitical agenda, and related sanctions against Russia, will likely cause headwinds from time to time.

Source: Rosstat, Bloomberg, SG Cross Asset Research/Economics

TALKS ABOUT SANCTIONS AND POOR HARVEST SPOILED GROWTH IN 3Q18





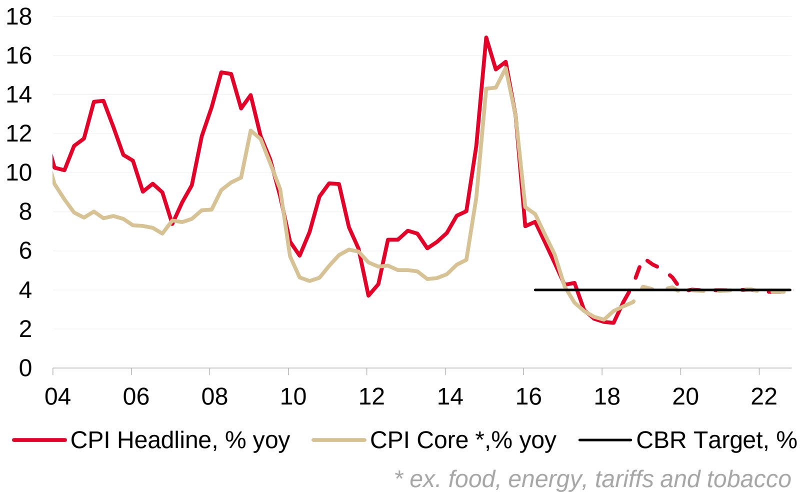
** Agriculture, wholesale and retail trade, construction, IP and transportation.*

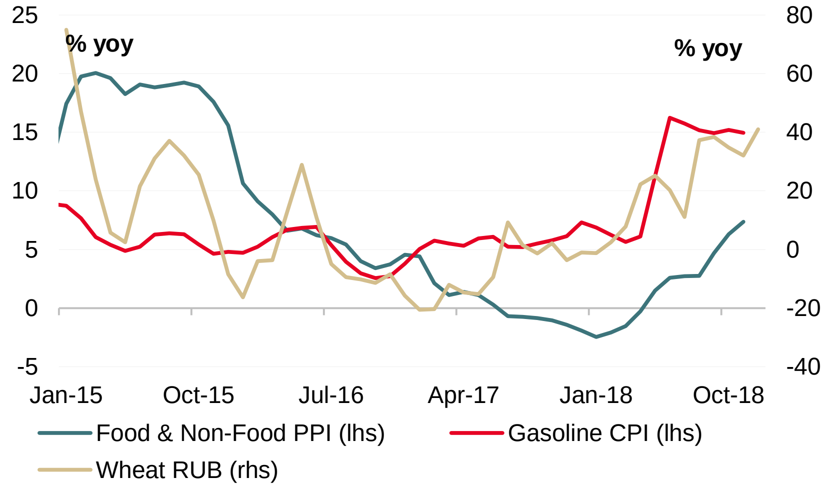
- In advance of getting the 3Q18 GDP details, **we suggest that the weakness came from at least three sources.** First, agricultural production plunged (-6.1% yoy) owing to a worse harvest than last year. Second, manufacturing industries (+2.2% yoy), especially investment-related production, responded negatively to persistent uncertainty with respect to sanctions against Russia. Finally, construction (-0.4% yoy) failed to recover amid a deceleration in residential construction and the completion of several major infrastructural projects.

- **We think at least two risks will persist**: (1) **mild stress** driven by implementation of US sanctions, including additional restrictions on external trade with the US, enlargement of the SDN list and a ban on investment in energy projects; and (2) **the potential reduction of oil production in cooperation with OPEC+,** while the US/China trade quarrel may damage the outlook for production.

Source: Rosstat, SG Cross Asset Research/Economics

INFLATION TO PEAK AT 5.7% IN 1Q19





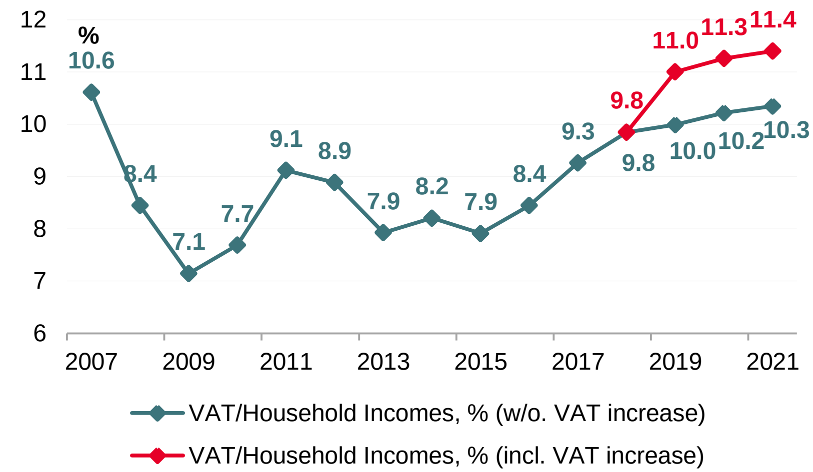
- **Headline inflation rose to 4.3% in December 2018,** indicating stronger inertia for price revisions among local retailers. Surprisingly, the materialised growth in prices had no relation to the VAT hike and was driven by cost-push effects from gasoline and food inflation. Export prices for both of them increased dramatically during the course of 2018 and pulled internal relative prices accordingly. The government introduced a moratorium on gasoline price growth until 1 March 2019, but structural measures are still falling behind.

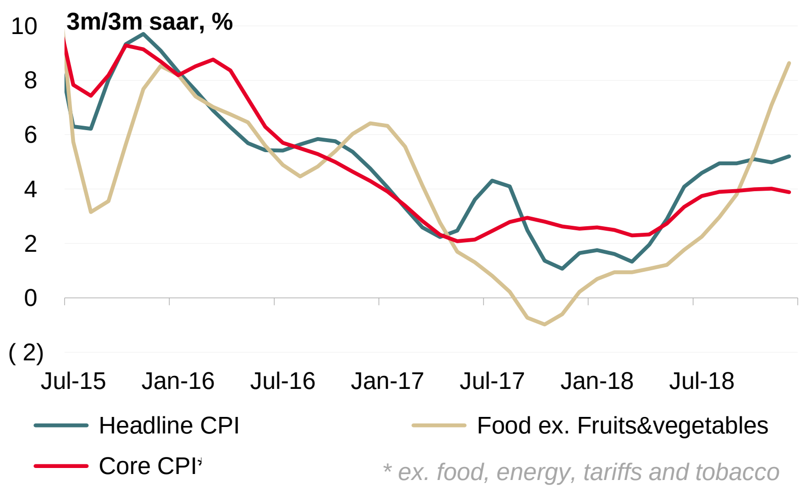
- Against this backdrop, we expect a stronger spike in expectations and some stronger secondary effects to persist during the course of 1H19. Also, **we revise our headline CPI estimate to 5.7% yoy in 1Q19** from 5.0% yoy**,** which may be easily challenged if food prices fail to calm down. The CBR confirmed its forecast CPI range of 5.5-6.0% yoy for 1Q19, but **we think the lower bound, rather than the middle of the range, is the baseline scenario**. Thus, some policy tightening may be needed to keep inflation under control.

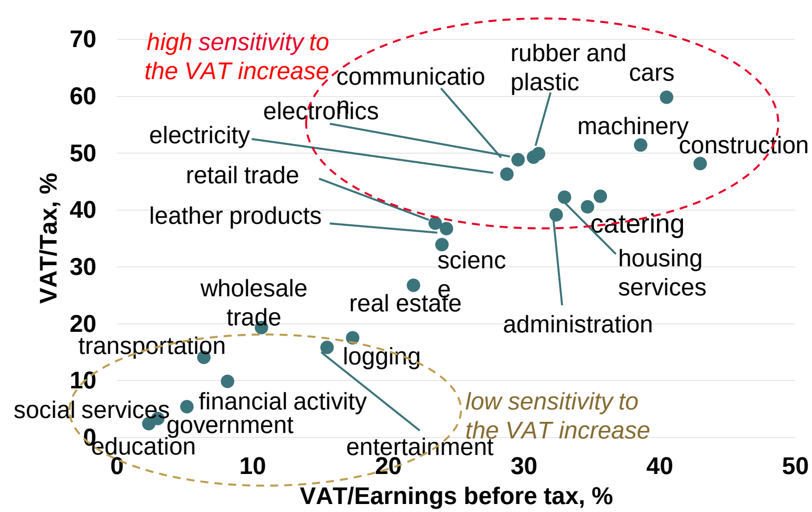
Source: Rosstat, SG Cross Asset Research/Economics

BURDEN OF VAT RATE HIKE TO BE SHARED BY PRODUCERS/CONSUMERS

- The government hiked the **VAT rate from 18% to 20% in 2019,** though exemptions for social goods & services (food, medicines, children's products) will remain in place. The government expects a contribution of RUB0.6tn annually (3% of federal revenues).
- We **expect the burden to be equally shared by producers and consumers** owing to highly fragile demand potential. However, the composition of the shared burden will depend on PPI dynamics, which may pre-empt safety margins in some industries.
- We expect the CPI rate to accelerate by only **0.6-0.7pp** during 2019 owing to the VAT hike. However, cost-push drivers have been pulling food prices in advance to the VAT rate hike.

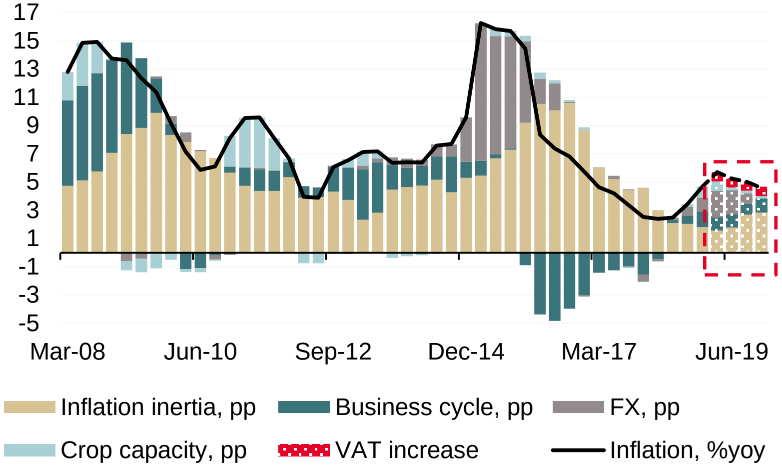


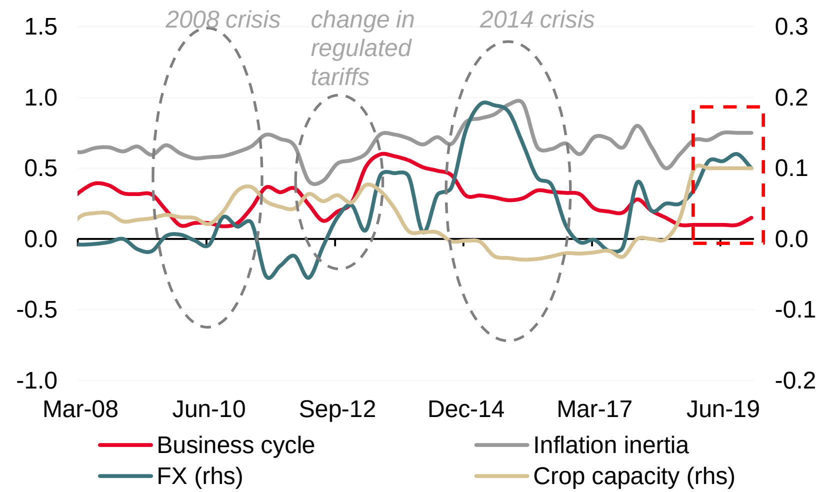




Source: Rosstat, SG Cross Asset Research/Economics

FISCAL AND FX SHOCKS TO HAVE VISIBLE IMPACT ON PRICES IN 1Q19





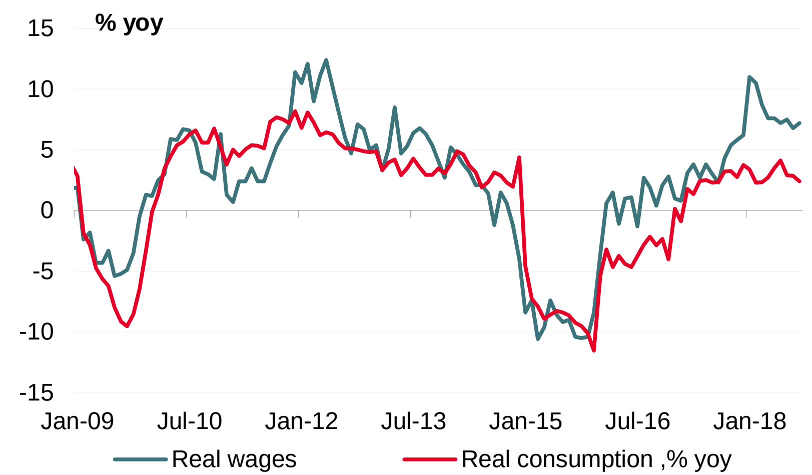
- Gradually improving cyclical drivers of inflation have taken a back seat from end-2018 amid **pass-through from volatile FX and the VAT rate hike.** Given the substantial reshaping of the Russian economy and a decreasing dependency on imports, we think the pass-through may be structurally constrained at 1.7pp in 2019. Moreover, the ruble recently gained momentum from the stronger current account and relaxed external backdrop.

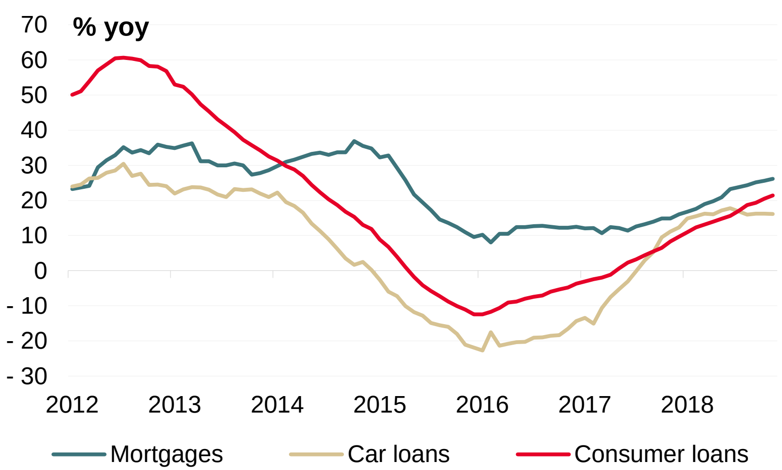
- The **contribution from price inertia,** or inflation expectations, may increase from a record low of 1.5pp to **2.5pp** over 2019. The impact may grow from 2Q19 when the government-induced regulation of the gasoline market expires. **We see the shock from the VAT rate hike contributing nearly 0.7pp** to inflation, with moderate secondary effects via inflation expectations.

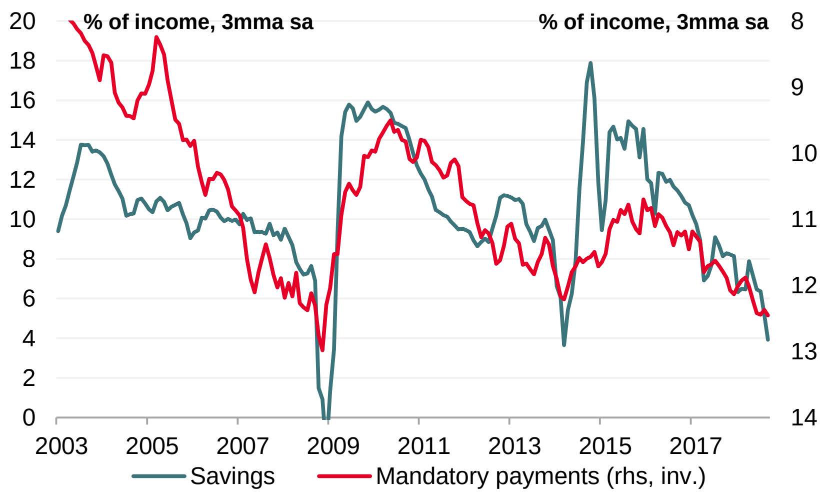
Source: Rosstat, SG Cross Asset Research/Economics

CREDIT AND WAGE GROWTH FAIL TO DRIVE CONSUMPTION

- Consumption decelerated in 3Q18 despite strong real wage growth and a sustainable credit cycle. Looking ahead, we see consumption being restricted:
  - We think the spike in public wages will be short-lived given the tight fiscal stance of the budget, while private wages will reflect the expected economic deceleration post the VAT rate hike.
  - The credit cycle was based on strong demand for mortgages. Household incomes have tightened significantly given high mandatory repayments. Against this backdrop, the savings rate and disposable income could be restrained.





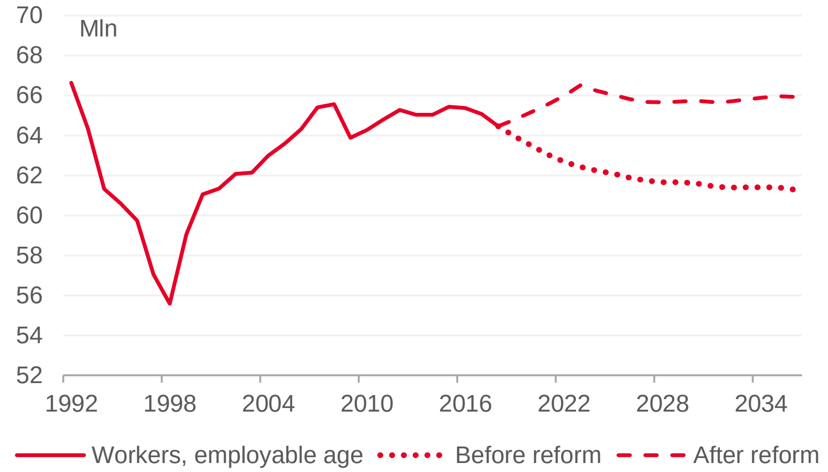


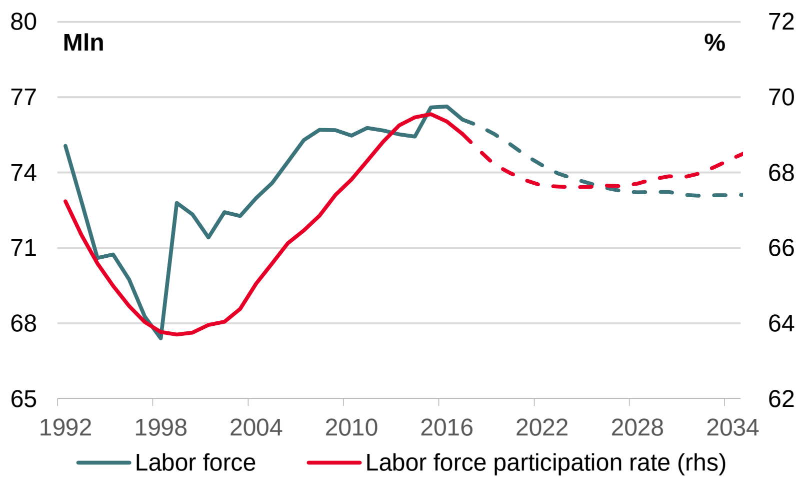
Source: Rosstat, SG Cross Asset Research/Economics

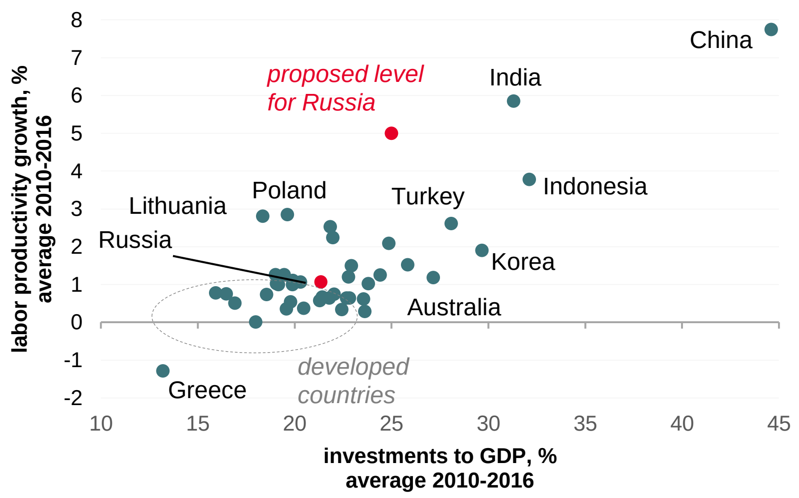
PENSION REFORM IN PLACE, BUT PRODUCTIVITY GOAL IS AMBITIOUS

- **Pension reform has raised the retirement age by five years** for women (to 60) and men (to 65) for 2019-2024. This won't change the labour force or participation rate much. Beyond being a cosmetic restructuring, the **reform should help alleviate the fiscal pressure** arising from an ageing population.

- The government will aim to achieve **productivity growth of 5.0% p.a.** We doubt that massive public capital spending via private-public partnerships and concessions aimed at **raising headline investment to 25-27% of GDP** (23.2% in 2Q18) will be sufficient.



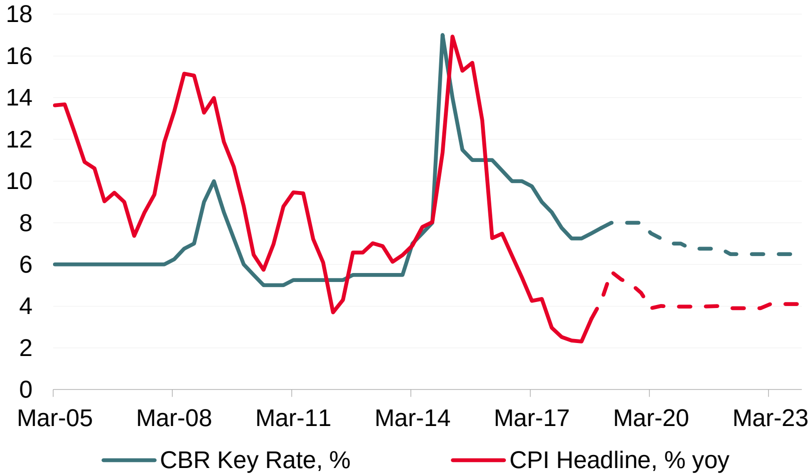


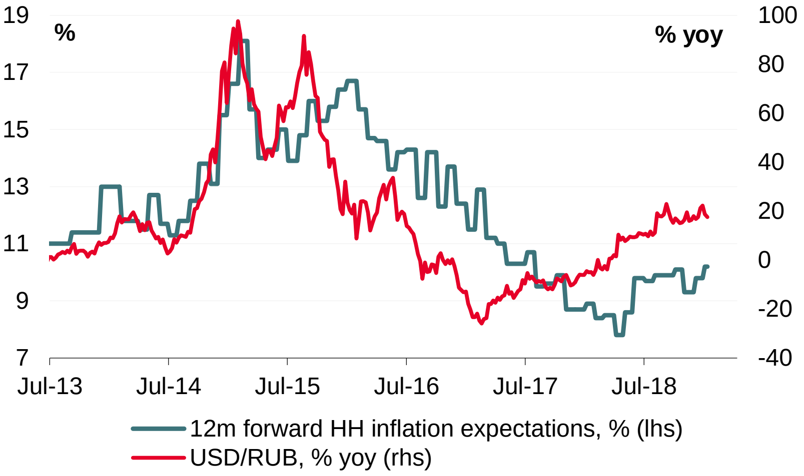


Source: Rosstat, SG Cross Asset Research/Economics

MONETARY POLICY – FURTHER TIGHTENING STILL NEEDED?

	2017	2018f	2019f	2020f	2021f	2022f	2023f	*Peak**
Central Bank of Russia								
Key rate	**8.75**	**7.44**	**8.00**	**7.19**	**6.75**	**6.50**	**6.50**	
year end	*7.75*	*7.75*	*8.00*	*7.00*	*6.75*	*6.50*	*6.50*	*8.00*
CBR balance sheet (RUB tn)	34.1	33.8	33.7	34.2	34.2	35.2	37.0	
Bond yield outlook (10Y)	**7.77**	**7.95**	**8.51**	**7.85**	**7.38**	**7.00**	**7.00**	
USDRUB	**58.30**	**62.80**	**65.98**	**65.50**	**66.00**	**67.00**	**68.00**	*68.00*

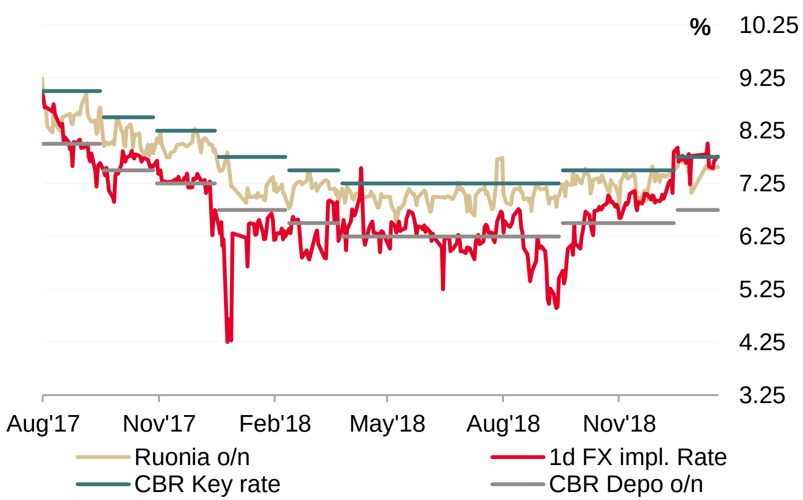




**Peak in forecast horizon (2018 – 2023), Source: Bank of Russia, Rosstat, SG Cross Asset Research/Economics*

MONETARY POLICY – FURTHER TIGHTENING STILL NEEDED?

- The CBR adjusted its policy stance twice in 2H18 by raising the key rate to 7.75% to combat accelerating inflation. These moves likely helped to alleviate the consequences of FX purchases on the open market, but we suggest the primary reason was related to the VAT rate hike (from 1 January 2019) and unexpected cost-push shocks in the food segment. Although early inflation prints did not point to strong inflation pressure emerging in January 2019, **we think another 25bp hike is on the table for 1Q19.**
- Necessary and **sufficient conditions for leaving the key rate flat are related to keeping secondary inflationary forces (i.e. expectations) under control.** However, they can hardly be satisfied, given the observed bias of expectations to food and gasoline prices. Moreover, export prices for gasoline and wheat are poorly managed, which could result in subsequent growth in internal costs.
- **We believe intensive easing (by 50bp) could emerge in 1Q20**, but this could spread over 4Q19 as well.



Source: Bank of Russia, SG Cross Asset Research/Economics

2019 CBR board meeting dates:

8 February 2019

22 March 2019*

26 April 2019

14 June 2019*

26 July 2019

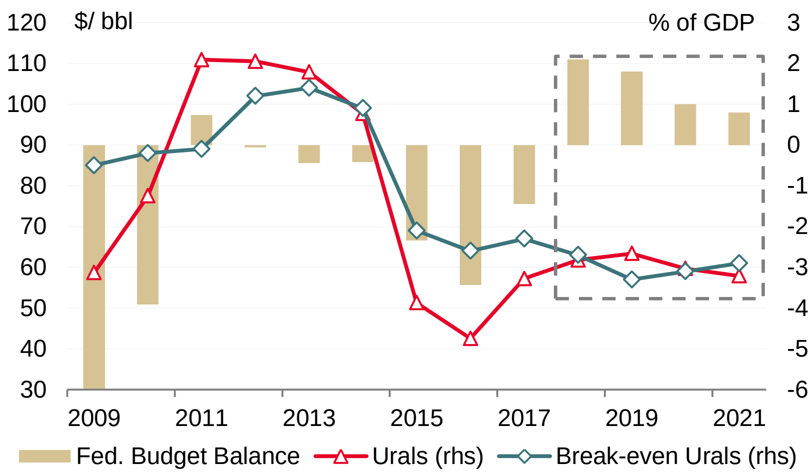
6 September 2019*

25 October 2019

13 December 2019*

* *CBR Governor statement and Monetary Policy Report (to be released in 1 week after the decision).*

FISCAL POLICY – REFORMS ENABLE MORE SPENDING



	2017	2018f	2019f	2020f	2021f	2022f	2023f
Consolidated budget balance (% of GDP)	-1.5	0.6	0.4	0.3	0.3	0.3	0.3

Key annual dates:

Budget update – March/September 2019 – revision of 2019-21 budget programme

Budget planning – late September/ early October 2019 – introduction of a budget programme for 2020-22 to State Duma

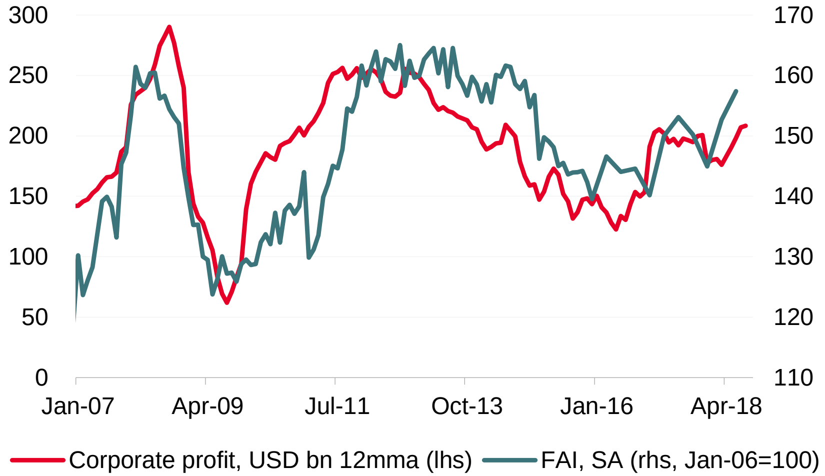
- The current **fiscal framework implies limited capacity for budget stimulus** to the economy despite the good performance of commodity markets. The **oil budget rule helped to accumulate c.RUB4.2tn (4.1% of GDP) in the National Welfare Fund in 2018 and may contribute RUB2.6-3.3tn (2.3-3.1% of GDP) in 2019-21e annually**. Against this backdrop, the federal budget will remain strong in 2019 (SGe: +1.8% GDP), though a tad lower than in 2018 (SGe: +2.1% GDP). Nonetheless, further steps should be taken to reduce imbalances among off-budget funds and regional budgets which will reduce the consolidated surplus to 0.3-0.4% of GDP.

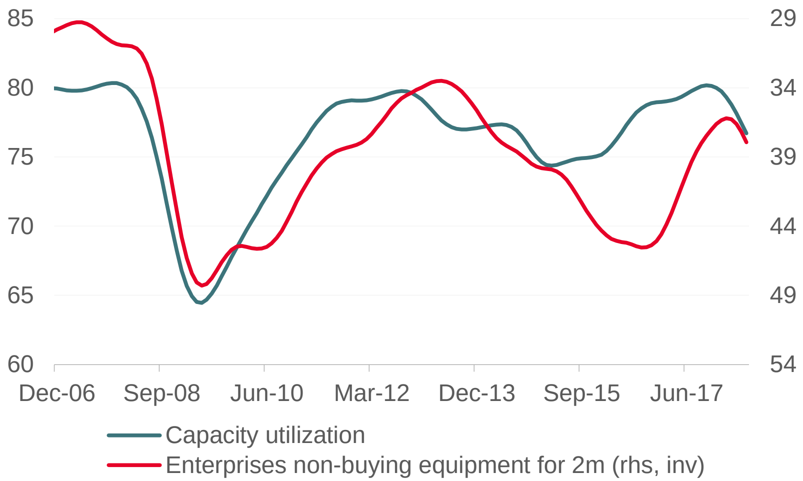
- **MinFin likely to soften stance from 2019.** The VAT rate hike will enable spending in President Putin's 'May decrees'. The pension reform (retirement age +5y for men and women to 65/60 until 2024) may help reduce federal budget transfers in favour of the Federal Pension Fund.

- According to the policy programme for 2019-21, **the MinFin aims to increase the federal budget internal borrowings to RUB2.38-2.56tn gross** to secure the budget rule and contribute to the new infrastructure fund.

**Source: Ministry of Finance73omberg,SG Cross Asset Research/Economics*

CORPORATE PROFITS TO IGNORE SANCTION THREATS

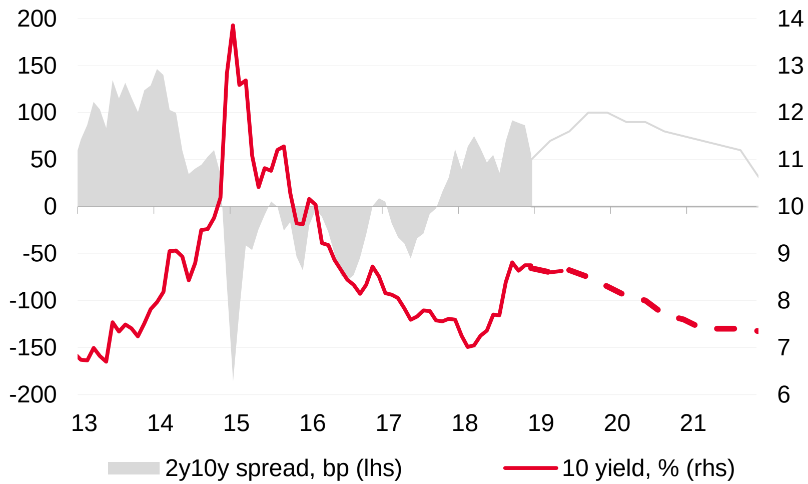


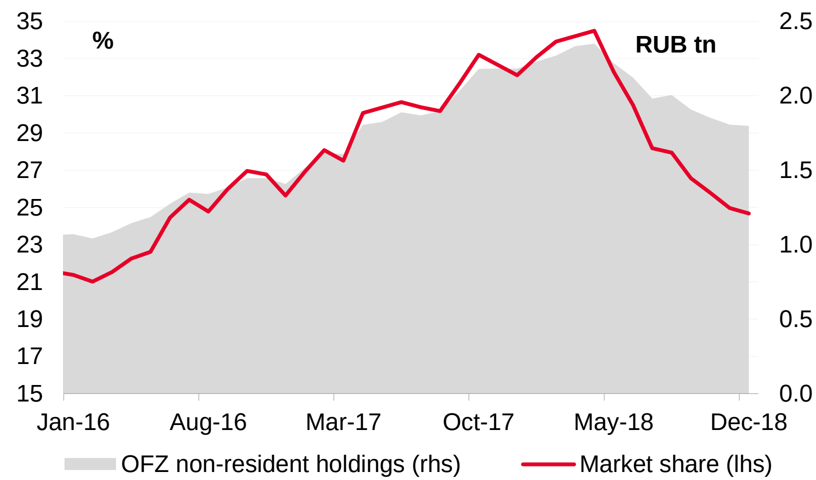


- **The financial results of oil and gas companies more than doubled over 8M18, accounting for nearly half of overall corporate profit growth (+30.6% yoy ytd).** Beyond the commodity-related sectors, there was a strong contribution from manufacturing industries (+24.8% yoy ytd), wholesale and retail trade (+54.9% yoy ytd) and railroad transportation (+27.4% yoy ytd). Other than that, performance was modest. The picture points to a positive backdrop for investment growth in 2019, but the major contribution should come from government-related programmes, which may be delayed due to coordination bottlenecks.
- **Capacity utilisation and equipment renovation started reversing in 3Q18.** This likely means that business optimism fell amid sanctions-related threats in 3Q18.

Source: Rosstat, CEIC, SG Cross Asset Research/Economics

BOND YIELDS – WEAK VALUATIONS TO PERSIST





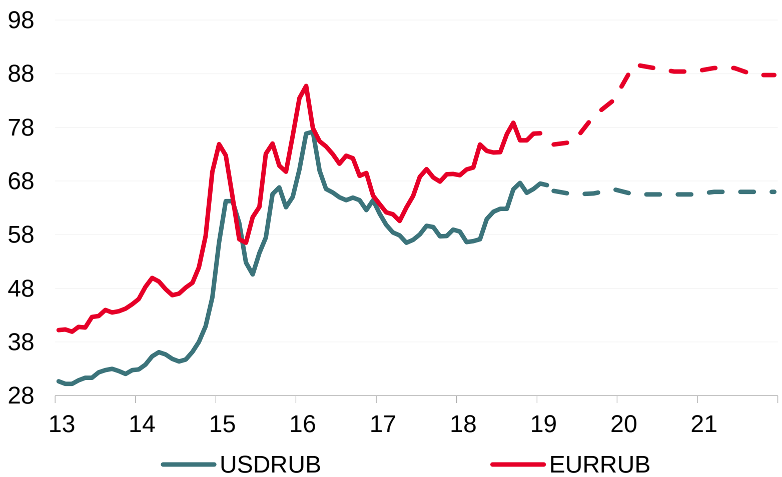
- **Foreign investors kept on reducing OFZ bond holdings** through end-November **(24.7%, RUB1.80tn on 1 December)**. This saw primary issuance fall to local lows and led to a temporary steepening of the sovereign yield curve to 60bp. The drivers were geopolitical risk (threats of sanctions against new sovereign debt) and the revival of inflation risks.

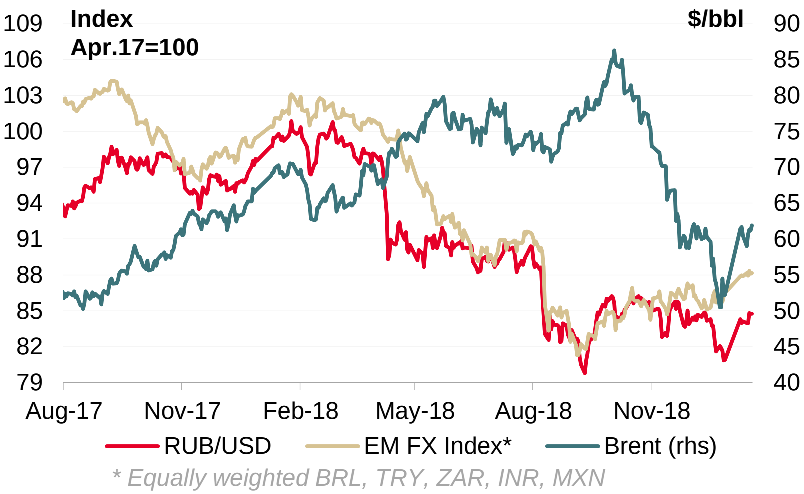
- After both these risks diminish in early 2019, the **valuation of OFZ bonds will remain sensitive to the MinFin's borrowing plans**. The fiscal programme suggests gross borrowing of RUB2.43tn in 2019 (RUB1.7tn net), which is well above the revised plan for 2018 (RUB1.2tn gross, RUB0.53tn net). Given investors' elevated expectations for the primary premium and the MinFin's conservative approach to pricing, the supply overhang may become a challenge for the10y yield and 2s10s spread.

- **We think the 10y yield will ease visibly to 30bp (8.30%) above the key rate by end-2019**, but 2s10s will tend to steepen owing to heavy borrowing overhang in the medium-term.

Source: Ministry of Finance, Bloomberg, SG Cross Asset Research/Economicsa

FX – GLOBAL MARKETS RELEASED PRESSURE ON RUB





- The **resumption of FX purchases by the CBR in January 2019 did not spook market sentiment** thanks to the overall relief delivered by external conditions. The threat of newer sanctions against Russia has yet to materialise, while less aggressive guidance from the global central banks and lightening of bearish positions in the oil sector favored risk-on appetites across the EM segment. Provided with a sustainable balance of payments profile, we think fundamentals remain supportive for the RUB and should help it outperform the EM segment.

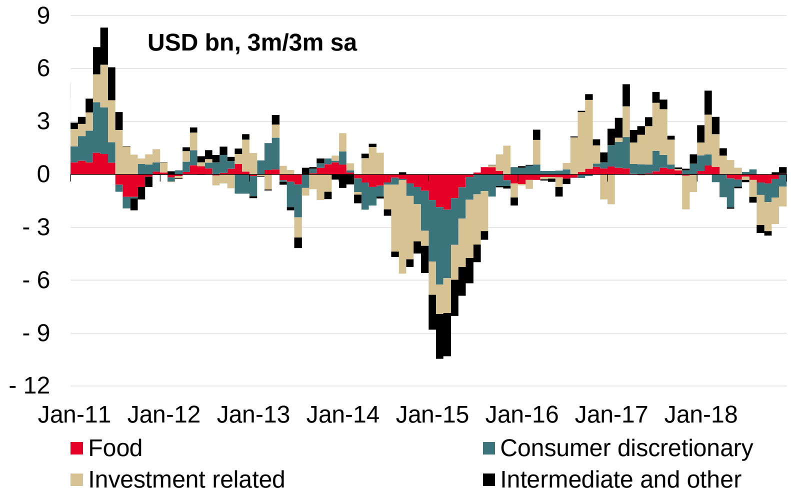
- Nonetheless, **we tweak our USD/RUB estimate by another +0.5 (to 65.5-66.2) in accordance with the new oil market assumption.** We see Brent averaging $64.5/bbl during the course of 2019, which is c.$9/bbl below our previous forecast. Other than that, the CBR took an option to reflect the full size of the MinFin's budget rule, which could significantly increase the RUB's sensitivity to extraordinary capital flows.

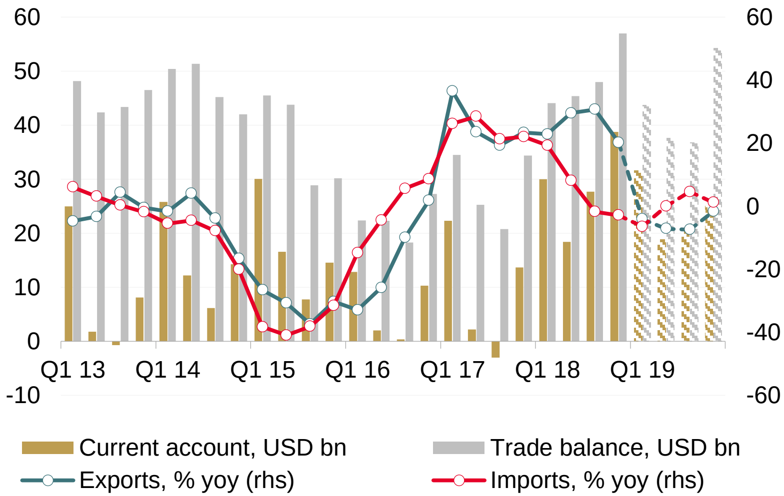
Source: Bank of Russia, Bloomberg, SG Cross Asset Research/Economics

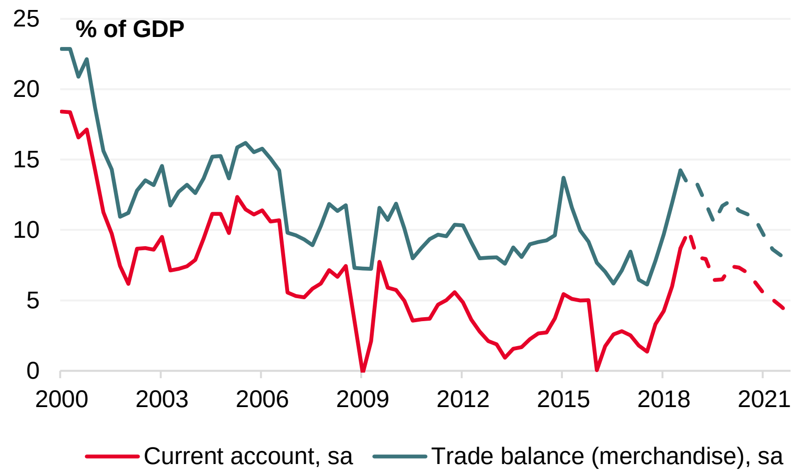
EXTERNAL BALANCES TO REMAIN HEALTHY IN THE MEDIUM TERM

- Imports of discretionary consumer, investment-related and intermediate goods demonstrated high sensitivity to rouble weakness. This leads us to believe **that the merchandise balance will remain healthy ($172bn) in 2019**, backed by a gradual oil price recovery.

- **The current account surplus profile will likely stabilise at c.6.0% of GDP ($96bn) in 2019** owing to structural support from muted net investment income payments. However, the outlook will remain highly dependent on OPEC+ collaboration and a non-escalation of global trade frictions.





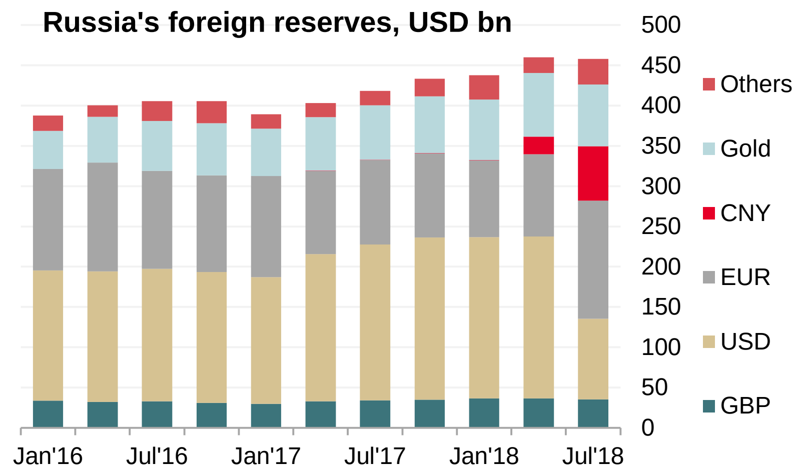


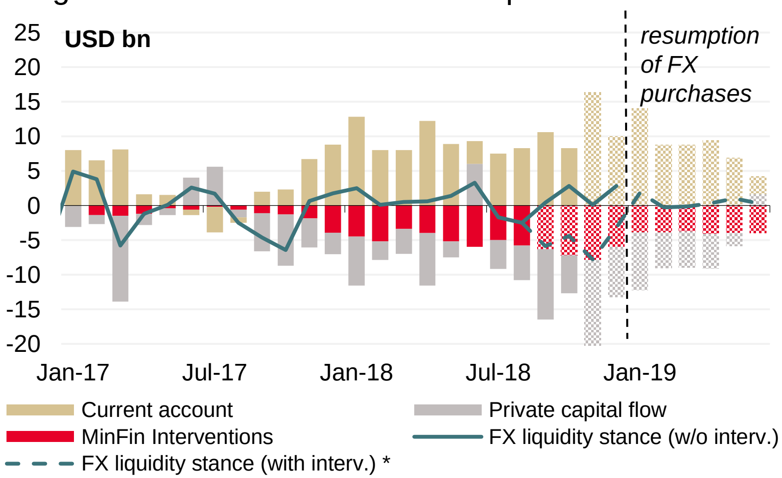
Source: Central Bank of Russia, Customs Service, SG Cross Asset Research/Economics

FINANCIAL FLOWS CONTINGENT ON CBR OPERATIONS

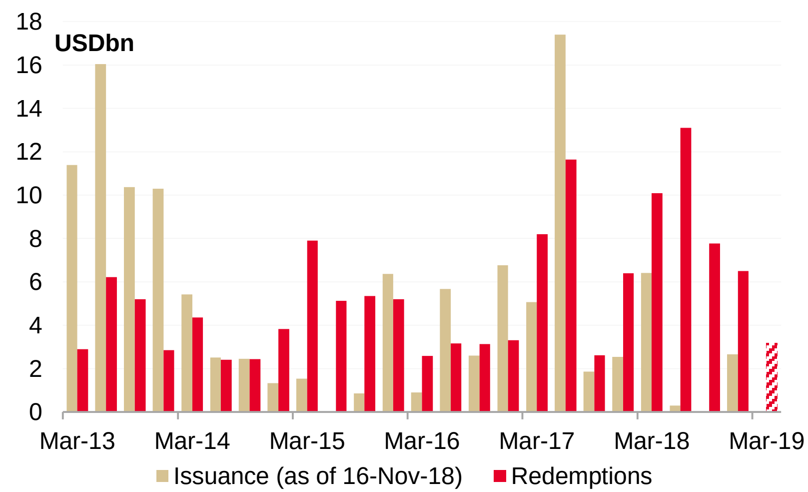
- The CBR will likely keep **accumulating reserves in accordance with** volumes prescribed by **the MinFin's budget rule** (**c.$48bn** using current oil market forecasts). However, the structure of reserves may continue drifting in favour of non-USD currencies. The cut in USD holdings in 2Q18 was reported to be replaced with gold, and EUR- and CNY-denominated assets.

- **FX liquidity conditions are unlikely to deteriorate much in 1Q19 after the CBR intervenes on the FX market.** The balance should backed by muted capital outflow (reduced debt repayment) and an expectedly high seasonal current account surplus.





** Current account excl Private flows & MinFin interventions*

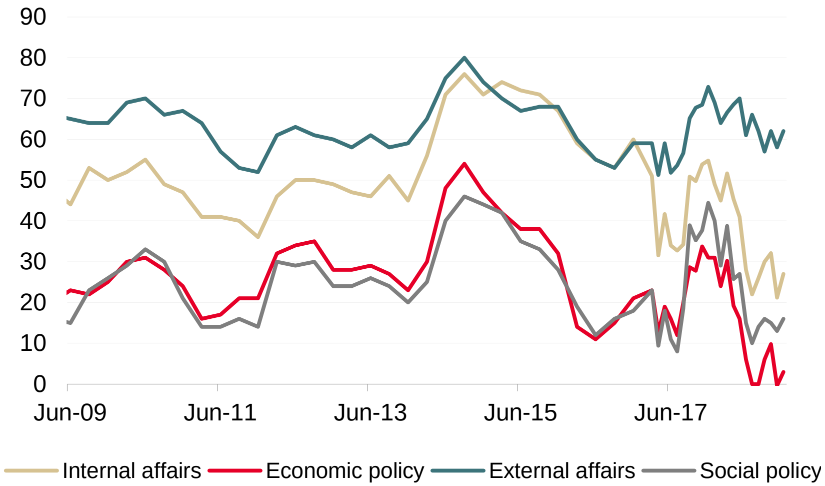


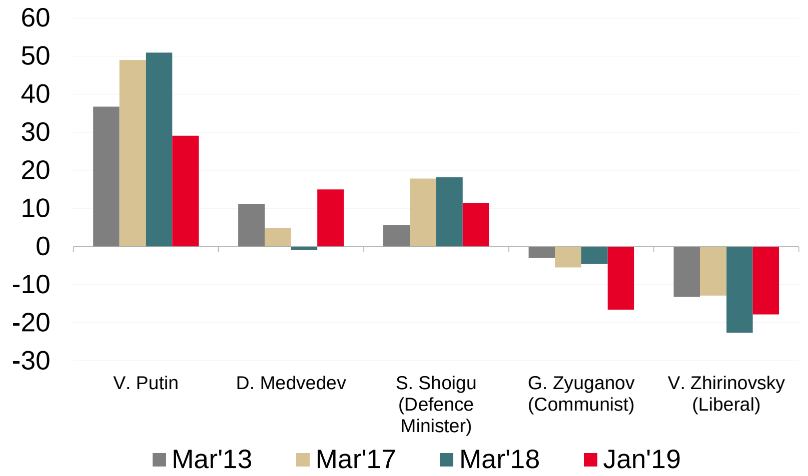
Source: Central Bank of Russia, SG Cross Asset Research/Economics

POLITICS – ELECTIONS AND REFORMS DRAGGING ON SENTIMENT

- **Russia's political leaders have fallen to record lows in opinion polls** despite last year's 'May decrees', which aim to fight poverty, promote capital investment and develop infrastructure. However, this is being accompanied by unpopular pension reform and the VAT rate hike. This implies that the expected benefits are associated with the front-load tightening of fiscal policy, which might derail households' consumption potential. Economy-related sentiment has plunged to record lows since the introduction of the pension reform.

- **Regional elections reflected a rise in the protest vote, requiring a change in federal-regional relations.** The campaign in the Far East saw protest voting against United Russia candidates. This benefited communist and liberal candidates, but did not imply improved management quality. A modest decentralisation of power from federal to regional authorities may be needed.





Source: WCIOM, SG Cross Asset Research/Economics

GEOPOLITICS – BASELINE SCENARIO NOT DISASTROUS

- Since the middle of 2018 Russia has fallen under threat of sanctions from the US due to the alleged use of the Novichok nerve agent on the UK territory and the accusations of meddling into the US elections. Both initiatives are pending at the moment owing to the US Government shutdown and ongoing turn of political debates to the US internal issues. Nonetheless, domestic market keep pricing some premium with respect to potential repercussions form each of restrictions.

Skripal case sanctions	Congress bill sanctions
• US opposition to extension of any multilateral development bank assistance to Russia. • Prohibition on extension of bank loans to the Russian government. • Downgrade of diplomatic relations.	• A limited number of political figures, oligarchs and companies added to the SDN list. • Ban on investment in energy projects outside of Russia. • Ban on sales of goods, services and technology to develop crude oil in Russia. • Ban on USD operations of a limited number of state-owned banks.

US authorities reiterated their intention to introduce the second package of sanctions related to the Skripal case but have spoken down the urgent adoption of legislative initiatives. This makes us believe that the final outcome will not aim to (1) hurt investors and businesses from the US and allied counties, or (2) break cooperation with Russia on diplomatic, military and geopolitical matters.

We aren’t expecting any catastrophic scenarios at this stage, e.g. a ban on all holdings of Russian sovereign debt, adding Russia’s largest state-owned oil & gas exporters to the SDN list, or banning the USD operations of the country’s two largest banks.

- Another threat related to US-Russia diplomatic and military cooperation emerged in December and was attributed to the agreement of limiting development and production of Medium and Small Range Missiles. The bilateral dialogue did not bear easy fruits, so degree of disorders may mount ahead of the deadline on 4 February.

Source: US Congress, SG Cross Asset Research/Economics

Market conditions could deteriorate rapidly

- FX and rates channels likely to pose challenges
- CBR could keep policy unchanged in the face of higher capital outflows

Structural budget reforms could be postponed

- Monopolies could increase prices, so tariff inflation could re-accelerate
- Spending on social needs may take centre stage, possibly derailing economic potential
- Inefficient oil taxation and break-up of a deal on gasoline with the government to hamper required investment and promote growth of gasoline prices

Geopolitical crisis worsens

- Barriers to capital allocation and technologies could derail ‘catch-up’ growth potential

Source: SG Cross Asset Research/Economics

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- ETF Research
- Technical Analysis

Fixed Income
- Rates & Forex Strategy
- EM Strategy
- Credit Strategy
- Credit Sectors

EUROMONEY FIXED INCOME RESEARCH 2017
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#2 Overall Trade Ideas

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- Sector Research
- Equity Strategy
- Equity Derivatives
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17 Sectors in the top 10

Quantitative
- Cross Asset Quant
- Equity Quant
- Equity Index

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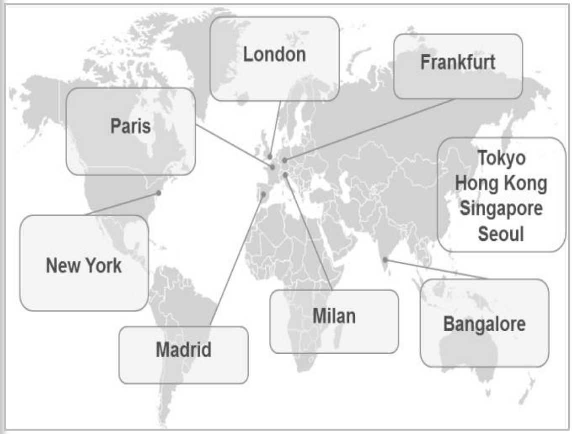
A global footprint



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