

Key Macro Forecasts - Base Case

	2017E	2018E
Growth, real % YoY	1.8%	2.0%
GFI, real % YoY	2.0%	3.5%
Retail sales, % YoY	2.0%	3.0%
CPI - year-end, % YoY	3.8%	3.8%
Budget balance, % GDP	-2.3%	-1.5%
Current account, % GDP	1.9%	1.9%
Unemployment, % eop	5.5%	5.4%
CBR key rate, %	8.0%	6.0%
Average lending rate, %	10.0%	8.5%
RUB/US\$, year-end	60.0	64.0
RUB/US\$, average	57.5	63.0
RUB/EUR, year-end	72.0	76.0
RUB/EUR, average	66.0	76.0
Average Brents, US\$ p/bbl	\$53	\$58

Source: Macro-Advisory estimates

For full list & YTD data, refer to Appendix 1

Macro Trends July & YTD - Prelim. Est.

	August*	YTD*
GDP, YoY, est	2.3%	1.7%
I.P. real % YoY	1.5%	1.9%
Retail sales, % YoY	1.9%	0.2%
Agriculture, % YoY	4.7%	1.5%
CPI - end period, % YoY**	3.3%	4.2%
Unemployment, % EOP	4.9%	5.2%
CBR key rate, %	8.50%	8.50%
RUB/US\$, eop*		58.0
RUB/US\$, average*		59.5
RUB/EUR, eop*		69.1
RUB/EUR, average*		70.3
Average Brent, US\$ p/bbl	\$57.0	\$54.0

Source: Federal Statistics Service

* to or at end-August 2017

** YTD is annualized

Market Trends - Sept & YTD*

	Index/Price*	YTD*
MICEX Index	2,077.2	-6.9%
RDX (Russia) USD Index	1,342.8	-1.1%
MSCI EM Index	1,081.7	25.5%
Copper, US\$ p/lb	\$295.5	17.9%
Brent, Fwd, US\$ p/bbl	\$56.8	-0.1%
Gold, US\$ p/oz, spot	\$1,280	11.5%
Wheat, US\$ d/bu	\$448.3	9.9%
RUB/US\$ - spot	57.48p.	6.6%
RUB/EUR - spot	67.94p.	-5.0%
Russia - Eurobond '23 *		3.19%
OFZ - 15 Yr, yield*		7.86%

Source: Bloomberg

* as at close September 30

For full list, refer to Appendix 4

Up Next

Current Account Q3	11-Oct
F.I.A.C. meeting with PM	16-Oct
Industrial Production September	16-Oct
Macro report September	18-Oct
Business Confidence update	26-Oct
Central Bank Policy Meeting	27-Oct
GDP Est September	31-Oct

Federal Stats Service, CBR, Macro-Advisory

Is Moscow facing a winter of “content”?

“I am under no illusion that serving as the US ambassador to the Russian Federation will be easy or simple.”

Jon Huntsman, US Ambassador to Russia

- **Another good month.** GDP growth was 2.3% in August, up from 1.8% in July. This came from good performances in industry and agriculture, and continuing recovery in the consumer sector. Construction is also strong, up 6.1% in August.
- **Inflation continues to fall.** August saw another post-Soviet low in inflation at 3.3%, helped by food inflation of only 2.3%. This should enable the CBR to continue cutting rates.
- **Ruble edges higher.** The ruble edged a little better against the dollar and the Euro, albeit less than the 7.4% gain in the oil price. The government assumes an average rate of 64.7 in its draft 2018 budget.
- **Mixed news on competitiveness.** Russia fell in the World Bank’s Ease of Doing Business rating, and rose in the World Economic Forum’s ranking. However, the scores in each were little changed.
- **Saudi investment commitment.** The first-ever state visit by a Saudi ruler led to some big investment commitments and a clear indication of an improved political relationship. Both countries indicated they may extend the oil production deal into late 2018.
- **Major bank failures.** The CBR has taken control of Otkritie and B&N Bank, both in the top fifteen by assets. There has been little knock-on effect in terms of a run on other banks and in the repo market.
- **Fitch upgrades.** Rating agency Fitch upgraded the outlook for Russia risk to positive (from stable) but kept the country at one notch below investment grade. It said that only geopolitical risks are keeping the rating below investment grade at this stage.
- **Five governors sacked.** There was a rush of sackings in the last week of September, part of the president’s broader personnel policy of bringing in younger managers. This is likely to be the last change of governors before the 2018 elections.
- **No interest in protests.** A poll carried out by Levada Center shows that only 11% of people said they are ready to take part in political protests while 82% said they would not. 69% of people said they do not expect any protests, even if economic conditions deteriorate.
- **Huntsman confirmed as new ambassador.** Jon Huntsman brings independent political clout, which should help in putting US-Russia relations on a more pragmatic basis. The best that can be hoped for is stabilization, at this point.

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Summary

Economy forecasts

- **EconMin remains bullish.** Speaking to the Duma on 27 September, Economy Minister Maxim Oreshkin said that the continued drivers of growth later this year would be “credit activity dynamics”, which he translated as higher mortgage lending.
- **OECD boosts its forecasts for Russia.** On 20 September, the Organization for Economic Cooperation and Development (OECD) announced that it would boost its 2017 forecast for GDP growth in Russia to 2%. Its previous forecast for 2017 was 1.4%.
- **Record grain harvest and world’s biggest wheat exporter.** Russia’s grain harvest has already exceeded 122 million tonnes, with 85% of the harvest completed, according to the Agriculture Minister. He said that Russia expects to export 45 million tonnes of grain this year, including 30 million tonnes of wheat. That will again make Russia the world’s biggest exporter of wheat.
- **Government expects 2.1% growth in 2018.** The government published a first draft for the 2018 budget. It assumes GDP expansion at 2.1% for the year. Key assumptions include inflation to average 4.0%, oil to average US\$43.8 per barrel and the US\$-ruble rate to average 64.7. The deficit is assumed at 1.4% of GDP, down from the 2.1% expected for this year.
- **Russia gains in one ranking, falls in another.** Russia rose from 43 to 36 in the World Economic Forum’s global competitiveness ranking, but fell from 36 to 40 in the World Bank’s Ease of Doing Business (EODB) ranking.
- **Fitch upgrades rating from stable to positive.** Fitch’s current rating for Russia’s sovereign debt is BBB-, one notch below sovereign debt. The outlook is upgraded from stable to positive. The agency said that it would have upgraded to an investment rating if not for the continuing geopolitical and sanctions risks. The rating agency also acknowledged that Russia is the least indebted nation amongst all those in the BBB category.
- **Diversified investment flows.** Russia is rated as the world’s most diversified commodity economy for greenfield FDI, according to a survey published by fDi Markets. Between 2003 and 2016, Russia recorded more than 4.400 separate investment projects across 39 sectors.
- **Russia tops the growth in wealth.** Russia topped the list of wealth gains in the world in 2016, according to the World Wealth Report 2017 from Capgemini. The wealth of Russia’s rich rose by 19.7% last year compared to a world average gain of 7.5%.
- **Russia is sixth largest economy based on spending power.** The World Bank has published an updated table of global economies based on Purchasing Power Parity (PPP). Russia ranks in sixth place, with PPP adjusted GDP of US\$3.4 trillion. That is just below Germany which has PPP adjusted GDP of US\$4.0 trillion.

Economy trend

- **August GDP remains strong.** The Economy Ministry reported that August GDP rose at 2.3%, up from 1.8% in July.
- **August data shows strength across the board.** Industrial production was up 1.5% year-on-year in August, well up from the 1.1% year-on-year growth seen in July.
- **Agriculture sector returns to growth.** The growth in the food sector was likely driven by the turnaround in the agriculture sector, which was up 4.7% year-on-year in August, after a fall of 2.9% in July.
- **Construction stays strong.** Construction growth of 6.7% in August, following growth of 7.1% in July, contrasted with the year-to-date performance of only 0.4%, and shows construction accelerating throughout the summer.
- **Car demand accelerates.** New vehicle sales were up 16.7% in August, down from July's number of 18.6% growth year-on-year, but were still above the year-to-date number of 9.6% growth.
- **Retail sales stay positive.** Retail sales growth was back to strength in August, up 1.9% year-on-year, making up ground lost in July when the growth rate fell slightly.
- **Balance of trade down sharply.** The fall in the balance of trade in July (these data come from the CBR and take longer to collect) was partly seasonal, and partly in line with a growing trend.

Ruble & rates

- **Small ruble gain in September.** The ruble strengthened against both the dollar and the Euro last month with the 7.4% gain in the price of oil proving the catalyst. However, there are clear headwinds building against for the ruble in both the short and medium term. The government assumes an average ruble-dollar rate of 64.7 in its draft budget for next year.
- **Markets digest rate cut.** Following the cut of the key rate by 50 bps to 8.5% at its 15 September policy meeting, the central bank may wait to see what happens to food prices after the harvest before deciding its next move. However, it may also return to its previous practice of cutting another 25 bps at the next meeting on 27 October.
- **Reserves helped by dollar weakness.** Reserves hit US\$424 billion at the end of August, the highest level since 2014. The main drivers were the stronger euro and gold, with gold now 17% of reserves, an all-time high.
- **Inflation still falling.** Inflation at the end of July was down to 3.9%, an expected fall relative to June's reported inflation of 4.4%. August saw another big cut due to food price deflation and the headline rate ended that month at 3.3% YoY. Food inflation was only 2.3% in August, after falling back down to 3.8% year-on-year in July, helped by better food supplies.
- **Slight increase in capital outflow.** Net capital outflow in 1H17 was US\$16 bln, up from the US\$8.6 bln reported in 1H16. The main reason for the increase was because banks paid down more foreign debt and also built up "external assets", according to the CBR statement.
- **Current Account deficit in August.** The Current Account ran a surplus of US\$25.4 bln through the first six months of the year but deficits in July and August cut that surplus to US\$20.5 bln.

Bank sector

- **Otkritie and B&N under administration.** The Fund for Consolidation of the Banking Sector (FCBS) took over the banks in September. At the moment, it owns 75% of both but it will take more if closer audits reveal the equity to be further depleted, which we expect to be the case. The action has been greeted calmly by the market and there have been no runs on other banks.
- **Signs of strain in the swap market.** The CBR's overnight FX swap funding for the banking system reached US\$1.5 billion in late September, its highest level ever. The CBR believes that the need for swap funding is temporary and that the situation will correct itself.
- **ACRA says bad loans may total US\$43.5 bln.** Russia's analytical agency, ACRA, reported that it sees bad loans in the banking sector at between 12-15% of the total loan portfolio. It calculates that amounts to US\$43.5 bln and, if written off, would cut banks' core capital adequacy ratio from the current 9.4% to 6.2%.

Domestic politics

- **Replacing Governors.** There has been another round of governor replacements as the Kremlin prepares for the next presidential term. The governors of Samara, Krasnoyarsk, Nenets, and Nizhny Novgorod as well the President of Dagestan were replaced.
- **Meeting with business.** Putin held his traditional annual meeting with the leaders of big business in Russia. He promised greater ease of doing business if sanctions got tougher, and indicated a moratorium on the tax burden through to 2024.
- **What does this mean for big politics?** The recent events suggest that Putin is setting himself up for the next term. He is putting in place a team of young, energetic and hungry "technocrats" who will be loyal to him, and eager to do his bidding to further their ambitions. The other signal is that oligarchs and senior officials would not be allowed to spread their influence inside government by placing their own candidates in mid-level posts in federal and regional government.
- **Election date confirmed.** The presidential election date has been moved from the second Sunday in March 2018 (11th) to the third Sunday (18th). The significance of this is that is the fourth anniversary of the Crimean referendum.
- **No interest in protests.** A poll carried out by the Levada Center shows that only 11% of people said they are ready to take part in political protests, while 82% said they would not. 69% of people said they do not expect any protests, even if economic conditions deteriorate.
- **Politics of bank bailouts.** The bailouts of Otkritie and B&N Bank have not had much direct effect, but have important implications, which is why they merit discussion in the monetary, political and corporate segments of this report. The political implications are important, as they show that the President is willing to step on some powerful toes in order to clean up the banking sector.
- **Scandal over airlines strengthens Medvedev.** The government's response to the failure of VIM-Avia was politically significant. Putin used it to publicly criticize a couple of ministers, but also to confirm his confidence in Medvedev.
- **Levada polls show little change.** The monthly Levada Center poll shows unchanged ratings for both Putin and Medvedev in September, which is not surprising as there was not much going on to shift these ratings.

Sanctions

- **Tillerson-Lavrov meeting may point to an end to diplomatic tit-for-tat.** At the UN General Assembly, US Secretary of State Tillerson and Russian Foreign Minister Lavrov had a one-on-one without advisors. The signals coming out of that meeting, on the Russian side at least, indicate that they agreed to draw a line under the diplomatic sanctions that each has been imposing on the other.
- **Huntsman confirmed as new US Ambassador.** The Senate confirmed Jon Huntsman as Ambassador to Russia, which is an important step in normalizing relations between Washington and Moscow. He was confirmed without objection, which at least is not a bad sign.

Capital markets

- **Another strong month in September.** The RTS Index gained 3.7% in September, building on its gains in August. The benchmark dollar-denominated index is now close to having erased its losses for the year. The ruble-denominated MICEX Index also rallied in September (+2.7%) but is lagging further behind YTD.
- **Well behind the MSCI EM.** Both Russian indices are still badly lagging the 25.5% YTD gain in the MSCI EM Index. But, if the price of oil stays in the mid-US\$50s per barrel, or better, then the flow of money seen into Russian equity assets in recent months may continue and that performance gap will close.
- **Oil improves sentiment.** A lot of the credit for the improved sentiment should go to the higher oil price, with Brent up 7.4% last month. Russia is still viewed primarily as an oil play by international investors. But, added to the oil price driver, investors are also encouraged by the strengthening of the economic recovery, the positive comments by several rating agencies and the strong commitment by Saudi Arabia to invest in Russia.
- **Sistema appeals against Rosneft ruling.** Sistema has lodged another appeal against the court ruling that it must pay damages to Rosneft for losses incurred by Bashneft when Sistema was its controlling shareholder. Sistema would have to find about US\$2.4 billion in damages.
- **Facebook warned over data storage.** In a case that has echoes of LinkedIn's banning in Russia, Roskomnadzor, the State communications regulator publicly warned Facebook that they needed to comply with Russian law requiring personal data on Russians to be held on servers located in Russia. LinkedIn's refusal to comply with similar regulations led to its being blocked in Russia.
- **Obuv Rossii plans IPO.** The company was doing pre-IPO meetings ten years ago, but had to put plans on hold because of the various crises that hit Russia. The listing is wholly primary, and designed to raise US\$120 million to expand the company's branch network.
- **EN+ Group may also list.** It is reported that EN+, which delayed a planned London IPO in Q2, because of poor market conditions and weak investor sentiment, may now take advantage of the improved conditions and list 10-15% of its equity and raise US\$1-1.5 bln.
- **Sberbank plans to exit European businesses.** In a move that must have been affected by recent changes to US sanctions on Russia, Sberbank has said it may exit some European businesses. The most recent US sanctions law reduced the number of days' credit that could be extended to Russian state banks.

Economy forecasts

2016-19 forecasts. Our base-case forecasts for 2017, 2018 and 2019 are in the table below. A more detailed breakdown is available in the table in Appendix 1.

Government publishes 2018 draft. The government published its draft budget assumptions for 2018 with a forecast for GDP to grow at 2.1%. This early draft does not have a lot of detail to focus on as yet. However, amongst the key assumptions are:

- Inflation (average) 4.0%
- Oil price (average) US\$43.8 p/bbl
- US\$/RUB (average) 64.70
- Budget deficit 1.4% of GDP

Russia: Macro Trends & Medium Term Forecasts - Base Case Scenario

	2012	2013	2014	2015	2016	2017E	2018E	2019E
GDP, RUB bln, nominal	66,865	70,499	77,200	84,320	90,222	95,636	101,278	107,456
GDP, US\$ bln	2,150	2,210	2,000	1,360	1,347	1,663	1,608	1,628
Growth, real % YoY	3.4%	1.3%	0.7%	-2.8%	-0.2%	1.8%	2.0%	2.4%
CPI - year-end, % YoY	6.6%	6.5%	11.4%	12.9%	5.4%	3.8%	3.8%	3.6%
CPI- average, % YoY	5.1%	6.8%	7.8%	15.6%	7.2%	4.2%	3.9%	3.7%
Gross fixed investment, real % YoY	6.0%	0.9%	-1.0%	-10.0%	-1.0%	2.0%	3.5%	4.0%
Industrial production, real % YoY	3.4%	0.4%	1.7%	-3.2%	1.1%	2.0%	3.0%	4.0%
Agricultural output, % change YoY	-3.6%	3.1%	1.2%	3.5%	4.8%	1.0%	3.0%	3.2%
Central Bank Key Rate, %			17.0%	11.0%	10.0%	8.0%	6.0%	5.0%
Bank average lending rate, %	9.1%	9.5%	11.3%	16.0%	13.0%	10.0%	8.5%	7.5%
Retail sales, % YoY	5.9%	3.9%	2.5%	-10.0%	-5.2%	2.0%	3.0%	4.0%
Real disposable income, % YoY	7.3%	4.8%	-1.0%	-6.5%	-5.9%	1.0%	2.0%	3.0%
Unemployment, % EOP	5.7%	5.6%	5.3%	5.6%	5.3%	5.5%	5.4%	5.3%
Budget, balance % of GDP	0.0%	-0.5%	-0.5%	-2.4%	-3.5%	-2.3%	-1.5%	-1.1%
Current account, % GDP	3.7%	1.6%	3.0%	5.3%	1.7%	1.9%	1.9%	2.0%
RUB/US\$, year-end	30.8	32.9	61.4	73.5	61.3	60.0	64.0	66.0
RUB/US\$, average	31.1	31.9	38.6	62.0	67.0	57.5	63.0	66.0
RUB/EUR, year-end	40.3	45.3	72.0	79.7	64.5	72.0	76.0	77.0
RUB/EUR, average	40.0	42.3	51.5	67.0	74.0	66.0	76.0	78.0
Brent, US\$ p/bbl, average	\$110	\$108	\$100	\$54	\$45	\$53	\$58	\$65

Source: State Statistics Agency, Central Bank, Macro-Advisory estimates

Tracking different scenarios. As is our usual practice, we also highlight a more optimistic and more pessimistic scenario for the next three years (see table below). The key point to make is that there is relatively little variation between the three scenarios over this timeframe because we have a clear understanding of the government's priorities and expected actions in the year prior to, and the year of, the presidential election. This is expected to be more of a period of preparation for economic and industrial change than for anything dramatic. The variations between the three scenarios expand to a much wider degree from 2019.

Scenarios for the Economy 2017-19

	2015	2016E	2017E	2018E	2019E	2017E	2018E	2019E	2017E	2018E	2019E
	Optimistic Scenario			Base Case			Pessimistic Scenario				
GDP, US\$ bln	\$1,315	\$1,300	\$1,641	\$1,624	\$1,680	\$1,663	\$1,608	\$1,628	\$1,530	\$1,605	\$1,652
Growth, real % YoY	-2.8%	-0.2%	2.2%	2.4%	2.7%	1.8%	2.0%	2.4%	1.4%	1.6%	1.2%
CPI - year-end, % YoY	12.9%	5.4%	3.5%	3.4%	3.3%	3.8%	3.8%	3.6%	4.0%	4.2%	4.0%
Central Bank key rate, %	11.0%	10.0%	7.5%	6.5%	5.0%	8.0%	6.0%	5.0%	8.5%	8.0%	7.0%
Bank average lending rate, %	16.0%	13.0%	9.5%	8.0%	6.5%	10.0%	8.5%	7.5%	11.0%	9.5%	8.0%
Retail sales, % YoY	-10.0%	-5.2%	2.5%	4.0%	5.0%	2.0%	3.0%	4.0%	1.5%	2.5%	3.0%
Real disposable inc., % YoY	-6.5%	-5.9%	1.5%	3.0%	3.5%	1.0%	101.0%	201.0%	0.5%	1.0%	1.5%
Unemployment, % EOP	5.6%	5.3%	5.4%	5.3%	5.1%	5.5%	5.4%	5.3%	5.7%	5.5%	5.4%
Budget, balance % of GDP	-2.4%	-3.5%	-1.5%	-1.0%	1.0%	1.9%	1.9%	2.0%	-3.5%	-2.5%	-2.0%
Current account, % GDP	5.3%	1.7%	3.0%	3.4%	3.6%	1.9%	101.9%	201.9%	2.4%	2.7%	2.9%
RUB/US\$, year-end	73.5	61.3	58.0	60.0	62.0	60.0	64.0	66.0	64.0	68.0	70.0
RUB/EURO Yr end	62.0	67.0	69.0	70.0	73.0	72.0	76.0	77.0	76.0	81.0	83.0
Urals, US\$ p/bbl, average	\$54	\$45	\$55	\$70	\$75	\$53	\$58	\$65	\$50	\$52	\$56

Source: State Statistics Agency, Central Bank, Macro-Advisory estimates

Tracking the changes. Each month, we also calculate the probability for each of the scenarios and explain the reason for any changes, or maintaining the probabilities.

Oil

The price of oil jumped in September, closing at just under US\$60 per barrel on 25 September, before edging a little lower towards the end of the month. The gain for the month was 7.4%. The reason for the increase was mostly due to the reaction of Turkey and the government in Bagdad to the Kurdish independence vote. Turkey said it could block oil exports from the region, which total approximately 600,000 barrels per day. So far, that is only a threat, but has added an extra risk support for the oil price.

In addition, both Saudi Arabia and Russia have said that they may extend the production control deal beyond the current deadline and, possibly, up to the end of 2018.

The reason why the oil price has not spiked even higher, on the back of the Kurdish referendum and the Saudi-Russia news, is because of the assumption that the higher the oil price goes then the greater will be the volume of US shale production. That fear puts an effective lid on how high oil can go, at least over the medium term.

Brent Crude, US\$ per Barrel



Source: OTC

- Sanctions** The White House has acted on the August legislation to cut allowable debt limits to the sanctioned Russian banks and energy companies. There is nothing new in this. Otherwise, it is a case of waiting to hear what OPEC says about the areas of concern for both US and foreign businesses in Russia and, then, to see if there will be any Russia response.
- Domestic politics** Here also it is a waiting game to hear which of the competing fiscal plans the President may favor as his key policy agenda for the next term. There is plenty of commentary about each plan but no final decision as yet. Meantime, the further changes amongst the governors is seen more as a positive than an area of concern. The Kremlin is putting place new people with better management credentials as it looks to extend and broaden the economic revival.
- Geopolitics** The Zapad military exercises, held in Belarus, went without incident, confounding the expectations of some Western analysts. Allegations about Russia’s role in last year’s US elections continue to make the headlines but, so far, there is nothing new beyond the assumptions that led to the August US sanctions.
- On a more positive note, the state visit of the King of Saudi Arabia, the first ever by a head of state from that country to Russia, brought some investment deals and promises for broader political and investment cooperation.
- Economy** The economic recovery continues to strengthen, albeit slowly, and broaden out. Growth this year and next should be close to 2.0% and, thereafter, it will depend on any changes resulting from the latest US sanctions and government policy changes.

Probability for Macro Scenarios -- October 2017

Scenarios	Probability
Positive surprise	5%
Optimistic	30%
Base Case	50%
Pessimistic	10%
Negative surprise	5%

Source: Macro-Advisory estimates