How long will the positive momentum last?

"You give 100 percent in the first half of the game, and if that isn't enough, in the second half you give what's left."

Yogi Berra, *American baseball coach*

- **Recovery strengthens.** Rosstat reported 1H GDP growth of 1.5% and Q2 at 2.7%. The question is whether 2Q was a one-off or a new trend.
- **VEB disagrees with EconMin optimism.** VEB's Chief Economist publicly disagrees with the optimism from the Economy Minister and expects growth to shrink to 1.4% in the second half of this year.
- **Agriculture expected to pick up.** The indicators are that Russia will have another record grain harvest this year and will reclaim the position of the world's largest wheat exporter.
- **Confidence numbers suggest recovery has peaked.** Official business confidence numbers fell from -1 to -2 in July. The PMI manufacturing index fell, indicating there is still growth, but at a slower rate.
- **Inflation continues to fall.** Year-on-year inflation fell to 3.3% at the end of August, from 4.4% at the end of June. Food price deflation was the main driver as food inflation dropped to 2.3% YoY.
- **CBR cut the key rate to 8.5%.** The decline in inflation allowed the CBR to make a 50-bps cut to the key rate at the 15 September policy meeting. The CBR indicated that it is likely to cut further during the next two quarters.
- **Deteriorating US-Russia relations.** Russia and the US traded tit-for-tat diplomatic restrictions, of the sort seen in the Cold war. The moves are serious but, are unlikely to lead to serious escalation.
- **Waiting for sanctions clarity.** It is hoped that in late October the OFAC will provide some clarity and guidance on vaguely worded sections in the 2 August sanctions law. Businesses have asked for clarity with regard to Russian Railways, in particular.
- **Local elections show some surprises.** There were big opposition gains in Moscow, but not elsewhere. Turnout was low for the elections of ten governors, where the United Russia candidates won.
- **Markets shrug off Otkritiye failure.** The RTS Index advanced 8% in August, despite the rescue of the largest private bank, Otkritiye, and the US sanctions. Valuations have fallen so low that Russian equities are a high-beta theme in emerging markets. Year-to-date, Russian indices are badly lagging both the MSCI EM and Word Indices.
- **Highest level Saudi visit.** It is reported that a delegation from Saudi Arabia, which will visit Moscow on 5 October, will he headed by the King. That has raised speculation that at least one major deal may be agreed.
- **Reforms continue in Uzbekistan.** The fast pace of reform continues, with the ending of the dual-currency rate system and an end to the border dispute with Kyrgyzstan. See our report "*Playing catch-up is neither a sprint nor a marathon*"

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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.

	July*	YTD*
GDP, YoY, est	**1.5%**	1.5%
I.P. real % YoY	**1.1%**	1.9%
Retail sales, % YoY	**1.0%**	-0.5%
Agriculture, % YoY	**-2.9%**	-0.7%
CPI - end period, % YoY**	**3.9%**	3.9%
Unemployment, % EOP	**5.1%**	5.1%
CBR key rate, %	**9.00%**	8.50%
RUB/US$, eop*		**59.8**
RUB/US$, average*		**59.6**
RUB/EUR, eop*		**70.8**
RUB/EUR, average*		**68.7**
Average Brent, US$ p/bbl	$49.5	$52.4

Source: Federal Statistics Service
** to or at end-July 2017*
*** YTD is annualized*

Market Trends - July & YTD*

	Index/Price*	YTD*
MICEX Index	2,022.2	-9.4%
RDX (Russia) USD Index	1,287.1	-5.2%
MSCI EM Index	1,088.0	26.2%
Copper, US$ p/lb	$309.9	23.7%
Brent, Fwd, US$ p/bbl	$52.9	-7.0%
Gold, US$ p/oz, spot	$1,321	15.2%
Wheat, US$ d/bu	$434.5	6.5%
RUB/US$ - spot	58.04p.	5.6%
RUB/EUR - spot	69.11p.	-6.6%
Russia - Eurobond '23 *		3.13%
OFZ - 15 Yr, yield*		7.96%

Source: Bloomberg
** as at close July 30*
For full list, refer to Appendix 4

Up Next

Q2 GDP Final Reading	11-Sep
Central Bank Rates decision	15-Sep
Industrial Production August	15-Sep
Macro report August	19-Sep
German federal elections	24-Sep
Business Confidence update	26-Sep
Russia-OPEC oil meeting	end-Sept
Saudi Arabia delegtion in Moscow	5-Oct

Federal Stats Service, CBR, Macro-Advisory

Summary

We have published a very detailed study of the sanctions applied by Russia and Moscow's counter-sanctions. The report looks at the impact, both positive and negative, from sanctions since they were first applied in early 2014. The report further looks at the recent US sanctions law and examines the potential impact of the new provisions and threats on Russia's economy in the years ahead. The report, **Sanctions Guide: What difference have sanction made and, is that about to change?** is available by emailing *info@macro-advisory.com*

Economy forecasts

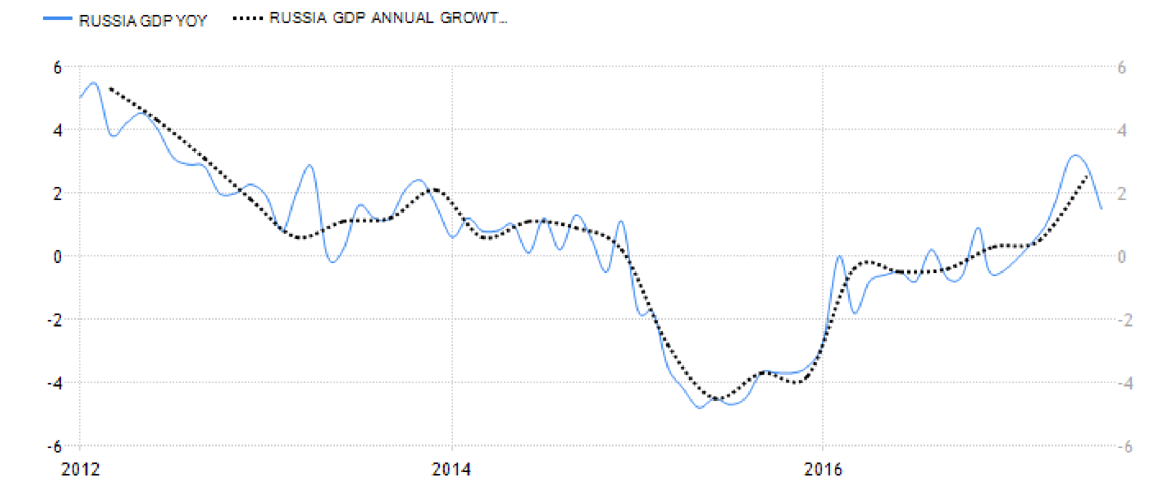
- **Central Bank boosts its forecast for GDP.** In its monthly economic commentary, the CBR raised its forecast for third quarter GDP growth from a range of 1.5-1.8% to 1.7-2.2% year-on-year.
- **Economic Ministry says lower GDP growth in July, but still bullish.** On 28 August, the Economy Ministry said that GDP growth in July fell to 1.5% year-on-year, down from 2.9% in June and 3.5% in May. Nonetheless, the Ministry raised its forecast for 2017 GDP growth to 2.0% and to 2.1-2.3% for 2018-20.
- **EconMin talking its own book.** The Ministry are professional optimists on economic growth, because to do otherwise would admit their own failure. The forecasts above contrast with much more conservative numbers at the Gaidar Institute, which represents a consensus of economic thinking in Russian academia. These show much lower growth with a higher oil price.
- **VEB disagrees with EconMin optimism.** VEB's chief economist, Andrey Klepach, disagrees with the Economy Ministry's optimistic view. He estimates that growth this year will be less than 2.0% as GDP expansion in 2H should be only 1.4%.
- **Heading for another record grain harvest.** Russia's Institute for Agricultural Market Studies raised its forecast for the grain harvest. It predicts the wheat harvest will reach a record 79-82 million tonnes (73.3 mln tonnes last year) and the total grain harvest may reach 128.5 – 131.5 mln tonnes. It also predicted that Russia will again be the world's largest exporter of wheat, with 30-32 mln tonnes predicted to be exported out of a total grain export of 41.1 – 43.1 mln tonnes.
- **Slight tweaking**. The positive second quarter and evidence available for the third quarter, to-date, allows us to again tweak our medium-term forecasts to show growth of 1.8% for this year and 2.0% or 2018. This is in keeping with the modest recovery trend based on the adjustment, or normalization, of the economy to lower oil and sanctions. In the Economy section (later), there is a comment on the revised forecasts issued by the Gaidar Institute (expecting an average of 1.5% growth for the next three years) and the much more optimistic assessment of growth from the Economy Minister.

Economy trend

- **Rosstat calculates 1H GDP growth at 1.5%.** On 17 August, Rosstat said that GDP growth in the first half was 1.5% year-on-year. This is a little lower than the 1.6% estimated by the Economy Ministry (EconMin).
- **More granular data is weaker than the GDP numbers imply.** Industrial production was up 1.1% year-on-year in July, down from the strong 3.5% shown in June. Agricultural production was down year-on-year, likely a result of the bad weather this summer, and the strong harvest last year.

- **Car demand accelerates.** New vehicle sales were strong in July, up 18.6% year-on-year, against the total for the first seven months of 8.5%. This is partly because the early part of the year was weak, but also lower interest rates and more aggressive lending by banks is boosting demand.
- **Retail sales stay positive.** July growth at 1% year-on-year was down on the June number of 1.2%, but not by much. Given that inflation is falling, and some food prices may have actually fallen in July, it may be that the lower sales are actually due to weaker prices rather than lower real spending.
- **Balance of trade remains stable.** The balance of trade was flat in the second quarter, reflecting the stability of the oil price and seasonally-lower imports. It is likely to fall later in the year.
- **China is Russia's biggest trade partner.** Russia's trade with China totaled US$38.4 bln in the first half of this year, albeit that is down 11% from 2014. Trade with Germany was US$22.9 bln (down 35%) and with the Netherlands it was US$20.6 bln (minus 45% from 2014). Trade with the US totaled US$10.7 bln, just marginally less than the US$11 bln recorded with Italy. The reason the value of trade with China and the EU states is down so much from 2014 is mostly due to the lower price of oil and gas.
- **Germany is diversifying and growing trade.** The Eastern Committee of the Germany Economy predicts growth in exports from Germany to Russia to grow by 20% this year. This is up from a predicted 10% increase made earlier this year. For the first five months of the year the value of German exports to Russia was EUR10.5 billion.
- **Current account surplus.** The CBR estimates that the current account ran a surplus of US$21.7 bln through the first seven months of this year. That includes a deficit of US$1.3 bln in July.
- **Capital outflow.** Net capital outflow is estimated at US$13.1 bln in the seven month period, up from US$8.8 bln in the same period of last year This was all explained with normal trade and investment flows and does not imply any additional "suitcase cash" or other exports of capital.

Leading Indicator and GDP YoY



Source: Trading Economics

Ruble & rates

- **Ruble strong in August.** The ruble was strong in August, bucking the traditional fears of an August meltdown. The 4% gain against the dollar and 3.1% gain against the euro was caused by the 2.1% rise in the price of oil.
- **CBR cut its key rate by 50 bps.** As expected, the CRB cut its key rate by 50 bps at its 15 September policy meeting. The CBR had been cutting by 25 bps but skipped that at the last meeting due to inflation fears. The big drop in the inflation rate has allowed the CBR to "catch-up" that missed rate cut.
- **Reserves rise again fueled by dollar weakness.** Reserves hit US$418 billion at the end of June, their highest level since 2014. This is driven by their euro and gold holdings and mainly driven by US dollar weakness.
- **Inflation back down at record lows.** July inflation was only 3.9%, an expected fall relative to July's reported inflation of 4.4%. By end August, the rate had fallen further, to 3.3%, and justified the CBR's 50 bps rate cut.
- **Food inflation falls in July, but still high.** Food inflation fell back down to 3.8% year-on-year in July, helped by better food supplies, after the problems of June. August saw the usual food deflation and that allowed the year-on-year rate to drop to 2.3% by end-August.
- **Producer price inflation at very low levels.** Producer price inflation fell to 1.8%, down from 2.9% in June, and well off its highs in January of 15.1%.
- **CBR to support banks.** The CBR announced it has launched the Emergency Liquidity Assistance Mechanism (ELA) to provide emergency support for banks which is not able to get support in the usual way. The CBR has, however, set out strict criteria for providing any such support.
- **Sharp devaluation and renewal of trading.** The Central Bank of Uzbekistan abolished the dual exchange rate system on 5 September. That meant the official rate, which was at UZS4,210 to the dollar, moved to the street rate of UZS8,100 to the dollar. At the same time, President Mirziyoyev issued a decree that allowed the free sale and purchase of hard currency, which had been stopped in November 2016.

Brent Crude, $ p/bbl

Source: OTC

Domestic politics

- **Kudrin plan dead in the water?** Press reports on 31 August suggested that a government discussion of its plans through to 2020 would follow the financial scenarios set out by the Economy Ministry, which means that neither the Kudrin plan nor the Titov plan have been adopted.
- **Political implications – boost for Medvedev.** The choice of the so-called "inertia scenario" as the base case for the next three-year budget greatly increases the likelihood that Prime Minister Medvedev will keep his job next year.
- **Oreshkin as a rising star?** There was a much-cited Bloomberg profile of the new Economy Minister, describing him as Putin's new favorite.
- **What does this mean for Kudrin?** The former Finance Minister, Alexei Kudrin, was described as a possible successor to Medvedev, after his rehabilitation following his resignation in 2011.
- **Low turnout, but generally successful elections for governor.** The Kremlin's key focus was on using this year's regional Election Day as a dress rehearsal for next year's Presidential election. Here, they will be disappointed at the low turnout. This ranged from 71% in Mordovia to 23% in Tomsk.
- **Big victory for the liberals in a low-profile election in Moscow.** Moscow did not have a Mayoral Election this year, nor for the city Duma. There were, however, elections for district assemblies, and a number of these were won by opposition candidates, either independents or from the Yabloko party.

Sanctions

- **Mutual cuts to diplomatic missions.** At the end of August, the Russian government cut the number of US diplomatic staff permitted in the Russian Federation to 455, the same as the number of Russian diplomatic staff in the US at that time. On 31 August, the US government ordered the Russian government to close consular sites in New York, San Francisco and Washington in reprisal.
- **Next steps in the sanctions war.** The new sanctions act called for the preparation of studies to investigate the possibility of further sanctions on individuals and entities, and also on extending the financial sector sanctions to Russian sovereign debt. These studies are due 180 days after the passage of the act, which would put them in January 2018. See our separately issued report "**Russia Sanctions Guide: What difference have sanctions made".**
- **OFAC clarification expected late October.** It is expected/hoped that OFAC will issue some guidance on some of the vaguely worded sections in the 2 August sanctions legislation, in late October or early November. The question market over Russia Railways (RZD) is of particular importance to foreign businesses working in Russia.
- **Expanding the Trans-Siberian and Baikal-Amur lines.** The sanctions threat hanging over RZD has not stopped the government from approving a US$2.5 bln grant to part-fund the US$9.5 bln project to modernize the Trans-Siberian and Baikal-Amur railways.

- **Austria is also proceeding.** The Austrian Transport Ministry announced plans to extend the Trans-Siberian Railroad from eastern Slovakia to Vienna. The 400 Km of broad-gauge track will cost US$6.5 bln.

Uzbekistan

- **Off the blocks quickly.** Uzbekistan is playing catch-up with the rest of the CIS and Eurasia after 25 years of isolation. President Mirziyoyev and his team have moved surprisingly quickly with some key changes that should yield a positive knee-jerk reaction from investors. But the "to-do" list remains long and daunting (see separate report **"Playing catch-up is neither a sprint nor a marathon"**).
- **Currency reform is the biggest move.** The change with the biggest impact is the ending of the dual exchange rate system. The official rate immediately fell to the street rate but at least investors now have a transparent system with which to work.
- **Inflation and rates spiked higher.** The result of the move is to reveal double-digit inflation. The risk is that a real devaluation would push inflation higher and keep interest rates also higher for longer. But, it is important to bear in mind that the double-digit inflation has been part of the economy and is only now exposed. It is not a new factor.
- **Growth rates are declining.** Uzbekistan's macro indicators have always raised suspicions about methodology and that is also now changing. Expect more volatility in the future. GDP may fall to 6.5%, or lower, this year and next as a result of the currency move, and other changes, but, if handled correctly, faster growth may resume from 2019.
- **Focus on SMEs.** Amongst the reforms announced this year, the government is providing support for SMEs, which already account for almost 60% of GDP. This is a very positive move.
- **Administrative reforms.** The major reform initiatives announced so far this year include an ambitious programme to make the bureaucracy more efficient and accountable.
- **Improved regional relations boosts power projects.** President Mirziyoyev has also moved quickly to improve relations with both Kyrgyzstan and Tajikistan. The result is an end to border disputes, with freer access to improve trade, and the long-overdue start to much-needed hydroelectric power projects.

Capital markets

- **Equities strong in August.** Equity Indices were up in August, with the dollar denominated RTS rising 8% and the ruble-based MICEX up 4.2%. This was an impressive performance given that crude oil was flat and the signing of the new sanctions law at the start of the month. The market also shrugged off the taking of Otkritiye, Russia's largest private bank, into administration.
- **Equities are still badly lagging.** Despite the strong gain in August, all Russian indices are lagging well behind both the MSCI EM and World Indices. The weak oil price is the main reason for the weak performance while issues such as sanctions risk and the Rosneft action against Sistema also hurt.

- **Otkritiye under temporary administration.** Following a disastrous July which saw Otkritiye losing about 20% of its liabilities in a run on both retail and corporate deposits, the Central Bank placed Otkritiye under temporary administration.

- **Rosneft wins suit against Sistema.** On 23 August, Sistema lost its final appeal against the court ruling that it must pay damages to Rosneft for losses incurred by Bashneft when Sistema was its controlling shareholder. Sistema must find about US$2.4 billion in damages. President Putin has finally broken his silence on the issue and asked both sides to settle the dispute behind closed doors.

- **Rosneft's new shareholder.** The Qatar Investment Authority (QIA) and Glencore said that they would sell 14.16% out of their 19.5% stake in Rosneft to CEFC China Energy. The stake will cost about US$9.1 billion. The sale price is in line with what QIA and Rosneft paid in December last year.

- **MTS share buyback.** MTS announced a share buyback worth RUB20 bln. The closing date is April 2018.

- **FESCO makes improved offer to buy back Eurobonds.** FESCO raised its offer to buyback Eurobonds with a nominal value of US$655 mln for US$547 mln. It said that holders of 47% of the debt have agreed. The deal is conditional on holders of at least 75% of the debt taking up the offer.

- **FESCO may sell equity to DP World.** It is reported that FESCO is in talks to sell an equity stake of 40% to a consortium of DP World and RDIF.

- **Yields down again in August.** The debt market was well bid in August, for both Eurobonds and local issues. Investors in local paper got an extra kick from the stronger ruble, which was up 2% on the month.

- **Non-resident holdings in Sovereign Eurobonds.** The Central Bank announced that between US$12 and US$14 bln of Russia's Sovereign Eurobonds are held by non-residents.

- **Eurobond swap details.** The Finance Ministry has published plans to swap Eurobonds with a nominal value of US$4 bln. The instruments involved will be the Russia 18, 28 and 30. Once the swap is complete, the Finance Ministry plans no further activity in the Eurobond market in 2017.

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.

Slight tweaking. The positive second quarter and evidence available for the third quarter, to-date, allows us to again tweak our medium-term forecasts to show growth of 1.8% for this year and 2.0% or 2018. This is in keeping with the modest recovery trend based on the adjustment, or normalization, of the economy to lower oil prices and sanctions (see our separately issued report "**Russia Sanctions Guide: What difference have sanctions made?**). In the Economy section (later), there is a comment on the revised forecasts issued by the Gaidar Institute (expecting an average of 1.5% growth for the next three years) and the much more optimistic assessment of growth from the Economy Minister.

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