# RUB Outlook

MONEX

November 2021

# Positive outlook riddled with risk

The Russian ruble saw a strong run in October following higher gas and energy prices, although the rally has moderated more recently due to the rise in front-end G10 rates. The rise in energy prices hasn't been the only supportive factor for the ruble, however. The early and consistent hiking cycle by the Central Bank of Russia meant the ruble's carry appeal has increased over the past quarter, while the CBR's swift responses to upside inflation surprises have shielded the currency from downwards pressures.


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With the central bank standing ready to tighten policy further if needed, which serves as a safeguard for inflation expectations hitting the fan, we argue that there is scope for further ruble appreciation as a result. Additionally, expectations of high energy demand over winter further support a case for a stronger ruble given Russia's position as a net exporter. While most arrows point in favour of a RUB rally, a major downside risk to the currency outlook has emerged as the Covid case count, along with related deaths and hospitalisations, stand at record-highs and first steps have been taken to slow the surge. Furthermore, political tensions around Belarus have escalated quickly recently, which means our overall conviction of sustained RUB strength is lower than previously.

At the same time, the euro underperformed in October as stagflationary concerns across the bloc remained prominent. Surges in energy prices and disruptions in supply chains led to increased inflation expectations, despite the European Central Bank standing its ground on inflation and stating the high prints are only transitory. This caused money markets to push back against communication from the ECB and price in aggressive tightening, while bear flattening occurred in European sovereign yield curves. The result thereof was a larger decline in EURRUB than in USDRUB. Looking ahead, we expect the elevated energy prices, hawkish CBR and strong trade balance to act as supportive drivers for the ruble, however, our forecasts are subject to more significant downside risks than previously due to the escalation of risks.

**USDRUB (navy) and EURRUB (turquoise) continue to tumble, but downside ruble risks are plentiful**

## Monex' November forecasts

| | 1-month *30th Nov 2021* | 3-month *31st Jan 2022* | 6-month *31st April 2022* | 12-month *30th Nov 2022* |
|---|---|---|---|---|
| **EURRUB** | 79.35 | 77.72 | 76.56 | 79.56 |
| **USDRUB** | 69 | 67 | 66 | 68 |

## Development in energy markets supportive for RUB

Oil and gas prices have skyrocketed this year due to a series of factors pushing up demand while supply is more limited. Economic reopening and a stronger growth outlook globally has boosted consumption over the year, while supply constraints have forced countries to draw on their oil stocks to help meet demand until year-end. Lower-than-expected wind power generation in Europe has provided additional upward pressure on oil to meet energy demands, and expectations of a harsh winter boost demand further as inventories remain depleted. Countless constraints on the supply side, ranging from low inventories to unforeseen repair works and lower exposure to short-term sales, further pushed up energy prices on the whole in the past months.

With no sign of the pressure in energy markets easing any time soon, **this should see the ruble remain a favourable choice for investors over the winter period given Russia's position as a net exporter**: in recent years, fuel and energy product accounted for over 60% of Russian exports, while Russia's trade surplus has been strong for decades.

While OPEC+ will continue to increase production by 400,000bpd each month, in line with their original plan despite President Biden having pressed the cartel to increase production faster to stabilise prices, this isn't seen as too disruptive to the overall bullish oil outlook.

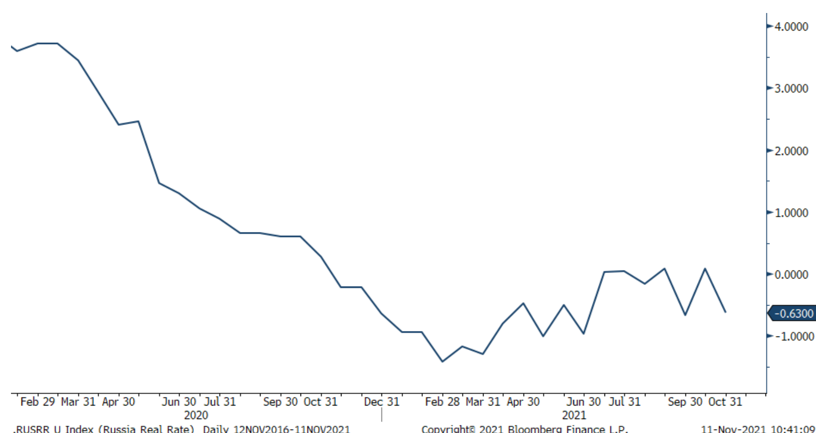
Meanwhile, supply related issues in the gas market are more politically sensitive, such as Gazprom's largest storage site in Germany being less than 10% full ahead of the start of winter, while the largest facility in Austria, also controlled by Gazprom, is at around 20% capacity. Experts suspect Russia is withholding gas from Europe to press for quicker approval of the Nord Stream 2 pipeline, something that has been denied by President Putin.

However, the International Energy Agency believes Russia has the capacity to send 15% more gas to help ease the crisis. Meanwhile, Nord Stream 2 is still waiting for regulators in Germany to approve it, and Russia is concerned the pipeline could be a victim of coalition negotiations over a new, greener, German government. While at present it looks like it would take months for the pipeline to be approved, if this occurs sooner than expected, it would drive down European gas prices. This could take some of the shine off the ruble in the process. In the interim, President Putin has ordered Gazprom to send more gas towards Europe, but this has had no impact on market pricing so far as Gazprom has made a slow start on boosting supplies to Europe. With energy prices likely to remain elevated, while Russia's external balances remain strong especially compared to other high-yielding emerging markets, we argue there is room for the ruble to appreciate.

## Central Bank of Russia consistent with rate hikes in an attempt to extinguish inflation-fire

With energy prices rising over past months, Russian inflation has been skyrocketing despite the Central Bank of Russia's efforts to contain inflation by increasing the base rate. Russia's headline inflation rose from 7.40% in September to 8.10% in October on a YoY basis, with price pressures broadly spread. Household inflation expectations also reached a fresh five-year high in October, which the CBR acknowledged in its latest policy meeting. Compared to other EM central banks, the CBR may be one of the most sensitive to inflationary pressures and clearly communicates its concerns around higher expectations of inflation rather than slow growth. The real rate, which is adjusted for inflation, have been broadly increasing since February this year, although it still sits in negative territory.

**Real rates still sit in negative territory but have stopped falling since Q1 as CBR's tightening policy seems effective**



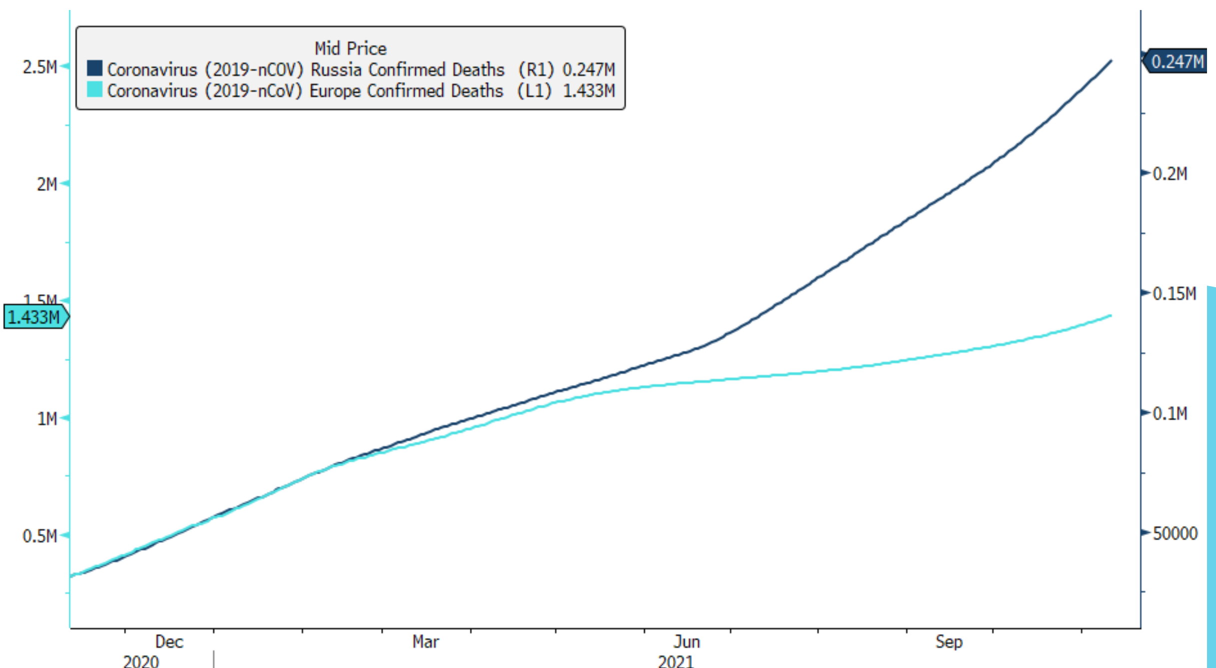

"**The CBR expects YoY inflation to fall by year-end**, but at least a 25bp hike in December is likely in order to anchor inflation expectations, although risks for the rate decision are tilted to the upside."

> If the CBR's expectation of a slowdown in inflation in December holds true, we expect a 25bp hike in December to be sufficient.

The CBR will then likely keep rates unchanged throughout H1 2022 as the food price shock dissipates along with the energy crisis and base effects, while a stronger currency should support fading price pressures further. However, if price pressure don't fade by December's meeting, policymakers could take on a more aggressive hike of 50bps, while this also opens the door to further tightening in H1 2022. The CBR has emphasised its concerns about the ruble being undervalued on a fundamental basis as well, which means the CBR won't feel limited by ruble appreciation to tighten policy further if needed.

While high inflation expectations and a hawkish CBR by itself have already lifted yields across the curve, a new stage of geopolitical confrontations has likely also contributed to October being the worst month for Russian bonds since 2017. This has led to the spread between German and Russian short-term yields almost doubling since the start of the year, further supporting the ruble rally. However, if the Russian economic outlook progresses in line with the CBR's forecasts, their hiking cycle is close to its peak, meaning spreads could begin to narrow as rates plateau in Russia and begin to rise in core eurozone bonds. We expect this dynamic to play out over the 6-to-12 month horizon.

## German 2Y – Russian 2Y sovereign bond yield



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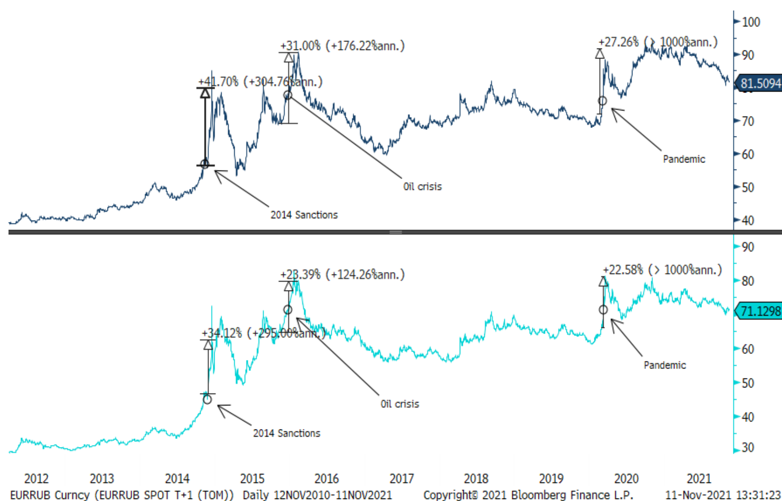
Beyond domestic Covid concerns, geopolitical tensions are also back at the forefront, although it no longer concerns a risk of US sanctions following tensions with Ukraine but rather hits closer to home as it all plays out on European grounds. Tensions between Belarus and Poland escalated recently over a surge of migrants at their shared border and the positioning of thousands of Polish troops on the EU's Eastern flank. While the situation has persisted for months, the escalation is a new development and points to a refugee crisis. Thousands of migrants have attempted to enter Poland and bordering EU countries after arriving in Minsk, raising suspicion that Belarus is violating international regulations on preventing human trafficking. While the EU is unlikely to take legal action against Belarus, as this is a timely process and enforcement is tricky, the bloc is currently working on a sanctions package that could be approved in Brussels by November 15. According to experts, the sanctions include asset freezes and visa bans on some 40 people and entities Brussels considers to be involved in the escalating tensions at the EU border. Also targeted will be state-owned banks that are not already under sanctions, according to those reports.

Meanwhile, **EU officials have called on Russia to exert its influence on President Lukashenko**, however Russia took the rare step of deploying two nuclear-capable strategic bombers to Belarus' airspace in a show of support for its ally.

Compared with the 2015 crisis, the current tensions have an added geopolitical aspect as it is unfolding on the line between NATO to the west and Russia-allied Belarus to the east. Poland's Prime Minister has also accused Russian President Putin of being behind the migrant crisis, and accused Russian and Belarusian leaders of trying to destabilise the EU. While the migrant crisis hasn't directly threatened the Russian ruble so far, there is a high risk of EU sanctions extending to Russia, especially as Russia appears to endorse Belarus' actions. A Kremlin spokesman told Interfax recently that "Belarusian migration services are taking all necessary measures to keep the situation in the legal field".

**2014 lows in ruble highlight risks of sanctions on RUB outlook compared to oil crisis and pandemic**



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Previous periods of sanction threats were coupled with a significant weakening of the ruble despite the CBR raising interest rates at the same time. Towards the end of 2014, both EURRUB and USDRUB rose some 60% throughout the quarter on fears that the US was considering a fresh set of sanctions against Russia for its support for separatists in Ukraine. Until the start of the pandemic, the ruble had only weakened beyond those levels during one period when oil prices fell sharply. However, a decline as sharp as the 2014 has not occurred since – even not during the USD crunch at the start of the pandemic. This highlights the significance of the risks related to the currency outlook, should sanctions be back on the table again for Russia.

> "Given the Covid developments and geopolitical tensions in place at the moment, **our RUB outlook is subject to severe downside risks** – more so than previously."

Should the risks of another lockdown or imposed sanctions on Russia materialise, then the ruble could fall back to pandemic lows. However, if the risks substantially decrease and the narrative of stronger energy prices, a robust trade balance, and a supportive central bank takes the overhand, we see the ruble trading back around the 66 level for USDRUB and 76 level for EURRUB over the next 6 months before the Fed and ECB catch up and tighten policy such that the crosses pare back losses over the 12-month horizon.

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