Russia

OUTLOOK 2021

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Political outlook

2021 got off to a dramatic start with the return of anti-corruption blogger and opposition activist Alexei Navalny who was promptly arrested on January 17. A week later Navalny successfully called for nationwide demonstrations on January 23 with somewhere between 100,000 and 300,000 participants in over 100 towns and cities.

Navalny successfully hijacked the narrative and the Kremlin was put on its back foot doing damage control. However, despite the large numbers the proportion of Russians involved in the protests remains relative small and a revolution is very unlikely. What the demos showed is the rising ill content with the economic stagnation of the last years and the increasingly arrogant attitude of the political elite.

The first half of 2021 will probably be given over to growing social unrest and repression by the state without the protest movement reaching critical mass.

The main political event of 2021 is the Duma elections in September. The popularity of the ruling United Russia Party has been falling but it is still expected to win a majority, albeit perhaps in partnership with some new smaller parties.

The main policy goals are to restart the spending on the 12 national projects that are supposed to “transform” the economy and specifically bring back the prosperity Russians enjoyed until the stagnation started in 2011 in the hope of countering Russia's slowly rising social discontent.

Macro economy

After the slump in 2020 Russia’s economy will start growing again in 2021 and expand by between 2.5% and 4%, according to the various forecasts. The rate of growth is uncertain due to the number of unpredictable factors.

On the down side real income growth is likely to remain negative, holding back consumption. The government is also planning to cut spending. On the plus side oil and commodity prices are likely to grow and bring in extra funds and inflows of foreign capital into Russia's local bond market, which has been significant and supportive of the ruble.

The biggest unknown is whether the US will impose new sanctions and if it does, how harsh these will be. However, the main macro indicators have already stabilised and are likely to remain close to current levels for most of

2021.

At its last meeting of the year the CBR kept the monetary policy rates on hold at 4.25% due to the reappearance of inflationary pressures, which means a rate cut in the first half of 2021 is very unlikely.

Food prices had spiked to the point where the government started negotiations with producers to artificially cap price increases. The CBR revised upwards CPI from 3.8-4.2% year on year to 4.6-4.9% y/y by YE20 due to the impact of short-term one-off factors, but its statements were less dovish going forward and it is now clear there will be no more cuts in at least the first quarter of 2021 and maybe not for the entire 2021. The easing cycle has definitely ended.

Budget & fiscal policy outlook

The federal budget deficit was 3.8% of GDP in 2020, with the non-oil deficit at 8.8% of GDP. Budget execution appeared to be better than previously expected (4.4% of GDP in September and 5% of GDP in June).

The budget deficit will be reduced to 2.6% in 2021 partly thanks to the government's ongoing commitment to a policy of austerity rather than one of boosting growth. This is wrapped up with the Kremlin's belief that it is in an economic war with the West and so won't spend from its large National Welfare Fund (NWF) to stimulate growth, instead preferring to sit on this reserve, which is seen more as a strategic defensive weapon.

"Extremely conservative" spending Federal budget expenditures in 2021, according to the analysts, will be 9% lower than the current year level, or by RUB2.2 trillion, which is about 2% of the potential GDP in 2021.

New spending is coming from reforms to the government that are designed to stop the stealing, more efficiently tax both the population and companies and find new revenue streams. The government has also committed to increasing borrowing modestly from 14% of GDP in 2020 to just over 20% in 2021. Austerity and budget deficits are expected to stay in place until 2023, slowing the pace of the recovery.

Real economy

Commodity prices were already rising again in November and are likely to continue to strengthen on the back of a global recovery, and boosted by the weakening dollar.

Industry was struggling in 2020 and after a brief recovery following the end of the lockdowns it stalled again in the autumn. Industry should pick up again in 2021, particularly in the second half of the year as the vaccines do their magic, and the numbers will be strong thanks to the low base effect. But fundamentally there will be a recovery too from the release of a year's worth of

pent up demand.

Corporate profits remain sensitive to changes in things like personal income. While the situation with companies remains stable, their outlook is still unpredictable. Profits remain below 2019 levels but are expected to continue closing the gap in 2021.

Markets outlook

The Russian equity market rallied strongly at the start of January, but after Joe Biden was inaugurated as president paused it climb as the political risks of the new administration in the US kicked in and investors took profits.

BCS GM set its end-of-year 12MF RTS index target at 1670 – borderline between a Buy and a Hold – that suggests the market has a 20% upside in the last month of trading.

The Russian stock market was growing strongly in the first two months of 2020 before the multiple shocks knocked it off the rails. However, it started to surge again in November after the coronavirus (COVID-19) vaccine trial results were announced and following the conclusion of the US presidential elections.

The prospects for a relief rally and a return to growing valuations are good, as traditionally the securities markets have done well in the year following a big crisis. On top of that, structural changes, like the anticipated weakening of the dollar over the next few years, will support emerging markets (EM) stocks in general and domestically the last of the big state-owned enterprises (SOEs) are expected to fulfil the MinFin order to pay out 50% of income as dividends that will also be supportive. Traders believe the market could rise over 30% in 2021 on a general re-rating and the RTS could end 2021 at 1,850, up from 1,400 at the start

2.0 Politics

The main event in 2021 will be the Duma election slated for September. The ruling United Russia Party has been steadily losing support in recent years and the Kremlin faces a major challenge to make it electable.

Having just scrapped in with over 50% of the vote in the last general elections, the party's approval fell to just 31%, according to independent pollster the Levada Center in a poll conducted in September 2020.

The study showed that 11% of respondents are now ready to vote for the ultra-nationalist Liberal Democratic Party of Russia (LDPR) headed by Vladimir Zhirinovsky, and 7% for the Communist Party of the Russian Federation (KPRF) headed by Gennady Zhuganov.

Other parties – Fair Russia, Motherland, Communists of Russia, Yabloko, Party of People's Freedom (PARNAS), Green Party, New People, Russian Party of Pensioners for Justice – will all get no more than 3% of votes each, says Levada.

Another 6% of the respondents said that they would spoil their ballot papers. But the most damning of all was a fifth of Russians (22%) will not vote, and 11% were undecided about their choice.

However, due to the state's control of the media and "administrative resources", the party is expected to retain office. The regional elections held in September 2020 were a dry run for this process and Untied Russia candidates won the vast majority of seats in the local councils and governorships that were up for grabs.

The Presidential administration is preparing for scenarios under which the ruling United Russia Party would not gain a constitutional majority in the State Duma after the 2021 elections, *Kommersant* daily reported on December 10. The Kremlin is ready to build coalitions between United Russia and smaller parties and independent regional candidates in the Duma. The constitutional majority would require at least 301 seats in a 450-seat house.

In the current situation United Russia could count on 250 seats, according to forecasts made by the presidential administration. At the same time, other sources told the daily that the Kremlin could accept United Russia having only a simple, not constitutional majority, as this would help avoid centring all responsibility on the ruling party with small ratings.

Instead, small regional parties will be supported in the elections with an aim to join the coalition. Newly established parties such as For Truth (Za Pravdu), New People (Novye Lyudi), the Green Alternative and the Direct Democracy Party do not exceed ratings of 1%. To compare, veteran liberal opposition party Yabloko has a 4% rating.

Another possible coalition partner is considered to be the Just Russia Party, on condition of being "diluted with the right people", other sources said.

Getting over the 50% mark is important, as that gives the party control of all the Duma committees where draft laws are actually drawn up and so control of the law-making process.

The Kremlin needs to address the rising social discontent with Putin's rule. The emerging middle class are becoming more active and outspoken as they master their material problems and the number of people that remember the Soviet Union dwindles.

Notably, while the propensity to protest with political goals remains subdued, the Russian population gets much more fired up over local issues such as landfills and parks. The government is powerless to prevent these protests, which can number thousands of demonstrators, as seen following the the arrest of the popular governor of Khabarovsk in the far east, Sergei Furgal, which went on for several months before eventually petering out.

The main thrust of the Kremlin's plan to deal with this issue is encapsulated in the May Decrees, which were expanded to become the 12 national projects in 2019. Progress on implementing the programme got off to a slow start in 2019, with most of the spending from the total RUB25bn ($379mn) being in the second half of 2019. But that spending did give the economy a bump and led to real income growth briefly turning positive at the start of 2020, before the coronacrisis hit, turning income growth negative again. As a result of the pandemic the implementation of the national project's deadline was extended from 2024 to 2030.

In the last half of 2020 the government is clearly getting ready to re-launch the national projects programme in 2021. The government was reshuffled, with Prime Minister Mikhail Mishustin ousting the last of former Prime Minister Dmitry Medvedev's appointees, taking tighter control of the Cabinet and adding three new ministries. Mishustin came to prominence as the head of the tax service where he transformed it and increased revenues by ending corruption and improving efficiency. He clearly intends to play the same trick again with the federal government.

At the same time, the 40 development agencies, which spend non-budget money, were shaken up and reduced to a dozen agencies, mostly under the control of VEB.RF (formerly Vnesheconombank) that is run by Putin's loyal lieutenant Igor Shuvalov. VEB will now be responsible for all the very large infrastructure project spending that accounts for a third of the bueget. Previous these projects were dished out ad hoc to a small group of so-called stoligarchs, close to Putin, but this work has now been institutionalised under VEB – presumably to reduce the stealing.

The main beneficiaries from the development agency reform appear to be VEB.RF, the mortgage broker DOM.RF and United Leasing Corporation (GTLK and VEB Leasing).

Finally, the control and financing of the regions have been revamped to better control spending of budget funds there and control their debt problems.

What is remarkable is how quickly Mishustin has gone from crisis management mode back to business-as-usual mode as he gets ready for the tackle the problem of implementing the national projects.

The 2020-22 recovery plan should drive the economy to growth, analysts universally say, but the issue is how quickly the economy will grow.

The national targets for 2030 that will transform Putin's 2018 national projects decrees include:

(1) coping with negative demographics, and improving the health and wellbeing of the general population;

(2) developing talent;

(3) providing a comfortable and safe living environment;

(4) fair labour practices and entrepreneurship; and

(5) a digital transformation.

The other big factor at play in 2021 is the foreign policy of the new Biden administration and possible new sanctions. At this stage it is impossible to call. However, the expectation is that Biden will be tougher on Russia and there are already several draft sanctions bills in the house. But at the same time Biden needs Russia's help in a number of international issues.

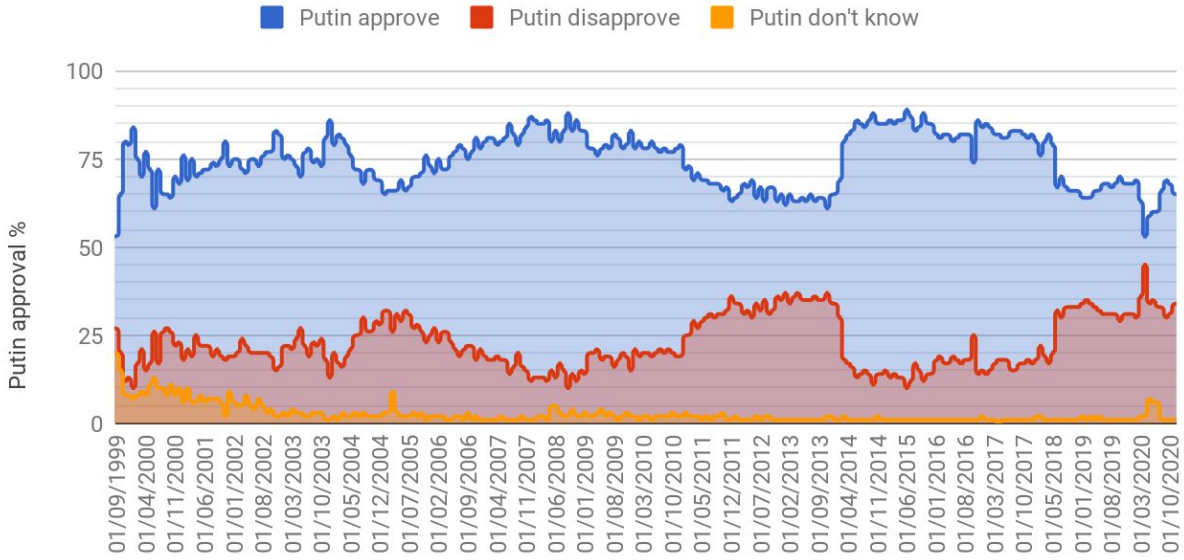
Relations with Biden got off to a good start after the two presidents rapidly agreed to extend the START II missile treaty for another five years in the kind of pragmatic cooperation that Putin is clearly hoping to forge with the US under Biden.

It is the *bne* view that more sanctions will be imposed by the US, but they will remain symbolic and not cause too much damage.

Part of the problem is that Russia's economy is already a lot more integrated into the global economy than many care to admit – as was shown by the crash in prices on the London Metals market after sanctions were imposed on aluminium producer Rusal. Likewise, the number of US pension funds and international investors that hold the Russian OFZ ruble bonds also make it difficult to sanction Russia.

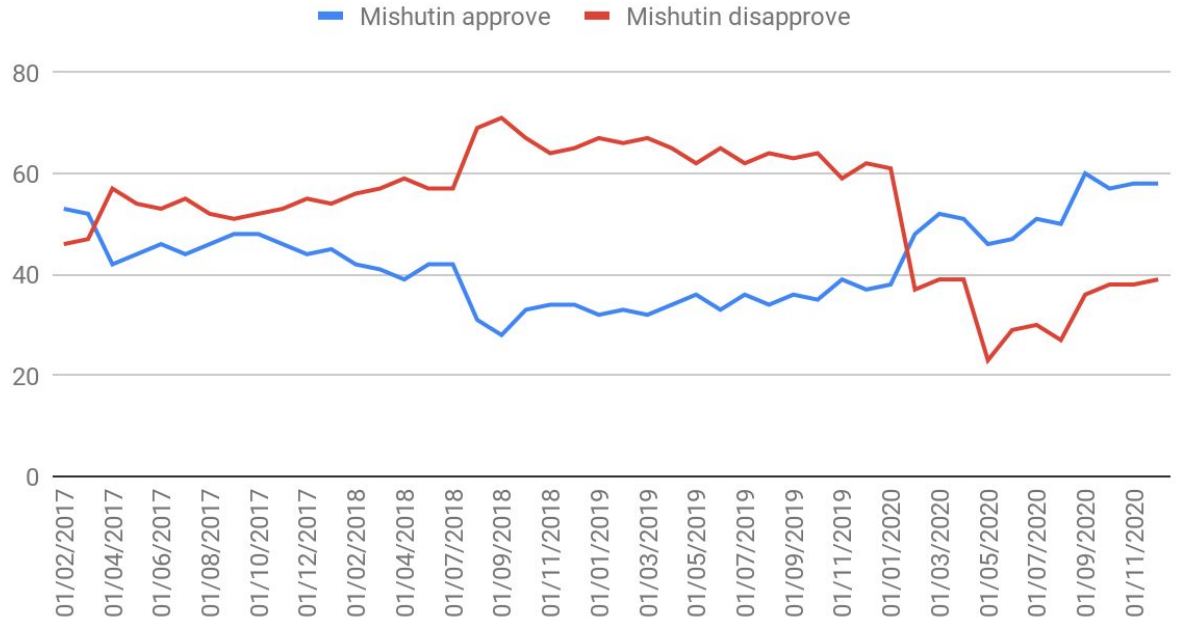
Finally, in recent years sanctions on Russia have been imposed as much for US domestic political goals as they were to punish Russia for any wrongdoing. For this reason the content of the sanctions is unimportant, as the goal is to look tough at home.

Russia Putin's approval rating %

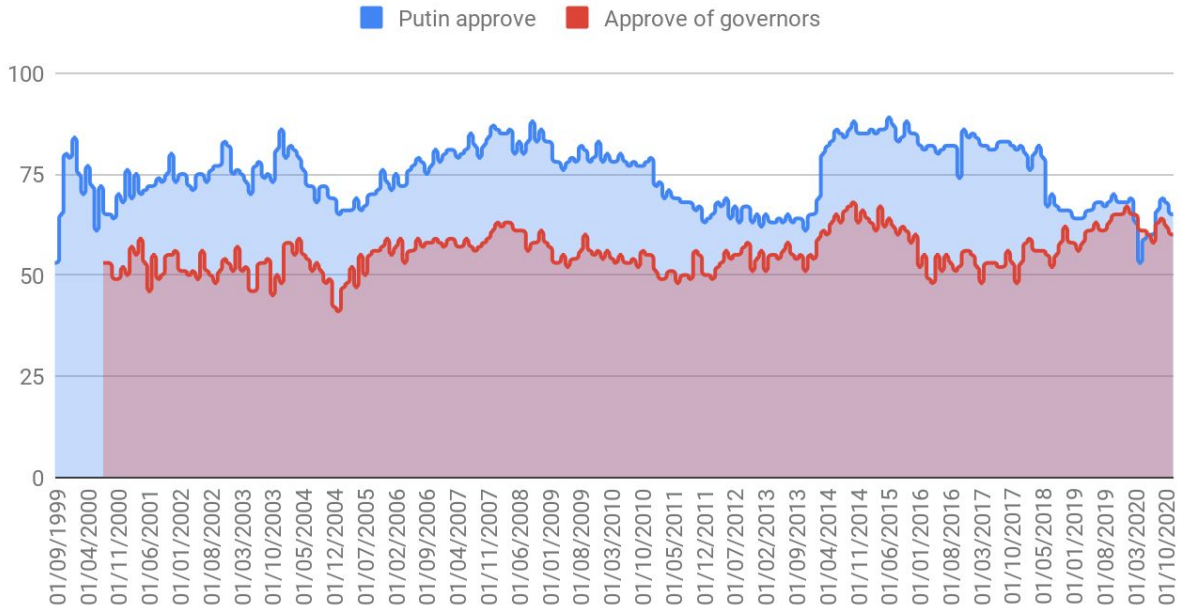


source: Levada Centre

Mishustin approval %

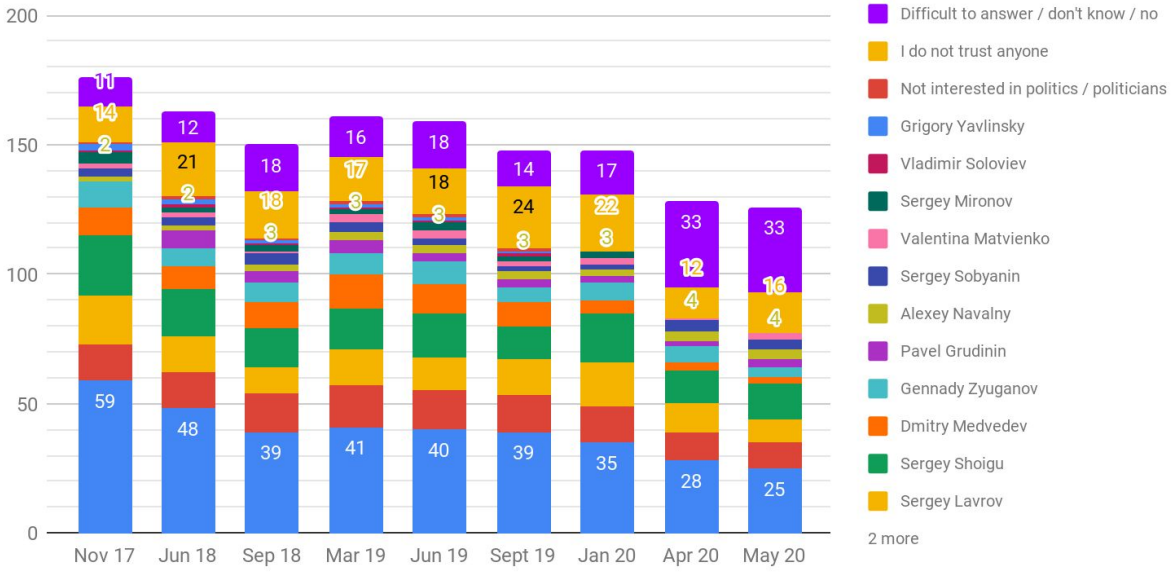


Russia popularity: Putin vs regional governors

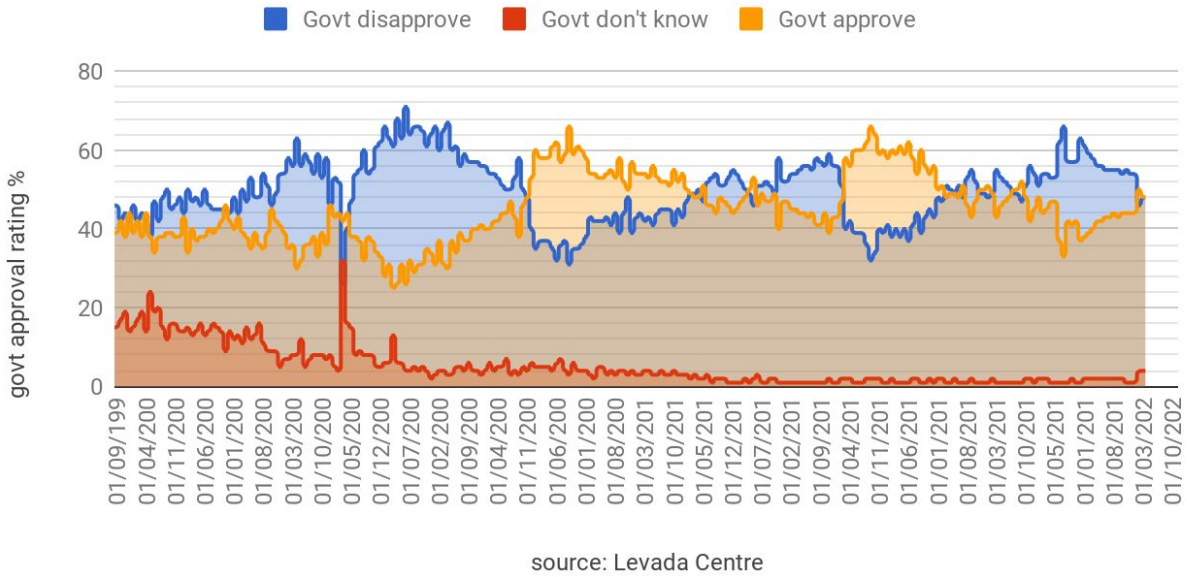


source: Levada

Russia's most trusted politicians

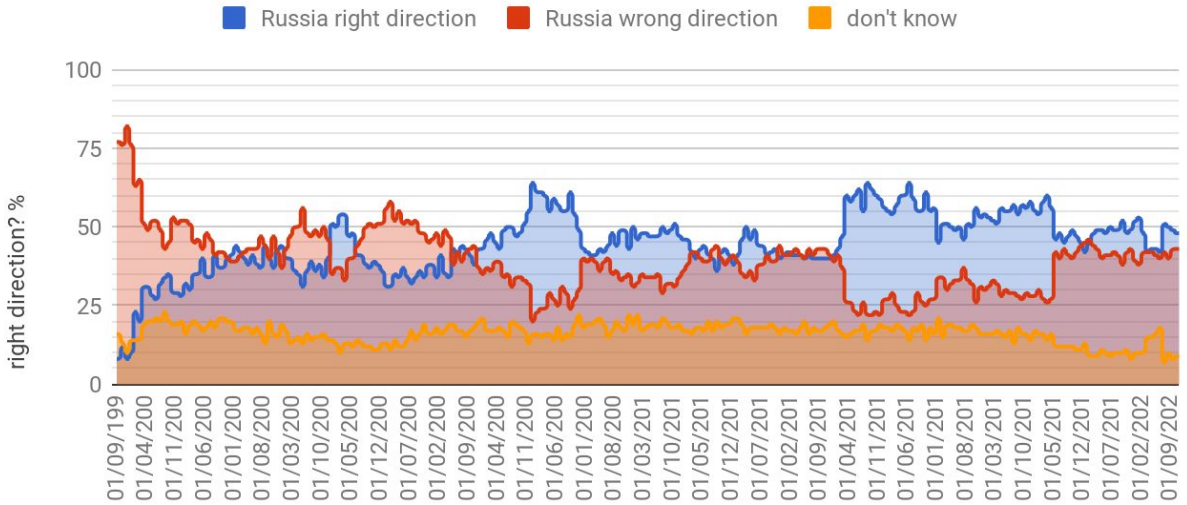


Russia government approval rate %



source: Levada Centre

Russia Country going in right direction?



source: Levada Centre

3.0 Macro Economy

Key economic forecasts: Russia

Russia	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22
Economic activity																							
Nominal GDP, RUB bn	72,761	79,030	83,087	85,616	91,843	104,630	110,046	105,854	113,681	120,484	126,506	29,816	25,318	23,288	28,068	29,339	25,707	26,289	29,937	32,010	27,413	28,098	31,856
GDP, % YoY	**1.8**	**0.7**	**-2.0**	**0.2**	**1.8**	**2.5**	**1.3**	**-3.5**	**2.8**	**2.0**	**2.1**	**2.1**	**1.6**	**-8.0**	**-3.6**	**-4.0**	**-1.4**	**5.7**	**2.6**	**4.7**	**2.7**	**2.9**	**2.2**
Private consumption	5.1	2.1	-9.5	-2.6	3.7	3.3	2.5	-5.9	4.7	2.5	1.8	2.5	3.3	-22.2	-5.9	0.6	-3.9	23.8	4.7	-0.8	4.0	1.4	2.5
Public consumption	0.1	-2.5	-3.6	1.4	2.5	1.3	2.2	8.0	-3.5	0.5	0.5	2.3	1.4	1.6	13.3	13.3	2.9	0.6	-8.1	-6.2	-0.5	1.2	1.5
Fixed investment	1.9	-2.1	-10.6	1.3	4.7	0.2	1.5	-7.0	4.7	1.5	3.0	2.9	1.8	-11.7	-9.5	-3.4	-5.1	5.2	5.8	5.0	4.4	3.2	1.7
Real exports	4.6	0.5	3.7	3.2	5.0	5.5	-2.3	-9.6	7.1	3.0	4.0	-2.5	-3.4	0.3	-16.4	-11.2	6.2	-21.1	18.8	18.5	-1.8	24.6	-1.3
Real imports	3.5	-7.3	-25.0	-3.7	17.3	2.6	3.4	-14.5	11.3	2.5	3.0	10.1	1.1	-22.2	-27.7	-11.4	6.3	22.3	21.1	5.1	-2.9	2.5	6.8
High-frequency indicators, % YoY																							
Industrial production	0.4	2.5	0.2	1.7	3.8	3.5	3.3	-3.8	3.1	2.2	2.3	2.8	2.9	-6.5	-4.6	-5.6	-1.6	6.8	3.2	5.6	3.3	3.4	2.6
Retail sales	3.9	2.7	-9.8	-4.8	1.2	2.8	1.9	-4.0	5.0	2.8	1.8	2.1	4.4	-16.1	-2.5	-3.0	-1.7	6.9	6.5	4.9	2.8	2.8	2.8
Real wages	5.3	1.5	-9.2	0.7	3.5	7.0	2.7	3.0	3.0	2.5	1.2	4.5	6.0	-0.1	1.7	-0.2	3.3	-3.4	0.6	9.4	-4.6	2.4	6.1
Real disposable income	4.13	-1.28	-2.25	-4.30	-0.45	0.10	1.03	-4.8	6.0	3.4	2.2	1.8	0.7	-8.4	-4.8	-3.6	-2.0	3.4	3.3	2.5	3.4	3.4	3.4
Unemployment, %	5.5	5.2	5.6	5.5	5.2	4.8	4.6	5.7	5.3	4.6	4.7	4.5	4.5	6.1	6.5	5.8	5.6	5.3	5.2	5.2	0.8	4.6	4.6
External activity, $ bn																							
Urals oil price, $/bbl*	106.9	100.0	51.8	42.7	53.5	70.1	63.7	41.9	47.4	48.0	50.4	61.4	49.1	32.4	43.1	43.0	44.5	46.7	48.4	50.0	49.0	46.0	48.0
Current account	33.4	57.5	67.8	24.5	32.2	115.7	65.3	25.4	38.5	20.1	24.5	11.2	22.1	-0.5	2.5	1.3	5.5	17.8	5.5	9.7	7.1	10.0	-2.2
% of GDP	1.5	2.8	5.0	1.9	2.0	6.9	3.8	1.8	2.4	1.1	1.4	2.4	5.8	-0.2	0.7	0.3	1.6	4.8	1.3	2.1	1.8	2.5	-0.5
Trade balance	180.6	188.9	148.4	90.2	114.6	195.1	165.3	78.2	87.2	96.0	102.8	41.0	32.4	15.3	17.0	13.4	16.6	27.9	19.4	23.3	22.4	28.9	19.5
Exports of goods	521.8	496.8	341.4	281.7	352.9	443.9	419.9	302.8	355.3	389.2	410.7	112.5	88.6	69.3	76.9	67.9	74.3	101.3	92.1	87.6	87.6	110.3	98.7
Imports of goods	341.3	307.9	193.0	191.5	238.4	248.9	254.6	224.6	268.1	293.2	307.9	71.6	56.2	54.0	59.9	54.5	57.7	73.4	72.7	64.3	65.3	81.4	79.2
Net private capital flow	60.3	152.1	57.1	18.5	24.3	64.9	22.6	46.4	37.9	21.0	26.4	1.2	17.2	10.5	7.8	10.9	8.7	6.4	8.6	14.2	6.6	5.3	5.2
Net flows to public sector	-5.2	-29.0	8.7	-3.0	-14.7	10.9	-24.4	0.4	-3.4	-3.4	-3.5	-5.8	-0.1	1.7	-3.2	2.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
External debt	728.9	599.9	518.5	511.8	518.4	455.1	491.4	460.5	473.6	463.6	451.3	491.4	456.0	481.6	461.2	460.5	474.0	481.2	478.5	473.6	470.1	465.0	466.2
International reserves	509.6	385.5	368.4	377.7	432.7	468.5	554.4	574.4	579.7	590.9	606.9	554.4	563.5	568.9	583.4	574.4	570.8	572.9	575.9	579.7	583.0	584.8	587.6
Public sector, % of GDP																							
Federal budget balance	**-0.5**	**-0.5**	**-2.7**	**-3.5**	**-1.4**	**2.7**	**1.8**	**-4.0**	**-2.6**	**-1.3**	**-1.5**												
Primary balance	0.1	0.1	-1.9	-2.8	-0.6	3.5	2.5	-3.2	-1.5	-0.2	0.0												
Revenue	19.7	20.4	18.5	16.0	16.4	19.1	18.5	17.0	16.3	16.8	17.2												
Expenditures	20.2	20.9	21.2	19.5	17.8	16.4	16.7	21.0	18.9	18.2	18.7												
Public debt	**11.4**	**14.5**	**14.9**	**13.2**	**12.6**	**12.4**	**12.4**	**19.2**	**20.6**	**21.3**	**22.5**												
External debt	2.8	4.3	4.9	3.7	3.1	3.4	3.1	4.6	4.5	4.3	4.3												
Money, % YoY																							
Credit to economy																							
Retail loans	28.7	13.8	-5.7	1.1	12.7	22.4	18.5	12.0	15.3	12.1	10.3												
Corporate loans	12.7	31.3	12.7	-9.5	0.2	10.5	-2.1	13.5	4.6	2.9	1.9												
CPI, % YoY	6.5	11.4	12.9	5.4	2.5	4.3	3.0	4.7	3.9	3.9	3.9	3.0	2.5	3.2	3.7	4.7	4.3	4.3	4.2	3.9	4.2	4.0	4.0
CPI, avg, % YoY	6.8	7.8	15.5	7.0	3.7	2.9	4.5	3.4	4.2	4.1	3.9	3.4	2.4	3.1	3.5	4.4	4.5	4.2	4.2	4.0	4.2	4.1	4.1
PPI, % YoY	3.5	6.3	12.1	7.5	8.4	11.7	-4.3	1.0	4.2	3.2	1.1	-4.3	-3.2	-8.3	0.0	1.0	2.4	8.0	3.8	4.2	3.4	4.2	3.8
PPI, avg, % YoY	3.1	6.1	13.8	4.2	7.7	12.1	2.0	-4.0	4.7	3.7	1.7	-5.7	-2.4	-12.1	-1.9	0.6	1.4	9.4	3.7	4.5	3.4	3.7	4.2
Financial markets																							
Policy rate, % eop	5.50	17.00	11.00	10.00	7.75	7.75	6.25	4.25	4.25	5.00	5.00	6.25	6.00	4.50	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.50	4.75
3M prime rate, % eop	7.15	23.77	11.79	10.49	7.88	8.58	6.45	4.50	4.50	5.25	5.25	6.45	6.68	4.86	4.64	4.50	4.50	4.50	4.50	4.50	4.50	4.75	5.00
2Y OFZ yield, % eop	6.47	15.14	10.14	8.36	6.84	7.86	5.61	4.25	4.50	5.00	5.00	5.61	6.25	4.57	4.64	4.25	4.25	4.25	4.50	4.50	4.50	4.75	5.00
10Y OFZ yield, % eop	7.88	13.01	9.55	8.46	7.64	8.78	6.41	5.75	5.75	6.00	6.00	6.41	6.83	6.05	6.42	5.75	5.75	5.75	5.75	5.75	5.75	6.00	6.00
$/EUR, eop*	1.37	1.21	1.09	1.05	1.20	1.15	1.12	1.19	1.23	1.25	1.25	1.12	1.10	1.12	1.17	1.19	1.20	1.22	1.23	1.23	1.23	1.23	1.23
RUB/$, eop	32.73	58.66	73.60	61.27	57.63	69.72	61.99	73.20	68.10	69.38	70.69	61.99	78.42	71.19	77.63	73.20	71.93	70.65	69.38	68.10	68.42	68.74	69.06
RUB/$, avg	31.86	38.57	61.22	66.96	58.31	62.82	64.70	73.35	70.44	68.79	70.09	63.66	66.83	72.33	73.80	76.37	72.35	71.08	69.80	68.53	68.31	68.63	68.95
RUB/EUR, eop	45.30	73.50	78.85	64.72	69.28	79.49	69.54	87.11	83.76	86.73	88.37	69.54	86.70	79.96	91.00	87.11	86.31	86.19	85.33	83.76	84.16	84.55	84.95
RUB/EUR, avg	42.32	50.97	67.98	74.14	65.91	74.04	72.41	84.04	85.44	84.73	87.61	70.49	73.76	79.64	86.26	90.25	86.34	85.76	85.39	84.29	84.03	84.42	84.81

* Memorandum items; SOVA Capital forecasts are in green. Sources: National authorities, *Bloomberg*, *Haver*, SOVA Capital Research

• GDP

Russia's economy will return to growth in 2021 after an economic slump in 2020 of circa 4% – much more mild than most were expecting – but the growth will be subdued thanks to the lingering effects of the pandemic, low spending by the Kremlin and inertia.

Predictions for the rate of growth vary between 2.5% from Alfa Bank to the CBR's 3%-4%.

The conservative scenario of Russia's macroeconomic outlook suggests GDP growth of 2.7% in 2021, and 2.9% in 2022, with further stabilisation at the level of around 2.5% amid persisting lower business activity in a number of sectors, according to the country's social and economic development outlook for 2021 and the planned period of 2022 and 2023 presented by the Economic Development Ministry.

According to the base case scenario of the outlook, Russia's GDP will contract by 3.9% in 2020, and grow by 3.3% in 2021, by 3.4% in 2022 and by 3% in 2023.

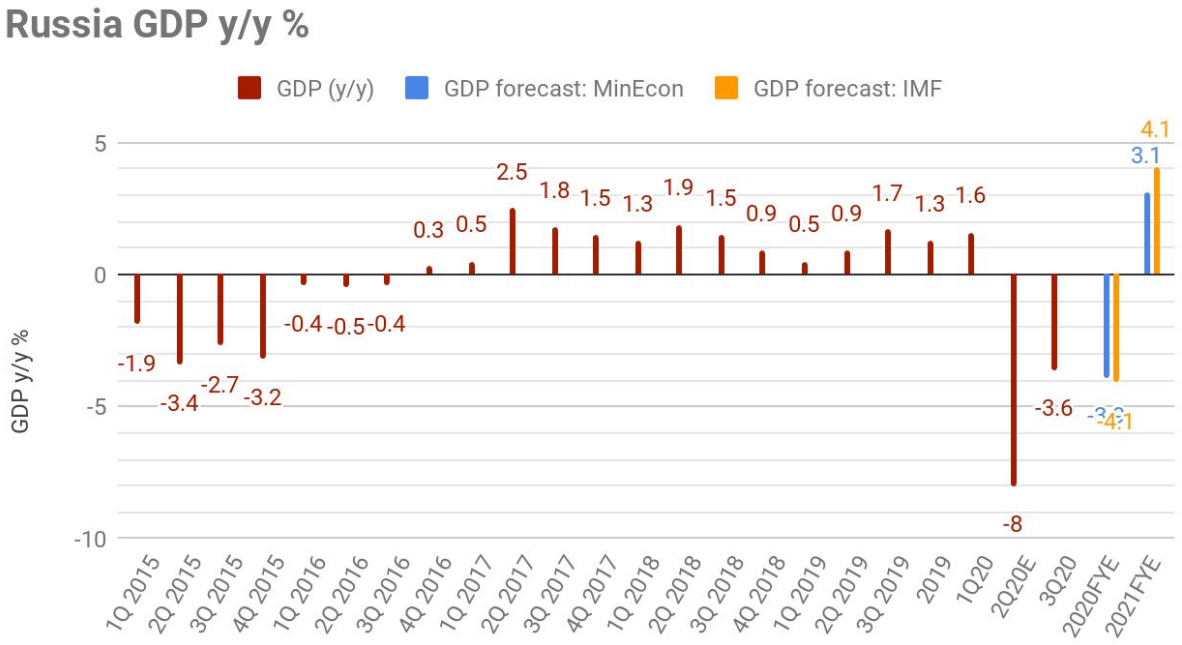
The base case option depicts the most probable scenario of Russia's economic development by considering the expected external environment and the economic policy measures being taken.

The conservative scenario "is based on the assumption that the sanitary and epidemiological situation in the world will become less favourable, a protracted recovery of the global economy and structural slowdown of its growth rates in the mid-term due to the aftermath of the novel coronavirus infection spread."

Russia's "extremely conservative" spending in 2021 will slow the economic recovery after the pandemic and the reduced spending will erase up to one percentage point from growth, say local economists.

Alfa Bank economists also said that the expected budget policy tightening was a factor for cautious assessments on the prospects of Russia's economic growth in 2021. Predictions for growth vary between Alfa Bank's low 2.5%, where growth is held back by restrained government spending, to the CBR's 4% at the upper band of its range, where there is a global bounce-back.

Russian GDP growth in 2021 forecasts	
Alfa Bank	2.5%
Sova Capital	2.8%
Economic Development Ministry	2.7%-3.3%
CBR	3%-4%
World Bank	2.7%
IMF	3%-3.5%
EBRD	*4%*



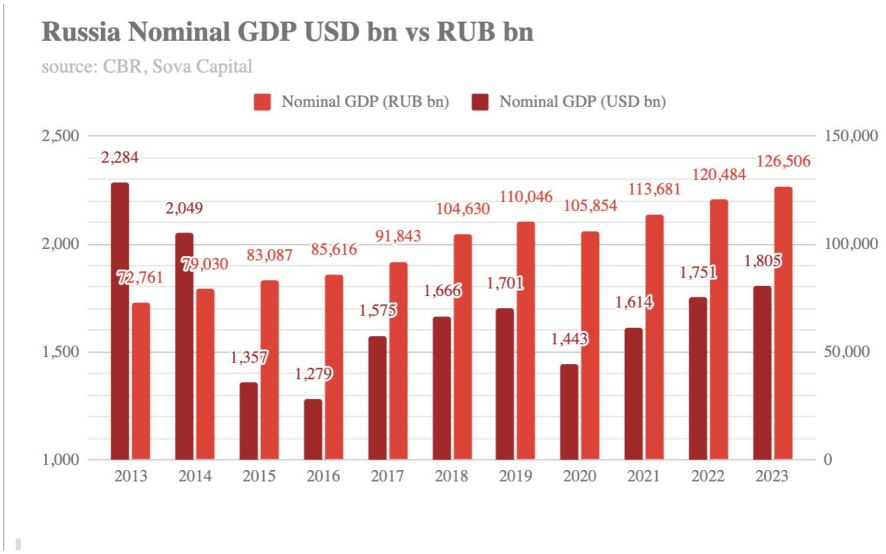
source: Rosstat, Ministry of Economy

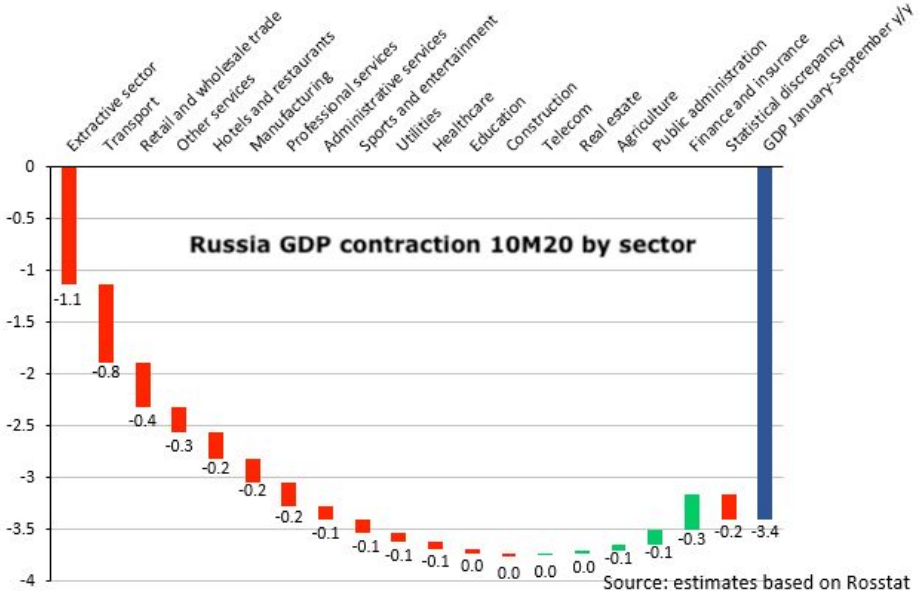
The coronacrisis has been very painful, but it has been a lot less so than the 2014 double whammy of the oil price shock that year coupled with sanctions imposed following the annexation of Crimea.

The Russian economy was worth over $2 trillion in 2013 but crashed in 2015 following the oil price shock in the last months of 2014, losing some $700bn.

This time round the oil price shock was as bad, if not actually worse, than in 2014, but the economy contracted by some $300bn, falling from $1.7 trillion to $1.4 trillion.

The value of the economy should recover to its pre-coronavirus level of $1.7 trillion by 2022, but the rate of recovery is going to be slow and Russia Inc. won't return to a valuation of over $2 trillion for at least four years.





• CPI

CPI accelerated from 2.3% y/y in February to 4.4% y/y in November 2020 thanks to food items and medicine, breaching the CBR's 4% target level and was just under 5% at the end of the year.

Services inflation remained low due to subdued demand, as services were battered again by the second wave of COVID-19.

CBR governor Elvira Nabiullina admitted for the first time on December 9 that

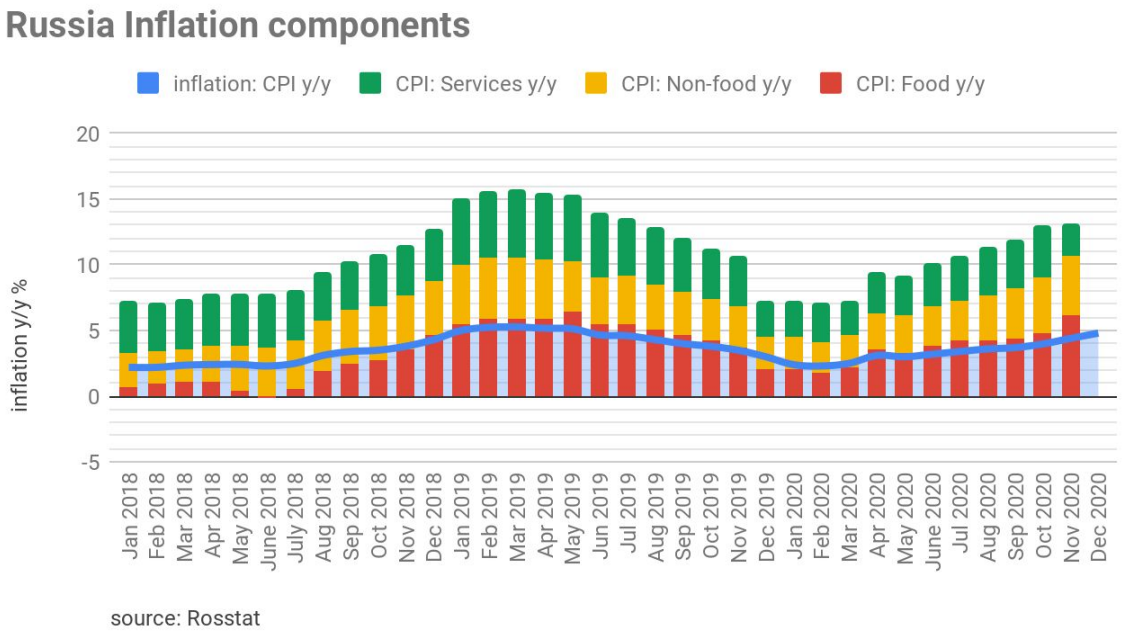
the inflation spike could significantly overshoot the target in December and 1Q21.

In the short term, analysts expect the increased inflationary pressure to remain and by February analysts say price growth may reach 4.5% y/y, while Nabiullina said inflation could reach its peak by February 2021 of 5%.

Going forward, inflation is projected to slow after passing the low base effects of March and April, as well as the disinflationary factors that could bring it back to the target of 4% in the summer.

Inflation is expected to be elevated at about 4.2% for most of 2021, only falling back to 4% by the fourth quarter of 2021, according to Sova Capital following the traditionally low inflation months of the summer.

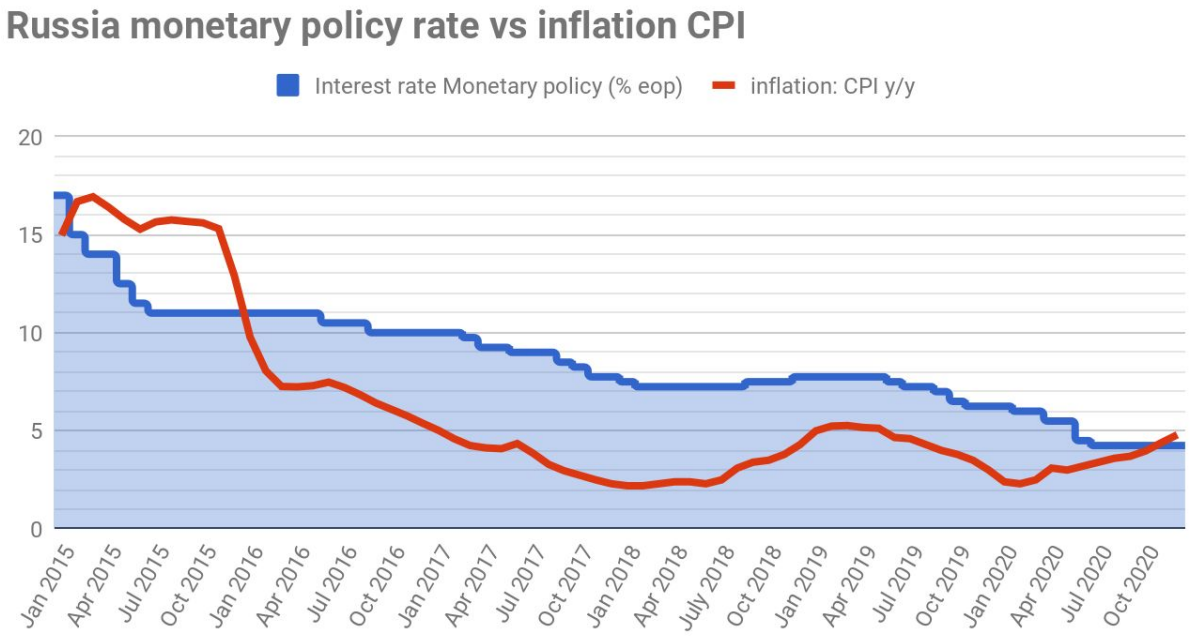
CBR is monitoring the surge in inflation expectations, which could have an impact on consumer behaviour and accelerate the growth in consumer prices. CBR is also seeing an impact on inflation expectations from the change in investment behaviour. Russians are seeking investment alternatives other bank accounts and have started to actively invest in foreign stocks and currencies that could weaken the currency and also boost inflation.



• CBR interest rates

Elevated inflationary pressures in 2021 will prevent the CBR from cutting rates beyond the 4.25% they will end 2020 at.

The ruble's weakness as of 3Q20 has started to affect inflation, offsetting the shock from lockdowns, and while the currency may appreciate in the short term that weakness may persist.



• FX

The ruble strengthened in November and December mainly on a notable increase in capital inflow to the Russian market in November as optimism returned on the back of an expectation of the end of the coronacrisis in 2021 – both into stocks and bonds. Capital outflow was the main driver of the ruble weakening, when it fell briefly to RUB80 to the dollar before recovering to RUB75 as of the middle of December.

Some big changes in the forex situation are expected in 2021. The dollar was weakening as 2020 came to an end and that trend is anticipated to continue for the next two years as FDI flows into the US are expected to reverse in the coming years, weakening the dollar in the process. The euro, on the other hand, has remains resilient at c. RUB90 and will change less.

In 2020, Russia posted a current account surplus of $32.5bn, according to preliminary data released by the CBR. This is twice lower than a year ago ($64.8bn in 2019), but still is a positive achievement, given the recession and a

spike in capital outflows caused by the pandemic. Analysts expect the current account surplus to rise by 50%+ in 2021

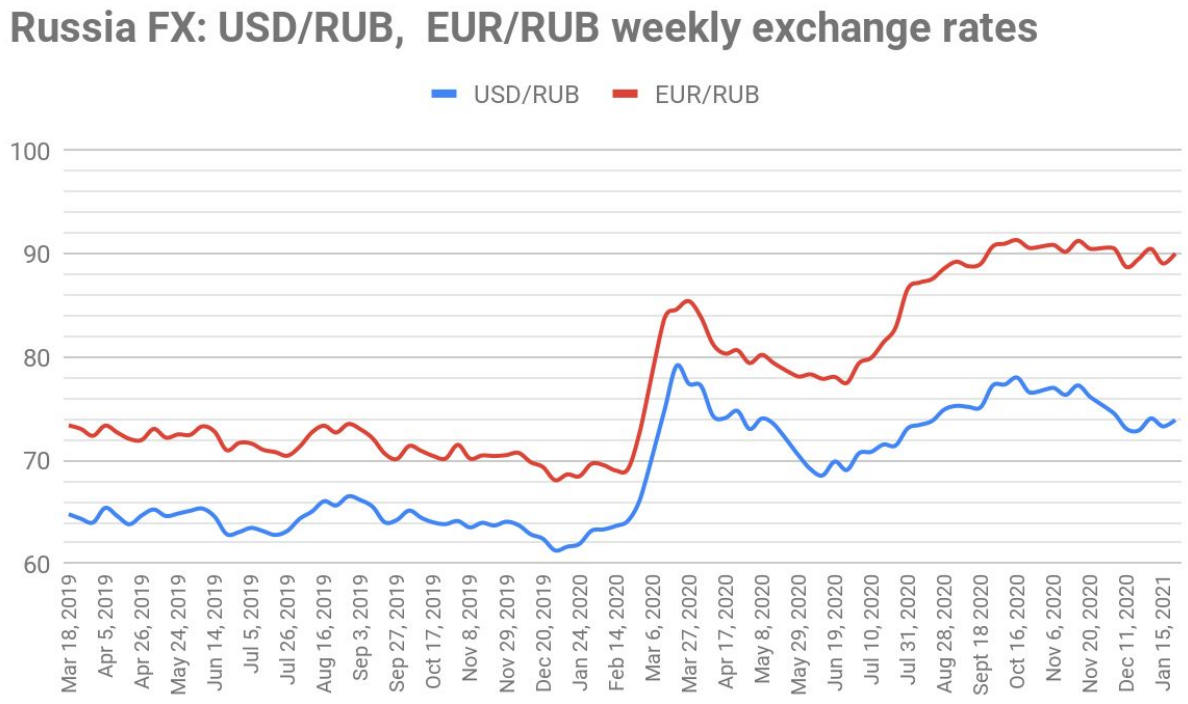
With the current account surplus down by half in 2020 compared to 2019 the ruble's value will become a lot more sensitive to Russia's foreign trade flow and so will become more affected by changes in the oil price and foreign investment into the Russian Ministry of Finance ruble-denominated OFZ treasury bills.

Foreign holdings of OFZs have already underpinned the value of the ruble in 2020. When oil prices crashed by 45% in March of that year the ruble fell by only 17% as inflows into the OFZ market went some way to underpinning the value of the currency.

MinFin issued a record RUB4 trillion of OFZ in 2020, almost twice the usual level, but intends to reduce borrowing on the domestic market to around RUB2.5bn in 2021 so the bond market will have less effect on the currency than in 2020.

The ruble's future trend will be shaped mainly by external factors. If global markets grow more, while the US dollar weakens (or stays at low levels), by the end of December the ruble may consolidate at RUB73-74/$.

The final factor affecting the ruble is that Russians have started to actively invest in foreign stocks and currencies as the rates on bank deposits have fallen dramatically in the last years. This outflow of capital has reached a point where the CBR is starting to worry that it will start to affect the currency's value. Retail investors' share of the turnover on the MOEX exchange was 43% as the end of the year loomed, a large part of that going into offshore stocks, and could increase to half in 2021.



• Trade

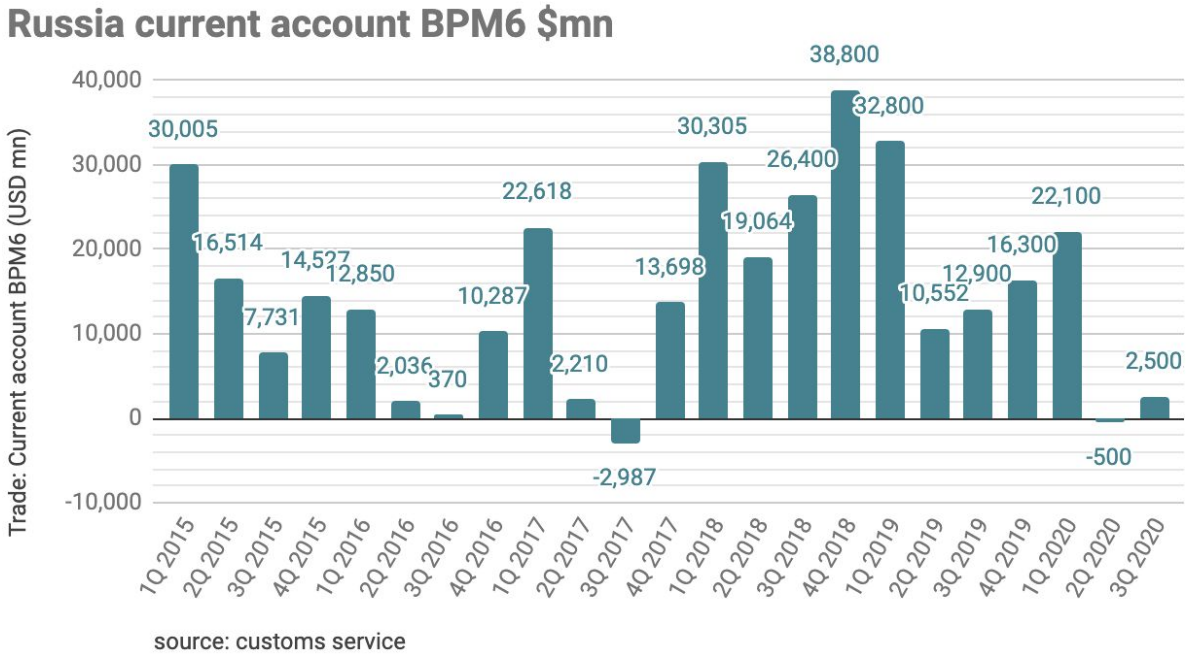
According to the Central Bank's preliminary balance of payments data, revenues from exports of goods and services recovered slightly in the last quarter of last year, but were still closer to a quarter lower than a year earlier.

By the end of 2020 revenues from exports of oil, oil products and gas were still more than 40% lower than a year earlier, mainly due to low export prices. Revenue from exports of other goods, on the other hand, was about the same throughout the second half of the year as a year earlier. Revenues from exports of services were still more than 35% lower than a year ago, especially as Russia's tourism revenues remained very low.

Recovery in demand in the external sector to offset import demand. Despite the drop in oil prices and volumes in 2020, the current account remained in surplus thanks to less demand for imports (from 3.8% of GDP in 2019 vs. 1.8% of GDP in 2020).

The recovery in external demand in 2021 could lead to a recovery in exports, while the recovery of imports will likely trail behind the trend. As a result, analysts see the current surplus rising to 2.4% of GDP in 2021. They think the capital outflows will gradually subside from $46.4bn in 2020 to $37.9bn in 2021 due to fewer geopolitical risks, but the risks from re-negotiating double taxation treaties could remain. Nevertheless, this level is still down significantly from the

$75bn current account surplus in 2019.



• Banking and corporate profitability

The banking sector has been one of the success stories of 2020. While the sector was hard hit in the middle of 2020, the previous crisis of 2014 means the banks had already dealt with their problematic loans. As the autumn closed in banks were making profits similar to those of a year earlier, and were even slightly ahead of 2019 profit levels in September and October.

In addition, the CBR campaign to clear up the banking sector launched by CBR governor Elvira Nabiullina after she took over in 2013 was officially declared over at the end of 2018. That meant the sector went into the crises of 2020 in fairly robust health and was well able to weather the storms.

While profitability was reduced the banks still made a profit of RUB1.3 trillion in the first ten months of 2020. The banking sector has more or less recovered from the shocks from earlier this year with the profits in October ahead of those in 2019, but behind those in 2018. Moreover, on a cumulative basis the bank sector profits have caught up with those of 2019 by October.

The coronavirus pandemic and low oil prices, resulting in an economic contraction and ruble depreciation, have caused banks' asset quality to weaken, putting moderate pressure on their credit profiles. Weaker economic activity in 2Q20 undermined banks' pre-impairment profitability, but they still

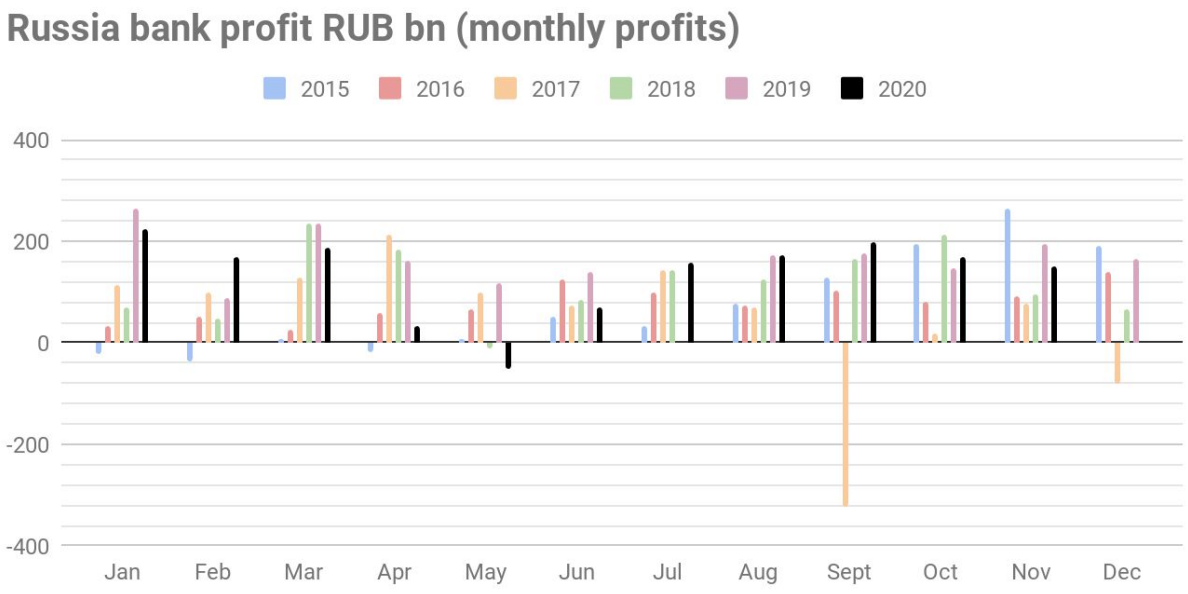
enjoyed a reasonable cushion for most Russian banks to absorb potentially higher loan impairment charges without significant erosion of capital positions, according to analysts.

Lending was also impaired but retail loan growth continued to grow steadily, but not excessively. The CBR is extremely cautious and already nipped the fast growth in retail lending in the bud in 2017 by introducing a scaled provision system that forces banks making unsafe unsecured retail loans to provision for bad debt, thereby reducing the attractiveness of this type of business. The upshot is banks paid more attention to the quality of the borrowers and so potential non-performing loans (NLPs) have been better managed and have been better provisioned for.

Corporate loans have grown a lot more slowly as the companies continue to fund most of their investment out of retained earnings and have, like the banks, drastically deleverage since the 2014 crisis.

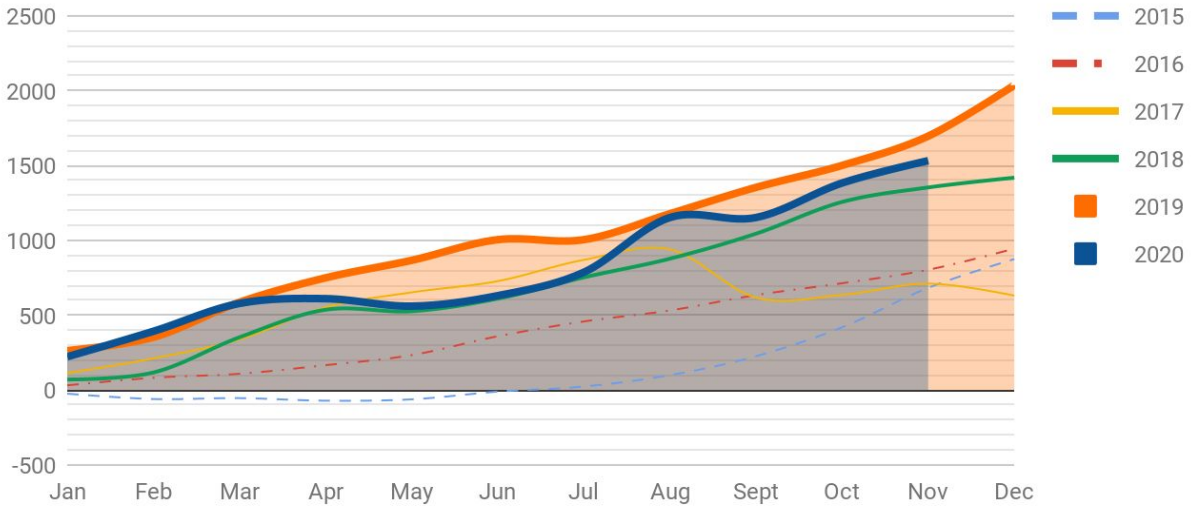
On the funding side, deposits of both retail and corporate clients have grown steadily throughout 2020, largely unaffected by the shocks.

These trends are expected to continue in 2021.



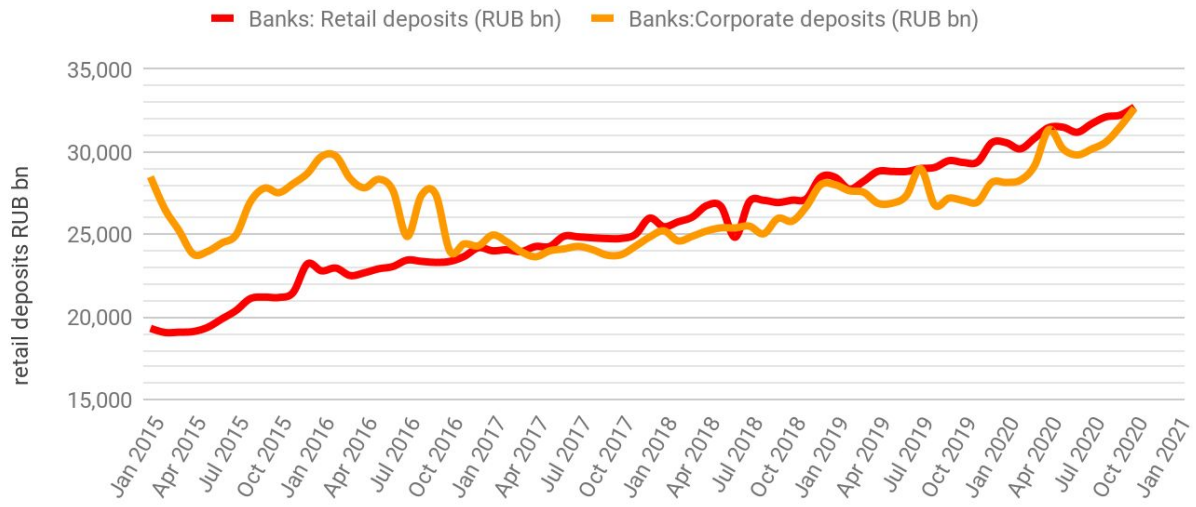
source: CBR

Russia bank profit RUB bn (cumulative profits)

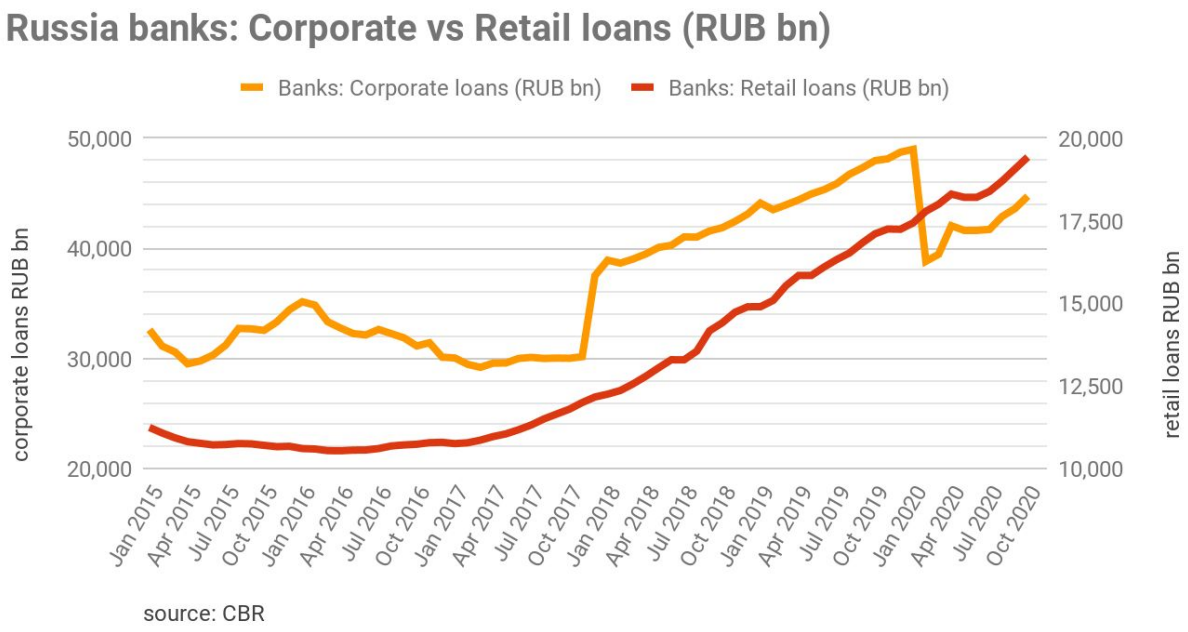


source: CBR

Russia bank Corporate vs Retail despoits (RUB bn)



source: CBR



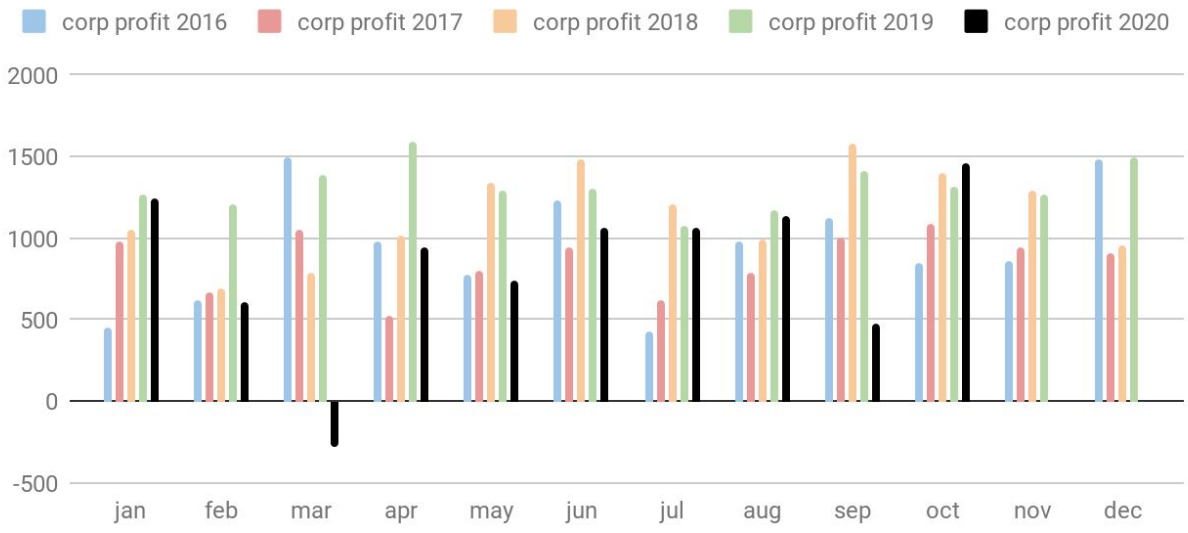
The situation with corporate profits was similar to that of banks, but not quite as good. Corporate profits fell earlier than those of banks starting in February as the first signs of the crisis made themselves felt.

Profits remained down in the summer, but recovered after the lockdowns were lifted in July. However, the economic slowdown that started in September cut heavily into profits, and cumulative profitability, while recovering, remained well behind that of the four previous years.

Given the state is expected to end the subsidy programmes in 2021 and cut budget spending too, the outlook for a pick-up in corporate profits remains poor. Corporate profits clearly benefited from the recovery in consumption in the summer following the lockdowns, but as real incomes are likely to remain stagnant or fall throughout all of 2021 (see section) there will be little respite from that quarter either.

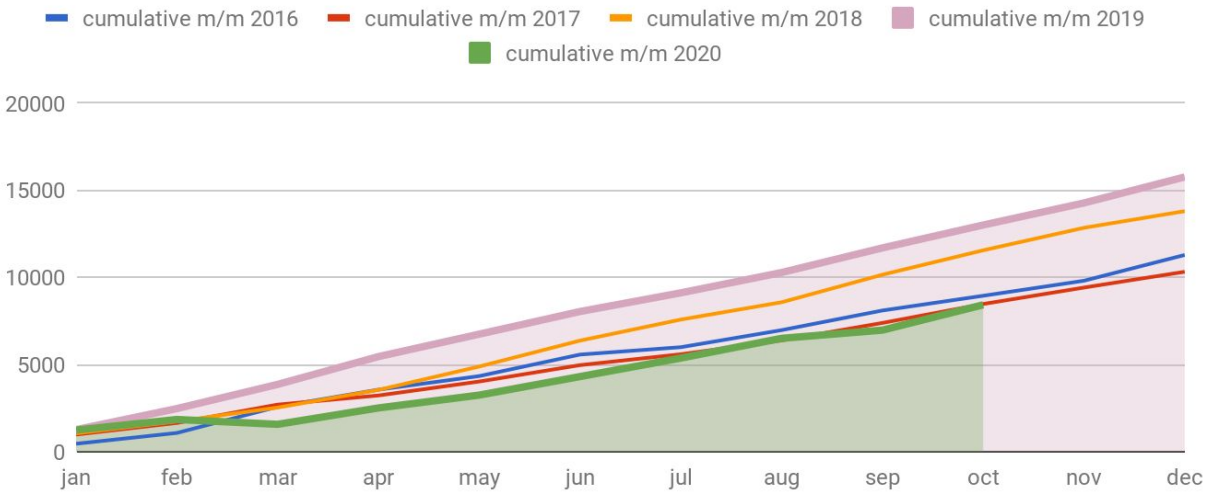
The silver lining is the government is expected to ramp up spending on the national projects in 2021 and that will be a source of liquidity that may improve profits, but as most of this spending will be concentrated in big projects, companies will benefit from a trickle-down effect which is not very effective in the Russian economy and disproportionately benefits the biggest companies.

Russia corporate profits RUB bn (monthly)



source: Rosstat

Russian corporate profits RUB bn (cumulative)



source: GKS

• Real incomes

The recovery of the Russian economy over the summer of 2020 was driven by a dramatic bounce-back in consumption after the lockdown restrictions were removed. However, by September the economy began to slow and that slowdown was made worse as Russians self-isolated again. Foot traffic plunged and was down by 50% y/y by November.

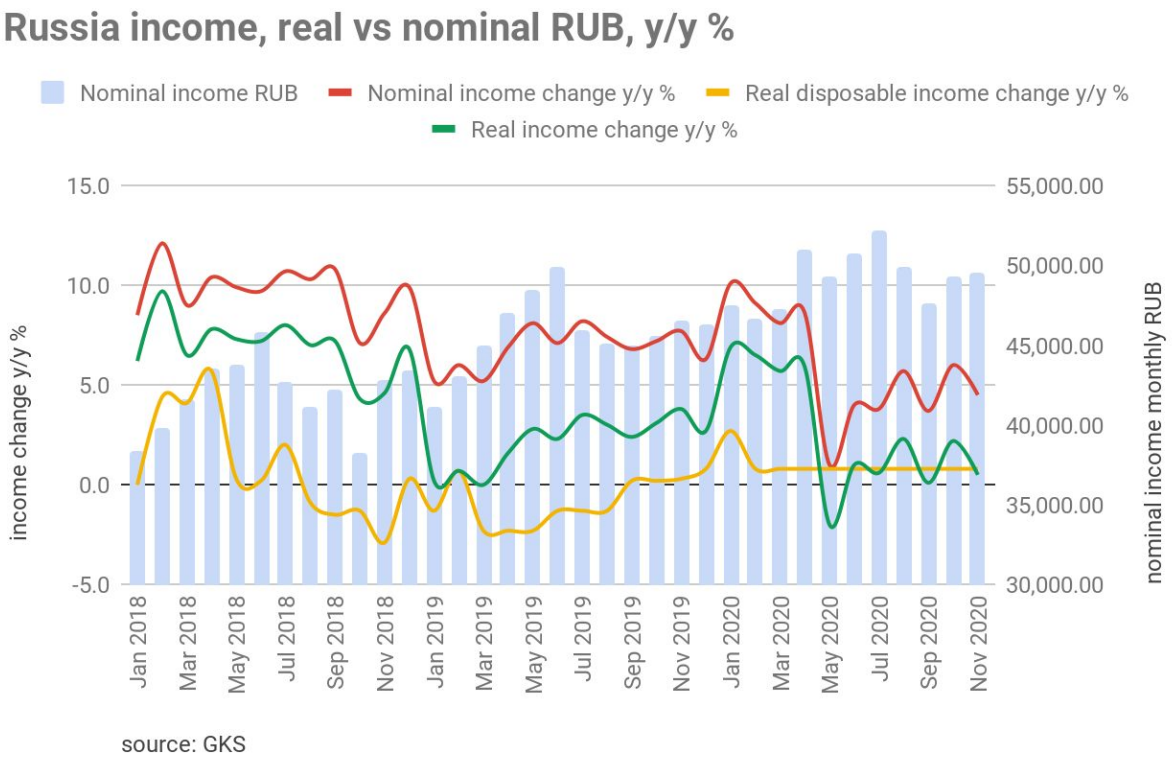
Retail sales have been depressed by declining real incomes, which have fallen for almost seven years in a row. In 2014-2017, the real incomes of Russians continuously decreased, in 2018 they showed a slight increase (by 0.1%) and by the end of 2019 they grew by 1%. By the end of the third quarter of 2020, real disposable income was 11% lower than in the pre-crisis 2013. According to Rosstat, in the first nine months of 2020 the drop was 4.3% in annual terms.

Consumption was a big driver of growth in the noughties but is not expected to reappear in 2021 as a growth driver. The recovery of real incomes of Russians after the failure due to the pandemic crisis will drag on at least until the end of 2022, say economists. However, the Ministry of Economic Development's forecast is much more optimistic and predicts a full recovery of real incomes as early as next year, which would boost growth if it happens.

In 2021, the real disposable income of Russians will expand by 2% at best after a 5% decline at the end of 2020, writes RBC, citing a review by Alfa Bank economist Natalia Orlova.

According to the forecast of the Development Center, the real disposable income of Russians in 2020 will decrease by 4.1%, next year they will grow by 2.2%, and in 2022 by 1.9%.

A decline in real disposable income leads to an increase in the level of poverty in the country. The Higher School of Economics calculated that due to the pandemic, at least 6.1% of the working middle class in Russia had dropped down into the poor category. The real share of the poor in the country following the lockdown has grown to 19-20%, the researchers note.



• **Unemployment**

Unemployment is up by half in 2020, rising from a post-Soviet low of 4.4% in the summer of 2019 to reach 6.3% in October 2020, where it stabilised.

The outlook for 2021 is for unemployment to remain at this elevated level for most of the first half of the year and could only start falling in the second half as the economic recovery gathers pace.

However, Orlova fears that unemployment may turn from a cyclical phenomenon into a structural problem and remain at the level of 6% at the end of 2021. The dynamics of unemployment could also be affected by the rapid digitalisation of the real economy that was underway in 2020, catalysed by the coronacrisis that reduces the demand for labour, as well as an increase in supply in the labour market as a consequence of the higher birth rate in the 2000s.

Russia ILO unemployment index

• **Retail**

2021 should see a recovery in retail despite the stagnation in real incomes simply because people can go out to the shops again.

Obviously retail sales collapsed during the lockdown, falling from a peak of 22% in April 2020 y/y before recovering to -1.9% in July the same year. But as the second wave of the infections got underway in the autumn retail sales slipped again and were down 2.4% as of October.

The bounce-back is not anticipated to be strong but it will benefit from a low base effect. The main change is that Russians who put off big ticket purchases are starting to make those again and looking at the sale of things like cars gives a better idea of consumer behaviour.

Since the stagnation of incomes began Russians have traded down from imported car models and made the domestic Avtovaz the most popular brand again. Avtovaz's sales will end 2020 down 7% y/y, analysts say, and the company will only break even. But since July sales began to recover as Russians started to make delayed big ticket purchases and that trend is expected to continue.

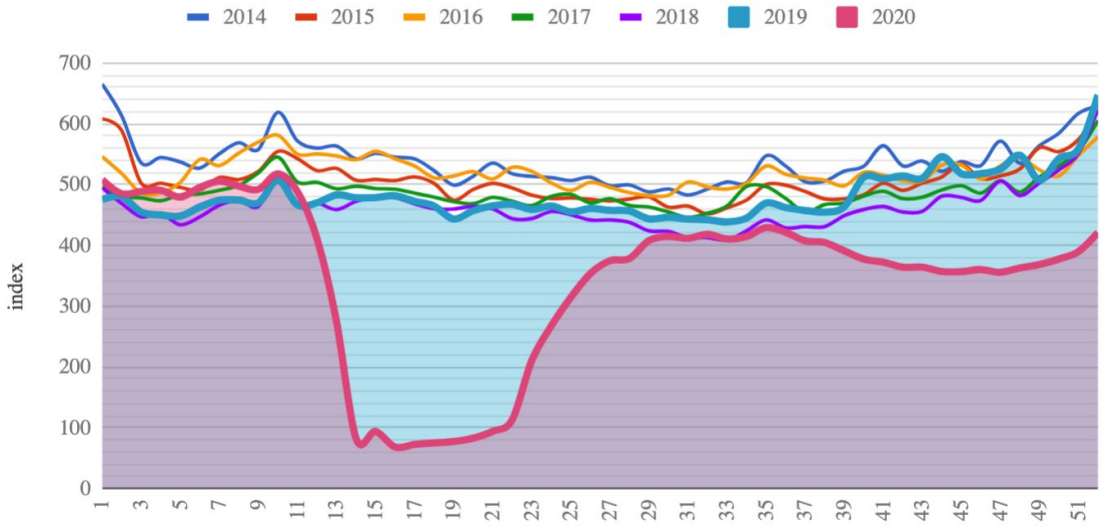
Russians may not be seeing their income grow but most still have a job and a salary and life goes on. Russia's sales of new cars and light commercial vehicles (LCVs) rose by 5.9% on the year to 157,580 units in November, according to the Association of European Businesses (AEB).

2021 could turn out to be the year of the discounter as the leading retail chains retrain their sights on the lower income clients. In the last half of 2020 both the two top retailers Magnit and X5 launched discount stores and the established discounters like Fix Price were expanding rapidly and eating into the sales of the established supermarket chains.

Magnit launched Moya Tsena discount chain in the summer of 2020. X5 Retail Group announced the launch of a new chain of hard discounters Chizhik in October. And the Novosibirsk chain of hard discounters Svetofor has become the fastest growing federal food retailer.

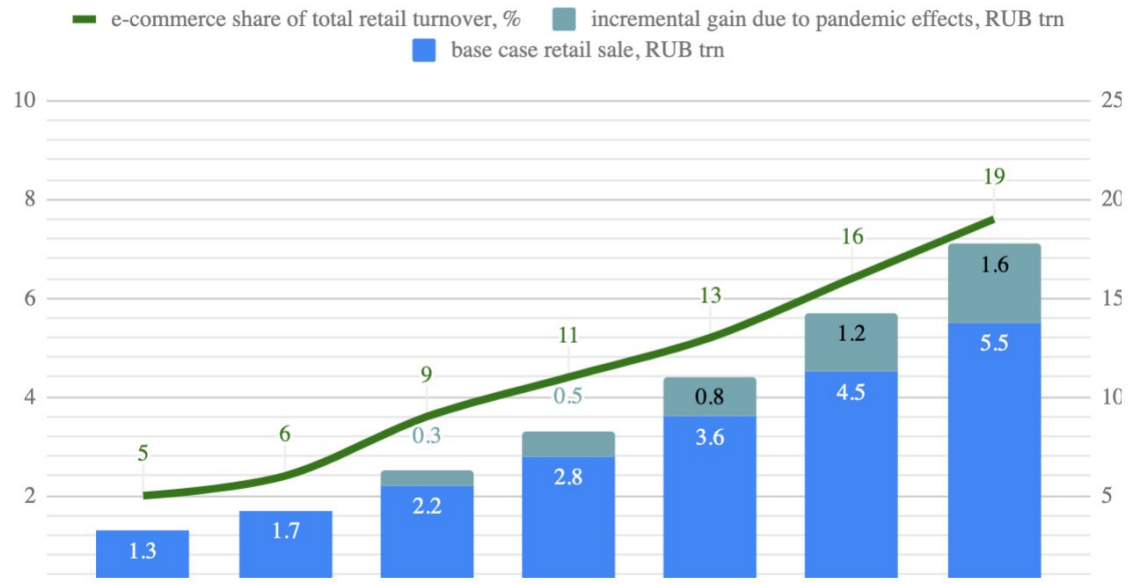
Russia Watcom shopping index (Moscow)

source: Watcom



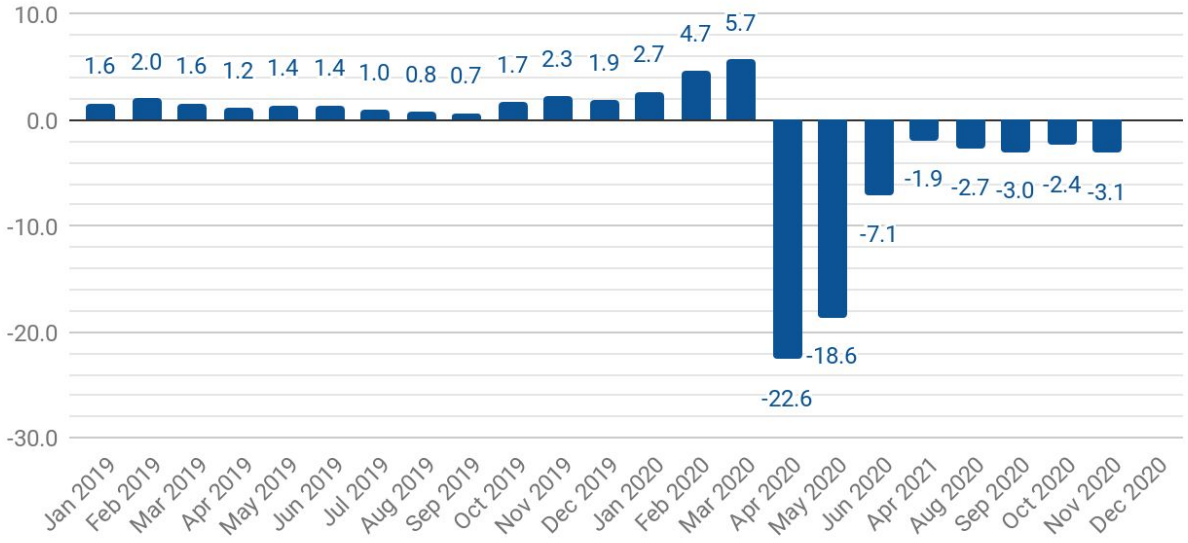
Russian e-commerce market RUB bn

source: Sova Capital

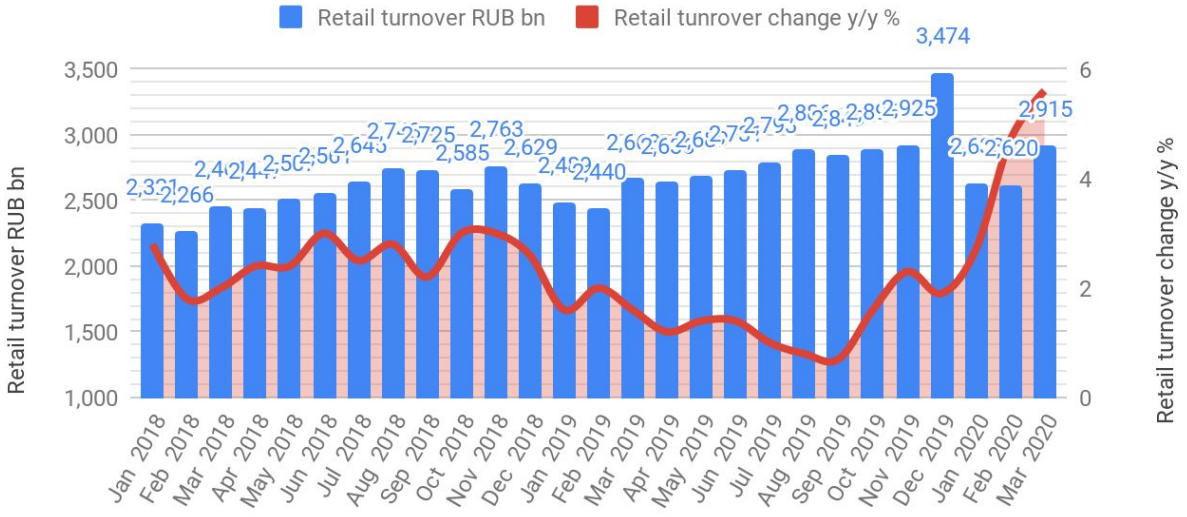


Russia retail turnover change y/y %

source: Rosstat



Russia retail turnover, volume vs change y/y %



source: GKS

4.0 Budget & Debt

Main parameters of 2021-2023 federal budget				
	2020	2021	2022	2023
Revenues RUB trillion	17.9	18.8	20.6	22.3
Expenditures RUB trillion	22.6	21.5	21.9	23.7
Budget deficit RUB trillion	-4.7	-2.8	-1.2-1.4	-1.2-1.4
Budget deficit % GDP	-4.4	-2.4	-1.0-1.1	-1.0-1.1
State borrowing RUB trillion	4.4	2.9	2.1-2.4	2.1-2.4
Source: Ministry of Finance				

• Fiscal policy

Since the near-miss budget crisis in 2016 when the MinFin had a RUB2 trillion hole in the budget that it was unable to finance, the ministry has been looking for fresh sources of revenues.

The main change is the government is insisting all state-owned enterprises (SOEs) pay out 50% of their income as dividends to the government and 2021 will probably be the first year where this actually happens. Most of Russia's SOEs are already paying 50% but some of the very largest – notably Sberbank and Rosneft – have paid less, pleading for exemptions to create money for large-scale investment projects.

Taxes are also slowly being raised. The VAT rate was already hiked from 18% to 20% in January 2019 and from the start of 2021 the flat income tax of 13% will be ended and the first step towards progressive income taxes taken, with a 15% rate being put on income over RUB5mn (about $65,800/€55,370 euros at

the current exchange rate). Given the average annual income in October was RUB590,000 ($7,900) the change in the tax rate will affect a very small percentage of the population.

The mineral extraction tax (MET) was also comprehensively reformed in the middle of 2020 to more efficiently tax the extraction of metals and hydrocarbons, which will continue to be phased in during 2021.

In parallel to the tax hikes Russia has also been trying to bring more Russian companies back on shore to better capture their tax payments.

The Kremlin has forced the renegotiation of its double taxation treaty with Cyprus, increasing the taxes on Russian companies domiciled there. And in December the MinFin threatened to withdraw from the deal with the Netherlands, which has been a very popular domicile for Russian companies registering offshore. Few Russian companies have moved their addresses back to Russia so far.

Going in the other direction, taxes on IT companies have been slashed in the hope of spurring the technology sector.

• Budget deficit and spending

The federal budget deficit was amount to 3.8% of GDP in 2020, with the non-oil deficit at 8.8% of GDP. Budget execution appeared to be better than previously expected (4.4% of GDP in September and 5% of GDP in June).

The lower fiscal deficit comes from expenditures. MinFin should have allocated RUB1.8 trillion in the last days of December. However, it is likely that around RUB1trillion will not be disbursed, bringing total federal expenditures to RUB22.8-22.9trillion (21.3% of GDP).

The ministry also managed to mitigate the spending pressures on the NWF, taking only RUB300bn out of the planned RUB350bn allotted by legislation thanks to better-than-expected oil prices. As for the 2021-22 budgets, the use of sovereign funds is limited to RUB100bn in total thanks to higher oil prices.

The unspent funds should be transferred to the 2021 budget. The main sources of under-spending were unfinished projects (RUB300bn); unexecuted expenditures on defense and law enforcement (RUB140bn); inter-budgetary transfers to regions (RUB70bn); and savings that will go to government reserves (RUB400-450bn), which could top RUB600bn next year.

"Extremely conservative" spending Federal budget expenditures in 2021, according to the analysts, will be 9% lower than the current year level, or by RUB2.2 trillion, which is about 2.1% of the projected GDP in 2020. Thus the reduction in budget expenditures is equivalent to about 2% of the potential

GDP next year,

The selected budgetary strategy will allow the stimulation of an advanced recovery in the most affected sectors of the economy and thereby quickly overcome the consequences of the 2020 crisis, the NKR believes.

Alfa Bank estimates that the government plans to cut nominal budget spending by 5% in 2021, or by RUB1.1 trillion. At the same time, an increase in non-oil tax collections will give the budget an additional RUB1 trillion in 2021, including about RUB500bn from the end of the tax break announced in 2020.

Anticipated spending in 2021 will be less than under the budget projected in 2018-2019 and some RUB3 trillion ($40.9bn) less than the pre-crisis plan for 2021, according to a draft federal budget.

The government has money in reserve but it is not going to use it. The Russian National Wealth Fund in March-November 2020 grew from $123bn to $167bn. The Finance Ministry has refused to use this fund to bankroll anti-crisis measures.

The government has earmarked a very modest 3%-4% of GDP spending to counter the effects of the coronacrisis in 2020 and will phase this support out in 2021.

The federal budget is predicted to end 2020 with a deficit of -4% after two years of surpluses. During the recovery phase the budget will remain in deficit for the following three years, falling from -2.6% in 2021 to -1.3% and -1.5% in the subsequent years.

This deficit spending will be largely funded by an increase in domestic debt that will rise from 12.4% in 2019 to 19.2% at the end of 2020 and then to 20.6% in 2021, 21.3% in 2022 and 22.5% in 2023, according to Sova Capital.

After a very accommodative fiscal policy stance in 2020 that has included the adoption of a RUB6.7 trillion recovery plan, authorities want to phase out the stimulus in 2021, with spending easing from 22% of GDP in 2020 to 18.6% of GDP in 2021. However, the reduction in social spending will likely be more gradual in 2021-22.

Revenue will remain at around 16% of GDP if the Sberbank deal is excluded from 2020 revenue.

A gradual increase in oil prices ($41.8/bbl in 2020 to $47.5/bbl by 2023) and higher tax rates for wealthy individuals, tobacco companies and commodity-related industries should offset the lower taxes for SMEs and the IT industry, as well as their other tax benefits.

The mix of inflation, key rate expectations, an intense OFZ issuance from one

side and the compression of the geopolitical risk premium could bring the 10Y OFZ yield down to 5.75% by YE21 from its yield of 6.11% as of December 2020.

Due the government's parsimony no large-scale support of the economic growth through public expenditure is expected in 2021-2023, according to the National Credit Ratings agency, RBC writes.

According to the International Monetary Fund, Russia's budget spending on healthcare and crisis-hit economic sectors reached 2.4% of GDP, while Canada, the US and Australia earmarked 12% of GDP on average. Among G20 countries, Russia is second from the last (Indonesia and Mexico) in terms of anti-crisis packages.

• **Debt and gross international reserves**

Russia has one of the lowest levels of external debt of any developed nation in the world and it continues to fall.

Russia's gross international reserves (GIR) grew by almost $100bn over 2020 to reach just under $600bn by the end of the year, which is enough to completely pay down the country's entire external debt and still leave $100bn over.

Russia's reserves also cover more than two years of forward imports, far in excess of the three months economists believe is necessary to ensure the stability of the currency. If Russia did pay off its debt then the $100bn left would still be more than the three months of import cover needed to keep the ruble stable. On this score Russia is in an excessively strong position.

CBR governor Elvira Nabiullina said in early 2020 that the CBR's comfort level for GIR was $500bn and that was reached in the middle of the year. That means the CBR is less concerned about accumulating more reserves in 2021, and it had already stopped buying gold in the fourth quarter of 2020, which accounts for about a third of the total reserves. However, as the CBR is concerned with controlling inflation it needs to sterilise excess income and so reserves are likely to continue to accumulate, albeit at a slower pace in 2021.

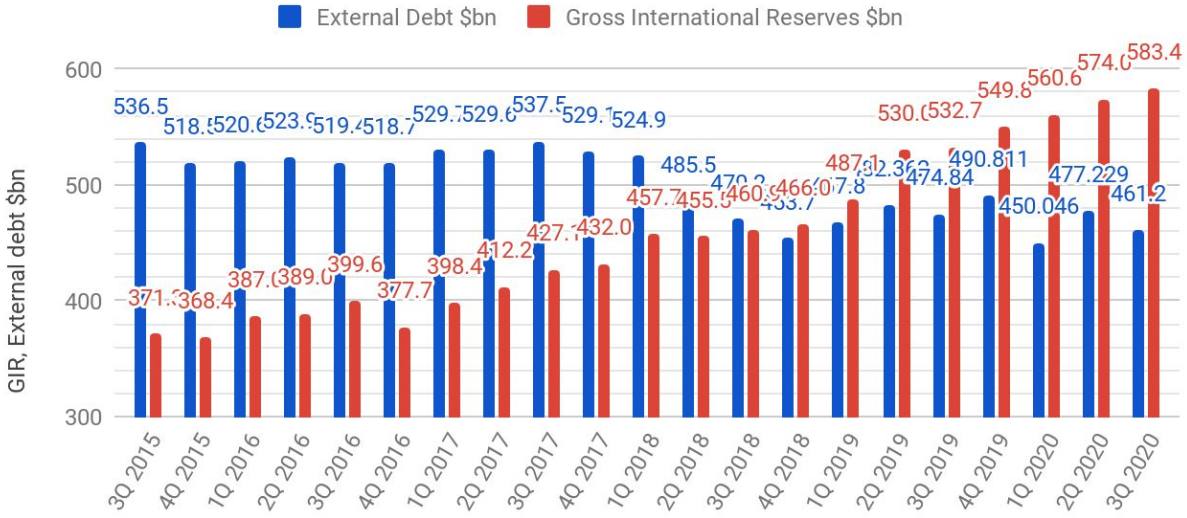
In 2021 the fiscal deficit should be financed by borrowings, which could total RUB3.7 trillion gross (RUB2.7 trillion net). On Siluanov's estimates, this translates into RUB75bn of issuances per auction in 2021. Siluanov does not see it as an issue given successful auctions of RUB400bn in 2020.

OFZ floater auctions, which raised RUB3trillion in funding, required a premium of 20-25bps vs. RUONIA, which rose to 50bps by November. This shifts the public debt risk structure from currency to interest rates.

As was the case in 2020, authorities would like to place $3bn via Eurobonds.

For domestic and external debt, the issue of sanctions remains essential, and this could limit the placement next year.

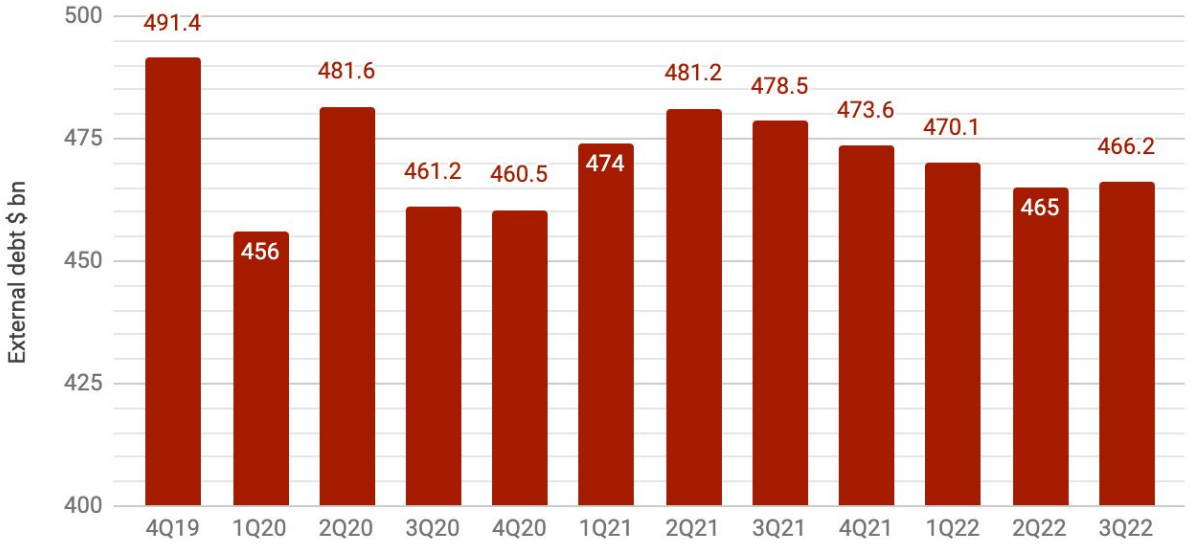
Russia External debt vs GIR $bn



source: MinFin

Russia External debt $ bn

source: CBR, Sova Capital



5.0 Real Economy

• Industrial production and PMI

Russian industry fell by 2.9% y/y in 2020. In October Russian industry posted 5.9% y/y decline, a deeper contraction than that seen in September (-3.6% y/y). Russia's industrial production has been spluttering for several years with its good months and bad, but industry has never been able to build up any momentum, and that is unlikely to change in 2021.

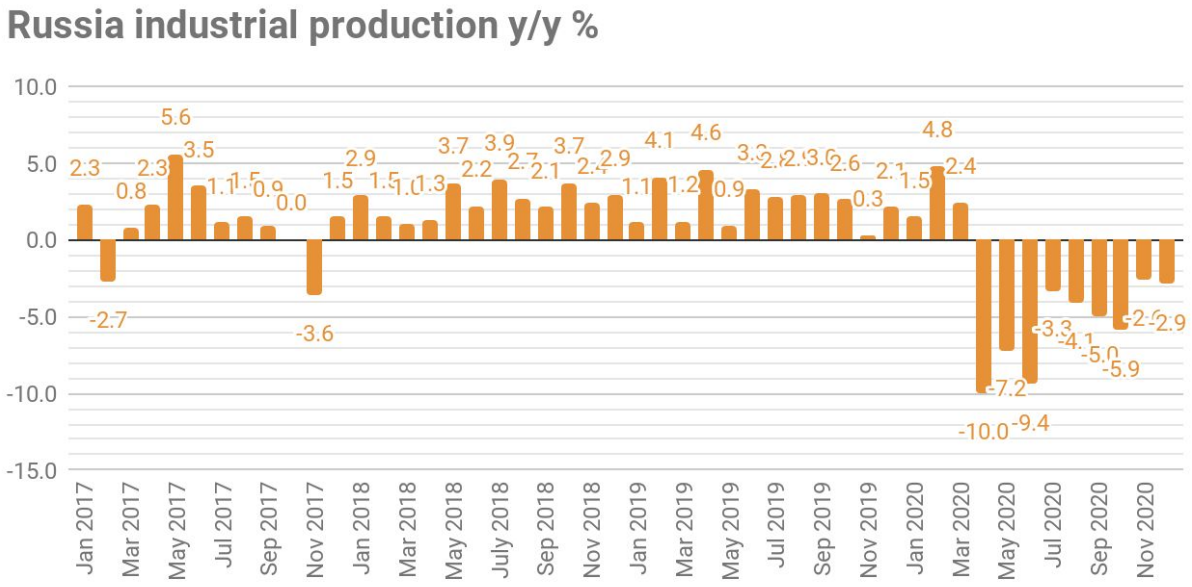
Manufacturing industry posted a sharp reversal with a fall of 4.4% y/y in November as the recovery in the last summer months stalled. In 10M20 industrial production was down by 3.1% y/y, according to Rosstat. Falling investment demand was the main culprit.

The sectors that did well in 2020 included food industry (1.8% y/y), textiles (11.5%) and automotive industry (1.6%, car production increased by 5.4% y/y), but even agriculture put in its first contraction in November in two years as the economy cooled. Falls in production of many investment goods were much more significant, including construction materials and non-consumer electronics.

There will no relief until 2021. Russian economic output will remain under pressure in 4Q20 due to weakening domestic demand and the introduction of stricter quarantine limitations to fight the virus' second wave.

The dynamic of economy and industry should start to improve in 2021, particularly from 2Q21 onwards, when a reversal in the base factor will produce high y/y gains in growth rates.

Fundamentally, there should be a stabilisation of seasonally adjusted output and a return to sustainable growth in the second half of 2021, when the mass vaccination will deliver a victory over the spread of coronavirus.



source: Rosstat

• Oil prices

As the end of the coronacrisis is in sight the expectation for higher demand for oil lifted prices at the end of the year, helped by another production cut deal from OPEC.

Crude oil prices will grow by more than 20% in this year, according to the forecast presented in the January report of the International Monetary Fund (IMF) on global economic development prospects. Oil prices are expected to grow by more than 20% against the lower base level of 2020 but still be much lower than the 2019-year level, IMF says. Prices for other commodities are also expected to increase, with the strongest growth anticipated in 2021 for metals prices, IMF experts say.

Russia retained its position of the world's second largest oil producer in the world after the US in November, when its output grew by 0.8% on the month to 9.351mn barrels per day, the Joint Organizations Data Initiative (JODI) said in a report on January 20. The US produced 10.93mn barrels per day, up 4.9%. Saudi Arabia's output remained flat at 8.972mn barrels per day.

Russia in 2020 ranked second after Saudi Arabia in the list of the largest oil suppliers to China. According to the General Customs Administration of China, in 12 months Beijing purchased more than 83.57mn tonnes of oil from Moscow. According to the report, the price of oil purchased from Russia exceeded $27.3bn. Similar figures for Saudi suppliers amounted to 84.92mn tonnes and $28.05bn, respectively. Next in the ranking was Iraq - last year it sold 60.11mn tonnes of oil to China for $19.17bn. The list included Brazil

(42.18mn tonnes), Angola (41.78mn tonnes) and Oman (37.83mn tonnes).

The price of Brent crude, which fell to $47 per barrel ahead of the OPEC+ meeting, rose to almost $50 per barrel after it. OPEC have agreed to only increase oil production by 500 barrels per day (bpd) in January, supporting prices.

However, in 2021, with the beginning of mass vaccination and the passage of the peak of oil production in the United States, oil prices may rise in the first quarter of 2021 to $45 per barrel, Raiffeisenbank predicts, and to $60 per barrel over the course of 2021.

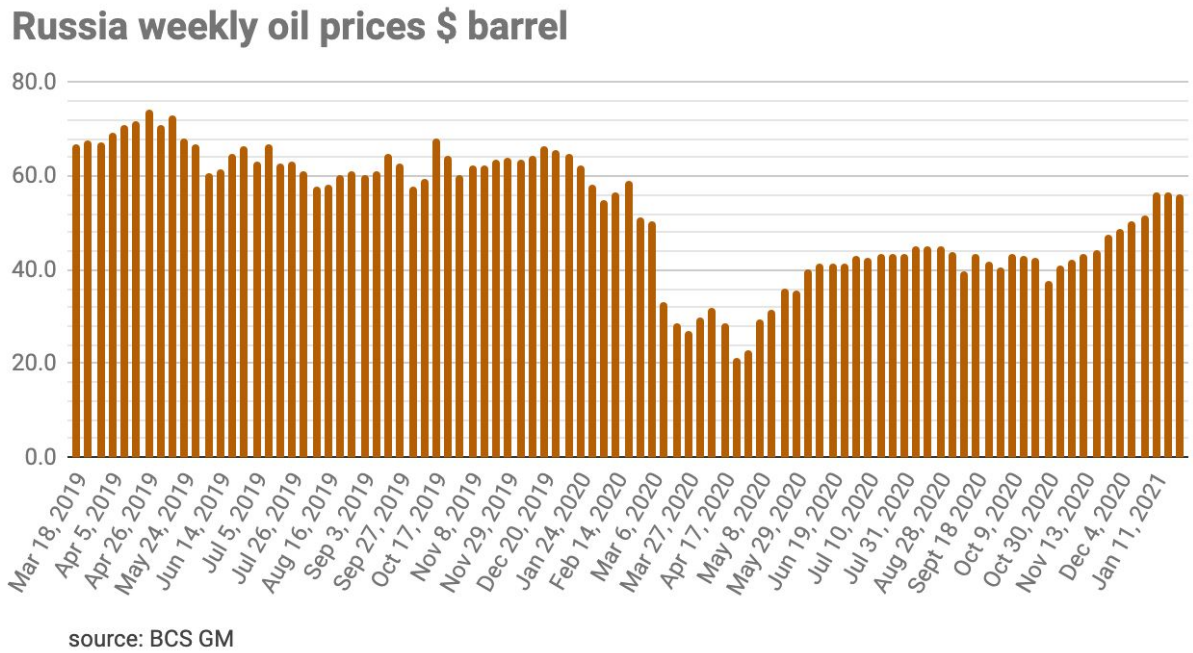
Russian oil output will rise 125 kbpd in January, according to Deputy PM Novak. He added that OPEC+ is wary of US shale and other producers who are ready to increase investment and production.

OPEC+ will likely continue to add output as 2021 progresses. The production increase is about 1.3% vs the 9.95mn bpd of output in the last months of 2020, and should take total Russian output to c10.1mn bpd.

The boost should be shared pro-rata among Russia's oil companies, implying a c.50 kbpd increase for Rosneft, 18 kbpd for Lukoil, 14 kbpd for Gazprom Neft, 11 kbpd for SurgutNG and 6 kbpd for Tatneft.

While positive for Russian oil producers, this leaves the country with at least 1.2mn bpd of idle capacity just vs March levels, and analysts think the country had at least 200-300 kbpd of capacity idled at that time from earlier OPEC+ agreements.

Novak noted that non-OPEC+ countries are preparing to increase output, including the US, Canada, Brazil and Norway.



source: BCS GM

• Commodity prices

Another bright spot for Russia in 2021 is the likely recovery in commodity prices, which were already rising in November on the back of a weakening dollar – another trend that is expected to continue in 2021.

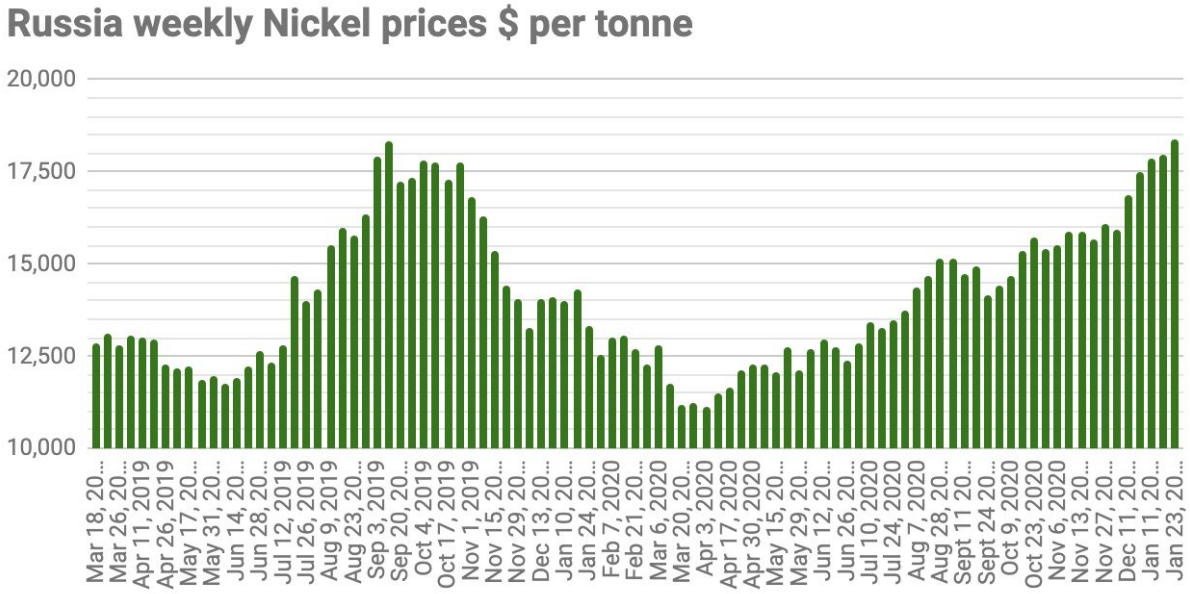
The rising price of commodities will positively affect both the budget revenues, the current account and the profitability of the major Russian corporates. In the previous big crisis of 1998 the following year saw profits at Russia's oil companies explode, as their costs are in rubles but their revenues are in dollars. A similar constellation is in place in 2021, although the ruble devaluation and the rise of commodity prices will be much less extreme than in 1999.

The profits that Russian oil companies earned in 1999 "primed the pump" of the economy and the wave of liquidity that entered the economy kicked off what was to become an almost decade-long boom. This time round the same mechanism will be at work, although rather than a boom, this liquidity will at least be supportive of growth and could lead to surprises on the upside.

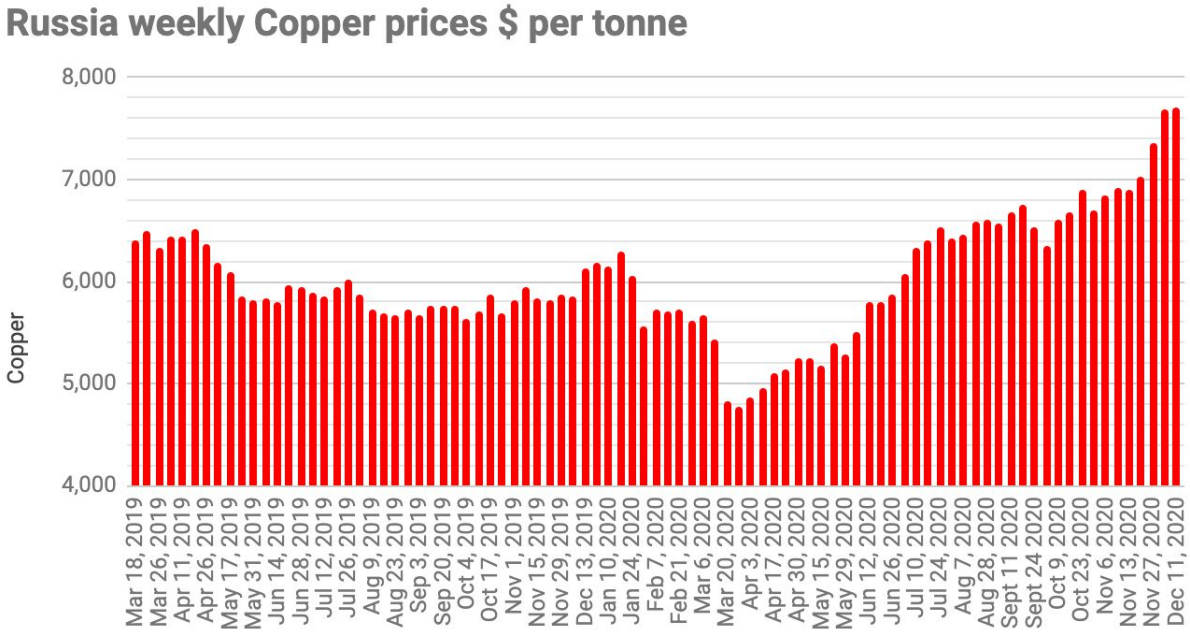
The iconic Magnitogorsk Iron and Steel Works (MMK) told investors in December that it expects steel prices to recover in 2021, although it also predicts demand to fall 6% y/y in 2020 to 37mn tonnes, before recovering in 2021 (+5.9% y/y to 39mmt). MMK sells 85% of its steel to the domestic market, and Russia's construction market, which accounts for over two-thirds of domestic consumption, should remain the dominant user of steel products over the next 24 months, followed by the energy (22%), industrial (7%) and

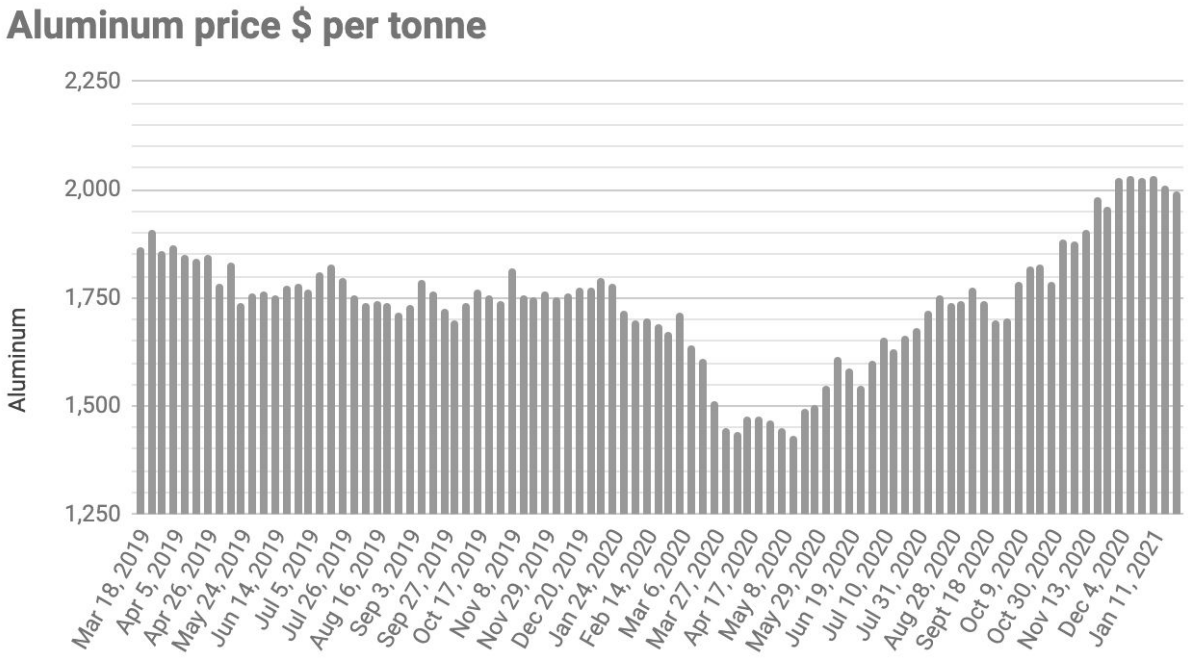
automotive (3%) sectors. Management expects the domestic steel price premium to be restored, a process that already started in December.

Aluminium, copper and of course oil prices were all recovering nicely in December, while the price of gold was starting to fall as investors rotated back into cyclical stocks.



source: BCS GM





6.0 Markets Outlook

The fundamental upside to BCS's RTS target remains 1,670, or almost 26%: "We still see a lot of long-term value in the market."

BCS GM set its end of year 12MF RTS index target at 1670 – borderline between a Buy and a Hold – that suggests the market has a 20% upside in the last month of trading.

"We do acknowledge upside risks to this view – we see risks of upside rather than downside revisions of fundamental stock price targets ahead as analysts roll their valuation models. The RTS should grow only by 3% to 1,450 to become a Hold. The mid-range of the Hold zone is 1,560, and we would Hold on through that level and start taking profits then after 1,560, " BSC GM said in its 2021 outlook.

"An aggregate 2020e P/E for the RTS index based on our estimates stands at 12.8x in the middle of December, and is expected to shrink to 9.1x in 2021," BCS GM added. "Aggregate USD-based net income in 2021 is expected to rise by 52%, thanks primarily to the earnings rebound in the energy names."

The last months of 2020 have seen the stock market soar and there was a record rotation trade out of the "stay-at-home" stocks of things like Netflix and

into the “back-to-work” stocks of things like Boeing in the first two weeks of November. At the same time, record large amounts of funds poured into Emerging Markets (EMs), reported the Institute of International Finance (IIF), as investors get ready for a relief rally in 2021. By the middle of December the RTS had broken out of its range again to top 1,400 and is expected to continue to gain until Easter in the traditional Santa Rally that can last until Easter.

In addition, the dollar has been weakening and that traditionally supports EM markets. The weakening dollar is expected to be a long-term trend, as *bne IntelliNews* reported in its cover story “Brighter days ahead”.

Traditionally there is a relief rally following a big crisis year, which in 1999 returned investors 197% and in 2009 returned 129%. The relief rally following the 2014 oil price shock didn't arrive until 2016 but returned 52%.

The other big driver of stock values is the exceptionally high dividends that Russian companies pay. As of November 2020 Russian stocks pay on average a 7% dividend yield, which is twice the benchmark MSCI EM average. Moreover, in 2021 the laggard SOEs should increase their dividend payouts to 50% of income: MinFin ordered all the SOEs to pay 50% several years ago and while most do, the very biggest companies – Rosneft and Sberbank in particular – have resisted, claiming the money was needed or mega-investment projects or to boost capital.

Those excuses are expected to fall by the wayside in 2021 while the remaining companies are seeing rising earnings only adding to the dividend yield story that has supported all these stocks. That could lead to a re-rating of the entire Russian equity universe, which continues to bear its specific “Russia risk” discount on top of the more general EM discount.

Where will the RTS end 2021? Of course that is impossible to say. The budget spending cuts expected in 2021 (see section), the falling real incomes (see section) and the possibility of new US sanctions on Russia by the Biden administration could all derail the Russian story in 2021. But in the mild version of these negatives Vyacheslav Smolyaninov, chief strategist and deputy head of research at BSC Global Markets, says their house view is for a fundamental re-rating of Russian equities and a 30% upside from the December levels. BCS GM’s official forecast for the RTS for 2021 year-end is 1,850.

• ESG

The last things to say on equities is that after a year of very strange weather in Russia – there was no snow in Moscow in December 2019, there was a heat wave with record high temperatures in Yakutiya in the summer of 2020, and "ice rain" plagued the Far East in the autumn – the Kremlin has woken up to the dangers of global warming. The biggest environmental disaster at Norilsk in Russia's far north, where millions of tonnes of oil was spilled into the delicate ecosystem causing billions of dollars of damage, has firmly put environmental, social and governance (ESG) on to the agenda.

Russia ratified the Paris Accord and a new national environmental strategy was adopted in 2019 and an Arctic plan was released in 2020, plus young reformer and senior Kremlin official Anatoly Chubais (who is also the former head of United Energy Systems) has been appointed the Green Tsar and is also an effective administrator.

Russia is heating up two and half times faster than the rest of the planet and the estimates of the damage warming will cause to cities in the hinterland and key energy infrastructure ranges from $100bn to $250bn across nine of the 24 permafrost regions.

There is a push at corporate level too, after the Norwegian sovereign wealth fund and state-owned pension fund banned investment into companies with poor ESG scores. Some of Russia's blue-chip companies lost up to a third of their shareholders as a result. That prompted Norilsk Nickel into investing $3bn into a clean-up operation (focusing on cutting SO2, as emissions are not

limited to CO2) and it plans to invest several billion dollars more.

Currently only Scandinavia is cracking down on ESG abusers but this trend is expected to continue and build momentum. More companies are likely to invest into a clean-up to become more ESG compliant.

Russian companies are rushing to hire sustainability officers and are rapidly going green in the hope of attracting more investment.