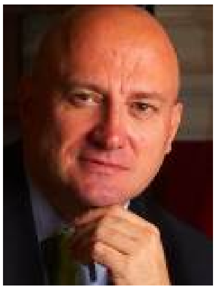
About the author



Dr Daniel Thorniley

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the CEEMEA and Russia Business Group, which is an advisory and consultancy service. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations.

Danny writes a well-received monthly position paper on the Russian market as well as quarterly presentation slides on other CIS markets. He visits Moscow on business every 2-3 weeks and hosts 8-9 private meetings of the Russia Business Group annually. The most recent one was attended by some 140 senior executives. He is also invited to make some 50 speeches/presentations each year by clients across the world on global business trends, business operations, emerging markets, corporate best practice. Many of these speeches are focused on Russia and the CIS and he has made some 60 "Russia presentations" to visiting western CEOs explaining the positives of the market without being naïve.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President and Senior Consultant at The Economist Group, Vienna on global corporate business trends, with specialisation in BRIC.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

Danny is regarded as a charismatic speaker who can present detailed business and economic analysis in an easily digestible fashion with a great deal of genuine humour. Danny is renowned for not using PowerPoint presentation slides - never. Dr Thorniley has also given guest presentations at Executive MBA courses on behalf of Oxford University, the University of Chicago, IESE (Spain) and the Central European University in Budapest. The executive MBA students at Chicago rated him "best speaker" on 12 occasions out of 12 over 5 years.

He has worked on a personal basis with companies operating in emerging markets for 26 years and has personal contacts with most senior western MNCs operating in the Russia and the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level and has long-standing personal friendships with leading executives.

He holds and has held a number of non-executive and advisory board memberships.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

He has published three books, including one on Russia with Macmillan (UK/USA) and two with Profile books on Doing Business in Global Emerging Markets.

His beloved daughter is called Natasha after he read Tolstoy's War and Peace when he was a young man. One of his other favourite books is Master and Margarita by Bulgakov.

Introduction

In the short-term the rouble will share the fate of all emerging market currencies of volatility and weakness. We need to see some stabilisation in the oil price before we can expect the rouble to stop declining. Global markets this month are on the verge of panic. We also have to wait for the announcement from the US Federal Reserve whether it will raise interest rates in September or December and this will ensure continued uncertainty on the currency markets.

The Russian Central Bank is probably unwilling to step in to defend the rouble at this stage and would probably wait until the currency hits 80+ to the Euro or 75+ to the dollar. The Bank takes the view that the rouble will be the "shock absorber" in the current downturn and fears wasting money fighting the markets when the oil price dictates the rate.

We do think the oil price and emerging market currencies including the rouble feel a little over-sold in the current panic and over-reaction. In the mid-term (3-6 months) we can see the rouble strengthening to 68-70 to the Euros and 63-65 to the dollar (<u>the Consensus forecast is however much more upbeat and stronger with the rouble already back to 61-62 to the dollar in September/October and at 60 through 2016)</u>. But the medium-term outlook will remain one of soft-ish oil prices (<u>average</u> $55 in 2015 and $58-60 in 2016) and a stronger dollar (1.1 to 1.0 to the Euro in 2016).

If the oil price remains at these depressed levels or falls further, then the Russia economic and inflationary outlook will worsen after recent months of relative stabilisation. We have tweaked our estimates and forecasts down in the tables below. But we will make further changes as the picture becomes clearer and we do outline below in a table the economic scenarios at different oil price levels. <u>Budgeting in 2016 will be all about scenarios.</u>

Some strategic thoughts

1) If the worsening global emerging markets crisis continues (and with US rates still to actually rise), this is a viable possibility, more international companies will want to reassess and tweak/modify their whole emerging market and CEEMEA strategies. This may involve trimming overall involvement and/or picking winners in the emerging markets.

2) China is slowing. Is that good news for companies in Russia? While the Russian economy wants to engage more with China and any slowdown will not be beneficial, the opportunities for Russia in China may have been over-played. Curiously, the deceleration in China may actually work to the benefit of western investors in Russia and the CEE region. How? The theory goes like this:

    For some 20 years major CEOs at many multinationals have said, "China is the big emerging market, we must be in China, put all or most resources in China, who cares about other EMs, China is the "big baby"".

    As sales for some consumer goods companies turn almost flat in China and as car sales may turn negative in the next quarter, there will be more opportunities for heads of the Russian business to argue not to "keep all the corporate eggs in the China basket" and to look long-term for market share in Russia.

Executive summary

- On 17 August 1998 the Russian rouble collapsed and fell over the following month by some 250%.
- As often is the case in August, events happen. Global markets today are taking fright, stock markets are tumbling and emerging market currencies are slumping (including the rouble and the tenge).

- As expectations for global growth are downgraded for a third time this year (and such downgrades have occurred in every year since 2010!), so too commodity prices are being rocked and the oil price collapses again to levels last seen in the December-February period.
- *In the last two months the oil price has fallen from $62 per barrel to $47 per barrel on 21 August: a decline of -26%.*
- *The rouble in the same period has declined by exactly -26%.*
- In addition to the volatility we spoke about just last month, now the Chinese renminbi devaluation has caused growing concern and panic in global markets.
- The rouble is falling sharply but most of the fall is attributable to this global mini-crisis, rather than anything domestically driven or by events in Ukraine.
- The consensus for the global oil price ($57 per barrel predicted for November 2015 and $64 in 12 months' time) remains quite high (!) and may need to be modified downwards.
- If this consensus were to prove accurate (and it does not always do so!), then it would be reasonably good news for the Russian economy and western investors.
- But the outlook in the short-term looks set to be both "bouncy and scary".
- The rouble used to be impacted by 3 factors but now 5 key factors are in play: the new ones are a) US interest rate movements and b) the slowdown in China.
- We also need to remember that the Russian Central Bank will probably decline to intervene in support of the rouble for some time, taking the view that the current rouble fall is merited by the oil price collapse: why throw money away fighting the markets?
- As we noted in earlier reports, this is not just a rouble crisis: the Brazilian real is at a 12-year low and the South African rand has hit a 14-year low figure; the Malaysian ringgit sits at a 17-year low and the Chilean peso is down at a 12-year low.
- The Kazakh tenge came under impossible pressure this month and after holding the line at 185 to the US dollar for the last 6-8 months defying expectations, the devaluation finally occurred by a level of 26%. The devaluation became inevitable as the renminbi was devalued and the oil price slumped taking the Russian rouble with it.
- The tenge simply could not hold the line against all those pressures.
- The Iranian sanctions deal, if ratified, will keep the oil price down and in the medium term shale energy is not going away; it is unlikely that energy prices will be strong again (sustainably over $70-75) in the next few years.
- Now it's not Ukraine and sanctions that are hurting the rouble but the oil price and the timing of the rise in US interest rates.
- Global financial markets are currently feverish about upcoming US interest rate increases
- Global financial markets are getting increasingly anti "Emerging Markets" and the rouble is getting sucked in along with other currencies.

Why is the oil price falling?

- The Saudis destroyed OPEC as a functioning cartel last November.
- The Saudis are currently pumping oil at close to record levels.
- The demand for oil is shrinking as customers become more efficient in energy usage and as global growth remains sluggish.
- A major game changer has been the output from US shale energy suppliers.
- The USA has become the largest global energy producer.
- US oil output is 80% up on its 2008 figure.
- Currently US energy imports are the lowest since 1960.
- A 10% drop in the oil price adds about 0.15% to global GDP so the current 40% decline could increase global GDP by about 0.6% in 2015.
- A 20% drop in the oil price results in $70bn of extra disposable income for US consumers and they will now have more than $120bn extra spending power which will add yet another stimulant to the US GDP growth outlook.
- But conversely Russia is obviously hurt.
- Total global oil exports in 2013 were worth about $1.1 trillion and a 40% drop in the oil prices entails losses of about $400bn and Russia is a big loser among those.

- A $1 decline in the oil prices entails losses to the Russian budget of about $2bn and so with oil at $46, down from $105, the Russian treasury forfeits in 2015 some $100bn on 2014 revenues.
- A 10% reduction in the oil price also means Russian GDP declines by 0.7% and this fits our current scenarios precisely: the consensus was that 2015 GDP would be +1.6% in 2015 when oil was at $100 per barrel whereas with a 50% cut in the oil price we are looking at GDP negative at around -2.5% and then other effects and consequences such as sanctions and weak financing add to the downturn and hence our estimate for -3.7% GDP this year.
- We are entering "the age of the dollar"; several trends dictate that the US dollar ought to be relatively stronger in the coming years. The oil price and dollar value move in inverse proportion to each other so this ought to impart downward pressure on oil.
- Libya and Iraq have increased their output significantly and somewhat surprisingly.
- Speculation and "shorting" account for at least 25% of the price movements.
- The low oil price looks increasingly like an indicator of weak demand just as much over-supply.

Oil Price Consensus Outlook November 2015 and August 2016

(US$ per barrel)

	End November 2015	End August 2016
Median forecast	56.9	63.8
High	72.0	85.0
Low	46.0	47.0

Source: Consensus Economics based on 50 respondents from major consultancies and multinational organisations.

The declining oil price will have many effects and consequences but just two important ones spring to mind:

1) How and when will companies now raise their prices in Russia? Until just a few weeks ago the new consensus was that if you had not raised price solidly already in 2015, then you had "missed the boat": the then strong rouble meant that further price increases were less necessary and the Russian supply chain would resist such price increases. However, we are back to the early spring scenario where western companies raised prices in February-March and proposed to raise them again at least once in 2015. Price rises are back on the agenda unless the rouble strengthens quickly.

2) As a consequence of such increases and imported price rises, inflation will probably remain a bit more stubborn than it would have been and we tweak our inflation expectations up marginally. Given that 8 months of the year are almost over and that the rouble could strengthen in the coming weeks, we do not anticipate an inflation surge, just some upward tweaking on what is proving already quite persistent inflation, although on a downward trend.

A couple of things we predicted

1) From early 2012 I did start to include a section in the economic outlook reports dedicated to shale gas developments and this was when oil was ticking along at $80-100 per barrel. Shale did look like a long-term threat and so it has transpired.

2) We also flagged that in summer 2012 the Russian Central Bank adopted a policy that in "any future crisis" the rouble would act as a "shock-absorber" and be allowed to fall more than in 2008-09. This too has come to pass.

These two factors certainly play important roles in the extent of the decline of the rouble.

Weakest, strongest, most volatile

We noted in recent reports that in 2014 the Russian rouble was the second weakest currency in the world behind the Ukrainian hryvnia and that for 4-5 months of 2015 it became the strongest currency in the world. We did add that it might well remain the most volatile currency and this has proven to be correct given the current slump.

The 3 and now 5 driving factors to monitor

There used to be 3 big standard drivers behind the rouble. These were and remain:

1) The global oil price.
2) The perceived situation in eastern Ukraine.
3) Whether western sanctions will be intensified.

Until 6-8 weeks ago, everything was reasonably manageable with these 3 factors. Then the oil price started to soften due very much to the announcement of the Iranian sanctions deal with the US (which still requires ratification by Congress by a specific majority) as well as on the back of weakening Chinese GDP and solid Saudi Arabian oil production. This weakening trend has been exacerbated by the announcement of the 3% renminbi devaluation (3%! –most countries would happily accept such a devaluation but it has to be remembered that this is the biggest drop in the Chinese currency in 18 years!)

Two new factors have come more to the fore in recent weeks and these are now our 4th and 5th factors affecting the rouble:

4) The global expectation that the US Federal Reserve will raise interest rates in September this year has spooked the markets for months and the fear factor has intensified significantly in recent weeks.
5) The 3-4% devaluation of the renminbi shocked the financial and currency markets and now commentators feel that Chinese GDP is under more downward pressure for this step to have been taken. More doubts are being raised about the current official Chinese GDP growth figure of 7% and some serious commentators estimate that actual growth could be as low as 5-6%.

The connection to the rouble is fairly clear:

China devalues renminbi = this must mean Chinese growth is decelerating = China will have less demand for commodities = energy and commodities continue to slump from existing soft levels = rouble and emerging market currencies slump downwards.

But the market mood for the rouble and all emerging market currencies has been hugely affected in recent weeks as global financial markets have again become obsessed with the timing of a rise in US interest rates, which is now expected to take place this September or December. One might have expected this to have already been factored into the markets (many times over!) but it appears that the markets are uncontrolled when this comes into play. We did expect all emerging markets to suffer some wobble due to a forthcoming US rate rise (which will be small from a low level close to zero with future increases taking place at a measured pace).

It should also be noted that any rise in US interest rates will jack up the US dollar value which in turn will likely put more downward pressure on the oil price because the dollar and oil price move in inverse proportion to each other: a strong dollar means a weak oil price and vice versa.

It seems the rouble is being hit by a new combination of punches: in the recent past it was a treble combination of oil price, Ukraine and western sanctions while today it is a treble of oil price, US interest rates and Chinese growth.

And there is no doubt that the oil price is a key deciding factor:

In the last 2 months the oil price has fallen by -26% and the Russian rouble has fallen by exactly the same amount minus -26%.

It's changed quickly

The extent of the sudden and violent change in the "operating environment" is typified by the following:

1) In May-June the Russian Central Bank was talking of building up FX reserves and they have in fact stabilised and actually climbed up to $360bn by the end of June.
2) The Central Bank also introduced in May a policy of selling FX to soften the rouble and then curtailed this policy in July.
3) And as recently as 1 August, the Bank was relaxed enough to cut the central interest rate from 11.5% to 11.0%, seemingly unconcerned about any potential impact on inflation and the rouble.

Things look bad but averages are a bit better

The rouble as of 21 August has crashed to 68 to the US dollar and 77 to the euro. But the average figures for the first 8 months are noticeable better: 58 to the dollar and 68 to the Euro. We can summarise the year 2015 so far as: very bad start, good spring and early summer and renewed slump in July-August.

In early July 66% of our executive respondents in our Survey understandably expected the rouble to average 55-60 to the dollar and 60-65 to the Euro. Compared with the current rate today, that looks very optimistic but compared with the average of the year-to-date it is not so far off.

But in the eye of a storm it's often hard to see light at the end of the tunnel (that horrible mixed metaphor was intentional! ☺ and I trust you will understand what I mean): put more elegantly it's very difficult to predict long-term trend when short-term ones are so volatile.

In our rouble report written just 3 weeks ago (!), I wrote that: "We expect the US interest rate saga to continue for most of this year and forecast more oil volatility" and here we are. But the new destabilising factor has been the Chinese renminbi devaluation which undermines global GDP forecasts and takes the oil price down with it".

It is hard at the minute to find much upside for the rouble in the short-term but as with most crises, the currency and other emerging market ones looks somewhat over-sold now, just as it was over-bought in April-May when it touched 50 to the US dollar.

We have often noted that the rouble is among the most volatile currencies in the world and this remains the case. The only problem is that this "Club" of volatile currencies is getting larger.

Taking all these factors into account, we have come up with this table of scenarios for the Russian economy and rouble in 2016 at various oil prices:

Average oil price 2016	GDP	Inflation	Rouble/US$ Average	Rouble/Euro Average
$80-85	2.9%	5.0%	46-48	52-55
$70-80	2.4%	5.5%	48-52	55-59
$60-70	2.0%	6.0%	53-58	59-64
$55-60	1.4%	7.0%	58-65	64-69
$50-55	0.2%	9.0%	65-72	69-75
$45-50	-1.50%	13.0%	72-76	75-84

The rouble is not alone

This is the next big thing to note: while the rouble is certainly hurting, other emerging market currencies are under severe pressure and the Brazilian real for example is at a 12-year low versus the US dollar, the South African rand is at a 14-year low while nearly all other emerging market currencies are at a 5-year low to the dollar.

Exchange rate movements 1 January 2015 compared with 21 August 2015

(Local currency versus the US dollar except when Euro is specified)

	January 1	August 21	% change
Euro-dollar	1.21	**1.13**	-5.7%
$ - Russian rouble	60.9	**69.0**	-14.7
Euro – Russian rouble*	72	**78.0**	-8.3
$ - Brazilian real	2.67	**3.50**	-30.7
$- South African rand	11.6	**13.1**	-12.9
$ - Turkish lira	2.31	**2.92**	-26.4
Euro-Turkish lira	2.75	3.32	-19.6
$ - Mexican peso	14.7	17.0	-15.6
$ - Indian rupee	61.8	66.2	-7.1
$ - Indonesian rupiah	12.4	14.1	-13.7
$ - Polish zloty	3.55	3.70	-4.2
$ - Romanian leu	3.9	3.9	0.0

*of course if one compares the rouble at 2 August 2015 with its mid-April 2015 level, then the rouble is down -24% versus the dollar and minus 23.8% against the Euro.

The Economic outlook numbers in more detail

Given recent fluctuations we have made small downward tweaks to some of our annual forecasts and we have also been able to add full June and July data.

Macro-economic data 2009-2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.7	0.6	1.9	2.6	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-5.8	1.5	2.4	2.8	2.9
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-6.3	1.0	2.0	2.8	3.0
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.3	0.0	3.0	3.0	3.3
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-3.3	1.0	2.4	2.9	3.1
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	12.0	7.7	6.6	6.3	5.9
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	5.9	5.8	5.7	5.5	5.4
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-9.8	0.5	3.2	4.2	3.9
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.0	0.7	2.4	3.3	3.0
FX reserves ($bn) year-end	447	485	510	528	509	385	328	330	350	360	368
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	68.0	69.0	71.0	75.0	79.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	74.0	72.0	73.5	77.8	82.5
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.2	-1.9	-1.0	-0.5	-0.2
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.7	3.6	3.3	2.8	2.2	1.0

Consumer-related statistics: by year and monthly

	2012	2013	2014												2015						
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July
Disposable income	3.7	3.3	-1.5	1.0	-6.8	1.9	5.8	-2.9	2.3	3.4	0.6	2.1	-4.7	-7.3	-0.8	-1.6	-1.8	-4.0	-6.4	3.5	-2.0
Real wages	8.2	5.2	5.2	4.6	3.1	3.2	5.0	2.1	1.4	-1.2	1.5	0.3	0.5	-4.7	-8.0	-7.4	-10.6	-13.2	-7.3	-7.2	-9.2
Real retail sales	5.7	3.9	2.4	4.1	4.0	2.6	2.1	0.9	1.2	1.4	1.7	1.7	1.8	5.3	-4.4	-7.2	-8.7	-9.6	-9.2	-9.4	-9.2
Unemployment	5.3	5.5	5.7	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2	5.3	5.5	5.8	5.9	5.8	5.6	5.4	5.3
Industrial output	2.6	0.3	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4	3.9	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.7
Fixed investment	6.0	-0.1	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7	-2.8	-2.9	-4.8	-2.4	-6.3	-6.5	-5.3	-4.8	-7.6	-7.1	-9.5
Consumer prices	6.6	6.5	6.1	6.2	6.9	7.3	7.6	7.8	7.5	7.7	8.0	8.3	9.1	11.4	15.0	16.7	16.9	16.4	15.8	15.3	15.6
Budget deficit (running)	0.0	-0.5	0.4	0.3	1.4	-0.4	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-0.6	-0.6	-1.6	-1.8	-1.8	-2.1	-2.5	-2.3	-2.8

As ever, I hope you have found this short report useful and if you have any queries or comments do get in touch danielthorniley@dt-gbc.com.

22 August 2015

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