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Russia Can't Decouple From U.S. Gloom

By Dieter Wermuth

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Despite the agreement earlier this week on raising the U.S. debt ceiling, the U.S. sovereign rating will likely be downgraded soon. But even so, it will still be in AA territory. Anything above BB is investment grade.

The net effect of the downgrade was not even mildly negative for U.S. bonds since there were no surprises. Longer term, the need to reduce the budget deficit by a considerable amount to regain the top rating has a deflationary impact and is therefore positive for U.S. treasuries.

In addition, the downward revisions of U.S. gross domestic product numbers last week and the poor performance of real GDP in the first half of this year suggest that the output gap is still huge. The labor market confirms this view. Employment is about 4.5 percent below its previous high. Real hourly wages continue to fall on a month-on-month basis. This means that there are no inflationary pressures.

Combined with several years of restrictive fiscal policies ahead, the pace of the U.S. economic expansion will remain subpar. It is no longer unlikely that there will be another recession.

Since banks get funds from the Federal Reserve at more or less no cost, they will have an incentive to buy longer-term government debt at a spread over funding of an attractive 270 basis points. So far, the United States continues to follow the Japanese model.

But it is clear that the dollar will resume its slide in trade-weighted terms, not least because the Federal Reserve is forced to keep interest rates at their near-zero level for at least one more year, while the European Central Bank and most other central banks are in a tightening mode. Capital inflows will thus be supportive for the dollar than in the past. On the other hand, it can be expected that the U.S. current account deficit will gradually decline, which in turn will prevent a dollar sellout.

Exports and capital spending have to be the main drivers of U.S. growth from here on, but the United States will not be the world's growth engine anymore. The United States relies on other countries for growth. But this may not be a big deal because emerging markets, which account for one-half of global output, are growing at a rate of 4 percent to 6 percent annualized at the moment.

Inflation has peaked everywhere. According to JP Morgan's analysts, the year-on-year rates of change to the consumer price index expected in the second quarter of 2012 are 1.4 percent in the United States, 1.6 percent in the euro zone, 6.9 percent in Russia, 3.8 percent in China and 5.2 percent in emerging markets as a whole. The reasoning is straightforward: Growth is slowing, while output gaps remain large.

For commodities, the message is that their prices will drift down over the coming 12 months. Gold remains an exception as long as there is the suspicion that the global financial system is in a precarious condition.

Equity markets, including Russia's, will be consolidating. There is a lack of growth drivers. The two-year expansion has run out of steam, and fiscal policies in key countries are tightened in a pro-cyclical manner because debt levels are too high.

Russia is protected by its extremely low valuations and sound macro financials but cannot decouple from global trends. Since the need to catch up with richer countries is as urgent as ever, domestic demand in Russia — infrastructure, housing and other capital spending, but also private consumption in the run-up to the two elections — will be stronger than exports. The main appreciation of the ruble basket lies behind us as nominal exports increase by less than imports.

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