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Financial Investors Should Brace For Bumpy Ruble Float

By The Moscow Times

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Russia's move toward a flexible ruble exchange rate may well prove a boon for the struggling economy, but foreign stock and bond investors should brace for short-term losses as the currency finds a new level.

The Central Bank this week scrapped so-called targeted interventions, bringing an end to hard currency sales of up to $60 million a day and indicating that a planned shift to a fully floating ruble on Jan. 1, 2015, is on track.

Having spent a third of its hard currency reserves to defend the ruble in 2008, the country is clearly signaling it will take a different tack during the current market turbulence by letting the currency take the strain.

The intention to target inflation rather than the exchange rate is widely seen as positive, with a weaker ruble providing stimulus and helping to halt the steady balance of payments deterioration.

But in today's world, which looks distinctly unfriendly towards emerging markets, the move was interpreted as an invitation to sell the ruble, which fell to four-year lows against a euro-dollar basket.

The weakness may continue — risk-reversals, a measure of the relative demand for options on a currency rising and falling against the dollar, show a clear near-term skew for sharp ruble weakness.

"They are doing the right thing, but it is going to be difficult to make the change in such a turbulent market for emerging currencies. It will make people wary of ruble-denominated assets," said Luis Costa, head of CEEMEA strategy at Citi.

He noted that Russian debt was relatively resilient during the emerging markets sell-off caused by the U.S. Federal Reserve's decision to start cutting back on its bond-buying.

That is down to Russia's relatively strong financial position but also authorities' implicit support for the ruble.

Foreign bond investors who piled into Russia following the 2013 liberalization of the OFZ ruble bond market have largely stayed put, their portion of the market at 26 percent at the end of November 2013, from less than 5 percent in early 2012.

They are also mostly in the mid- to longer-dated bonds, which Costa says is most correlated with the ruble rate.

"From a foreign investor's point of view, the ruble component of holding the OFZ is now definitely negative. The odds are you will have losses on the currency irrespective of how the bonds do," he added.

Positive

The flip side? Policy focus on inflation and transparency will benefit financial markets if it brings down volatility and encourages saving. The economy, which the government acknowledges will grow at just 2.5 percent a year in the next two decades, may also get a boost.

And crucially during these turbulent times, a flexible currency may insulate the economy from 2009-style shocks.

The country's exchange rate has long been a political totem for President Vladimir Putin, who took power a year after a default crashed the ruble and wrecked the banking system in the 1998 economic crisis. The post-Soviet history of hyperinflation, devaluation and default in the 1990s has engendered deep-seated aversions among the population to long-term saving and investment.

But with the country's $2 trillion economy now stalling, the targeted exchange rate had exacerbated economic volatility, said Morgan Stanley economist Jacob Nell.

"Fixed exchange rates generally make it more difficult for policymakers to adjust to changing commodity prices, especially oil prices," Nell said. "The move to a flexible regime opens up the prospect of a much smoother adjustment to a changing oil price."

And the ruble is by no means undervalued: against its main trade partners and adjusted for inflation, it is just off decade-highs hit last year.

The $200 billion defense of the currency in 2008 averted a run of defaults by indebted Russian companies, but deprived the economy of a lift that could have been provided by a cheaper currency. The economy shrank 9 percent the next year.

"The ruble may weaken, but you cannot be too short-termist, they are doing it for right reason. It is positive if they seriously target inflation," said Grant Webster, a bond fund manager at Investec Asset Management.

Webster said short-dated Russian yields were high enough at more than 6 percent to compensate for currency volatility, providing a roughly 2 percent pickup over inflation.

But most Russian bond positions are unprotected from ruble fluctuations, because of a flat bond yield curve. That means hedging currency exposure is costlier than, say, in South Africa, where yields on short-dated bonds are much lower than on the 10- or 30-year segment.

An investor hedging exposure on his 10-year South African bond would get a net return of about 2 percent a year after hedging costs, a similar level to what is available in Russia, said UBS analyst Manik Narain.

But in Russia, returns may diminish as the curve extends while in South Africa the reverse is true, he said, adding that bond coupons net of hedging costs are also more attractive in other markets such as Mexico and Hungary at about 3.5 percent.

Equity Good News

Equity investors are less fazed. Ed Conroy, portfolio manager at HSBC Global Asset Management says a weaker ruble would provide an earnings margin boost for the energy and metals exporters that dominate the Moscow stock market.

That upside will take the edge off the weak ruble's immediate impact on foreigners' equity portfolios.

"Then we get to the issue of at what point does it become a problem to be exposed to ruble weakness and to companies that may be highly geared to debt in dollars," Conroy said.

He noted that Russian companies' gearing level — the ratio of borrowed funds — has risen to 2.1 times from 1.3 in 2008, but attributed this to increased borrowing by solid big-name state firms such as Gazprom and Sberbank.

"[Since 2008] most companies have de-geared and others have refinanced wisely," Conroy said. "Now is not a bad time to go for exchange rate flexibility.

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