RUB & Rates wrap

Two reasons for outright cheapness of RUB funding

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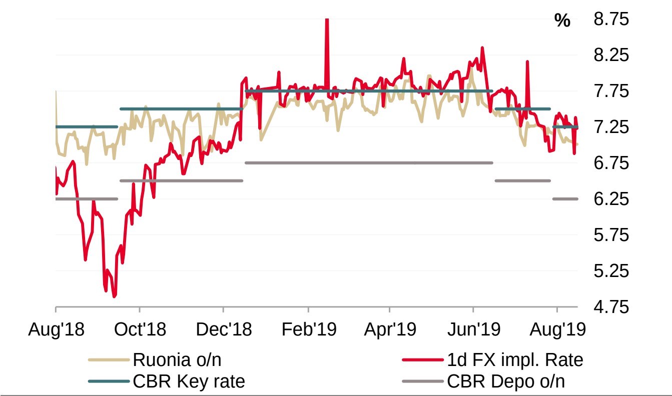
Market review

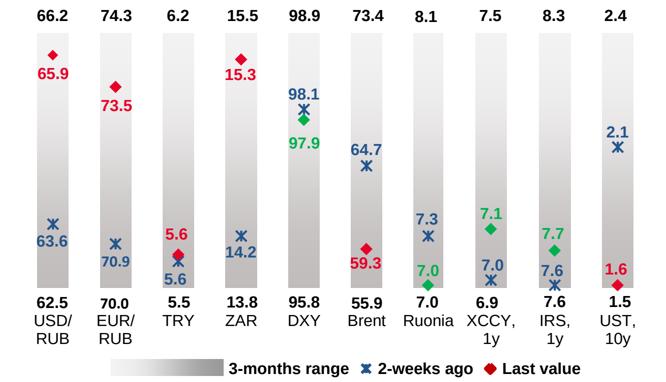
- A plunge in funding rates since mid-July has puzzled the market given the conservative outlook for ruble liquidity in 3Q19. **Two factors likely triggered a knee-jerk reaction of rates – a cut in KOBR limits in 3Q19 and the MinFin's launch of an FX swap facility**. Here, we investigate the conditions that could help to normalise cash rates. Nonetheless, abundant liquidity does not guarantee avoidance of funding rate shocks through the year-end, as banks are becoming more dependent on MinFin liquidity funding and, thus, the intra-year fiscal cycle.
- Given the risk-off mode across markets and reduced expectations for CBR policy easing through year-end, **4X7m fwd IRS and XCCY rates still look fairly attractive** in order to hedge against the risk of a spike in rates.
- Market sentiment has deteriorated sharply in recent weeks amid topsy-turvy US-China trade negotiations. While global markets have started to entertain the idea of a recession in the US, as hinted at by the 2y10y UST spread flirting with negative territory, the ruble and local rates have managed to resist the pessimism afflicting the EM space. **Fundamentals still favour CBR policy easing in September (SG:-25bp). Nonetheless, the medium-term outlook is not well aligned with too flat USD/RUB basis curve beyond 1y.**

Funding rates under pressure since mid-July



Source: Bloomberg, SG Cross Asset Research/EM

Markets switch into risk-off mode



Source: Bloomberg, SG Cross Asset Research/EM

Market thoughts

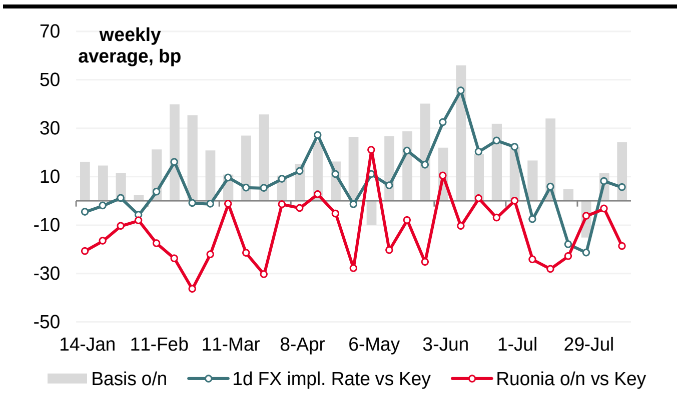
MinFin and CBR push money market rates down

The money market was softer in late-July and early-August than we had expected in our recent outlook for ruble liquidity in 3Q19. Despite intensive liquidity withdrawal by the General Government at the tax payment deadline at end-July, the ruble and cross-currency overnight funding rates simultaneously drifted below the key rate in advance of the CBR's decision to cut the key rate by 25bp (to 7.25%) on 26 July. Mutual positioning between Ruonia o/n and the overnight FX swap, or the overnight basis[1], turned negative for a time in mid-July (-15bp from 22 to 26 July) and struggled to become positive since then (24bp from 5 to 9 August).

Two regulatory developments are behind the volatility of rates. The first is a change in the limit for KOBR placements by the CBR. In 1H19, the overall limit was RUB1.5-1.7tn, which helped absorb up to 70% of the available structural liquidity surplus in the banking sector. However, the limit for 3Q19 was tightened dramatically owing to the expected narrowing of the ruble liquidity surplus (CBR liquidity survey, in RUS). This option will release RUB0.2-0.3tn each month during the placement of new KOBR bonds and maturity of older ones.

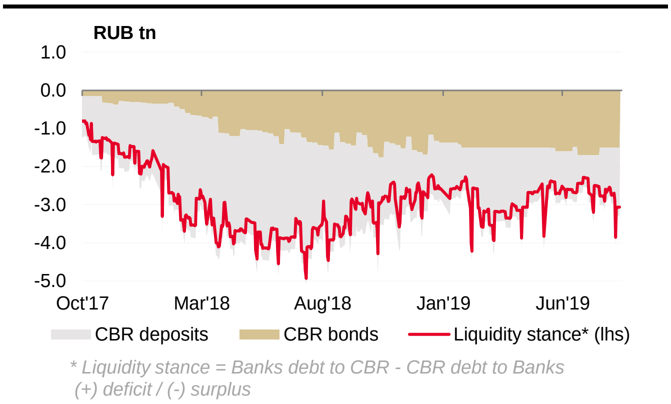
This change in the KOBR limit was not broadly expected by the banking sector and broke the 'rolling' parity between CBR liquidity management tools – KOBR and weekly deposits – for a time. This is evident by comparing the auctions for the KOBR-23 and KOBR-24 held on 14 July and 13 August, respectively. The average price was equivalent to a 5-6bp annual yield premium above the key rate in the July auction, while in August the premium shrank to a tiny 3bp. The normal premium for KOBR placements was equivalent to 24-25bp until 14 July and corresponded to: a) the minimum acceptable KOBR price for the auction and b) the perfect roll of CBR weekly deposits, with all the supply of liquidity placed at the key rate.

Funding rates simultaneously under pressure



Source: Bank of Russia, SG Cross Asset Research/EM

The role of weekly deposits started to grow again



Source: Bloomberg, SG Cross Asset Research/EM

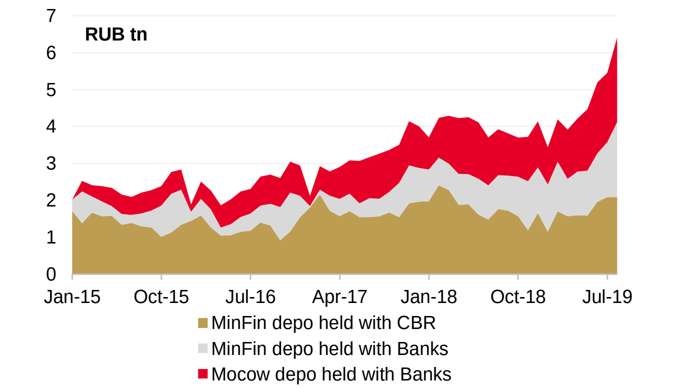
[1] By the o/n basis, we mean a difference between the FX swap implied rate and Ruonia: a sustained positive value indicates a shortage of ruble liquidity and, vice versa, sustained negative values imply a shortage of FX liquidity.

We suggest that generous limits for CBR weekly deposits and timely absorption of liquidity with fine-tuning deposits[2] could help restore parity and alleviate pressure on the money market. The CBR reportedly increased the limits for the recent weekly deposit auctions, but the strategic coordination of liquidity provision with the MinFin stepped to the forefront

The second factor that affected funding rates via the FX swap market came via the MinFin. The ministry as expected launched the buy-sell USD/RUB overnight swap facility on the MOEX in mid-July. The limit was set at RUB0.1tn (c.$1.5bn), which equals nearly 9% of the MOEX overnight swap daily turnover. This helped satisfy marginal demand for ruble funding, especially for banks that rely on this facility on a regular basis. Nonetheless, given the amount of excess liquidity held by the MinFin at the CBR (RUB2.1tn on 1 July), the market became concerned about potential growth in the limit and a sustainable build-up of pressure on the FX swap curve.

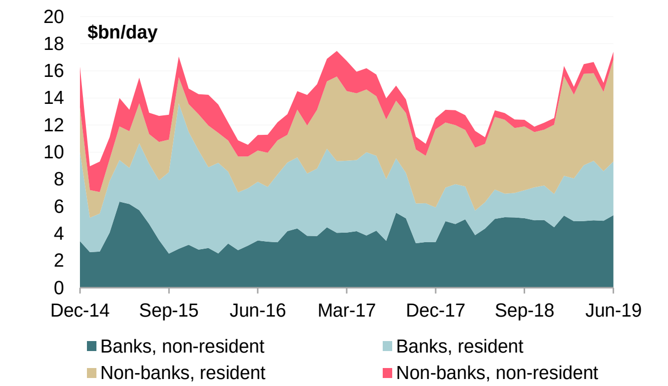
We suggest that an increase in the MinFin's swap limit is first and foremost of concern to the CBR because it may go beyond the technical utilization of spare liquidity held by the MinFin and may challenge the key rate level. The role of liquidity facilities provided by the General Government (of which MinFin and Moscow DepFin term deposits are the most important) has greatly increased for banks since 2017, when the budget switched to being in exceptionally tight mode. Since then, all these instruments have mostly affected the monetary transmission mechanism, helping to manage medium-term rates and satisfy CBR liquidity regulations rather than affect short-term funding rates.

Liquidity provision to banks by General Government shoots up



Source: Bloomberg, SG Cross Asset Research/EM

Daily average turnover of USD/RUB swap



Source: Bloomberg, SG Cross Asset Research/EM

If the MinFin starts dominating the FX swap market, it will contest for the role of monetary policy regulator. That said, hihger volumes for the overnight swap facility may derail the central bank's operational target of locking overnight funding rates close to the key rate level. Technically, the dominant provision of RUB liquidity via MinFin swaps may pull rates

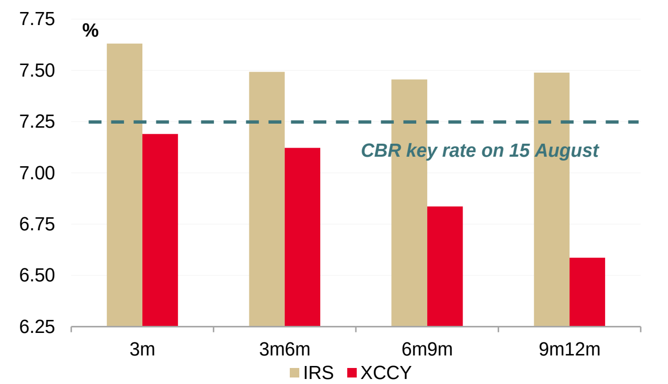
[2] Fine-tuning deposits are offered for 1-6 days on an irregular basis.

below the key rate level, namely, to the 6.25% level where the CBR absorbs RUB liquidity (sells $3.0bn) via FX overnight swaps. Even if the CBR does not increase the swap limit, other things being equal, the market will likely find opportunities to keep the implied overnight rate close to 6.25% (i.e. the standby deposit facility at the CBR) for the time being.

This scenario will imply a new 'effective' key rate level. However, we believe that is not acceptate to the CBR, so swap limits of MinFin's operations will likely be structurally restrained.

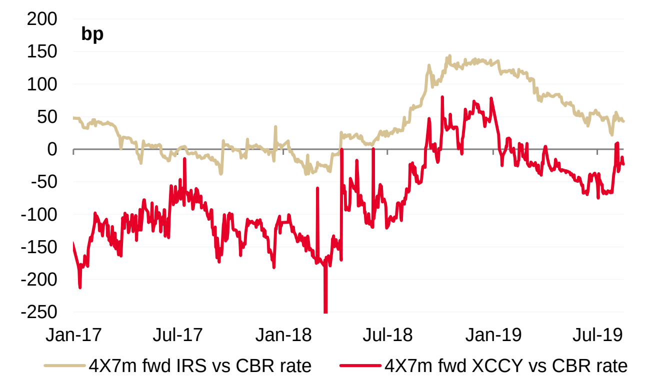
Recommendations: The flipside of the MinFin's increasing role as liquidity provider is banks' greater dependence on the fiscal cycle. That said, the expected year-end spending spree may cause liquidity gaps owing to a reduction in the supply of deposits to banks. Thus, regulatory and ALM needs may push rates up in 4Q19 irrespective of the prospect of monetary easing. Therefore, we still view the prospect of 4Q19 adjustment of liquidity balances with concern and **see 4X7m implied rates along the IRS and XCCY curves** as undervalued. Moreover, risk-off sentiment globally may hamper the CBR's easing cycle if risks of a global recession start materialising.

Policy easing in 2H19 expected to be modest



Source: Bloomberg, SG Cross Asset Research/EM

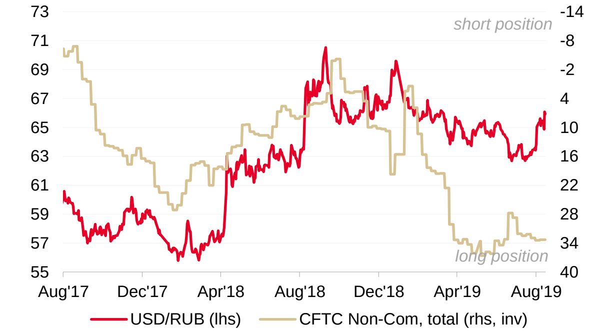
4X7 implied rates to adjust on liquidity cycle /risk-off mode



Source: Bloomberg, SG Cross Asset Research/EM

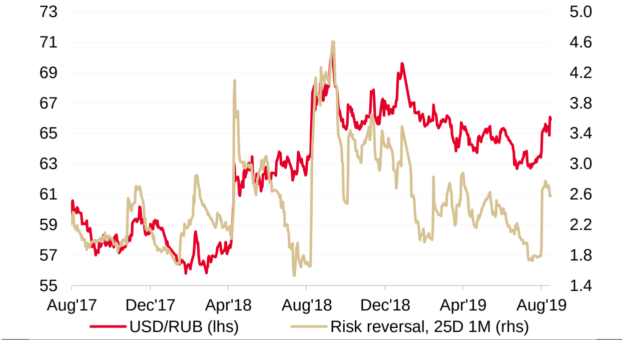
Market snapshot

Market not yet positioned for RUB weakness...



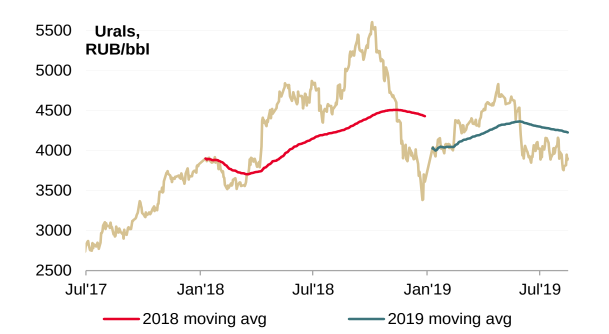
Source: Bloomberg, SG Cross Asset Research

....nonetheless, hedging costs have started growing



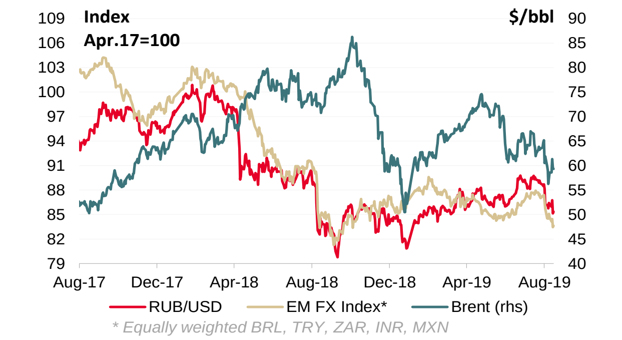
Source: Bloomberg, SG Cross Asset Research

Oil price contains pressure from the oil-rule



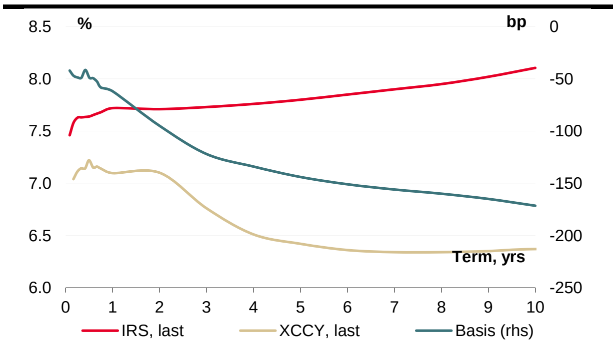
Source: MinFin, Bloomberg, SG Cross Asset Research

Ruble resisted plunge in oil



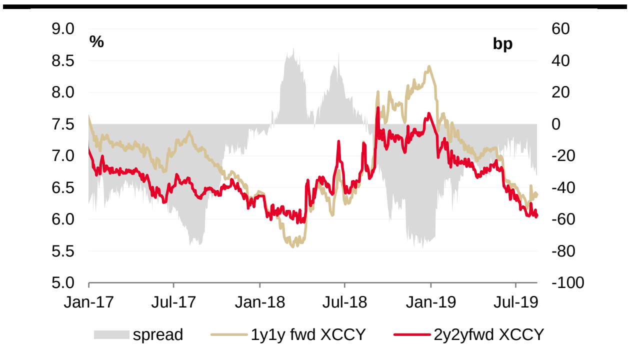
Source: Bloomberg, SG Cross Asset Research

Mid-year basis too wide vs the front



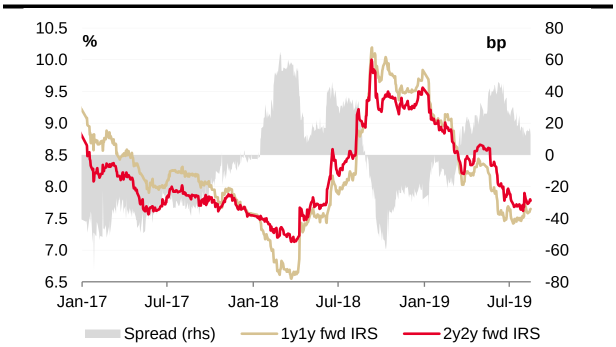
Source: CBR, Bloomberg, SG Cross Asset Research

XCCY still optimistic about rates in medium term...



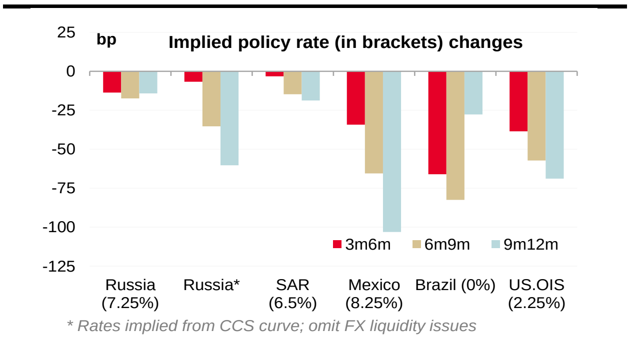
Source: Bloomberg, SG Cross Asset Research

... however, the IRS is marginally bearish



Source: Bloomberg, SG Cross Asset Research

Easing expectations in Russia diverge from Fed's



Source: Bloomberg, SG Cross Asset Research

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