EMFI Monthly Market Outlook

by L. Bryan Carter, Head of EMFI

May 2016

For Professional Investors

Will Russia cut interest rates?

Incredibly, the Russian central bank has become one of the country's strongest institutions - not only domestically but comparatively strong amongst of the emerging market (EM) central banks.

President Putin and other government leaders have respected central bank decisions and refrained from any public exertion of pressure over the past three years, even during the height of geopolitical crisis. Governor Elvira Nabiullina managed to raise interest rates aggressively in 2014, allowing a large depreciation in the Russian ruble (RUB), and refrained from reversing course until inflation has subsided - all textbook responses to a terms of trade shock that have nevertheless proven exceedingly difficult for other countries' central banks to undertake.

This episode now creates an opportunity for impressive interest rate cuts, owing to three factors: most intuitively, conservative monetary policy with a bias to anti-inflation decisions allows for the central bank to undertake a full cycle of easing without risking a relapse of inflation risk or vulnerability. Second, inflation expectations are likely to remain anchored, built on a pattern of stability and prudence, reducing inflation risk premium along the curve. Last, enhanced central bank credibility under Nabiullina helps compress term premium and can allow for a lower neutral real interest rate level over the longer run. Having taken advantage of the crisis to demonstrate orthodoxy and independence, the central bank in theory may even be able to guide real interest rates to an even lower level than before.

How can investors benefit from these changes? Local currency bond duration is one of the few unique alpha sources in EMs. Unique, we say, because it is uncorrelated to general risk factors that typically drive emerging market assets like currencies and credit. Also what one central bank does has nothing to do with another -- or any other -- central bank, even in a neighboring country. Each country can exhibit its own local monetary dynamics and idiosyncratic set of domestic risks which, in theory, each central bank responds to according to its individual mandate and reaction function.

Russia's ability to ease interest rate policy may sound counterintuitive at a time when EM credit risks are heightened, currencies have devalued sharply, and other countries - from Colombia to South Africa - are raising interest rates. Even specific to Russia, credit spreads have widened from 140 to 220 basis points and the RUB stands over 50% weaker compared to the eve of the taper tantrum that occurred in May 2013 (see chart below). Here, unique alpha plays out clearly: with Russian GDP (Gross Domestic Product) growth running -3.8% on a rolling year-over-year basis and inflation having declined to 7.3% on an annualised basis from 12.9% last year, conditions clearly permit a reduction in policy rates from 11% currently. Assuming inflation remains in a stable range, real interest rates now measure nearly 4% and could be reduced by as much as 400 basis points simply to match levels prior to the currency devaluation.

Russian Ruble (RUB) versus US dollar (USD)

Source: BNP Paribas Investment Partners, Bloomberg, May 2015

Why hasn't this been priced in? In a world of perfect information, surely investors would have already incorporated the above views into their market pricing and potential gains would have been arbitraged away. However with the Russian yield curve yielding 9-9.5% across tenors, it's clear that only a small easing has been priced. We note two phenomena at play here: first, investors appear to systematically underprice cyclical movements into asset prices. One interest rate cut or drop in inflation tends to be followed by additional changes in the same direction with a high probability in any given country, yet investors routinely ignore the autocorrelation and typically refrain from taking a view without infallible evidence. Second, hedging costs can be prohibitive. RUB forwards cost above 10% to employ, such that the negative carry on a hedged bond position can be costly over anything but relatively short periods. In a market without liquid interest rate swaps, the trade can prove uninvestable for some participants.

We would be remiss in concluding without consideration of risks to the trade. Principally, oil prices are a key driver of the RUB, and a renewed drop in crude would almost certainly cause RUB weakness and renewed inflation pass-through. Geopolitics are unpredictable and any new conflict involving Russia could also cause term premium changes. We have low concerns regarding Russian domestic crisis risks or political instability that could feed through to central bank policy, but these are of course possibilities that investors should take into account.

About the author

L. Bryan Carter, Head of EMFI

Bryan is the Head of Emerging Market Fixed Income at FFTW, a trading name of BNP Paribas Investment Partners UK Ltd. In this role, he is responsible for setting strategy, generating alpha ideas and risk budgeting for the firm's emerging markets fixed income business. Bryan joined our firm in 2016 and is based in London.

Prior to joining us, Bryan was a Portfolio Manager at Acadian Asset Management, where he was lead manager for the Emerging Market Debt and Global Absolute Return Bond strategies. Prior to that, he was an Economist at T. Rowe Price Associates Inc., where he developed economic models to analyse global economic data, estimate risks to growth and inflation, and forecast interest rates. He began his career as an International Economist at the United States Treasury Department, where he recommended US vote on hundreds of International Monetary Fund, World Bank and Inter-American Development Bank loans.

Bryan has 13 years of investment experience. He holds a bachelor's degree in Economics and Spanish from Georgetown University as well as a Master of International Development from Harvard University. Bryan is a CFA charterholder.

DISCLAIMER

This material is issued and has been prepared by FFTW, a trading name of BNP Paribas Investment Partners UK Limited (“BNPP IP UK”)*, a member of BNP Paribas Investment Partners (BNPP IP)**.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or

2. any investment advice.

This material makes reference to certain financial instruments (the “Financial Instrument(s)”) authorised and regulated in its/their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the Financial Instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus, offering document or any other information material, as applicable, of the relevant Financial Instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such Financial Instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the Financial Instrument(s).

Investors considering subscribing for the Financial Instrument(s) should read carefully the most recent prospectus, offering document or other information material and consult the Financial Instrument(s)’ most recent financial reports. The prospectus, offering document or other information of the Financial Instrument(s) are available from your local BNPP IP correspondents, if any, or from the entities marketing the Financial Instrument(s).

Opinions included in this material constitute the judgment of BNPP IP UK at the time specified and may be subject to change without notice. BNPP IP UK is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client’s investment portfolio.

Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instruments may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested. The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

This document is directed only at person(s) who have professional experience in matters relating to investments (“relevant persons”). Any investment or investment activity to which this document relates is available only to and will be engaged in only with Professional Clients as defined in the rules of the Financial Conduct Authority. Any person who is not a relevant person should not act or rely on this document or any of its contents.

* BNP Paribas Investment Partners UK Limited, is authorised and regulated by the Financial Conduct Authority. Registered in England No: 02474627, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom. FFTW is a brand name of BNP Paribas Investment Partners UK Limited in the UK.

** “BNP Paribas Investment Partners” is the global brand name of the BNP Paribas group’s asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information please contact your locally licensed Investment Partner.