BCA RESEARCH

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GEOPOLITICAL STRATEGY

CLIENT NOTE

Russia: The Day Of Panic

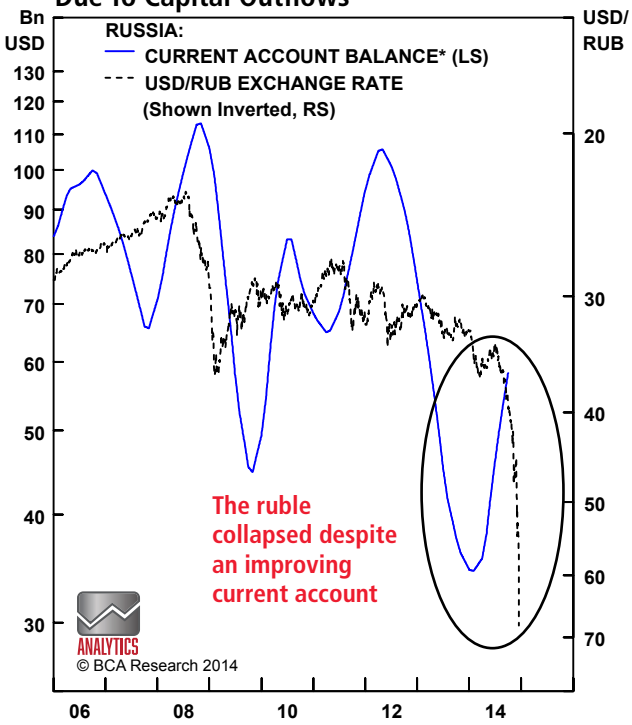
December 16, 2014

In this Issue:

The attempt by the Russian central bank to avert the ruble's slide has been strongly rebuffed by the market. The USD/RUB has fallen 15% since the surprise 650 basis point rate hike on December 16, a clear signal that Russian policymakers have lost credibility with investors.

The ruble's collapse is fundamentally a manifestation of political uncertainty, and it can be directly linked to a collapse in confidence by both domestic investors and depositors. **Chart 1** shows that Russia's currency is collapsing at the same time that its capital account is actually improving, a clear indication that the collapse has very little to do with foreign speculators and everything to do with capital outflows.

CHART 1
The Ruble's Plunge Is Due To Capital Outflows



* SHOWN AS A 4-QUARTER MOVING TOTAL.

There are three implications of the ongoing crisis that we wish to briefly reiterate in this note. First is our view, contrary to conventional wisdom, that Russians are not impervious to pain.[1] As such, domestic political risk will rise. Second, we expect that Moscow's rhetoric and assertiveness toward the West may rise over the next several months, but its concrete actions on the ground may in fact become much more conciliatory. Third, the probability of capital controls being implemented will continue to rise.

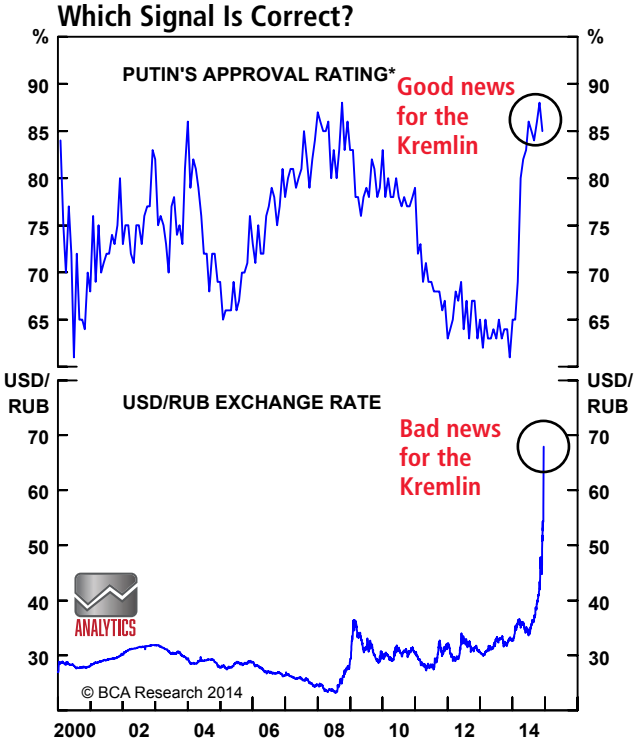
[1] Please see *Inside Geopolitical Strategy Blog Post*, titled "Are Russians Impervious To Pain?", dated July 31, 2014, available at gps.bcaresearch.com/blog.

The current BCA House View Matrix will be published on the last page of all BCA reports from 16/12/14-23/12/14.

Domestic Political Risk

The common adage that the Russian people can withstand a high degree of economic pain in the face of geopolitical hardship is a misapplication of a few cherry-picked historical examples. In reality, and by our back-of-the-envelope count, Russia has faced more full-scale revolutions in the 20th century than any other advanced economy (1905, 1917, and 1990). The Russian people are willing to endure immense pain when invading armies are at their doorstep, but they are also quick to lash-out against incompetent policymakers who bite-off more than they can chew.

CHART 2
Ruble Versus Polls: Which Signal Is Correct?



* SOURCE: LEVADA CENTER.

The Russian leadership faced the wrath of its people following the disastrous 1904-1905 Russo-Japanese War, the unsuccessful foray into the First World War – which was perceived as unnecessary imperialism at home and thus was the main trigger for the Bolshevik Revolution, and the Soviet adventure in Afghanistan. In each case, Russia was the aggressor, and while the population cheered its leadership's efforts at the beginning of the conflict, the economic toll ultimately led to a full-blown revolution.

Today's situation in Ukraine is not much different. Yes, President Putin's support level is extremely high; he stood against the West's meddling in the Russian sphere of influence and has successfully won the battle of competing narratives in the Russian media. However, the cost-benefit analysis of the conflict is quickly turning against Moscow as the economy slides into what could be a severely deep recession in 2015.

We have published **Chart 2** many times in the past, wondering which indicator is more relevant as a measure of domestic support for the Russian leadership. On the one hand, President Putin's popular support remains high. On the other, the ruble's weakness is a reflection of a deep lack of confidence by the Russians in their (geo)political circumstance. The divergence of the two indicators is unsustainable and we expect President Putin's popularity to begin to suffer.

Bottom Line: The USD/RUB cross is not just a currency cross. It is an important bellwether of political stability and confidence in the country's leadership. President Putin himself came to power in what was essentially a 'palace coup,' which saw his predecessor Boris Yeltsin peacefully removed due to the gross economic mismanagement leading up to the 1998 ruble crisis. As such, President Putin is well aware of the political dangers of today's market reaction. We therefore expect policymakers in Moscow to enact a policy mix of the following strategies:

- Capital controls to stem the decline of the ruble;
- Increased rhetoric and assertiveness against the West to maintain a perception at home that the economic hardship is due to exogenous factors (sanctions, conspiracy by Saudi Arabia and the U.S. to undermine oil prices, etc.);
- De-escalate tensions on the ground in Ukraine.

Geopolitical Repercussions Of Domestic Political Risk

How can we expect both increased assertiveness against the West and a de-escalation on the ground in Ukraine? Simple: the first is rhetorical and the second is concrete.

In terms of assertiveness, we expect Moscow to continue to use rhetoric and brinkmanship tactics with the West, particularly Europe and its neighboring NATO member states. Recent mid-air incidents between Russian military planes and Scandinavian passenger flights, for example, are a low-cost and relatively low-risk tactic to illustrate to Europe why antagonizing Russia is a mistake. Similar incidents – including the increased visibility of Russian military operations both inside and outside of Europe – will serve to bolster voices in Europe that call for a de-escalation of tensions with Moscow out of fear that the crisis could get out of hand. This is a similar tactic to the one the Soviet Union used during the Cold War: it ratcheted-up tensions in order to strengthen the hand of 'doves' that feared World War Three in Europe.

Outside of rhetoric, however, we expect little in the way of concrete actions on the ground in Ukraine. In fact, our view that Moscow may use its window of opportunity ahead of the expiry of the EU economic sanctions on June 31, 2015 to re-escalate the conflict in East Ukraine appears to be losing credence as fast as the ruble is losing value. A recent visit by President François Hollande to Moscow suggests that Putin is looking for a way out of the quagmire in Ukraine, as do reports from December 16 that the pro-Russian rebels in East Ukraine have stopped shelling pro-Kiev positions in the region.

Our view remains that Moscow is severely constrained in pursuing a military solution beyond its sphere of influence.[2] Russia's constraints are considerable:

- Its military strength is overstated;
- Its economic dependency on Europe (and Germany in particular) is understated;
- And its domestic political constraints are misunderstood.

The collapse of the ruble and the ongoing oil price rout will only further enhance these three structural constraints.

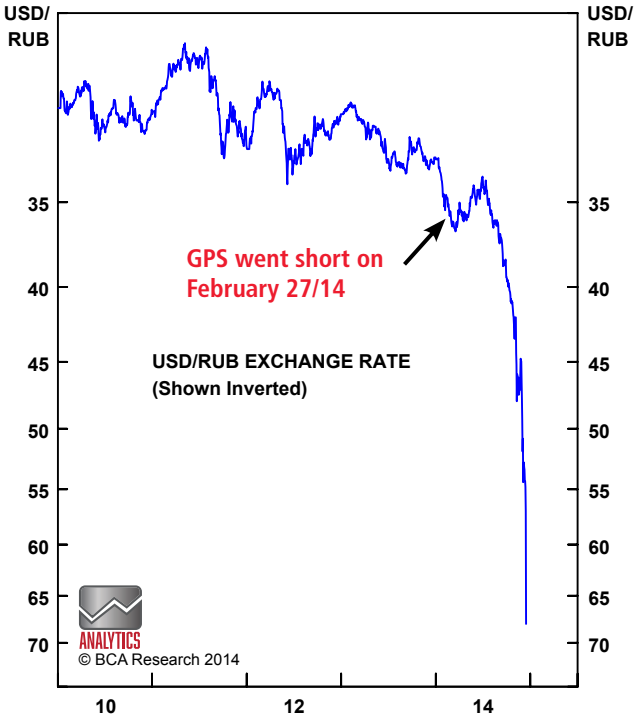
Bottom Line: Investors should expect more rhetoric and assertiveness out of Russia, such as military flights over European airspace or military exercises near NATO member states. However, the investment-relevance of these essentially rhetorical moves will be low, as they will be intended mainly for domestic consumption. In fact, the constraints on Russia's geopolitical manoeuvring room are growing.

The Coming Capital Controls

BCA *Geopolitical Strategy* has shorted the USD/RUB since February of this year (**Chart 3**), a trade that has netted a 89% return. However, today's market reaction raises the probability that Moscow is forced to enact capital controls. As we discussed in a November *Special Report*, capital controls fit the governance philosophy of Russian policymakers despite their obvious shortcomings.[3]

Capital controls are ultimately a political decision, making it difficult to forecast and time when the decision to impose them will be made. That said, the chances are that capital controls will be devised in a way to prevent domestic capital from leaving the country, yet the controls will be less strict on foreign capital.

CHART 3
Our Trade On The Ruble



[2] Please see *Geopolitical Strategy Special Report,* titled "Cold War Redux?", dated March 12, 2014, available at gps.bcaresearch.com; and *The Bank Credit Analyst Monthly Publication,* titled "Crisis In Ukraine: Realities, Myths, And Consequences - April 2014", dated March 27, 2014, available at bca.bcaresearch.com.

[3] Please see Section III of the *Geopolitical Strategy Monthly Report* titled "Russia - Governance Trilemma In Action", dated November 12, 2014, available at gps.bcaresearch.com

The authorities understand that they need foreign capital, and it is unlikely that they will act in such a way as to completely staunch it.

At this point, the possibility of capital controls, combined with the dramatic fall in the ruble, signal that it may be time to take profits on our USD/RUB trade. BCA's *Emerging Markets Strategy* is recommending the same tactical move in their upcoming *Weekly Report*.

Bottom Line: Take profits on USD/RUB.

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BCA House View Matrix

December 16, 2014	6-12 MONTHS	2-3 YEARS
U.S. EQUITIES	Flat, medium conviction, reflecting bullish and bearish crosscurrents. Risks are tilted to the bearish side over the next 3-6 months, but we would upgrade to bullish if a vicious correction emerges. Continue to favor domestic and defensively-geared over global and deep cyclically-exposed sectors, as well as large over small cap.	Flat, medium conviction. Recent returns have far exceeded our long-term expectation of 5-6% returns per year.
U.S. TREASURY BONDS	Neutral duration, medium conviction. Odds on side of positive U.S. economic surprises, but upward pressure on savings in the EMU zone and emerging markets argues for a flatter yield curve.	Manage duration exposure tactically, rather than staying structurally short, low conviction. Lower U.S. potential growth means Treasury yields will not sustainably trade above current levels discounted in the forward curve.
U.S. DOLLAR	Slightly bullish, medium conviction. Bearish on yen, but next move in euro less clear because of massive EMU zone current account surplus.	Flat, low conviction. Fed tightening will be slower and smaller than the consensus expects, but other major currencies are hardly attractive.
CHINA	Chinese authorities will not let the economy spiral downward, but the main policy focus is structural reform. The main risk is a policy mistake as credit growth slows.	Bullish, medium conviction. Aggressive supply-side reforms should improve economic efficiency and the structural appeal of Chinese equities.
EUROPE	Cautiously optimistic (equities). Rate of change in credit is bottoming, putting odds slightly above 50% that EMU zone will avoid deflationary riot point. Still, market action in bank stocks is worrisome.	Bullish, high conviction. Equities valuations are relatively attractive, assuming no euro breakup.
JAPAN	Bullish Nikkei, hedged for currency exposure. VAT will be delayed for 18 months until April 2017 following LDP election victory.	Bullish bias (equities). Watch to see if the authorities use weak yen to soften the blow of Abenomics structural reforms.

Geopolitical factors to monitor:

- Oil supply: plenty of hotspots to monitor in wake of price collapse, including Nigeria, Iraq, Libya and Venezuela
- East Asia tensions: short term, risks are stable; long term, risks remain elevated
- EM domestic politics: risks are rising, especially for commodity producers, both short and long term
- DM domestic politics: risks are rising from low levels, uncertainty in the U.S. is overstated

The BCA House View Matrix will be published in our reports – for a period of one week – after the monthly view meeting of our Editorial Board.

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