Latest Business Gossip and Economic Outlook

Inputs for the 2016 Budget

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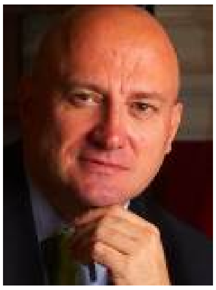

Dr Daniel Thorniley

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) which is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in CEEMEA, global and emerging markets especially Russia. These companies are part of the CEEMEA and Russia Business Group, which is an advisory and consultancy service. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations.

Danny writes a well-received monthly position paper on the Russian market as well as quarterly presentation slides on other CIS markets. He visits Moscow on business every 2-3 weeks and hosts 8-9 private meetings of the Russia Business Group annually. The most recent one was attended by some 140 senior executives. He is also invited to make some 50 speeches/presentations each year by clients across the world on global business trends, business operations, emerging markets, corporate best practice. Many of these speeches are focused on Russia and the CIS and he has made some 60 "Russia presentations" to visiting western CEOs explaining the positives of the market without being naïve.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President and Senior Consultant at The Economist Group, Vienna on global corporate business trends, with specialisation in BRIC.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

Danny is regarded as a charismatic speaker who can present detailed business and economic analysis in an easily digestible fashion with a great deal of genuine humour. Danny is renowned for not using powerpoint presentation slides - never. Dr Thorniley has also given guest presentations at Executive MBA courses on behalf of Oxford University, the University of Chicago, IESE (Spain) and the Central European University in Budapest. The executive MBA students at Chicago rated him "best speaker" on 12 occasions out of 12 over 5 years.

He has worked on a personal basis with companies operating in emerging markets for 26 years and has personal contacts with most senior western MNCs operating in the Russia and the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level and has long-standing personal friendships with leading executives.

He holds and has held a number of non-executive and advisory board memberships.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

He has published three books, including one on Russia with Macmillan (UK/USA) and two with Profile books on Doing Business in Global Emerging Markets.

His beloved daughter is called Natasha after he read Tolstoy's War and Peace when he was a young man. One of his other favourite books is Master and Margarita by Bulgakov.

Executive summary

- Comments from the consumer goods sector are mixed but many companies reckon they can manage 6-11% rouble sales this year.
- Executives from the food & beverages sector are more sceptical about hitting double digits this year and predict slower FX sales in 2016 than other consumer product companies.
- Hamleys toy store in Detskii Mir Moscow is the most successful toy store in the world today!
- Profits are down across sectors but many managers say they remain reasonably good.
- Companies which have localised are generally satisfied with what they've done.
- Executives still want to see if they can get business leverage out of the Eurasian Economic Community but there is a degree of scepticism.
- The US Federal Reserve did not raise interest rates last week but perversely this did not help the rouble as it should have done.
- Mangers plan for some rouble and FX sales growth next year dependent on some relative oil and rouble stability. This is fair enough but there are also negative signs that volatility could still be with us for the next 6 months.
- Hence why executives will need to resort to scenario planning for their 2016 budgets.
- We think the GDP turn-around can start mildly from about the turn of this year.
- But the consensus is coming back to our sober prediction of -3.7% GDP this year and +0.6% in 2016.
- Inflation is more sticky than expected as the rouble dipped again this early autumn.
- Consumer indicators and industry and investment ones are still strained.

Business Gossip – what executives are saying

The following are just a sample of business remarks in the last 2-3 weeks from across sectors and tend to substantiate the results from our survey above.

The good old days

The MD of a major European pharmaceutical company commented a bit nostalgically the other week that:

> Russia was always the market on which we could rely. Now we have to hunker down and look at new business models. We also have to look at other markets in the CIS but also at a regional level at Turkey and Central Europe. Russia always sued to support them and bolster their results; now it's the other way round.

Comments from the consumer goods sector

In our survey results we see that in consumer products there is a wide range of anticipated business results for rouble and FX sales but on a rouble basis as a sweeping generalisation, we can say that most consumer products companies (and that's a wide range) plan for roubles sales growth this year of 7-11% but recent comments are mixed depending on sub-sector:

The MD of one major European personal care company reports that:

> We started the year very well; we then slowed noticeably in May-June and then August looked threatening but recent weeks in August and September suggest we will grow this year at 14-15% in roubles. That was my expectation at the start of the year but this slumped to 5% in early August. It's a roller coaster.

One of the largest FMCG companies operating in Russia (among the top-8) is growing sales to September at 17% but nearly all of this stems from price increases while volumes are close to flat or in low single digits.

But the MD of a major European food producer is more sober:

> The trend has been fairly consistently downwards and our business which is mostly brand orientated is hurting. Volumes are down significantly and we can only compensate to some extent with price rises. So profits are sharply down and headquarters are complaining.

Food & beverages in Russia appear to match the outlook for consumer products generally for most sale and profit indicators, but the sector is noticeably weaker when looking at FX sales forecast for 2016.

But another note of caution was expressed recently from this sector. The business development manager of a major European food investor commented:

> I see your survey reports that most consumer product firms and many food & beverages ones predict double digit rouble sales this year (2015), but that looks very optimistic to us. With the retail decline currently taking place and only a soft recovery ahead, I think mid-single digits is more realistic or even ambitious for food & beverages.
>
> We did forecast strong single-digit growth for this year but we are struggling to manage even that number.

This company is very large and so could be feeling the pressure of growing when scale is already very sizeable. But the point is well taken and it does seem that the category of food & beverages is perhaps under more pressure as consumers downtrade, change frequency of purchase, choose more local-local produce.

But on the other hand, a European supplier to the food industry says that business is in reasonably good shape growing sales at 15% in roubles:

> Our customers are still buying premium and branded products from us because their customers are still very demanding. Customers are asking: what's new? They want new insights and experiences every quarter, just like in the fashion industry. There are more limited time offers and so you consistently need something new to both attract and to appease consumers. This is an exciting environment to be working in.

The marketing director of a major US consumer product company reported last week in Moscow that:

> Russian tourists to our outlets in Western Europe are down -30%. But the other 70% staying in Russia are still spending well. Advertising terms for us had collapsed in January but by September we are sold out. Our local partners are willing to invest in promotional offers.

This manager also echoed another theme we are aware of:

> We have not fired anyone this year and actually not in the last 5 years. But in the last couple of months we have lost a couple of good people whom we would have liked to keep. They have gone to other companies (non-competitors) who are building up their businesses in Russia.

This executive also noted in passing that the most successful toy store in the world today is Hamleys toy store located within Moscow's Detskii Mir—even in today's environment. Russian parents still want to make their children happy!

To the point above about profits, we have noted consistently, profits have fallen for nearly everyone but many mangers state that profits were previously at super levels and have simply come down to more rational, normal, sustainable levels.

The MD of a mid-sized European shoe and clothing company echoed the remarks above:

> Our products are mostly our strong European brands which sell at premium prices or just lower. Our volumes are down -35% and price rises only go so far. The trend has been bouncy up and down but I have to say there is more down than up.

The MD of one of the largest consumer product investors in Russia said two weeks ago in Moscow:

> The recent rouble re-collapse is just another hurdle to overcome. But we have had so many challenges in the last 12 months that I and my team are readably used to them. We don't like them but we don't get as frightened as we used to be!

Executives from the B2B sector

The MD of a European industrial company which is just about to start output at a 50mn Euro production facility in the regions made the following set of remarks:

> We postponed the date for production by about 6-8 months which was probably a good idea and we think that localisation is still "the way to go". We ended up being a month or two later than we wanted but this was due not to local partners messing things up, but due to a German supplier not meeting delivery dates for the plant! Being local will now get us into more local projects and I expect a bit of a take-off in the next 18 months. We are running just a little bit below 2014 in FX numbers which of course is excellent and I think the plant opening will drive our business further. We put a massive amount of attention on sales and we are breaking into lower price segment markets and introducing affordable innovation.

This executive also talked about "profits becoming more normal now: and how this is a "good thing" given that the past super records were always going to prove unsustainable. The executive was also very upbeat about the CIS markets especially Kazakhstan:

> I am exuberant about Central Asia and it's going extremely well for us [this conversation took place before the recent tenge devaluation, but the executive in question did anticipate this]. Central Asia is buoyant for us and is performing stronger than a good 2014. We are also doing quite well in Belarus and even in Ukraine. We are seeing strong competitive developments in Kazakhstan. We hope that localisation will help us with the Eurasian Economic Community and already Belarus will treat us like locals given our Russia plant, but in Kazakhstan they still want us to be local over there. That may need further negotiations.

When speaking about "big issues", the executive commented:

> Yes, the rouble is down but I am frankly fairly pleased that it is not in worst shape given the oil price collapse. The recovery for business overall is going to take time and at least another 18 months or more. Like everyone we manage our overall financial policy and cash flow. So far, we are doing better than surviving and I am quite pleased about where we are and we are also taking small or larger market share.

The MD of one US industrial inputs company noted just last week:

> Business is tough but much better than at the start of the year. But still very tough. However, I was just in Krasnodar and Rostov and it's was very refreshing. The mood there was much more optimistic than in Moscow and we were discussing 2-3 reasonable sized projects with clients which will come to fruition in the next 2-3 months.

Executives from the pharmaceutical industry

The MD of a major US pharmaceutical firm noted two weeks ago in Moscow:

> We probably started the year too optimistically. Last year we managed to hold rouble top-line sales at 14% which was not bad. And I think we and many of our peers thought we might be able to repeat that. But even though we have a wide portfolio, federal and hospital sales are struggling badly and we have no price leverage. OTC and retail has been good but we are seeing more pressures here was well. So overall generally quite a lot of stress and we look like finishing this year at about +7% in sales and that is disappointing.

The MD of a European pharmaceutical company with a slightly different portfolio commented thus:

> We do have a big exposure to OTC and I have pushed the team to make that bigger. We have a good set of distributors and probably rely on one of them too much. But we have been able to leverage on prices and that has certainly helped us. We have some non-OTC which is just surviving but some segments of the OTC are growing 25% in roubles and when we combine everything we will probably manage 15-18% in roubles this year which I think is an achievement

Both of these pharmaceutical executives mentioned that they had either executed localisation plans or were just about to do so.

The economic back-drop to the 2016 budget

We have pointed out that the Russian economy and business are driven by at least 5 major factors:

1) The oil price
2) The perceived situation in eastern Ukraine
3) Western sanctions and their after-effects
4) US interest rate policy which impacts emerging market currencies and the rouble
5) GDP growth in china which impacts the oil price

US interest rates: heads she wins, tails you lose

Last week the US Federal Reserve kept US interest rates close to zero and did not raise them by 0.25%. This ought to have helped boost emerging market currencies including the rouble. However, as we noted in our last report, if US rates were not raised in September, then a sense of uncertainty and volatility would persist for weeks and months to come until December when it is expected that US rates will rise and then hurt emerging market currencies and the rouble. However, the Fed's report was sober reading and suggested that the global economy outlook was perhaps weaker than expected especially thanks to declining Chinese growth outlook. Some commentators now think a rate increase will only come in 2016. This means that the outlook for the oil price ought to remain soft and thus the rouble ought not to rally much.

In other words, if US rates rise, the rouble ought to fall; but if US rates doesn't rise and the global mood is sombre, the oil price will stay soft and the rouble will be under pressure.

It's seems there's not much joy for the rouble on this front.

And with the free-float of the currency, the rouble now acts as a proxy for the oil price: when oil goes up 1%, so does the rouble and when oil goes done 1.75%, so does the rouble!

There is a big consequence from this: if the oil price stays soft for the next 2-5 years which seems logical, so too will the rouble. There is possibly some good news behind this apparent bad news.

The oil price ought to remain low for many reasons (see our earlier reports for 1-2 page analysis) including likely Iranian output reaching the market, sluggish global/Chinese demand and the resilience of shale energy producers. That's the obvious downside for Russia. But on the plus side, the consensus (from some 20 major consultancies and the World Bank and IMF etc.) is not that bad actually:

> This consensus currently believes that the oil price will finish 2015 at $53 per barrel and end December 2016 at $59 per barrel. Essentially any number over $50 means that the Russian economy and western business "hangs on in there" and anything over $55 has some small plus side and also meets our mid-case scenario outlook (see tables below)

In our recent survey most executives plan for some moderate rouble sales growth in 2016 and also for fairly noticeable improvement in FX sales and profits. This can only mean that most executive plan (hope) for a less volatile year in 2016 than in the period October 2014 to October 2015 with a more stable oil price and rouble. The "betting odds" suggest that 2016 "ought to be" less wild and extreme than 2015 and a more quiescent outlook in eastern Ukraine would help. Executives can plan legitimately for such a central scenario.

However, as we have noted before, there is also another valid scenario which suggests that global financial markets remain fixated on US interest rate developments and anticipate such a rate hike in December or in early 2016: in other words the period of extreme uncertainty continues seemingly endlessly, inflicting stress on all emerging market currencies including the rouble. As we noted above, The US Federal Reserve chose not to raise interest rates last week but in their findings underlined that they saw global and Chinese economy output as fragile at the moment and in the short-term future. In this scenario, uncertainty and possibly further poor economic results emanating from China maintain a drip-drip of disappointing and uncertain news.

The consequences of this would be:

> …maintained global financial and regional volatility, a generally strong dollar, a generally weak and volatile oil price and a weaker rouble.

When does it get better?

We expect that the first positive GDP figures will appear at the end of this year or first months of 2016 but we underline again that the recovery will be mild: -3.7% GDP growth this year and +0.6% in 2016. Risks are evenly balanced but perhaps to the downside. Note that the Russian Central Bank is now more sober than we are: the Bank now predict oil closer to $50 per barrel rather than $60 and has thus reduced its estimates for this year down from -3.2% to a range of -3.9% to -4.4% which fits with my own thinking that risks are slightly to the downside.

Current economic trends

But at the moment the economy is doing favours to business:

> Poor industrial and investment numbers are holding back B2B industrial sales and automotive and IT within this sector remain the two sub-sectors under most severe downwards pressure.

Automotive sales fell by about 12% in 2014 and after recording a slump of -24% in the first 6 months of this year, will probably decline by -30% for the whole of 2015. This should see total car sales tumble from 2.34mn in 2014 to about 1.65mn this year. During the autumn 2015 Russia local cars sales were down -12%, foreign cars produced in Russia were down -30% and imported vehicles had collapsed by -50%.

Sales to the Russian federal authorities are among the toughest to achieve as overall budget spending was targeted to fall by -10% this year, but when we add back in some social and defence spending, we believe that overall state spending will be down about -7%: still enough to hurt already weak "federal sales".

Trends in real wages are critical to monitor business: we have noted how in the last 20 months Russian real wages have swung from +12-13%, among the highest in Europe and the world, to -9.8% this August. One of the lowest figures in the world. The reasons are very clear: inflation has jumped from 6.6% in 2012 to 15.8% in August while nominal wage increases have fallen from 13-18% in the Russian civil service and Russian economy to just 4-5% today.

In August this year, nominal wages increased just 4.4% and the average monthly wage declined in August from July to 31,870 roubles, the steepest fall since January this year.

Consumer confidence levels crashed in the first quarter this year to -32, the second worst level in 20 years and then rallied in the second quarter to -23 which is still a bad figure compared with recent annual averages of -6 which is actually a good comparative figure with other European countries. We will see in a few weeks what the recent rouble devaluation has done to consumer confidence when combined with stubborn inflation.

New consumer bank credits, after being +33% some 20 months ago, are now estimated in a range of -6% to -12% and when this is combined with the collapse in real wages we can understand why retail sales are in such negative territory (-9.1% in August). We see household spending falling by -6.3% this year before turning slightly positive in 2016 at +1%. On the one hand it does remain remarkable that the Russian consumer has remained so resilient until the autumn 2015.

Industrial and investment numbers remain stressed and weak against backdrop of sanctions, relatively high interest rates, financial challenges and remaining weak confidence. These indicators have been running poorly since January 2013, well predating the Crimean events of March 2014. We see investment and industry stuck in bleak negative numbers this year at -9.8% and -3.0% respectively followed by soft positive numbers in 2016. The Purchasing Managers' Index is also stuck below the figure 50 which is the benchmark for positive and negative growth: this figure was 48.8 in June, 48.4 in July and declined to 47.9 in August while in the core CEE markets this number is very strong at about 53-55. On the positive side, industrial confidence is surprisingly upbeat or has not collapsed and has remained stable at -6 for nearly all of this year compared with an average of -3 over the last 5 years.

Tarde overall and therefore exports and imports are running at about -45% in dollars due to the FX change and the collapse in the dollar oil price. In July exports were at a 5-year low figure of $27bn while imports slumbered at $18bn which also indicates that the trade balance remains healthy, if only because of collapsed imports.

In recent weeks and months I have been marginally more downbeat than the consensus view on the economic outlook for 2015-16. Now the consensus is moving toward my own assessment.

The Budget 2016 will depend on scenarios and here we append our oil scenarios table for 2016 and our current central economic scenario for 2016.

Central Scenario - 2015 economic outlook

GDP	-3.7%
Inflation (year-end)	12.5%
Inflation (average)	14.5%
Consumer spending	-6.3%
Investment	-9.5%
Industrial output	-3.0%
Rouble to US dollar average	64-68
Rouble to the Euro average	73-77

Economic scenarios for 2016 at different oil prices

Average oil price 2016	GDP	Inflation	Rouble/US$ Average	Rouble/€ Average
$80-85	2.30%	5.80%	42-48	46-55
$70-80	1.90%	6.00%	48-52	55-59
$60-70	1.80%	6.60%	53-58	59-64
$55-60	1.40%	7.50%	58-65	64-69
$50-55	0.20%	9.00%	65-72	69-75
$45-50	-1.50%	13.00%	72-75	75-82

After a slightly better than expected for quarter GDP results, expectations for quarter two were not met and since then the slumping rouble and negative global environment suggest that the economy will stumble along at current levels.

Macro-economic data 2009-2019

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
GDP	-7.9	4.3	4.3	3.4	1.3	0.6	-3.7	0.6	1.9	2.6	2.7
Retail sales	-5.5	6.3	7.2	5.7	3.9	2.5	-5.8	1.5	2.4	2.8	2.9
Household spending	-7.6	5.5	6.8	7.9	4.7	1.8	-6.3	1.0	2.1	2.8	3.0
Real wages	-2.8	4.4	4.9	8.2	5.2	1.9	-8.3	0.0	3.0	3.0	3.3
Disposable income	1.0	3.7	2.8	3.7	3.3	2.1	-3.3	1.0	2.4	2.9	3.1
Inflation (year-end)	8.8	8.7	6.1	6.6	6.5	11.4	12.5	7.7	6.6	6.3	5.9
Unemployment rate	7.9	7.6	6.5	5.3	5.5	5.3	5.9	5.8	5.7	5.5	5.4
Gross fixed investment	-17.9	5.6	9.8	6.0	-0.3	-4.8	-9.8	-1.2	3.2	4.2	3.9
Industrial output	-10.8	8.3	4.7	2.6	0.3	1.1	-3.0	0.7	2.4	3.0	3.1
FX reserves ($bn) year-end	447	485	510	528	509	385	340	330	350	360	370.0
Rouble/$ (year-end)	30.3	30.4	32.1	30.4	32.9	58.0	68.0	70.0	72.0	75.0	79.0
Rouble/Euro (year-end)	43.4	40.0	41.5	40.1	45.1	72.0	76.5	75.6	76.3	79.0	83.5
Budget balance (% of GDP)	-6.3	-3.5	-0.2	0.0	-0.5	-0.5	-3.2	-1.9	-1.0	-0.5	-0.2
Current-account balance (% of GDP)	3.8	4.9	4.9	3.6	1.6	2.7	3.6	3.3	2.8	2.2	1.0

Consumer-related statistics: by year and monthly

	2012	2013	2014												2015							
	year	year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	July	Aug
Disposable income	3.7	3.3	-1.5	1.0	-6.8	1.9	5.8	-2.9	2.3	3.4	0.6	2.1	-4.7	-7.3	-0.8	-1.6	-1.8	-4.0	-6.4	3.5	-2.0	-4.9
Real wages	8.2	5.2	5.2	4.6	3.1	3.2	5.0	2.1	1.4	-1.2	1.5	0.3	0.5	-4.7	-8.0	-7.4	-10.6	-13.2	-7.3	-7.2	-9.2	-9.8
Real retail sales	5.7	3.9	2.4	4.1	4.0	2.6	2.1	0.9	1.2	1.4	1.7	1.7	1.8	5.3	-4.4	-7.2	-8.7	-9.6	-9.2	-9.4	-9.1	-9.1
Unemployment	5.3	5.5	5.7	5.6	5.4	5.3	4.9	4.9	4.9	4.8	4.9	5.1	5.2	5.3	5.5	5.8	5.9	5.8	5.6	5.4	5.3	5.3
Industrial output	2.6	0.3	-0.2	2.1	1.4	2.4	2.8	0.4	1.5	0.0	2.8	2.9	-0.4	3.9	0.9	-1.6	-0.6	-4.5	-5.5	-4.8	-4.3	-4.3
Fixed investment	6.0	-0.1	-7.0	-3.5	-4.3	-2.7	-2.6	0.5	-2.0	-2.7	-2.8	-2.9	-4.8	-2.4	-6.3	-6.5	-5.3	-4.8	-7.6	-7.1	-6.8	-6.8
Consumer prices	6.6	6.5	6.1	6.2	6.9	7.3	7.6	7.8	7.5	7.7	8.0	8.3	9.1	11.4	15.0	16.7	16.9	16.4	15.8	15.3	15.8	15.8
Budget deficit (running)	0.0	-0.5	0.4	0.3	1.4	-0.4	-0.1	-0.1	-0.1	-0.2	-0.4	-0.5	-0.6	-0.6	-1.6	-1.8	-1.8	-2.1	-2.5	-2.3	-2.9	-3.1

Inflation is proving slightly more sticky than anticipated due to the weakening rouble in mid/late August and to hikes in administrative prices in July: inflation has stayed in a range of 15-17% since the start of the year and did not fall in August and remained at 15.8%. We still presume some slight softening to 12.5% in December presuming no further serious rouble deterioration. Thus average inflation this year will be 14.5% and then decline to 9% average in 2016 and 7.7% in December 2016.

The Central bank's key interest rate was left untouched on 11 September at 11.0%. Given sticky inflation and threats to the rouble, we imagine that the Bank will be cautious about any quick and big cuts but imagine that there is a 50% chance that the rate could be down to 10.5% or 10.0% by the end of the year

As ever, I hope this report proves helpful for you in creating your 2016 budget/business plan for 2016. If you have any comment or queries, do get in touch danielthorniley@dt-gbc.com

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