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## Curriculum Vitae of Dr Daniel Thorniley

Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company) and co-founder of the CEEMEA Business Group which advises senior executives on global business trends. DT-Global Business Consulting is Danny's own consultancy company based in Vienna through which he works with some 330 key clients on business strategy in global, and markets and the CEEMEA region and Russia. The services he provides include written position papers, presentation slides and private client meetings as well as in-house presentations. He is also invited to make some 60 speeches/presentations by clients across the world on global business trends, business operations, emerging markets, corporate best practice.

Sir John Major, the former British Prime Minister has called Danny "The world's leading business expert on emerging markets"

For 23 years Danny was Senior VP at The Economist Group, Vienna on global corporate business trends.

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. 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.

He has worked on a personal basis with 330 companies operating in emerging markets for 27 years and has personal contacts with most senior western MNCs operating in the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level (over 100). He has personal friendships with leading executives in Coca Cola, Procter & Gamble, Ernst & Young, Raiffeisen, Robert Bosch and many, many others.

He holds and has held a number of non-executive and advisory board memberships with major European and US corporations including the Global Advisory Board of the US company Aecom.

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.

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This Business Report is in 3 parts for you:

1) Business Gossip—executive thinking and comments
2) Short summary of our survey findings: what are the corporate numbers for 2016 and 2017 budget
3) Short rouble and economic update following on from the fuller version last month

## Part 1 - what are executives saying?

I would like to repeat recent joking remarks from executives. One managing director noted last month in Moscow that for global presentations to the global board, slide No. 2 should simply be:

**Digitisation, innovation and efficient growth!**

So long as you include those on the slide, the meeting will go fine! Another executive refined this and said the slide No 2 should read:

**Localisation, diversification and efficient growth!**

I think you get the point and remember this should be Slide No2 in the presentation because management stops paying attention after slide No 2 ☺

More seriously, business comments reflect the sectors in which managers are operating and while we can and do argue that there is some upside to the market, a core of managers are still have a tough time.

As we have constantly argued, the global business outlook is doing few favours for most international companies which means that European and global management are:

1) Turning to Russia as a reasonably good market and demanding more top-line and bottom-line growth.

2) Or if the Russian market is not doing so well, then management is getting impatient and frustrated and saying: "The last 3 years have been less than good and less good than in the past so now we want stronger profits no matter what the profit levels may be".

### Some tough stories and some better ones:

Just to put things in context and to show that some sectors are doing very well (while others are not!) we provide the following quotation from the regional head of a western personal care company who noted just last week (and these remarks can be irritating if your own business is struggling!):

> I tell my staff in Russia: if this is a crisis, then long may it continue. Our numbers are very strong both in roubles and now in FX and that means 25%+ in roubles and 10-15% in Euros. The consumer has changed and many operational things involve hard work but this is normal business.

This EMEA executive has personal experience of the Russian market and is aware enough to add that:

> I realise that these results are in the personal care sector where the consumer (usually a woman) still wants to spend discretional income on our products and is willing to pay for premium and we offer mid- and low-price points as well.

Now to some tougher stories to provide balance.

The MD of a western IT company commented last week in Moscow that:

> Our European headquarters is saying that sustainable growth in the Russian IT market doesn't look very attractive for the next 2-3 years so we should cut back on Russia and treat it like a cash cow. This would be a crying shame given all the efforts and resources that have gone into the last 5 and 25 years. I am arguing, and it is far from easy, that we require to still invest in the market and look for medium-

> term growth channels while managing the business sensibly and tightly but not too tightly. I believe if we give away market share now, then Russia will be lost to us for the next 10 years.

The MD of a European B2B company told me last week by phone that:

> Yes, the last 2-3 years have been tough but I think we have survived resonantly well and we are localised. But we are suffering from some strains of "wear and tear" as you call it. And we probably need another 14 months of re-adjustments. But this makes European HQ want to really double down on costs and I am frightened that we are cutting costs too deeply which could harm relations with customers and suppliers. Our results are not bad; it's just they are not as good as 3 or 7 years ago.

One sector which is also hurting is medical equipment and reimbursed pharmaceuticals and 2-3 senior managers have shared their thoughts with me on this in recent weeks:

The MD of a US medical equipment company stated that:

> The last 15 months have been steadily tougher and tighter and we are barely growing at the moment and of course 3-4 years ago we were increasing sales by 40% with a stable rouble. The industry faces issues of regulations and tenders and price cuts with the Russian government cutting spending overall by at least 10% and with regional authorities and hospitals also strained. We are also facing political and price competition from Asian suppliers as the government prefers to choose non-US or non-west European suppliers.

The MD of a major pharmaceutical comment also noted last week in Moscow:

> We are mostly reimbursed pharmaceutical and the picture is very mixed but generally hard. There are some drugs which are still a priority but the regulations for tenders and the end results of what localisation brings confuse the picture. But sales are definitely declining and in many categories quite sharply or profits are slashed brutally.

The MD of another pharmaceutical company with a more diversified portfolio commented that:

> We have been less exposed to the shifts in reimbursed although it has hit about 20% of my business. Thankfully we have been able to rely on better results from the OTC/retail sector but we have been noticing a steady deceleration even there and a few months ago I would have said, we can get 13% top-line growth in 2017, I am now budgeting for 8-9% and most of that will come from moderate price rises in the OTC sector. A new threat to my business model would be if the OTC part of the business stays subdued. We are only judging this on about one quarter of results so far.

But just to show how diversified and nuanced the picture is, another diversified European pharmaceutical company reports very strong positive trends:

> For the last 12 months we have been growing at 19% in Euros and we know that puts us in a positive outlier category. But the problem is that our European headquarters thinks this is normal and sustainable. We would need solid investment to continue with such numbers and they may not even be sustainable given we get most of the growth from the OTC sector and we are also noticing some deceleration there. Like everyone, we may have less upside to raise prices sharply. But I hope that slower inflation and the stronger rouble will make life easier. Fingers crossed for that and that is the basis of the budget which is still to grow at 12-15% in Euros.

This company is different from the IT firm cited above because while the IT firm fears being a cash-cow because of weak results, the danger for this health company is that they are treated like a cash-cow because of the good results.

Back to the bad news: the European MD of an automotive supplier summed up his Russia business at a meeting in Vienna:

> Russia is still very hard for us and we have been deeply negative in Euros for 3 years although I confess with a small improving trend. But this year we will still be negative 10% in Euros and about flat in roubles. But my senior management just want to keep a holding position in Russia and wait and see. Our market/categories are down currently minus 18-25% in Euros so we are doing a bit better than the market but that is hardly enough for my board.

And back to some good ones:

But there are still many good stories out there in consumer products and even B2B. The MD of one US company was able to post top-line sales growth in 2015 of +23% in US dollars and this was in large part due to extensive diversification of their business and localisation. The company supplies to 5-7 different sectors of the Russian economy:

> Yes, last year we grew 23% in dollars and in 2016 I think we will manage about 17% but for 2017 I want to be careful and am budgeting for 12% in dollars. And the exchange rate ought to help me more from now on. But the danger is that my global management are getting "greedy", they are on the drugs of super sales and Russia is outperforming nearly 80 markets globally. And of course they want more and more as I plan for less and less! ☺

One European retailer also reports a similar trend from very strong levels in 2015 but with a declining trend through 2016. The relevant MD noted last week in Moscow:

> Yes, we were growing in roubles in the first 9 months of 2015 by 35%+ and this started in the dark days of end 2014. As we all know, many Russian consumers started buying ahead of inflation and the falling rouble and our home products were regraded very favourable as even low-cost investment items. Also as Russian tourists going abroad declined, so more consumers spent money at home. These positive trends have stayed with us but on a declining trend: first quarter of 2016 was 28%, second quarter 18% and third quarter will come in about 15% in roubles. But if the rouble stays close to 70 to the Euro, that will be a big compensation.

The MD of an ingredients/food company also reports very good results:

> We sell premium and sub-premium products but have also broadened our portfolio in the last 18 months. Until September this year we are growing 20% in Euros although our business is not huge, neither is it tiny. Several categories are expanding and we are also raising prices quite steadily. As the rouble stabilises around 70 to the Euro, I expect sales and profits to improve from that perspective. The only issue is whether consumers can keep spending as they have done for the last 2-3 years. .

Some of these themes were remarked upon in our report last month which merit repetition here as they summarise trends in the consumer products sector. The MD of a major drinks company commented over coffee recently in Moscow:

> We thought 2015 was tough and that 2016 would be easier but this is not quite so. This is a second year of struggle and we are hoping for an easier 2017!
>
> People are buying on price and not with their stomach or tongue! Our concern is that once they downtrade, will they ever come back up? We do not think that they will all come back for sure. The brands are doing well but this has to be:
>
> **Brand at the best price.**
>
> We are even seeing some weakening in super-premium which is rare and there are changes in frequency and volume.

This MD went on to make an excellent point about brands and sub-premium etc. She noted that:

> Yes, we are diversifying and introducing sub-premium products because the consumer is trading in and out of categories and is much more volatile.

> **But we are also starting to stretch existing brands as well as introducing new ones.**
>
> By this I mean we keep existing brands but stretch them in terms of price at the margins and perhaps package sizes so that the consumer can stay loyal to them if he/she wants to.

She made another excellent comment when she remarked:

> We do have to diversify but we also need to be careful and protect the brands. We don't want to disturb the consumer excessively and to confuse them with "over-choice".

This manager also alluded to challenges among distributors who are "facing a real dog fight". Other managers have commented on how some distributors will go to the wall.

The MD of a major food investor also commented with intensity about trends in promotions and discounts at a recent private dinner for senior managers in consumer products. Afters several executives had grumbled about the extent and depth of promotions and discounts, the executive pulled out his iPhone and asked the small audience to wait a few seconds while he downloaded an App on his phone:

> Look here we are. My company's products are listed by the extent of discount by product, with product name and name and address of store. Look the first and deepest discount is -53% on one of our lines at this store with address and look, I just trawl through hundreds and thousands of discounts for my company's products by store starting at -53% and ending up at about -2%. And I just have to type your company name into the App and the same applies to all major and medium manufacturers.

## Some executive comments on the Russian consumer

We repeat here a few important comments from recent reports which summarise remarks made by many executives in consumer products:

- The Russian consumer may be tired and flagging and less resilient than in the last 2-3 and 6-7 years.
- The Russian consumer is exhausted.
- The Russian consumer is now almost completely "normal" i.e. westernised.

The Russian consumer has of course changed radically in recent years and now looks more for value, promotions and discounts and chooses to or is obliged to downtrade. All these factors are clear. However, for the last 5-7 years most managing directors of consumer product companies have been positively amazed at the resilience and survivability of Russian consumers which has generally helped many consumer product companies to flourish or do reasonably well.

Executives in this sector are NOT suggesting that the Russian consumer is on the verge of collapse, only that finally after so many years, there is a sense of some fatigue and of course this explains why retail sales are negative this year which means that most western consumer product companies are capturing or maintaining some share and raising prices steadily.

***So the bad news is that more executives think the Russian consumer is flagging but the good news is that most macroeconomic indicators are picking up. We may be able to conclude that this disparity may not last long and that the flagging Russian consumer may be able to tick up again in the coming weeks/months if inflation stays low and the rouble stabilises…. which is our and the consensus view.***

This analysis would seem in principle to be correct as of early October as real wages and retail sales start to improve (see below). But we still believe that there will be no easy future for consumer product companies or any others in the years to come.

## Executive comments on localisation

I have written about localisation and we discuss the topic at all our Moscow events. Just to say that the following quotations would summarise the situation for most:

Some 8-10 MDs have told me personally that:

> We set up a factory in 2014/2015/2016 and thanks to this local entity we have been able to increase our rouble sales to 16-22% and without the local factory we would be increasing sales by 2-5% in our industry. The localisation has also improved relations with suppliers and distributors and we are sure it has provided some intangible benefits with local and even federal authorities and it helps us benefit from the trends of import substitution as well as sourcing our inputs from less traditional (and expensive) western suppliers.

The other main comment on localisation which stems from many pharmaceutical executives but from other sectors is the confusion about the actual benefits from localisation and what is the official definition of localisation.

> Like many others we have localised or are continuing to do so. However, while there is a bit more clarity in the regulations, we are still not 100% comfortable with the precise definition of localisation. Certainly in the pharmaceutical sector we realise this will/ought to give us better access to the market in terms of access to tenders and pricing. We also feel that it will improve our relations with partners and governments. But headquarters understandably is asking for a proper ROI and when there is any nebulous or vague response, they ask more questions and get more doubtful.

## Part 2 - what are executives planning? Some key findings for the 2017 budget.

- Through the summer and autumn of 2016, the business mood has stabilised in Russia for at least 80% of companies. Tough sectors remain automotive, IT sales to the Russian government and reimbursed pharmaceutical and medical equipment sales especially to the government.
- Anecdotally, more executives are talking about wear and tear and getting accustomed to the new normals in the market.
- Some companies and executives are experiencing signs of wear and tear on their business. They have survived the last 2-3 tough years and thankfully the economy is heading in the right direction (if slowly). BUT some managing directors based in Moscow are feeling bigger pressure from regional and global HQs to “make even higher numbers”.
- In the last 7 months (April-November 2016) the Russian rouble has fluctuated in a 5% FX range versus the Euro and US dollar. When it has moved out of this band in recent weeks, it was because of strengthening (to 68 to the Euros for example) and not due to weakening.
- Some 62% of companies send in their 2017 budget to HQ during September and October and by end of November almost 84% of respondents have wrapped up the budget process.
- 60% of respondents make 2-3 economic-business scenarios in their 2017 budget while another 38% confine themselves to one.
- Some 28% expect a better and decent year in 2017 compared with 2016 while 65% think it will be a business environment similar to 2016: manageable but tough.
- No respondent company in our survey is budgeting for negative rouble sales in 2017.
- Some 8% of all companies budget for rouble sales increases of 1-5% in 2017 but the BIG cluster for rouble sales forecasts is in high single-digits and low double digits.
- In 2017 some 66% of companies budget for rouble sales growth in a range of 5-15%.
- Many companies are budgeting for significant improvements in FX sales in 2017.
- While 30% expect single digit FX sales growth this year (2016), the number in 2017 jumps to a massive 62% and a further 23% forecast sales increases in FX over 10% in 2017!
- Put another way: in 2015 almost 66% of companies saw negative FX sales results and this declines to 25% in 2016 while only 3% forecast negative FX sales in 2017. IF this proves accurate, then clearly it is a massive improvement.
- These are strong budget numbers and this is where the risk lies for getting caught in a 2017 budget trap.
- The FX sales outlook is (and has to be) based on the presumption that the rouble will be very stable versus the Euro and dollar in the coming year.
- The budgeted profit outlook remains good for three-quarters of companies and this matches many anecdotal comments.

 

- But we also note that 20% of companies are seeing profit strains and HQs are exerting more demand for profits even after 2-3 years of wear and tear.
- In 2016 and 2017 Russia will represent 82-86% of total sales revenue from the CIS markets.
- The CIS markets are no longer acting as a marginal support for slowing business in Russia.
- Some 45% of companies still keep Ukraine in a CIS structure reporting to Moscow.
- In terms of salary increases budgeted for 2017, the magic number remains for the third year at 7-8%. This is the average percentage increase that companies will pay for average white collar staff in Russia.
- As in 2016, some 33% of companies plan/budget to make NEW investments in manufacturing, logistics and warehousing in 2017.
- 41% of companies have already received rent reductions in 2015-16; another 44% budget for big or moderate rental cuts in 2017.
- Some 44% of firms' budget for significant investment in e-commerce and digitisation while another 30% will make a small start and 18% are not sure.
- Price increases in 2017 are planned to be more moderate than in 2016 and certainly less aggressive than in 2015.
- Companies (36%) do use Russia as an export base and another 20% are considering the option.
- Regarding the status of distributors and their inventories and purchases, we saw a very slight deterioration in mid-summer but think that a better economic climate and stable rouble could help a bit through the end of the year.
- Receivables remain good: 46% of executives see no change; 49% perceive a mild but manageable deterioration while just 5% have serious issues.

### Organic sales growth in Roubles, 2016 and 2017

| | All companies | | Consumer products | | Pharma/health | | B2B/industrial | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 |
| 20%+ | 10 | 8 | 28 | 13 | 8 | 3 | 8 | 11 |
| 10%+ | 27 | 22 | 37 | 28 | 32 | 21 | 32 | 0 |
| 5-10% | 30 | 44 | 21 | 50 | 36 | 53 | 35 | 54 |
| 1-5% | 13 | 8 | 4 | 7 | 20 | 9 | 19 | 13 |
| Flat/zero | 8 | 5 | 4 | 0 | 4 | 0 | 4 | 12 |
| Minus 1-10% | 6 | 0 | 5 | 0 | 0 | 0 | 2 | 0 |
| Minus 10%+ | 2 | 0 | 3 | 0 | 0 | 0 | 2 | 0 |

### FX sales outlook 2015 and 2016, by sectors

| | Consumer products | | Pharma/Health | | B2B/Industrials | |
|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2016 | 2017 | 2016 | 2017 |
| 10%+ | 18 | 26 | 8 | 9 | 8 | 26 |
| 5-10% | 19 | 42 | 27 | 50 | 26 | 18 |
| 1-5% | 7 | 33 | 11 | 23 | 11 | 27 |
| Flat/zero | 18 | 0 | 21 | 10 | 23 | 28 |
| Minus 1-10% | 21 | 0 | 24 | 0 | 26 | 0 |
| Minus 10%+ | 14 | 0 | 21 | 3 | 4 | 0 |

## Part 3 - economic outlook

- The rouble has been stable for almost 7 months and any fluctuations are currently on the strong side. Even when oil ticks down (in August), the rouble remains stable or even strengthens a little.
- Why? Because international portfolio investment is flowing into Russia (and other emerging markets) as investors/speculators search for yield (see text below).
- As capital flows into the country, capital flight leaving the country is decelerating quite sharply: at the start of September 2016 the outflow was a mere $10bn compared with a total for all 2015 of $59bn (and the 2015 figure was smaller than the 2014 number).
- Inflation is diminishing faster than expected and the stable rouble explains that with other factors.
- The fact that the Russian Reserve Fund shrank from $50bn on 1 June to $32.2bn on 1 September was significant and negative news in the media for the Russian economy. We agree that it is not a positive trend and we do not belittle it and its consequences, but there are several other positive compensatory factors as well such as the low levels of debt to exports and public debt as well as the rising level overall of FX reserves.
- This Fund was also stable through September and started October unchanged at $32bn.
- The Central Bank cut the central rate as excepted to 10.0% in mid-September but then took a harder line by postponing more cuts until the first months of 2017. But with slumping inflation and the much stronger rouble, the Bank may yet be tempted to tweak rates one more time downwards and this is potentially good news.
- GDP is following the trend we expected and will turn positive at end of this year on a monthly basis but full year growth only returns in 2017.

### Macro-economic data 2009-2020

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP | -7,9 | 4,3 | 4,3 | 3,4 | 1,3 | 0.6 | -3,8 | -0,7 | 1,4 | 1,8 | 1,9 | 2,0 |
| Retail sales | -5,5 | 6,3 | 7,2 | 5,7 | 3,9 | 2,5 | -8,8 | -2,5 | 2,1 | 2,8 | 2,8 | 2,9 |
| Household spending | -7,6 | 5,5 | 6,8 | 7,9 | 4,7 | 1,8 | -8,5 | -2,8 | 1,8 | 2,6 | 2,6 | 2,8 |
| Real wages | -2,8 | 4,4 | 4,9 | 8,2 | 5,2 | 1,9 | -9,2 | -1,7 | 2,2 | 2,7 | 2,9 | 3,2 |
| Disposable income | 1,0 | 3,7 | 2,8 | 3,7 | 3,3 | 2,1 | -4,0 | -2,5 | 1,8 | 2,2 | 2,6 | 2,7 |
| Inflation (year-end) | 8,8 | 8,7 | 6,1 | 6,6 | 6,5 | 11,4 | 12,9 | 6,8 | 5,5 | 5,3 | 5,2 | 5,0 |
| Unemployment rate | 7,9 | 7,6 | 6,5 | 5,3 | 5,5 | 5,3 | 5,4 | 5,8 | 5,6 | 5,5 | 5,4 | 5,3 |
| Gross fixed investment | -17,9 | 5,6 | 9,8 | 6,0 | -0,3 | -4,8 | -7,6 | -3,2 | 2,4 | 3,5 | 3,9 | 4,0 |
| Industrial output | -10,8 | 8,3 | 4,7 | 2,6 | 0,3 | 1,1 | -3,4 | -0,2 | 1,7 | 2,5 | 3,1 | 3,3 |
| FX reserves ($bn) year-end | 447 | 485 | 510 | 528 | 509 | 385 | 365 | 410 | 390 | 400 | 415 | 420 |
| Rouble/$ (year-end) | 30,3 | 30,4 | 32,1 | 30,4 | 32,9 | 58,0 | 73,0 | 65,0 | 68,0 | 72,0 | 73,0 | 74,5 |
| Rouble/Euro (year-end) | 43,4 | 40,0 | 41,5 | 40,1 | 45,1 | 72,0 | 78,0 | 70,0 | 74,5 | 79,0 | 79,0 | 80,5 |
| Budget balance (% of GDP) | -6,3 | -3,5 | -0,2 | 0,0 | -0,5 | -0,5 | -3,6 | -4,1 | -3,2 | -2,6 | -2,2 | -1,8 |
| Current-account balance (% of GDP) | 3,8 | 4,9 | 4,9 | 3,6 | 1,6 | 2,7 | 4,3 | 4,1 | 3,8 | 3,2 | 2,5 | 1,9 |

### Key statistics by year and monthly

| | 2012 | 2013 | 2014 | 2016 | | | | | | | | 2017 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | year | year | year | Q1 | Q2 | July | Aug | Sept | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | June | July | Aug | Sept |
| Disposable income | 3,7 | 3,3 | 2,1 | -1,4 | -2,3 | -2,0 | -4,9 | -4,3 | -5,6 | -6,5 | -0,7 | -6,3 | -6,9 | -1,2 | -7,1 | -5,7 | -4,8 | -7,0 | -8,3 | -2,8 |
| Real wages | 8,2 | 5,2 | 1,9 | -8,6 | -9,2 | -9,2 | -9,8 | -10,4 | -10,9 | -10,4 | -10,2 | -6,1 | 0,6 | 1,6 | -1,7 | -1,0 | 1,4 | 0,6 | 2,7 | 2,6 |
| Real retail sales | 5,7 | 3,9 | 2,5 | -6,7 | -9,4 | -9,1 | -9,1 | -10,4 | -11,7 | -13,1 | -15,3 | -7,3 | -4,3 | -5,8 | -4,8 | -6,1 | -5,9 | -5,0 | -5,1 | -3,6 |
| Unemployment | 5,3 | 5,5 | 5,3 | 5,7 | 5,6 | 5,3 | 5,3 | 5,2 | 5,5 | 5,8 | 5,8 | 5,8 | 5,8 | 6,0 | 5,9 | 5,6 | 5,4 | 5,3 | 5,2 | 5,2 |
| Industrial output | 2,6 | 0,3 | 1,1 | -0,4 | -4,9 | -4,3 | -4,3 | -3,7 | -3,6 | -3,5 | -4,5 | -2,7 | 1,0 | -0,5 | 0,5 | 0,7 | 1,7 | -0,3 | 0,7 | -0,8 |
| Fixed investment | 6,0 | -0,1 | -4,8 | -6,0 | -6,5 | -6,8 | -6,8 | -5,6 | -5,2 | -4,9 | -8,7 | -8,4 | -8,4 | -8,4 | -4,8 | -4,8 | -4,8 | -4,3 | -4,3 | -4,3 |
| Consumer prices | 6,6 | 6,5 | 11,4 | 16,2 | 15,8 | 15,8 | 15,8 | 15,7 | 15,6 | 15,0 | 12,9 | 9,8 | 8,1 | 7,3 | 7,3 | 7,3 | 7,5 | 7,2 | 6,9 | 6,4 |
| Budget deficit (running) | 0,0 | -0,5 | -0,5 | -1,7 | -2,3 | -2,9 | -3,1 | -3,0 | -3,0 | -3,3 | -2,6 | -1,8 | -1,9 | -2,6 | -1,4 | -3,0 | -3,2 | -3,3 | -3,3 | -3,7 |

 

**We often state that 60% of Russia's economic problems stem from the oil price and 40% from western sanctions impacting financing and confidence. But we know that this ignores the fact that GDP growth started to trend downwards in January 2013, well before Crimea, and that it was industrial and investment figures which led the downward trend. Russia's economic problems pre-date the Ukraine crisis.**

We expect the political and global environment to help the Russian economy a bit this year and in 2017 and we predict GDP will start quarter-on-quarter growth in the third quarter of this year as do most commentators and the Russian Central Bank. This means some GDP growth at the end of 2016 but not enough to compensate for the negative numbers in the first 8-9 months. But this does mean that 2017 will turn positive by about +1.3%.

The economy is improving but in fits and starts depending on sectors (a bit like the business outlook). Overall the economic recovery, while clearly visible is luke-warm: trade is improving a bit thanks to the higher oil price; some consumer sector indicators are getting a bit better but still negative year-on-year in September; industry is bobbling around zero growth; and fixed investment is the weakest link.

The three big obvious positives are:

1) The stabilisation and improvement in the oil price around $50 per barrel
2) And the related solid strengthening in the rouble (the strongest currency in the world in 2016 after being one of the weakest in 2015)
3) Inflation is declining quite quickly: from an average of 15.6% in 2015 to 7.3% in 2016

Thanks to lower inflation real wages turned positive again this autumn and retail sales continued to improve while still negative. A possible record grain harvest of 106-110mn tonnes could prop up GDP this year.

## GDP - short and medium term

- We maintain our GDP upgrade for 2016 at -0.7% which is close to the consensus of -0.6%.
- We also stick with our estimate for 2017 at +1.4%. but the Russian Central Bank is now more down-beat at a figure below 1%.

It is clear that (without any unexpected boom in the oil price to $65-75) there will be no quick bounce-back from this recession. GDP will increase about 1.3% in 2017 and then average around 1.8% to 2.3% during 2018 to 2022 depending on the oil price.

We do not anticipate much serious and quick structural economic reform over the next 3-5 years and so the dependency on the oil price and potential volatility remains in the foreground.

As many executives argue, "This is what we've got. This is not a crisis anymore, this is the new normal and the daily reality and we better get used to it".

## Central scenario - 2017 economic outlook (oil averages $46-55)

| | |
|---|---|
| GDP | 1.4% |
| Inflation (year-end) | 5.5% |
| Inflation (average) | 6.2% |
| Consumer spending | 1.6% |
| Investment | 2.1% |
| Industrial output | 1.7% |
| Rouble to US dollar average | 63-69 |
| Rouble to the Euro average | 68-75 |

## Economic scenarios and the rouble for 2017 at different oil prices

| Average oil price 2016 | GDP | Inflation average | Rouble/US$ Average | Rouble/€ |
|---|---|---|---|---|
| $80-85 | 3.3% | 5.5% | 45-52 | 52-58 |
| $70-80 | 2.8% | 5.5% | 52-57 | 58-64 |
| $60-70 | 2.4% | 5.8% | 57-60 | 64-66 |
| $55-60 | 1.8% | 6.1% | 60-63 | 66-69 |
| $50-55 | 1.3% | 6.4% | 62-67 | 69-73 |
| $45-50 | 0.3% | 7.5% | 64-69 | 72-77 |
| $35-45 | -1.3% | 8.2% | 68-74 | 74-82 |
| $25-35 | -2.5% | 11.5% | 74-80 | 83-92 |

## The rouble outlook

- The rouble is 24% stronger than it was at its recent low on 11 February (68.0 to the Euro on 28 October compared with almost 91 on 11 February).
- Our prediction of recent months has proven correct: "The rouble is stable and we expect it to move sideways for the next few months presuming oil stays at $46-52 over the coming months".
- And in fact with speculators searching for yield (see our last report), the rouble has ticked further upwards in recent weeks and thus the rouble can do a bit better than the oil price because of these capital flows searching for yields.
- Some two-thirds of Russians are still willing to keep their deposits in roubles rather than FX.
- Capital flight is shrinking: down to $10bn in the first 8 months of 2016 compared with $60bn total in all of 2015. This is obviously supportive of the rouble.
- Total external debt has fallen by -30% in the last year and total debt exposure of $550bn is very manageable because total debt repayments in 2016 are about $70bn with much already paid off.

Our central scenario is for oil to average around $42-$48 per barrel in 2016 and end the year at $50-52 range and then average $49-57 in 2017. This is close to the consensus.

Based on this oil scenario we now expect the rouble to fluctuate on average within 7% of either side of current (October) levels so about 70-75 to the Euro and 63-69 to the US dollar. We also expect the Euro-dollar to average around 1.08 during 2016 and to be close to this figure in 2017.

**These numbers for the exchange rate also reflect closely what most executives are putting into their 2017 budgets.**

Other factors affecting the rouble: (taken from last month's report)

1. Capital flows and hugely reduced capital flight is helping the rouble as well. In August net flows were +$1bn and the net outflow until 1 September were a mere $10bn compared with $60bn for the whole of 2015.
2. Russian banks are actually selling off some FX foreign assets because the funds are NOT needed to pay off FX debt which is diminishing.
3. But there will probably be some further outflows this autumn as this is the busy season when traditionally FX debt is serviced.
4. BUT "capital flight" will be down -60% to -75% this year.
5. As we note above, real interest rates are attractive in Russia with inflation at 6.9% in August and the central rate at 10.0% offering a premium of 3% and this can be even higher for short-term "in-and-out" flows.
6. External tourism will be considerably less this year, despite the removal of travel bans on Turkey. This means that there is less personal demand for dollars to travel abroad and perhaps more demand for "holiday roubles" as people go on holiday in Russia.

 

7. As the rouble strengthens, there is some self-perpetuation in the rise of the currency especially with individual citizens as they become more confident with the rouble and we note below that two-thirds of Russians are happy to hold their bank deposits in roubles rather than FX.

## Inflation

- Inflation is also trending downwards and came in at 6.4% in August; we expect an average figure this year of 7.3% and year-end of 6.3% with continued moderation through 2017 averaging about 6.2% and ending
- 2017 as low as 5.5%.
- But achieving the Central Bank's target of 4.0% will prove sticky and probably be missed.
- The bumper summer harvest is also helping push food prices down and the August month-on-month figure was negative
- Core inflation (excluding food and energy) also decelerated from 9.1% in January to 7.0% in August.
- Prices for services also fell to 5.5% in August
- Inflation has come down since December reaching 9.8% in January and to 7.3% in the spring months and then fell again in July and dipped below 7% in August at 6.9%.
- IF the rouble continues its current stabilization while food prices remain under control, and GDP increases but only moderately, then it looks like inflation will fall further.
- Interest rates are following inflation downward but they are still positive by about 3 percentage points and this will exert downward pressure on prices.
- Inflation is also ticking down of course due to weaker household spending and consumers are downtrading thanks to competitive retail prices, although western brands are raising their prices solidly.
- Lower energy prices also play a part as they do globally.

## Interest rates

The central rate was stuck at 11.0% for 10 months and then cut to 10.5% in June and trimmed down again in mid-September to 10.0%. But the Bank then nnounced that this was probably the last cut until Q1 and Q2 of 2017. However, with inflation falling and the rouble strengthening, there is some possibility that the Bank tweaks this policy with another small cut in the next 3-4 months.

## The consumer sector

- Retail and household spending will be negative this year by -3.5% and -2.6% respectively and then turn positive in 2017 by 2.1% and 1.8%.
- Consumer confidence improved a little in the second quarter as we predicted from minus -30 in Q1 to -26 in Q2 and then, as we predicted in our last report, continued to get better at -19 in the third quarter which is the best level in about 20 months..
- Recent monthly consumer indicators are showing a soft recovery but a noticeable one: real wages have started to rise thanks to nominal wages increasing by 9% in September while inflation slumped to 6.4%. Real wages were revised upwards for August to +2.7% and rose again in September by 2.6%. This is the first two-month increase during the last 20 months.
- As we noted in our last report, it does seem that the economy may slowly be starting to arrive to support the tired Russian consumer.
- Retail sales continue to disappoint at -5.1% in August but then rallied to -3.6% in September so the trend at least is in the right direction.
- Disposable income was down heavily by -8.3% in August but the latter indicator is unreliable as it includes citizens' currency activity and this is reflected in the jump upwards in September to an improved figure of -2.8%.
- In July and August nominal wages at +5.8% were at the lowest levels since January 2016. BUT these rallied strongly to 9.4% in September and the August figure was revised upwards. The result is that real wages (after inflation) trend positive in both August +2.7% and again in September by +2.6%. This is an important and positive indicator.
- It looks like most government and Russian corporate employees will receive average nominal pay increases of 5-7% in 2016 and with inflation at 7.3% average this means real wages will still be down -1.7% on average this year. BUT this is a huge improvement on last year.

- The retirement age for government employees will gradually rise to 65 for men and 63 for women. Starting in 2017, the retirement age for all government employees will rise by 6 months each.
- We have noted in another report recent executive comments that the "Russian consumer is finally getting tired". It is too early to say when the improvement in real wages will transfer into sales in the shops and the consumer may be adopting a wait and see approach. The mild economic recovery may come "just in time" to save any consumer collapse.
- Unemployment actually improved in August to 5.2% after reaching 6.0% in the spring which is good news but we note that many workers receive shorter hours and less pay per hour.
- Consumer credit was exploding by +35-40% annually in 2012-2013 and then decelerated to 20% growth in 2014. New consumer credits (in roubles) were still rising at the start of 2015 by about 10% but by the end of last year they had turned negative and remained so through the first half of 2016 at an average of -6% to -8%. The July figure was -7.8%. Of course less available credit will hold back household spending and is a major reason we keep our spending estimate in negative territory this year.

## Industry/investment/agriculture

- Investment and industry remain weak as well as construction although the latter ticked up recently
- Investment will be down this year by -4.4% or worse and is trending at -4.3% in Q3.
- These sectors are finding it difficult to get traction.
- Industry has reported 4 months of negative numbers this year and 5 months of positive figures and was back at -0.8% in September. The rising oil price is helping trade figures and this eventually should flow through into industrial output. Industry will grow by just 0.2% this year and then by 1.7% in 2017.
- Conversely manufacturing PMI is better at 51.1 in September rising from 50.8 in August.
- The services PMI also rose to an average of 53.2 in June-September, which is also at 3/4–year high so services are helping to buttress output.
- But again conversely business confidence declined to -6 in October from -5 in September from a level of -3 in the summer.
- And yet another indicator entitled the business sentiment indicator stands at a 3-year high in June-September.
- SO A VERY MIXED PICTURE INDEED.
- Car registrations were up by 125,000 in September after a figure of 114,000 in August but this is seasonal and compares for example with a high of 291,000 in April 2008.
- Car production in August was at a seasonal low of 74,000 which matches the low levels of 2010 and then rose seasonally to 87,000 in September.
- But the construction sector still struggles with a figure of -2% in September but this is an improvement on -9.0% figures in May.
- Agricultural/grain output looks quite bumper this year and agriculture was growing at +6% in August (and +1.9% in September) which will help GDP but will also be very positive for inflation and is already playing a part.
- The banking sector is stabilising but after being positive in the spring corporate credit fell -2.3% in July after a -1.1% decline in June while in recent months consumer credit has been negative by minus 7-8%.
- The budget deficit will come close to -4.0% this year and while commentators fear financial problems, we think there are enough available options to avoid crisis in the next 18 months providing oil stays over $40 per barrel.
- Banks' funding and liquidity profile continues to improve and the banking system is sufficiently capitalised with an aggregate capital adequacy ratio of 12.0%, which is above the regulatory minimum of 8.5%.
- Corporate bank deposits went negative in January by -3% for the first time since 2009 after generally increasing by 10-20% in recent years. Deposits did start to improve though in spring. On the other hand, corporate loans (in roubles) are diminishing finally: new corporate loans increased annually by 15-20% in 2013-14 and by around +6-8% last year and were growing by 4% to April 2016 but by July the trend was negative -2.3%.
- Non-performing loans have risen to 9.7% in the first half of 2016 which is still manageable.

As ever, I hope you have enjoyed this report and found it useful. If you have any queries or comments, then do get in touch with me danielthorniley@dt-gbc.com

 

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