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Subject: FW: Pavel:Good Morning Russia!CBR FX REPO: implications for RUB, bonds,rates

Date: Tue, 31 Mar 2015 04:16:36 +0000

Attachments: Good_Morning_Russia_3003.pdf

From: Isin Sumengen-Ziel (DEUTSCHE BANK AG, LO) [sumeisi.lndb@bloomberg.net]

Sent: Monday, March 30, 2015 6:39 AM

Subject: Pavel:Good Morning Russia!CBR FX REPO: implications for RUB, bonds,rates

trading commentary

Fed's Yellen speech last Friday is probably the most interesting thing to discuss this morning. On one hand it looks like Fed really wants to hike this year, unless data really betrays them. Yellen mentioned all sorts arguments US bulls love to provide including rapid progress in labor market and expected rise in inflation towards the target. On the other hand she talked quite extensively about the risks and even explicitly mentioned "secular stagnation" theme. The assessment of current neutral real rate was also surprisingly low at zero and it's only gradually expected to return to historical norms. To summarize: Fed really wants to hike and it will probably do this year but expectations of fast policy normalization are no way justified. It's going to be long easily spooked process that justifies very flat global yield curves. Among other news, oil is down again.

Back home in Russia ruble opened weaker on the back of lower oil and CBR's late Friday decision to hike rate on FX repo by 50bps to LIBOR+100bps. USDRUB spiked to over 38.30, internationals are rhs but export flows are still supportive to local currency.

To my faithful readers CBR's decision on FX REPO rates should not be surprising although some people are concerned that move is potentially premature and it may also "send a signal" about where CBR wants to see ruble. I only partially agree and think that at the same point benefits of such move outweigh costs.

The peak of external debt redemptions is behind us already and RUONIA basis doesn't show any signs of USD liquidity problems. Ruble is very strong and the popularity of Eurobond carry trade among local banks is growing. The later is not what CBR hard-currency facilities were created for. Once the original mission is accomplished there is no reason why CBR should risk reserves on funding carry-trade. It's not a charity organization. Especially, it doesn't make sense to keep FX liquidity spigots wide open when some economists in the street are calling for outright purchase of FX on spot. Clearly less aggressive FX lending should be considered before anything like that.

The size of hike is also very well measured in my view. For example, two weeks ago there was very little demand for Minfin 1M FX funds at 1.2%, the one last week at 1% went much better but still under subscribed. So it's seems that LIBOR+100bps is exactly the reason where the risk of abusive demand is much lower but the price is not yet prohibitive. At LIBOR+100bps FX REPO is still likely to provide the floor under RUONIA basis at around -100bps, which is more or less safe for FX. Today CBR offers USD3.5bn in 28 days and 365 days FX REPO. That is still quite ample, especially with likely roll of 1 week funds tomorrow. Probably, CBR will diminish amount of funds it offers via 28 days and 365 days facilities later, provided ruble doesn't demonstrate disorderly volatility. The amount of 1 week is likely to stay abundant. Dysfunctional local FX money market still needs crutches.

On the cost side, the strongest argument against is a notion that such move will be taken as "a signal" that CBR

prefers weaker ruble. This is indeed a risk, especially, given what I wrote before about potential regime mutation into PEP-targeting. Nevertheless, at this point that risk is also manageable. Ruble has been incredibly strong recently and even more ruble strength may be indeed undesirable. Economy and financial system already paid the price for ruble devaluation in terms of instability and inflation pass-through. Recent ruble strength won't unwind those effects. Once the price was paid it makes no sense to reaping the benefits in terms of higher economy competitiveness, stronger current account and more stable budget. That said, medium term inflationary risks are still there.

Trading implications are probably as follows:

1) The lows in USDRUB are probably behind us if oil doesn't rally massively or at least the lows in OILRUB. It makes sense to expect USDRUB above 60 again over coming weeks.

2) The end of Eurobond carry rally. The hike is clearly the sign that massive influx of local banks' money into Russia 30 was not desirable effect. Probably, besides Russian banks many free-riders among international investors also joined the Eurobond rally recently. FX-REPO rate hike is a good reason to take profit there.

3) Rollercoaster in FX-implied curve and basis. Initial reaction in FX-implied curve is widening, XCCY basis is also moving higher on the back of ruble weakness. O/n premium internationals have to pay over local market also doesn't help. Nevertheless, any further widening I would use as an opportunity to sell both. More expensive and less ample CBR FX lending is likely to lead to somewhat negative RUONIA-basis and cheaper o/n on MoEx swaps over coming months. It's not yet clear that o/n on internationals will follow local market 1 to 1 but I still assume that there is reasonable link between those two markets as ruble liquidity flows not only via narrow interbank lines but via corporate business flows as well. So unless there is capital controls two markets cannot be completely segregated. Moreover, ruble liquidity is likely to improve soon with the start of new month.

Thoughts & Ideas

Potentially we may see the end of Eurobond rally, peak of ruble strength is also probably behind us. It makes sense selling on spikes short-end FX-implied rates and XCCY basis.

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