

EM Hedging Recommendation

We recommend hedging RUB exposure

Rouble market performance has surprised us in recent months

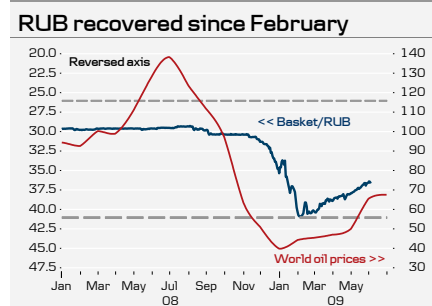
- Improved risk sentiment and rising oil prices have pushed the rouble up by more than 11% against the dual currency basket since the beginning of February.
- Furthermore, short-term rates have dropped with the liquidity situation improving and investors betting on lower inflation. The Russian central bank (CBR) supported the market by lowering the floor on short-term repos and refinancing rates. However, in reality, the CBR has very limited influence over short-term rates, which are mainly liquidity driven. Hence three-month MosPrime rates almost halved to 12.3%.

Rouble risks are skewed to the downside going forward

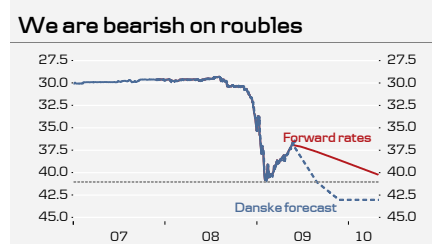
- The chairman of the CBR said last week that further rouble appreciation would be a cause for concern. We do not think the rouble will be allowed to appreciate much further from here. So, should sentiment continue to be rouble-positive (higher oil prices and positive global risk appetite), we think the CBR would probably continue to intervene in FX markets to keep the rouble fairly stable. In fact the CBR already bought USD/RUB corresponding to USD17bn in May alone to stave off appreciation.
- Should global sentiment turn more negative perhaps by events in CEE – e.g. concerning Latvian devaluation fears – we would expect the rouble to come under pressure. The CBR has measures to support the rouble – with FX reserves around USD404bn – but we think the central bank will be conservative in using them due to a need for a large FX reserve buffer.
- A large buffer is needed due to huge refinancing needs of foreign currency liabilities within the corporate sector as well as sharply declining public revenues. More than USD200bn worth of foreign FX debt is due to mature in 2009 and 2010, and that could create some financial distress, due to a rising number of defaults, which will raise Russian banks' need for more capital. The S&P ratings agency recently published a report saying that Russian banks will struggle with large losses in the coming years. This would potentially be a threat for the rouble.
- Oil prices have rallied strongly in recent months and we look for a downward correction in oil prices the coming weeks/months. This would exert downward pressure on the rouble.
- Inflation is still an issue for Russia. In fact, Russia has had very high inflation compared with its neighbouring countries in the past decade. Consumer prices are currently rising at around 13% y/y and inflation rates will only drop slowly. The next set of inflation numbers is due out on 5 June – we expect inflation to stay above 12.5% y/y in May. That overall points towards an overvalued rouble.

Our recommendation

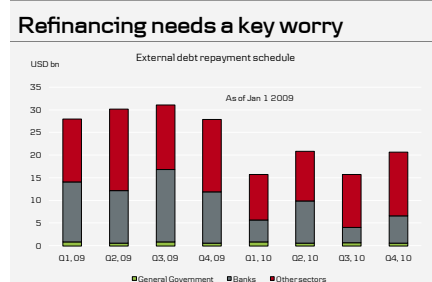
- Based on a strong rouble, lower interest rates and rising event risks stemming from the Russian corporate sector, **we recommend hedging rouble exposure on a 3-12 month horizon.**



Source: Reuters Ecowin



Source: Reuters Ecowin and Danske Markets



Source: Reuters Ecowin

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Disclosure

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