MV Capital Management Weekly Market Flash

Russia: The Economic Cost of Geopolitics

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It's not a good time to be a consumer in Russia, particularly if that consumer is drawing her salary in the local currency. Since the beginning of 2014 Russia's currency, the rouble, has declined by more than 30% against the U.S. dollar. In the past week alone it has fallen by more than 7%. The Bank of Russia, after spending $30 billion in October to defend the currency, is for the moment throwing in the towel and allowing market forces to take over. That may bode worse still for the local economy, and potentially beyond to other markets.

In Russia's consumer economy a currency depreciation against the dollar or euro shows up nearly instantly on grocery and department store shelves. A bottle of milk that cost 100 roubles in January may fetch 130 roubles today. Local employers, on the other hand, are not so wired into currency trends. The rouble-denominated salary of our consumer, staring at the 30% hike in dairy prices at her local Okei (a popular grocery chain), probably hasn't changed at all over the course of the year. In a very real way, the relatively far-off conflict that began in the Crimea and spread to eastern Ukraine is showing up in the daily lives of Russia's large, recently vibrant middle class.

Old Story, New Twist

This is by no means the first time that Russia's financial system has seriously malfunctioned. In 1998 the Bank of Russia, the central bank, sharply devalued the rouble and the Russian government defaulted on its sovereign debt. The ensuing selloff of Russian assets was the critical factor in the collapse of vaunted hedge fund Long Term Capital Management, which required a major intervention by the Fed, Treasury Department and a coterie of Wall Street banks to stave off a financial pandemic. Capital fled Russia during the global 2008 financial crisis as well.

But there are important differences this time around, principally geopolitics and growth. Since the annexation of the Crimea earlier this year, relations between Russia and the West have grown increasingly antagonistic. Western sanctions are beginning to have an effect on the local economy and in particular the operating functionality of the financial system. Russian sanctions have also had a negative impact on foreign companies active in the region, including McDonald's and Schlumberger among others. Then there is oil. Russia is the world's largest oil exporter by volume, and the economy is largely dependent on hydrocarbons. The near-30% decline in oil prices since June has laid bare the lack of a diversified economic base to contribute to growth in a weak price environment.

Deep Impact?

It is hard to measure the extent to which Russia's woes have the potential to create severe problems elsewhere, but it would not serve one well to be overly complacent. Russia is one leg of the BRIC economies, the large emerging market growth engines also including Brazil, India and China. What happens in the BRICs matters elsewhere in the world. Brazil is also facing some stiff economic headwinds, though not of the magnitude of Russia's. China and India are doing relatively better, but growth trends are below recent norms. All of which is not to mention the dicey macroeconomic climates in Europe and Japan.

Our concern is that a long-tail event – a collapse of the rouble, sovereign debt default or something of a similar impact – could trigger enough instability elsewhere to jeopardize the still-fragile global recovery. We believe such an event has a fairly low probability. But they do happen. As sentinels of your capital, we need to be on guard.

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