

Dispatches from Russia: Lights at the end of the tunnel?

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For professional investors only



Hugo Bain, Senior Investment Manager,
Pictet Asset Management

Ukraine and pro-Russia rebel forces agreed a ceasefire on September 5, the first step towards ending a five-month conflict in eastern Ukraine. But the United States and Europe have imposed fresh sanctions on Moscow in a bid to put further pressure on President Vladimir Putin. How is the country dealing with the effect of Western sanctions and how do ordinary Russians view Putin's moves? In this commentary, Pictet Asset Management's senior Russian equity investment manager Hugo Bain discusses the findings from his trip to Russia, where he discovered that the situation is not quite as bad as the gloomy headlines suggest.

It was the most united Russia I've ever seen in my 15 years as an emerging market investment professional. Despite the bleak headlines in the Western press, I got the sense ordinary Russian people are standing behind President Vladimir Putin, genuinely concerned that the West is threatening what they see as their country's legitimate security interest. Putin's approval ratings still fly high at 84 percent, near a record peak hit in early August.¹ With one of the lowest unemployment rates in history and improved standards of living, it seems that political issues matter more to Russian people right now than economics.

Putin's endgame

In meeting with officials close to the government's strategy, we were told that Russia, or rather Putin, has no pre-determined goal in relation to Ukraine. He is making quick and opportunistic decisions; the decision to annex Crimea, for instance, was apparently shaped within two to three days. Another important thing to note is that Putin is clearly deciding these things on his own, and takes guidance from only a very small circle of advisors. This makes it difficult for us to make long-term forecasts. I got the impression however that Putin wants a federal Ukraine, with autonomy for the eastern part of the country and a veto on all strategic decisions affecting it – such as a NATO membership.

But for all his autocratic tendencies, I did learn from meeting key officials that Putin does care about opinion polls, mindful that former President Boris Yeltsin's approval rating plunged to 2 per cent from 67 per cent between 1997 and 1998 before his resignation. The current high approval rating means Putin is free to pursue his political and strategic aims right now, but this could change quite quickly.

Flat growth, sticky inflation

There is no doubt the country's economy is suffering. Gross domestic product had contracted in annual terms in June and July as capital outflows surged and investment slumped. There is a concern about a recession but we think economic growth should be flat in 2014.

Inflation continues to be a problem – the country is likely to overshoot its inflation target of 5 per cent by a wide margin this year. Ironically, I found that it was more Russia's own retaliatory measures, rather than Western sanctions, that have affected the economy the most: during the trip, I heard that Moscow's ban on Western food imports in August has led to price increases of up to 20 per cent for chicken in rural areas. The impact of food import bans is expected to add 1.5 percentage points to inflation this year. It seemed to me an immediate effect from Western sanctions was limited as they have not directly targeted the country's dominant energy exports. I was rather struck, however, by the lack of thorough contingency planning among economic officials. Those I met largely played down the impact of Western sanctions, and they appear to give no consideration to the risk that sanctions may drain liquidity in the financial market, leading to a bankruptcy of one of the weaker banks, which could pose systemic threats.

¹ Levada Center opinion polls cited by Moscow Times, Aug 28

Capital outflows – not a universally negative picture

The rouble has fallen more than 8 per cent against the USD this year, mainly as a result of capital outflows. However the flow picture is not as bad as it looks and it also seems to be stabilising. Russia saw USD74 billion of net capital outflows in the first half of this year. Of these, we expect USD12 billion have come from foreign currency demand among Russians who converted their roubles to dollars. As these dollars are sitting in domestic bank accounts, they can be easily exchanged back to the rouble when risk aversion eases. In the third quarter, net private capital outflows are expected to be about zero.

Grounds for optimism

Given the weakening rouble, we've found a curious trend developing: risk-averse Russians are converting cash into real assets, buying up domestic property and pushing up house prices. Moscow house prices increased by 3 per cent on the year and in St Petersburg by 6 per cent in rouble terms; new mortgage loans issued have risen 42 per cent so far this year.

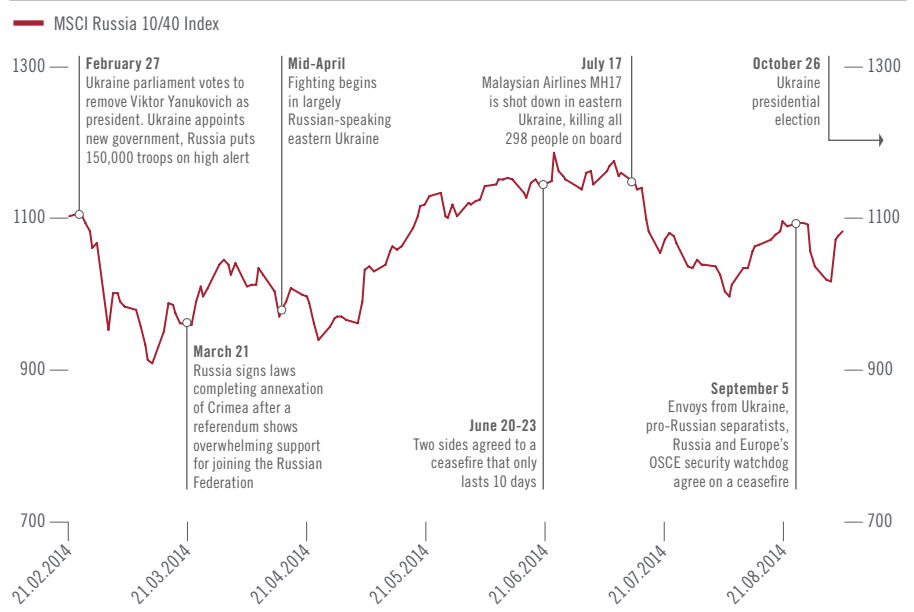
Rouble depreciation is also a boon for Corporate Russia, where energy, steel and mining industries dominate. Exporters account for more than three quarters of the benchmark MSCI Russia index. According to our models, the rouble is undervalued by 23 per cent against the USD.

Government capital investing is also expected to recover next year; officials we spoke to signalled that one of Russia's largest companies was about to see a major public investment - an infusion they said would be so substantial that it could raise Russia's GDP growth rate by 0.5 percentage points.

An additional plus is a favourable crop forecast. Thanks to good weather conditions, the agriculture ministry has upgraded its grain harvest forecast to above 100 million tonnes this year, up from around 70-80 million last year. This will also help ease pressure on the economy.

There is no doubt we will see volatility over the next few months, especially ahead of Ukraine's presidential election in October. But the ceasefire deal may mark the beginning of an end for the conflict – the deal, if it holds, can have a profoundly positive effect on Russia's economy, a scenario which is yet to be discounted by investors. Any easing of geopolitical tensions can be expected to boost Russia's stock markets, which are among the cheapest in the world as they trade at a huge 70 per cent discount to benchmark global stocks and at 62 per cent discount to broader emerging equities.²

TIMELINE OF THE UKRAINE CRISIS



² MSCI Russia index against MSCI All-Country World index and MSCI Emerging index as of 15.09.2014. Source: Thomson Reuters Datastream

Portfolio positioning – emerging market bonds, emerging market equity, developed market equity

Sovereign emerging market debt

We are defensively positioned or underweight in both hard and local currency bonds in Russia. We are underweight the Russian rouble and neutral to underweight duration in rouble-denominated debt. Our cautious stance had a positive effect on our portfolio as the escalation of tensions between Russia and the west pushed the rouble down almost 4 per cent in August alone.

We hold no quasi-sovereign Russia bonds as they tend to underperform in periods of stress and are seen to be more severely affected by sanctions.

We remain cautious about Russia's economic outlook. On the political front, a quick resolution to the crisis in Ukraine is unlikely. Our portfolio remains relatively liquid and easily tradable so that we can look at larger active positions.

Emerging market corporate debt

Given the uncertain outlook, we have concentrated our exposure in Russia by investing in companies that are of strategic importance to the Putin government and therefore most likely to be supported should economic and financial conditions deteriorate. The fund is currently overweight Russia but we do not have any exposure to the companies targeted by the sanctions. We continue to invest on a company by company basis.

Emerging market equity

We have trimmed our exposure to Russia in recent months to hold slightly above the index weight. While we remain comfortable with both company and country fundamentals in Russia, the situation in eastern Ukraine is changing rapidly and it is difficult to see a positive mood returning to the Russian market in the very near term. If we see tensions ease, investment opportunities could emerge quickly as the market is both attractively-valued and under-owned by international investors.

European equity

We hold a slightly overweight stance in Russia relative to the benchmark index. While Russia's valuations are attractive, the geopolitical situation and the likely impact of financial sanctions are very difficult to quantify. We prefer to take advantage of Russia's attractive valuation through our European holdings, for example in the financial sector, where we feel more comfortable about the safety of capital.

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Pictet Asset Management Limited
Moor House
120 London Wall
London EC2Y 5ET

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