

# Dispatches from Russia: an unlikely land of opportunity

IN BRIEF

OCT  
2016

Hugo Bain, senior investment manager at Pictet Asset Management, reports on his recent trip to Russia, where the green shoots of economic recovery eclipse Moscow's strained relations with the West. He argues that the combination of solid growth prospects, looser monetary policy, a competitive exchange rate and low equity valuations create a sweet spot for investing in Russian equities.

HUGO BAIN  
SENIOR INVESTMENT  
MANAGER



Hugo Bain joined Pictet Asset Management in 2009 as a Senior Investment Manager in the Emerging Markets Equities team, specialising in Emerging Europe and Russia.

Before joining Pictet, he spent five years with Fleming Family & Partners Capital Management LLP (FCM) and was a founding partner and co-manager of the FCM European Frontier Fund. He began his career in 1997 at ING, where he remained until 2002 as Head of Russian, Emerging Europe, Africa and Latin America Sales. In 2002 he joined Merrill Lynch as an EMEA Sales Specialist.

Hugo has an MA in Modern History from the University of St Andrews.

Even after enduring two years of sanctions, Moscow feels vibrant, with few signs of recession. The restaurants and shopping malls are full, and every time I visit it feels more and more like a wealthy Western European city. Russia may remain in the cold politically, but things are definitely warming up for the economy – and thus for investment prospects.

### **A very good crisis**

Sanctions did affect sentiment, but I feel the economic impact has been negligible. What has hurt, clearly, is the massive fall in oil prices, which collapsed from well over USD100 a barrel in mid-2014 to less than USD30 at the start of this year.

As this coincided with the long-planned end of the ruble's soft peg to a euro-dollar basket in late 2014, it meant the currency took most of the strain of the oil price adjustment. In some respects the timing of the float could not have been more advantageous, as it acted as a kind of safety valve for the economy.

However, this hurt many ordinary Russians, who found they could no longer afford holidays abroad and had to cut back on a wide range of imported goods. There has been a significant decline in real disposable incomes over the past two years. Consumer-focused companies have had a difficult couple of years as a result.

On the flip side, energy companies are in pretty good shape. The depreciating ruble eased the pain of falling crude prices for Russia's oil and gas giants, making their production costs very competitive. In the end, despite the oil market collapse, Russia's economy contracted by just 3.7 per cent last year and the employment market has remained stable throughout. So, all things considered, I think you could say in retrospect that Russia had a very good crisis. This is the third crisis that I have witnessed since I started looking at Russia in 1997 – and this one felt the least detrimental, so maybe practice makes perfect... I would argue that investors should give some credit to Russia for prudent fiscal and monetary policy, and that evidence of this prudence should have a positive effect on equity prices through a lower risk premium.

### **Rate cuts on the cards**

The economy has now troughed; forecasts for next year's gross domestic product growth range from the government's conservative 0.6 per cent (based on USD40 oil) to Goldman Sachs's 2.5 per cent, with further acceleration expected in 2018.

Notably, this recovery started without help from the central bank, which – mindful of a history of runaway inflation – had been very hawkish until this summer. Only after a steady easing of price pressures did the central bank decide to lower interest rates. This year's two cuts should be followed by more next year.

Easier monetary policy, in turn, should help support consumption. Russians with spare cash are already struggling to find where to put it. Last year, they could get 18 per cent interest from a reputable commercial bank; on my recent visit it was just 6-8 per cent. It seems highly likely to me that, as rates come down, you will see a significant decline in the savings rate and an increase in consumption. Some domestic funds may find their way into the equity market, particularly as the dividend yield is now close to the deposit rate.

### **Oil: not too high and not too low**

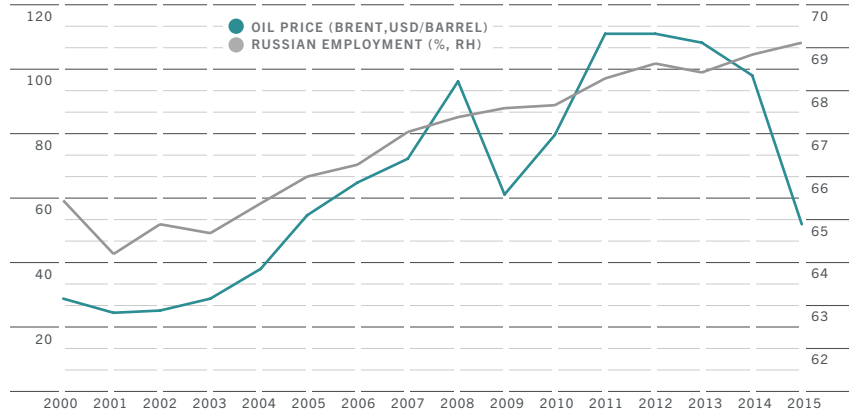
Of course, Russia's outlook remains closely tied to the price of oil.

I have always believed that a very high oil price is a cause of economic inertia and corruption in Russia. There is simply no impetus for structural reform.

The ideal scenario would be if oil stabilised around USD45-65 a barrel for the foreseeable future. That would be high enough to support decent economic growth, but low enough to ensure a degree of fiscal prudence, and to maintain pressure on the authorities to push through structural reforms.

FIG.1

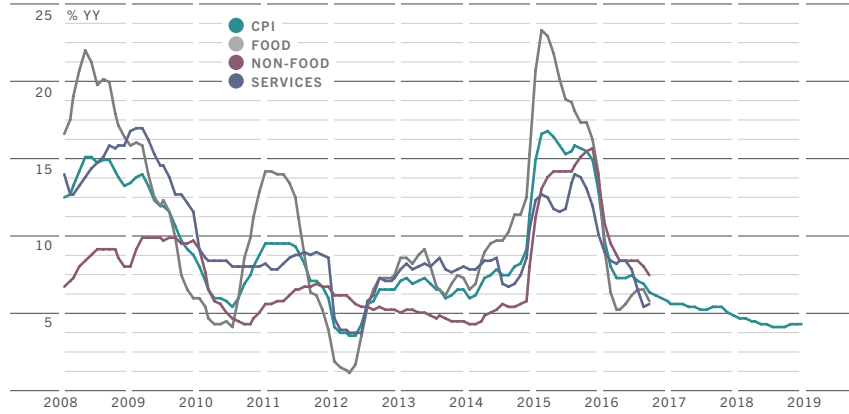
Russian employment rate versus the oil price



Source: Rosstat, Thomson Reuters

FIG.2

Inflation easing on all measures



Source: Rosstat, Renaissance Capital

Employment in Russia has continued to grind higher despite the recent collapse in the oil price

The downward trend in inflation should enable more interest rate cuts in the coming months

### Investment sweet spot

Investors are slowly waking up to the opportunity presented by Russia's recovering economy and competitive exchange rate. First comers have already been richly rewarded, with the stock market up nearly 35 per cent since the start of the year in local currency terms. However, stock valuations and dividend yields remain extremely attractive (MICEX trades on a price-to-earnings ratio of 9.8 times and a dividend yield of 5.8 per cent, versus S&P 500 on 24.8 times and 2.0 per cent). I think that we are very much in the sweet spot for investing in Russian equities.

Corporate balance sheets are in good order. There are some exceptions where we see higher leverage, mainly in the energy sector, but this borrowing is offset by very strong free cash flows. We would expect corporate Russia to continue to decrease the levels of net debt, from already low levels in the next few years. From the Russian food retailers,

where you still see EBITDA margins of 10 per cent, to the oil giants, which are some of the lowest cost producers in the world, or the materials companies, there are no signs of distress.

Energy companies and miners are reaping the rewards of ruble depreciation through low costs. Oil production is at historic highs and even if the government raises taxes for the sector, which it may well do, companies should still have plenty of cash leftover to pay attractive dividends.

Interestingly, even during the fall in oil prices, energy companies retained their appeal among investors, particularly those from China and Japan. Since the start of 2015, Russian corporations have secured some USD32 billion of funding (mainly in the oil sector) and a further USD7 billion in M&A investment from Asia.

On the domestic front, the real estate sector should do well, with interest rate cuts providing a double boost. On the one hand, the reduced appeal of holding money in a bank will likely encourage people to invest in property, as the dif-

ferential between rental income and deposit rates converges. On the other, affordability should improve as mortgage rates come down. The property companies I met with in Moscow say that demand could rise by 50 per cent or even more.

So, despite the ongoing political tensions with the West, the outlook for Russia's domestic economy is positive. As long as oil stays above USD40 a barrel, the return to economic growth, accompanied by looser monetary policy, should benefit asset prices. Stocks in particular are woefully under-owned, despite the recent rally. This means that there is still everything to play for in Russian equities – at least until the football World Cup and presidential elections in 2018.

---

## Pictet Asset Management

For further information,  
please visit our websites:  
[group.pictet](http://group.pictet)  
[pictetfunds.com](http://pictetfunds.com)

---

### Disclaimer

For professional  
investors only.

This marketing material is issued by Pictet Asset Management (Europe) SA. It is neither directed to, nor intended for distribution or use by, any person or entity who is a citizen or resident of, or domiciled or located in, any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation. Only the latest version of the fund's prospectus, KIID (Key Investor Information Document), regulations, annual and semi-annual reports may be relied upon as the basis for investment decisions. These documents are available on [www.pictet-funds.com](http://www.pictet-funds.com) or at Pictet Asset Management (Europe) SA, 15, avenue J. F. Kennedy L-1855 Luxembourg.

The information and data presented in this document are not to be considered as an offer or solicitation to buy, sell or subscribe to any securities or financial instruments. Information, opinions and estimates contained in this document reflect a judgment at the original date of publication and are subject to change without notice. Pictet Asset Management (Europe) SA has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor and this document is not to be relied upon in substitution for the exercise of independent judgment. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Before making any investment decision, investors are recommended to ascertain if this investment is suitable for them in light of their financial knowledge and experience, investment goals and financial situation, or to obtain specific advice from an industry professional.

The value and income of any of the securities or financial instruments mentioned in this document may fall as well as rise and, as a consequence, investors may receive back less than originally invested. Risk factors are listed in the fund's prospectus and are not intended to be reproduced in full in this document.

Past performance is not a guarantee or a reliable indicator of future performance. Performance data does not include the commissions and fees charged at the time of subscribing for or redeeming shares. This marketing material is not intended to be a substitute for the fund's full documentation or any information which investors should obtain from their financial intermediaries acting in relation to their investment in the fund or funds mentioned in this document.

© Copyright 2016  
Pictet – Issued in  
October 2016.