TKB INVESTMENT PARTNERS

Flash note

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Why Russian equities outperformed emerging markets in H1 2019?

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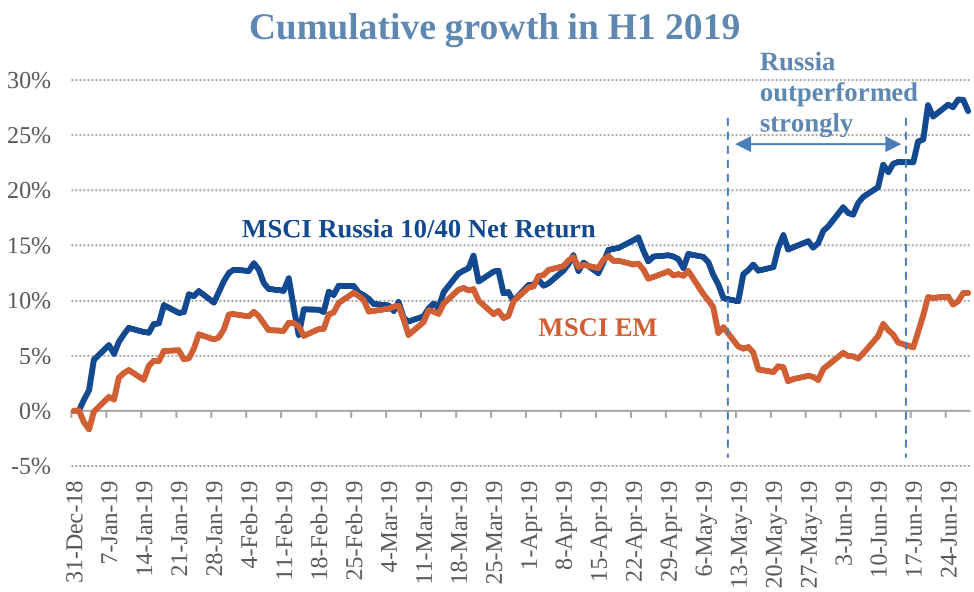
The MSCI Russia 10/40 Net Return index has risen by 27% over the first half of the year in US dollar terms. It **outperformed MSCI EM by 16%** mainly due to the following:

1) **Partial realisation of dividend-related positive optionality in May and June**. We wrote about this optionality in February (pages 2-3 of the Russian market outlook). We think that over the next several years, some of the Russian companies are likely to generate much more cash than their expected dividends. There is a significant room for increasing dividends or buybacks for these companies.
2) **Fewer worries about US sanctions.** US removed three Russian companies from the Specially Designated Nationals (SDN) sanctions list. This is the first such exclusions since sanctions against Russia began. US Special Counsel Robert Mueller's report indicated no material interventions by Russian state in the US presidential election in 2016.
3) **The Central Bank of Russia (CBR) restarts cutting rates**. The regulator cut its key rate in June and hinted that there could be further cuts in future.

We consider these Russia-specific factors to be structural in nature:
Partial realisation of dividend-related positive optionality in May-June. Russian equities materially outperformed broader EM equities between 10 May and 14 June (see graph below), largely due to one of the Russian index's heavyweight names, **Gazprom, whose stock rose by 43%** in US dollar terms over this period.



in USD terms; total return
Sources: Bloomberg, TKB Investment Partners, July 2019

In April, Gazprom's management proposed a record dividend for 2018 of RUB 10.4 per share. **On 14 May it announced a 60% hike in its dividend** vs. the April figure. During the last week of May, Gazprom said it **is set to revise its dividend polic**y by the end of this year, with the aim of maintaining its **dividend pay-out ratio at 50%** of its IFRS net profit. For several years **before 2018, the ratio was around 20%-25%** in most cases.

The positive surprise concerning Gazprom's dividends sparked **an interest in other state-controlled companies** Inter RAO, Sberbank and VTB, all of which have the **potential to materially hike their dividend pay-outs**. With the market appearing to believe that there is now a higher probability of dividend hikes occurring, the stock prices of these companies **rose by 13%-24% over the period**.

Fewer worries about US sanctions:

- On 27 January, the **US Treasury Department removed Rusal, En+ and EuroSibEnergo from the SDN sanctions list**. The regulator took this decision on 19 December 2018, giving the US Congress a 30-day notice period to block it, which it failed to do. This news further **supports our conviction that there is a low risk of material sanctions against Russia.** The US authorities are taking into consideration the possibility that sanctions could backfire. Please see our flash-note for more details.
- **US Special Counsel Robert Mueller's team concluded that there was no conspiracy between Mr. Trump or his team and the Russian state during the 2016 elections**. There was no significant Russian interference into US democracy. We believe **this has reduced the probability of material sanctions against Russia**.

The CBR restarts cutting rates.

The CBR cut its key rate by 25bp to 7.50% in June. The main reasons were: 1) a fall in short-term inflation risks; 2) lower-than-anticipated inflation; 3) the rouble being more stable. Since February, monthly inflation rates have been around 4% in annual terms adjusted for seasonality. Overall inflation in annual terms has been contracting. The CBR **hinted that a further reduction of the key rate is possible later this year**, and that it intends to cut the key rate to a neutral level of 6%-7% by mid-2020.

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