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Will Russia outperform EM?
Focus on Russia-specific factors

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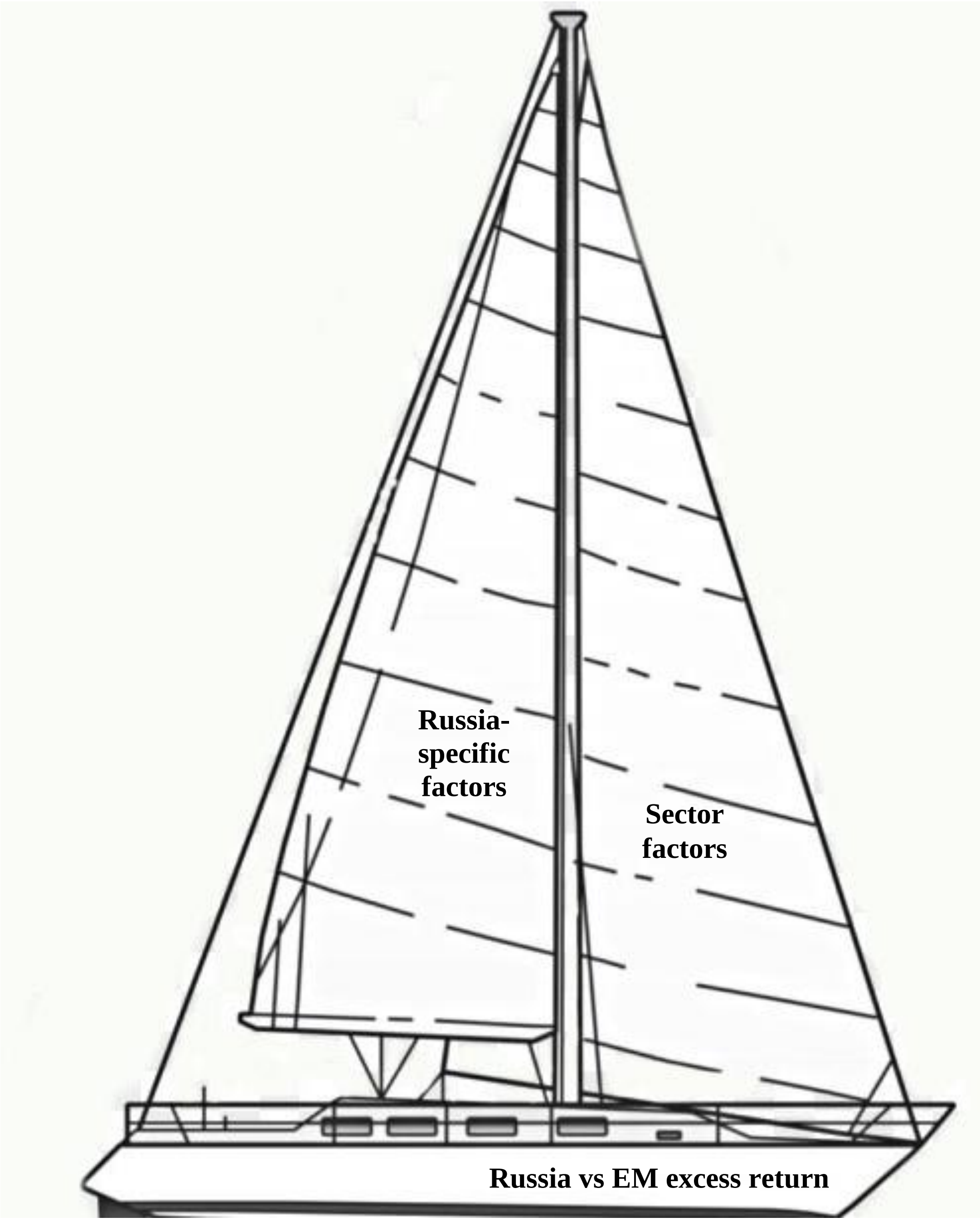
We admire people who make decisions about asset allocation across equity markets of different countries. It is much more difficult than stock-picking within one particular country. When considering stocks from just one country, it is more likely that an investor will find a materially mispriced stock than a materially mispriced sector. At the sector level, the upside potential from undervalued stocks is cancelled out to some extent by the potential downside from overvalued stocks. Equally, material mispricing is more likely to be found in a particular sector than for a country overall. At the country level, the upside potential from undervalued sectors is cancelled out to some extent by the potential downside from overvalued sectors. There is also a need to somehow compare the unique risk factors that pertain to different countries, as well as to assess exposure to various global and other influencing factors.
In this paper, we would like to provide you with some perspective on how to approach the question:
Will Russian equities outperform the broad emerging market (EM) equity index over a one-year period?

Types of factors influencing whether Russian equities outperform EM



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Occasionally we see an oil-dominant view on the Russian equity market's ability to outperform EM. Such a view assumes that if oil prices rise there is a strong chance that the Russian market will outperform EM and vice versa. However, this is shown not to be the case when we back-test it.
Oil prices did not move materially differently during the periods of Russian equity outperformance compared to the periods of Russian underperformance. Since the end of 2009 we calculated the excess return of the MSCI Russia 10/40 Net Return index over the MSCI EM index over moving 12-month periods in one month increments. Oil prices dropped in around 50% of the cases in both sub-samples when Russian equities outperformed or underperformed.

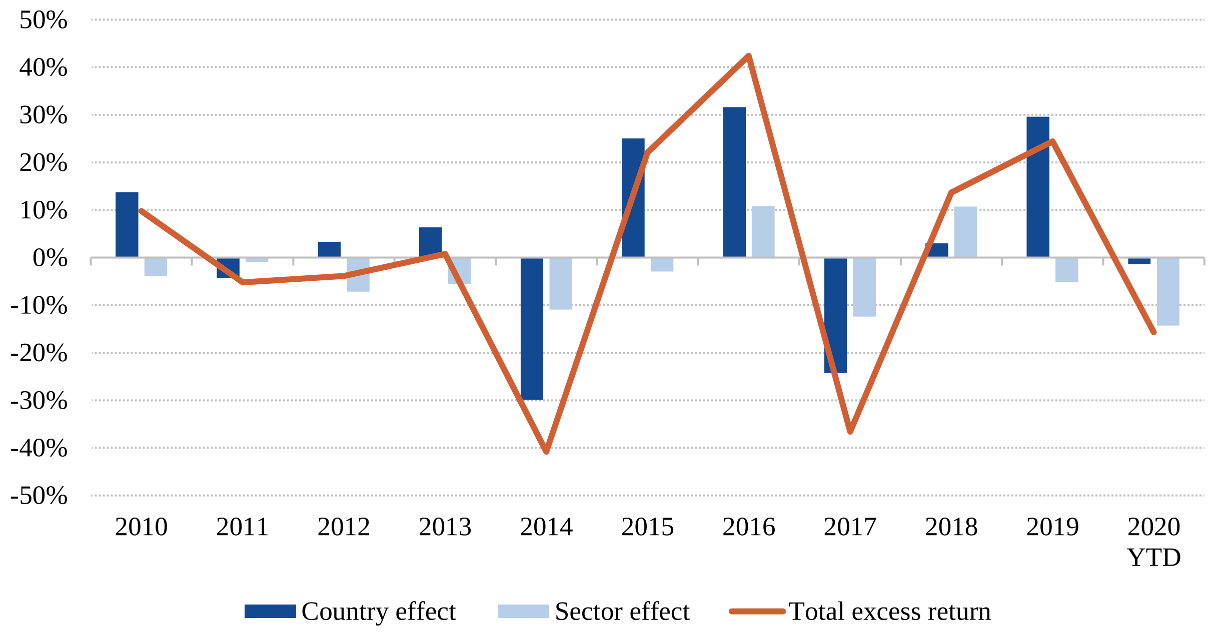
Table 1. Oil price drop and Russia performance vs EM

Russia vs EM	Share of periods when oil price dropped	Average oil price drop
Outperformance	50%	-23.4%
Underperformance	57%	-22.8%

Sources: Bloomberg, TKB Investment Partners, September 2020

If not the oil price, what are the key factors for Russian equities achieving an excess return over EM? Answer: Russia-specific factors.
The average contribution of Russia-specific factors to the excess return of Russia vs. EM in absolute value terms was 1 663bp on average over 2010-2019. The same figure for sector factors was less than half of that: 701bp. We constructed an index from the EM sector indices with the structure of MSCI Russia 10/40 Index. For example, we took the performance of the MSCI EM Energy index YTD and weighed it as 42.4%, MSCI EM Materials index performance was weighted as 28.3%, etc. We call this index MSCI EM Russia Weighted index or MSCI EM RW. The difference between MSCI EM RW and MSCI EM is the impact from the difference in the indices sector structures and global factors affecting various sectors, including oil prices. The impact from Russia-specific factors on the excess return of Russian vs. EM equities is equal to the difference between MSCI Russia 10/40 and MSCI EM RW.

Graph 1. Contribution to the annual excess return of the MSCI Russia 10/40 index vs. the MSCI EM index



Based on net return figures, USD terms, YTD as at 02.09.2020
Sources: Bloomberg, TKB Investment Partners, September 2020

Let us dig deeper into Russia-specific factors.

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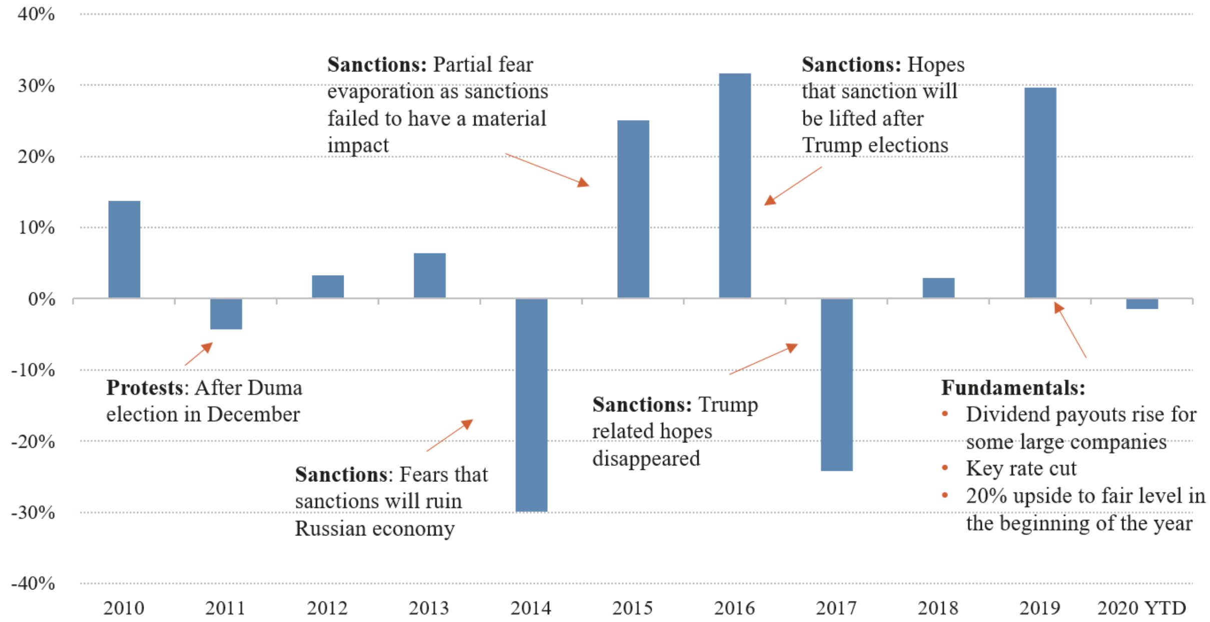
Russia-specific factors

There was a positive contribution from Russia-specific factors to the excess return of Russian vs. EM equities in 7 out of the last 10 calendar years.

Graph 2. Russia-specific factors contribution to the annual excess return of the MSCI Russia 10/40 index vs. the MSCI EM index



Note: Each year we estimate MSCI EM index return with sector structure like in MSCI Russia 10/40 – index EM Russia sectors. We take end of previous year sector structure of MSCI Russia 10/40 index and sector indices for EM: MSCI EM Energy, MSCI EM Materials etc. We calculate return of a sector EM indices portfolio with the Russia index sector weights. Country effect = MSCI Russia 10/40 net return – index EM Russia sectors net return. Net return – return including dividends excluding taxes on dividends. All figures are in USD terms. YTD as at 02/09/2020

Sources: MSCI, Bloomberg, BNP Paribas AM, TKB Investment Partners, September 2020

Sanctions were mainly responsible for the two out of three years when Russia-specific factors detracted from the excess return:

- 2014: Fears of the economic consequences of sanctions drove investors away from the market. The oil price collapse also played a role. The response of the central bank proved effective as the bank used only market tools to tackle the crisis. The national currency quickly became less volatile at the beginning of 2015. Investors realised the significance of sanctions was minor and their concerns began to evaporate. That led to Russia-specific factors making a positive contribution to Russian equities' excess return over EM equities in 2015.
- 2017: Donald Trump won the president elections in the US in November 2016, which led investors to believe in the possibility of sanctions being lifted. When such expectations were proved wrong, investor optimism faded, which led to an overall detraction by Russia-specific factors from the excess return over EM equities in 2017.

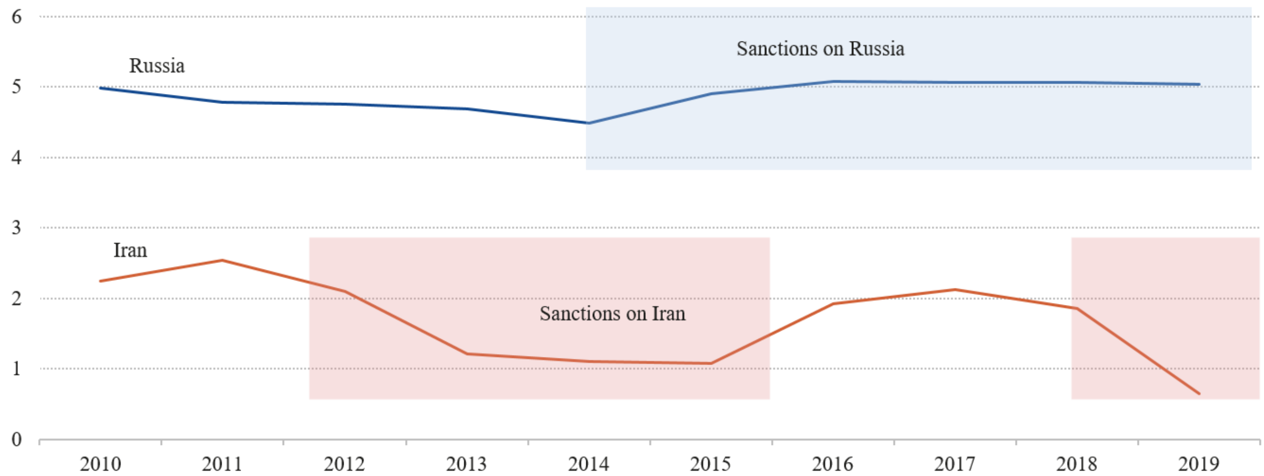
Currently, **the Russian market is not pricing in the possibility of sanctions being lifted**. This leaves us with two possibilities: A positive surprise should the sanctions be lifted partially/completely; or no consequences should they remain in place.

After Navalny poisoning and protests in Belarus the positive optionality has improved. The Russian market is already pricing the risk of additional sanctions against Russia. The crucial question is whether they are likely to be material? We do not think so.

We believe the introduction of material sanctions against Russia to be highly unlikely. Overall, **there were over 55 sanction actions against Russia by the US and the EU between March 2014 and July 2020.** The reason for these sanctions were annexation of Crimea, MH17 crash, Murder of Nemtsov, Skripals poisoning, etc. None of the sanctions affected Russia's ability to export commodities and **none has been significant.** Why? Any material sanctions are likely to have a dramatic boomerang effect on Europe and the US. The Russian economy is deeply integrated into the global one. Russia is the world's

second largest net exporter of crude oil and has approximately a 60% share of overall gas exports to Europe. It is one of the top 20 largest countries in terms of international trade volumes.
We think that **Navalny case or potential Russia intervention in Belarus affairs are far less significant reasons to impose sanctions on Russia than annexation of Crimea** and similar other reasons for sanctions which the US and the EU used since 2014.

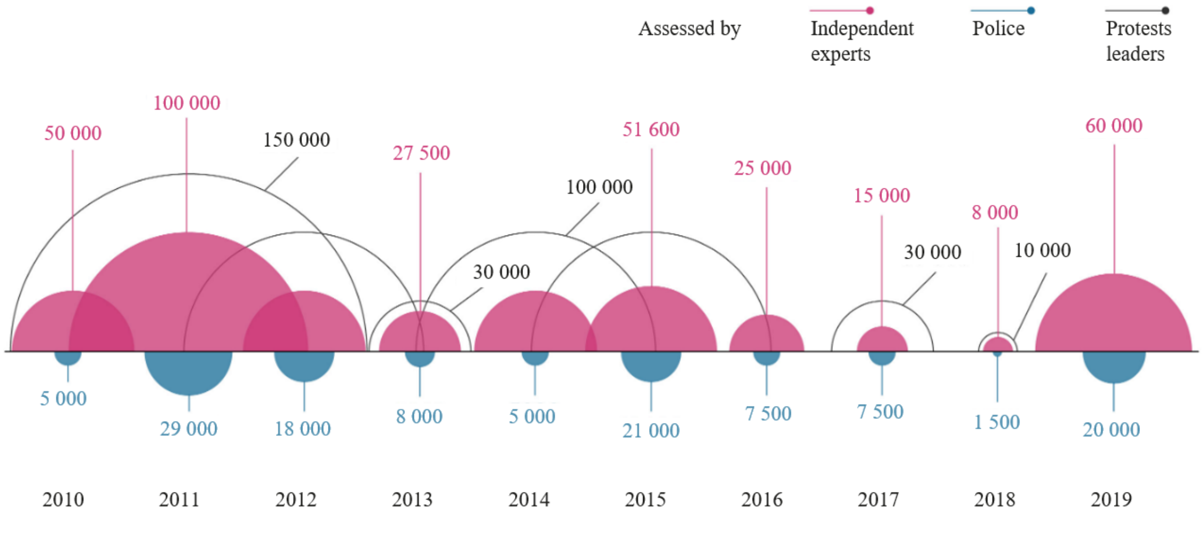
Graph 3. Daily crude oil export (in millions of barrels)



Sources: OPEC, CDU TEK, Kommersant.ru, TKB Investment Partners, September 2020

Local protest activity was mainly responsible for Russia market underperforming EM in 2011. On 4 December that year, there were Duma elections. The results sparked public protests. On 10 December, gatherings pushing "for fair elections" took place in many Russian cities. The largest was in Moscow at Bolotnaya Square, attended by between 29 000 and 150 000 people according to various estimates. Moscow's population was 11 million in 2011. At the time, the protest was seen as the largest opposition meeting during President Putin's era. Other gatherings occurred later the same month.

Graph 4. Number of people on largest protests in Moscow during 2010-2019



Sources: tvrain.ru, September 2020

For public protests to have an impact on Russia's equity market, they would need to be nationwide and to involve relatively high numbers of people going on the streets, preferably Moscow streets. **The next nationwide event will be the Duma elections in September 2021.** Between now and then, there is unlikely to be a trigger for a significant nationwide protest. It is hard to predict now, whether there will be reasons for people to go on streets after that Duma elections and how many people will be ready to do it.

Other than in 2011 and 2014-17, the main Russia-specific factors to influence the excess return of Russian equities over that from EM equities were economic ones. In all the remaining five years there was a positive contribution to the excess return from Russia-specific factors.

Firstly, let us consider how economic factors worked in 2019 – the year when they made the largest positive contribution to the excess return from Russia-specific factors. In 2019, some of the large Russian companies decided to increase their dividend pay-outs. For instance, Gazprom's 60% dividend hike in May led to a comparable rise in its stock value in May-July. There are similar instances among some other state-owned companies. In addition, the Central Bank of Russia (CBR) cut the key rate by 150bp, which was welcomed by the market. At the end of 2018, there was an upside of 20% to fair price for the Russian market, according to our estimations. This normally helps make Russian equities more attractive from a fundamental point of view than broader EM equities. Our base assumption is that EM equities overall should be at close to fair value, with any upside from undervalued stocks largely offset by downsides from overvalued stocks. All these three factors are likely to have a positive impact in the future.

Table 2. Key fundamental factors in 2019 and 2020

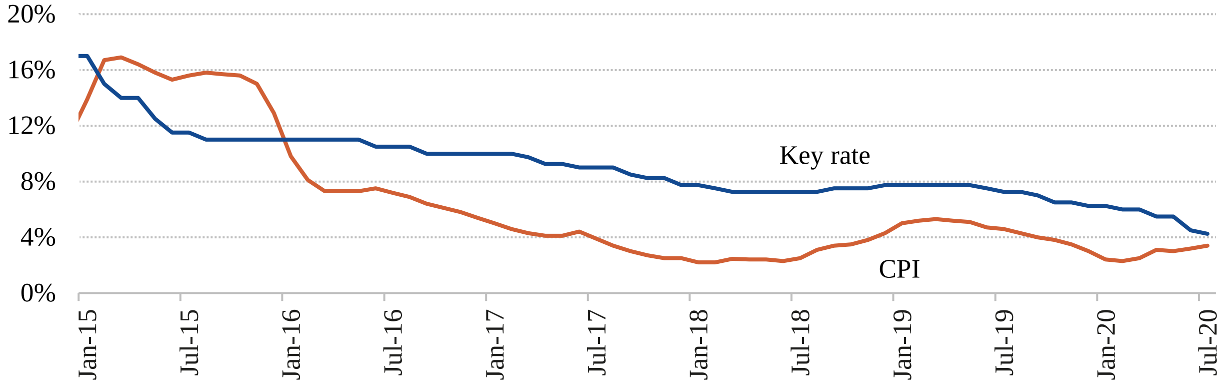
Russia-specific economic factor	2019	Now
Russian market upside to the fair price *	20% as at the beginning of the period	13%
Potential for dividend payout growth	High	Medium
Central Bank of Russia rate cut	150 bps – actual	25-50 bps – expected over next 12 months

* for MSCI Russia 10/40 index

Potential for dividend payout growth. Gazprom still pays dividends of less than 50% of its profits – it paid 30% for 2019. For many years, the Russian government has been pushing state-controlled companies to increase dividend pay-outs to 50%. We expect Gazprom to double its dividends over the next two-year period. Another gas producer, Novatek, also has the capacity to increase its dividends several-fold over the coming years. From power generator, Inter RAO, the pay-out is around 16%, even though the company could pay at least two times more than that given its ability to sustainably generate double-digit free cash flow yields. For steel producers, the potential for further dividends growth is limited. They have been paying out around 100% of their profits and it appears that this has resulted in under-investment, which they will have to address in the future.

Expected rate cut. Russia has kept inflation under control, which has allowed the CBR to move into a rate-cutting cycle without threatening capital outflows even during the current period of turmoil. So far this year, the CBR has cut its key rate by 200bp to 4.25%, its lowest rate yet. This is the first time in history that the central bank has cut the key rate during a crisis. In 2014, the CBR hiked the key rate by 11.5% in response to worsening market conditions. Its current policy is a result of many years of gradual improvements and of preparing the economy to be resilient to shocks. The CBR now has the capacity to act like a developed market central bank. The CBR governor, E. Nabiullina, has also hinted that further cuts are possible.

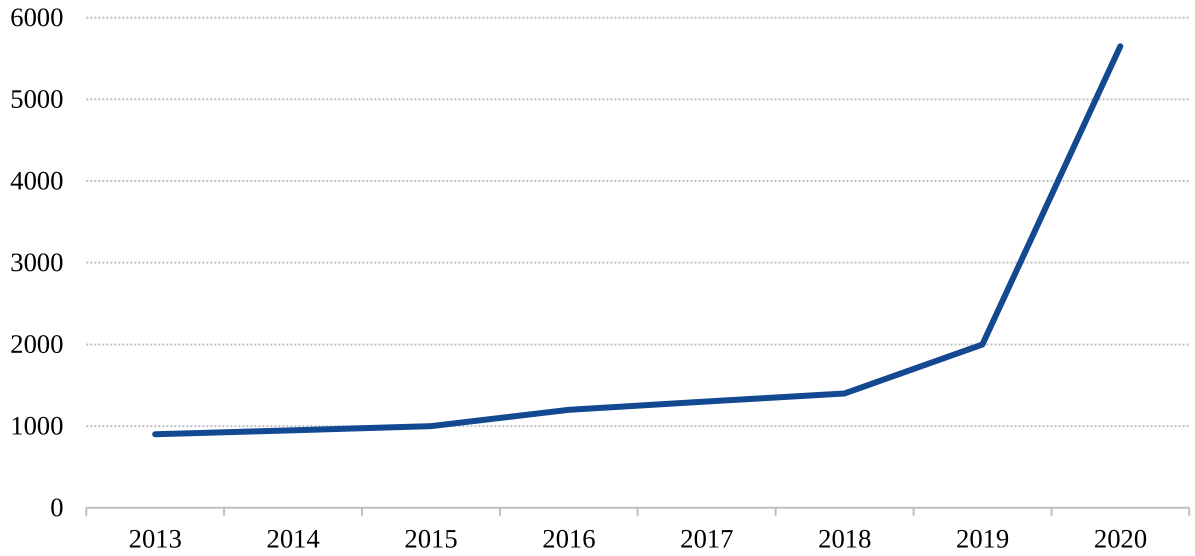
Graph 5. Central Bank of Russia key rate and inflation year-on-year



Data as of 31 July 2020
Sources: Bloomberg, CBR, TKB Investment Partners, September 2020.

Rising demand from private Russian investors. This factor did not have a material impact on the market in 2019. It has started to gain influence this year. The growth in demand for equities from Russian citizens – which we expect to continue long term – started to emerge when bond yields and deposit accounts in banks became less attractive due to the CBR's key rate cuts. **Since the beginning of this year, the number of private investors on the Moscow Exchange has increased by 32% to over five million.**

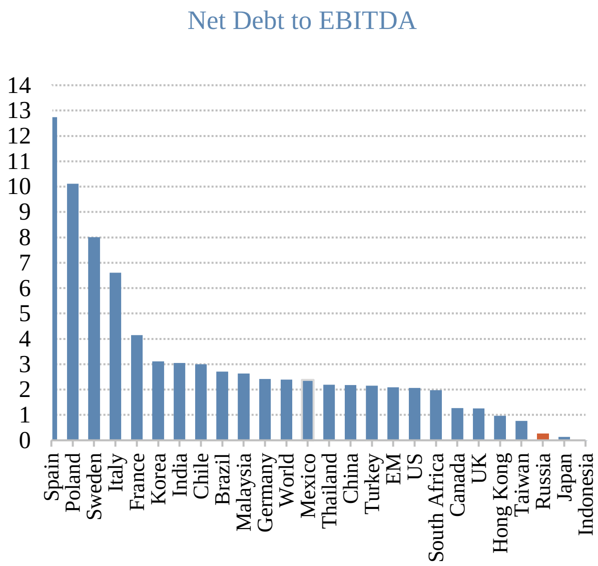
Graph 6. Number of individual brokerage accounts on the Moscow Exchange (in thousands)



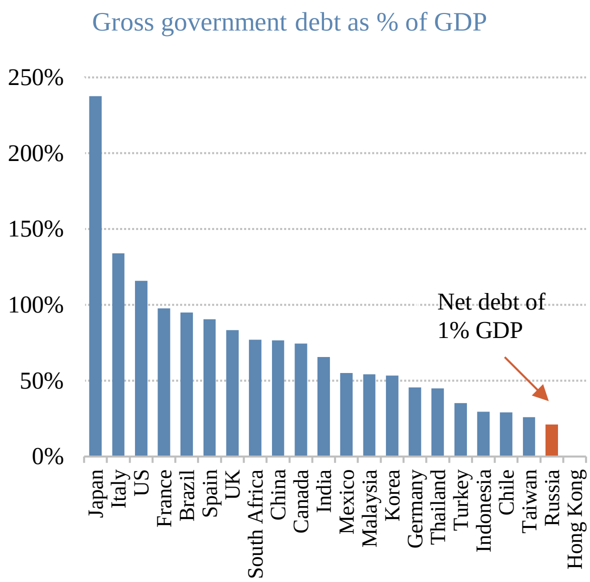
Sources: Moscow Exchange, Sberbank CIB, OECD, TKB Investment Partners, September 2020.

As for the risk scenario, Russia is well prepared for global turmoil.
Low debt. The Russian state's net debt equates to approximately 1% of GDP. In the MSCI Russia index, companies' average net debt is close to zero. Many companies have been reducing their debt over the last five years. For instance, oil producer Lukoil's net debt shrank by 94% from USD 10.4 billion in 2014 to USD 0.6 billion in 2019.

Graph 7. Corporate and government debt



Based on MSCI Indices. Data as of August 2020
Sources: Bloomberg, TKB Investment Partners, September 2020



Based on MSCI Indices. Data as of August 2020
Sources: Bloomberg, TKB Investment Partners, September 2020

Low production costs. Total costs for Russian oil producers are USD 9-10/bbl. They remained profitable even at the extremely stressed Urals oil price seen in March-April 2020.
Tight control over federal budget and material reserves. The Ministry of Finance currently expects the federal budget deficit for 2020 to equate to 5% of GDP. The National Wealth Fund had USD 174 billion in its reserves in July 2020 or 10.7% of GDP, which is sufficient to cover a federal budget deficit similar to this year’s for two years. In addition, there were cash transfers from the previous year’s budget of around USD 25 billion.

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