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Russian equities riding the long-term commodities growth trend

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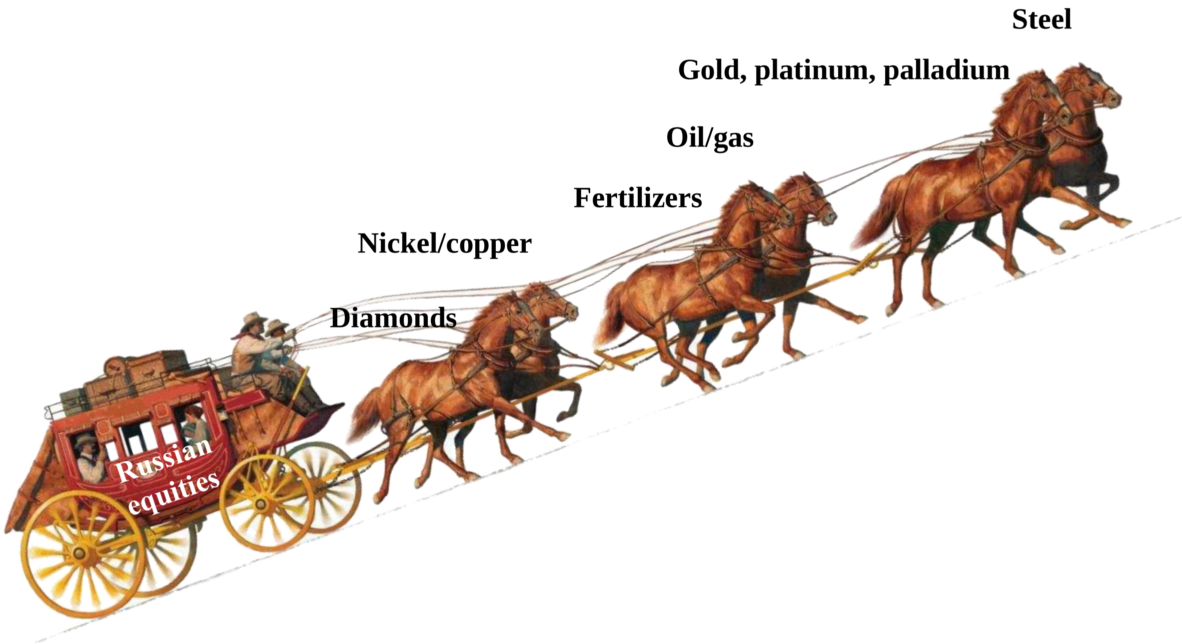
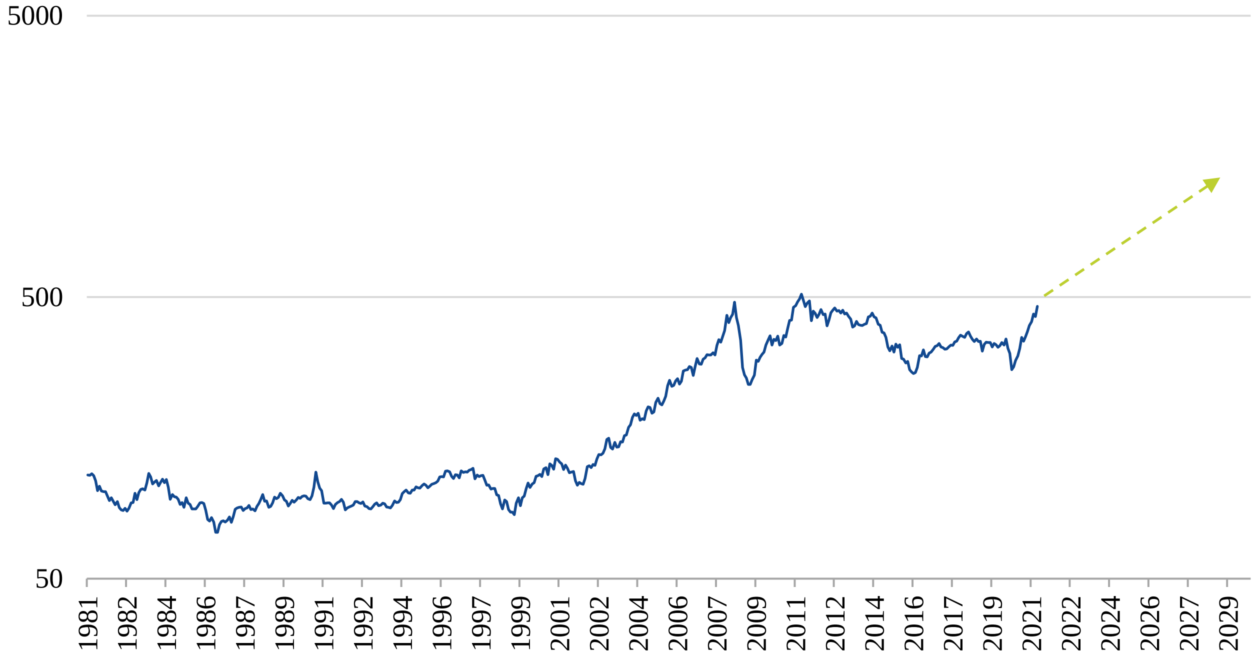


Exposure to long-term growth in commodities

It is possible that commodities prices will continue to rise for the next 5-10 years on the back of:

- Monetary and fiscal stimulus in the largest countries (1-2 years)
- The post-pandemic rise in spending (1-2 years)
- Underinvestment in various commodities sectors for many years (2-5 years)
- Global population ageing (decades)
- Growth of economies in Asia and Africa (decades).

Graph 1. Bloomberg commodity spot index (in USD; index points; log scale)



Source: Bloomberg, May 2021

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Monetary and fiscal stimulus in the largest countries

Economic stimulus could continue for another one to two years. Trillions of US dollars have been injected and spent by authorities in numerous countries, with further trillions on the way, according to recently announced measures. Major central banks are in no rush to hike interest rates. All this is likely to be pro-inflation, which is good for commodities prices.[1 2]

Table 1. COVID-19 response in top-5 largest economies

Country	Fiscal (USD bn, announced during 2020-2021)	Monetary policy rate (%)	Central bank balance growth since end 2019 (USD bn)
United States	5 739	0-0.25	3 657
China	992	3.85	575
Japan	1 754	-0.1	1 327
Germany	594	0 (EU)	3 879 (EU)
India	250	4	178
Total	**9 330**		**9 616**

Top-5 largest countries based on 2019 GDP in US dollars, representing 53% of world GDP.
Changes in central bank balance growth are up to the most recent figure as at 18 May 2021
Sources: IMF[3], BIS[4], TKB Investment Partners, May 2021

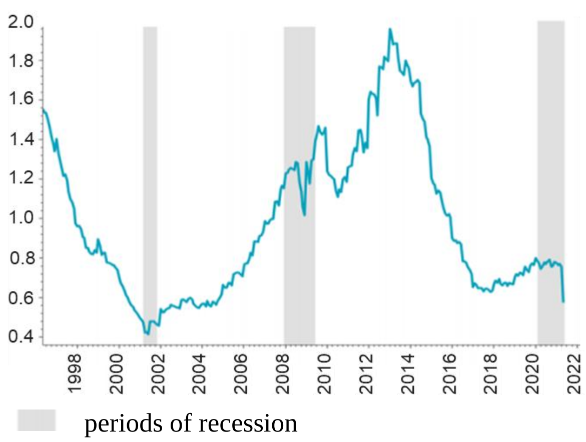
The post-pandemic rise in spending

Many experts predict this to happen. JPMorgan expects a USD 1 trillion rise in consumer spending per year once people return to post-COVID ‘normal’[5]. McKinsey’s research suggests that “more than 50 percent of US consumers expect to spend extra by splurging or treating themselves”[6]. Experts from the McKinsey Global Institute believe there is likely to be a rapid rebound of consumer spending once the world returns to normal.[7]

Underinvestment in various commodities sectors for many years

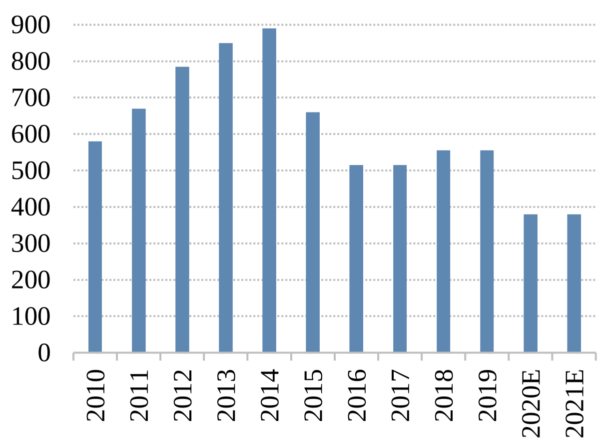
Experts from Shroders see the current situation as resembling that at the start of the century[8]. Underinvestment in commodities sectors in the 1990s was one of the key factors for commodities growth during the period from 2000 to 2007.

Graph 2. Global capex metals & mining (USD bn)



Source: Refinitiv DataStream, Robeco, May 2021

Graph 3. Global capex in energy sector (USD bn)



Source: Rystad Energy, November 2020

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Population ageing

Charles Goodhart and Manoj Pradhan in their book *"The Great Demographic Reversal: Ageing Societies, Waning Inequality and inflation revival"*[9] argue that future demographic trends will be pro-inflationary. The intuition behind their argument is that once the number of dependents (who do not work but do spend) grows faster than the number of workers, the environment becomes inflationary, and vice versa. In the coming decades, the dependency ratio (dependents to workers) is likely to grow mainly due to population ageing and slow work force growth.

Growth of economies in Asia and Africa

The expansion of Asian and Africa economies can help boost demand for commodities, just as the expansion of China's economy did in the period 2000-2007.

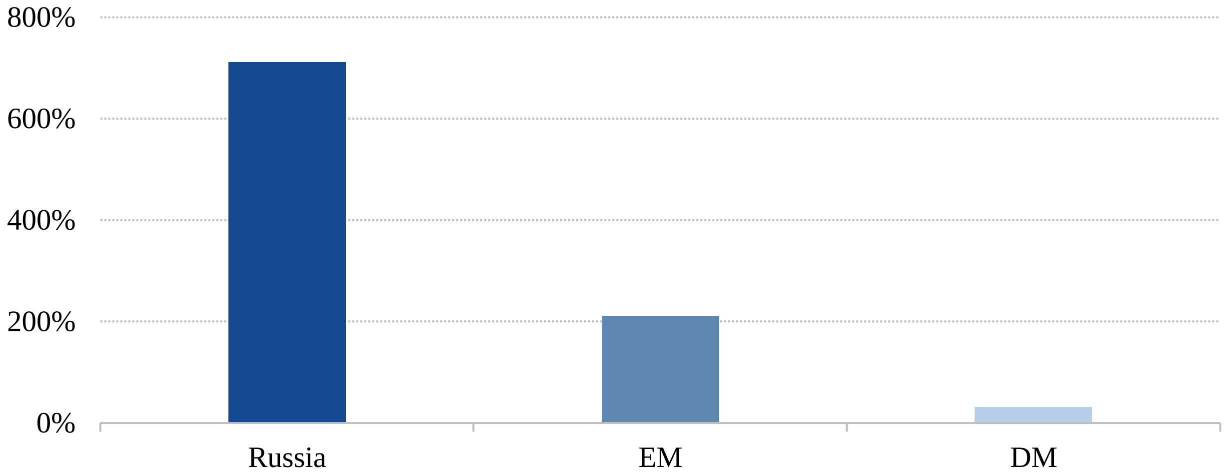
Table 2. Expected expansion of India's and Sub-Saharan Africa's share of world GDP in 2019-2026 vs. increase in China's share of world GDP in 2000-2007

Country	**2000**	**2007**
China's share of world GDP	3.5%	6.1%
	2019	**2026**
India and Sub-Saharan Africa	5.3%	5.9%

Share in nominal GDP
Sources: IMF[10], TKB Investment Partners, May 2021

Long-term commodities price growth should be great for commodities producers. From 2000 to 2007, the MSCI Russia index returned a cumulative 700%+ in US dollar terms vs 200% for the MSCI EM index and 30%+ for the MSCI World (DM) index.

Graph 4. Russian market performance vs EM and DM during the 2000-2007 period of commodities price growth



For MSCI indices; in USD terms; from end-1999 to end-2007; EM – emerging markets; DM – developed markets
Source: Bloomberg, TKB Investment Partners; May 2021

We believe there is huge potential for a re-rating of commodities producers' stock prices. The new commodities super-cycle is far from being the consensus view: we are seeing backwardation on the commodities futures market. A re-rating of c**ommodities producers' stock prices could occur if the futures market turns out to be wrong.**

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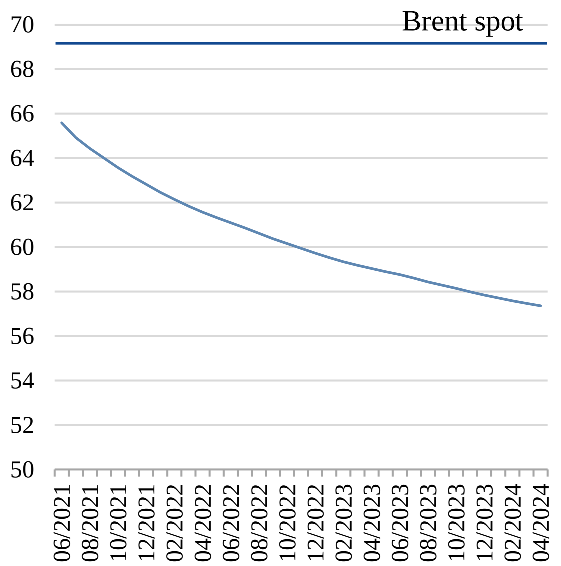
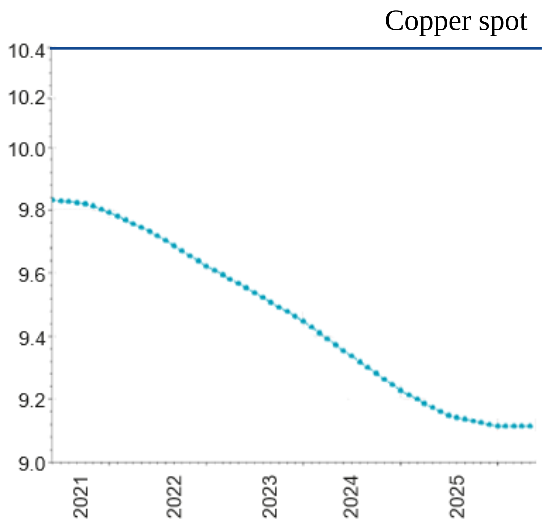
Graph 5. Brent oil price future curve (USD per barrel)



Source: Bloomberg, TKB Investment Partners, April 2021

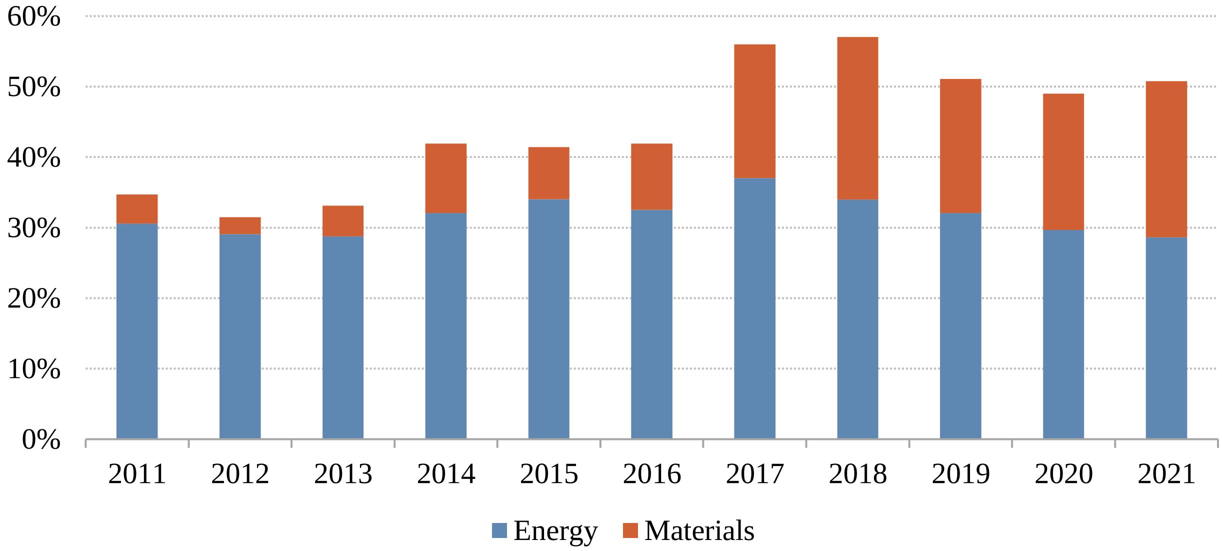
Graph 6. Copper price future curve (USD thousands per tonne)



Source: Refinitiv DataStream, Robeco, May 2021

The Russian equity market has a 50% overweight in commodities compared to the broader EM index. This overweight in commodities is more diverse than in the past: 22% in materials and 28% in energy now vs. 4% in materials and 30% in energy 10 years ago.

Graph 7. Overweight in commodities Russia vs EM*



* MSCI Russia 10/40 index vs. MSCI EM index
Source: Bloomberg, TKB Investment Partners; May 2021

Strong fundamentals

Sustainable macroeconomic situation. In 2020, Russia came through the COVID-19 test 'relatively well' despite the 36% YoY drop in average oil prices. This is comparable to what happened in the 2008-2009 Global Financial Crisis. The main reasons for such resilience include a decade of efforts by the Russian authorities to limit the exposure of the Russian economy to external shocks through inflation targeting, tight control of budget spending, its budget rule and low debt in the corporate and government sectors.

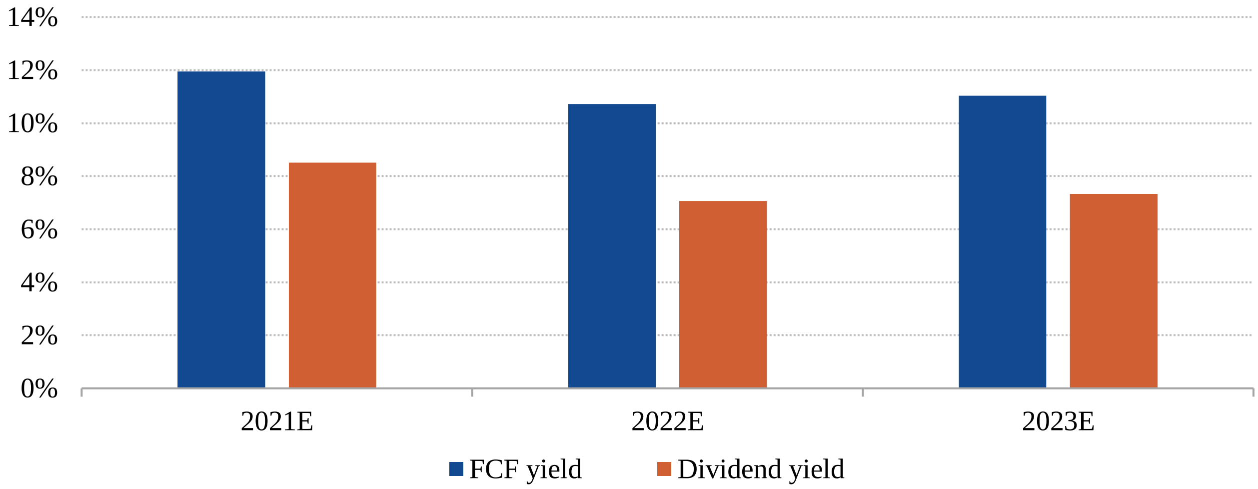
Table 3. The Russian economy has weathered the COVID-19 shock relatively well

	2020	2015	2009
Average YoY oil price drop	-36%	-46%	-35%
Russia GDP change	-3.1%	-1.9%	-7.8%
World GDP change	-3.5%	+3.5%	-0.1%
Maximum Inflation change	From 2.3% to 5.8%	From 6.1% to 16.9%	From 11.9% to 15.1%
Central bank actions during crisis peak	Rate cut by 200 bp from 6.25% to 4.25%	Rate hike by 900 bp from 8% to 17%	Rate hike by 300 bp from 10% to 13%

Source: Bloomberg, IMF, CBR, TKB Investment Partners; May 2021

'Cash cows' dominate the Russian market. The expected free cash flow (FCF) yield for the Russian market is 11% on average for the next three years with an expected dividend yield of 8%. This is far above the expected average inflation of 4%-4.5%.

Graph 8. Expected dividend and FCF yields for the equity market



Source: Bloomberg, TKB Investment Partners; May 2021

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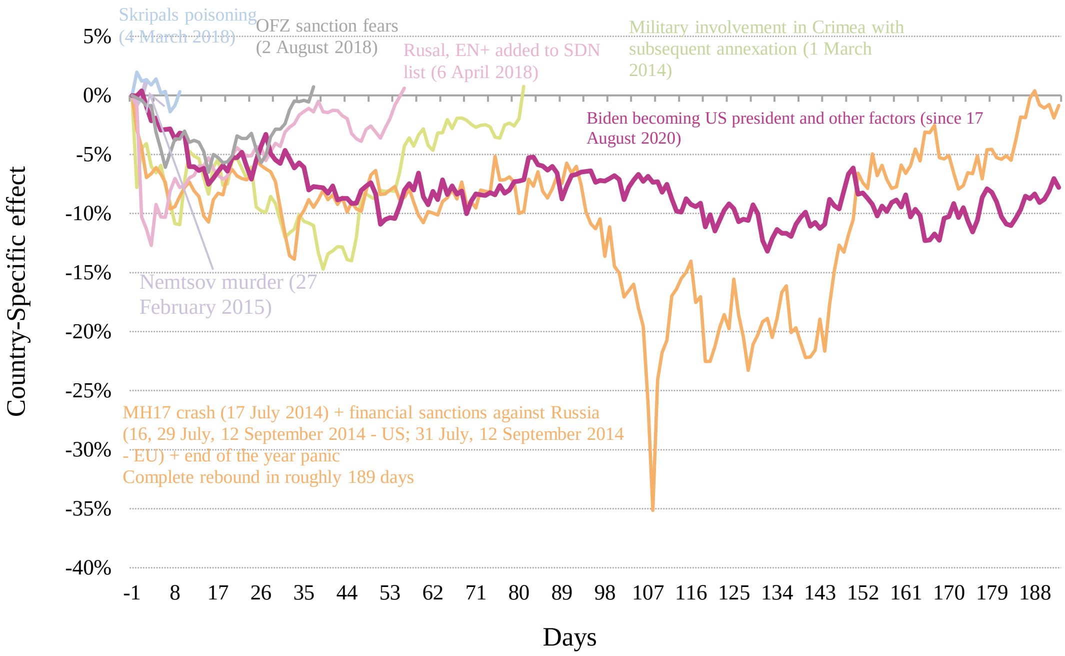
Potential for some evaporation of sanctions risk

The market believes that the risk of material sanctions has increased with Joe Biden becoming US President. Since August 2020, this has cost the Russian market around 10% in relative underperformance vs. the broader EM index. Biden has always talked tough in relation to Russia.

Graph 9. Cumulative Russia-specific effect on excess return of Russia vs. EM after sanction risk-related events



Note: The cumulative country-specific effect is demonstrated from the day before the sanctions risk-related event until the effect evaporates. Based on net return figures, in USD terms.
Source: Bloomberg, TKB Investment Partners; May 2021

Contrary to the market consensus, we believe the **risk of material sanctions against Russia has not changed** with Biden becoming president. So far, Biden's actions have been much softer than Trump's.

Table 4. Key actions towards Russia/its allies during first months of the Trump and Biden presidencies

Trump	Biden
Launched 59 missiles into government-controlled airbase in Syria	Agreed to extend New Strategic Arms Reduction Treaty until 2026 (Trump opposed this)
Lifting of sanctions became subject to Congressional approval	Invited Putin to virtual climate summit
	New sanctions on state debt. Immaterial

Sources: Vedomosti, Andrei Illarionov, Kommersant, FT, May 2021

Overall, the main reason why there have been no material Iran-style sanctions against Russia since 2014 is the fear of a ‘boomerang effect’. This is still in play. Russia is much more integrated into the global economy than Iran.

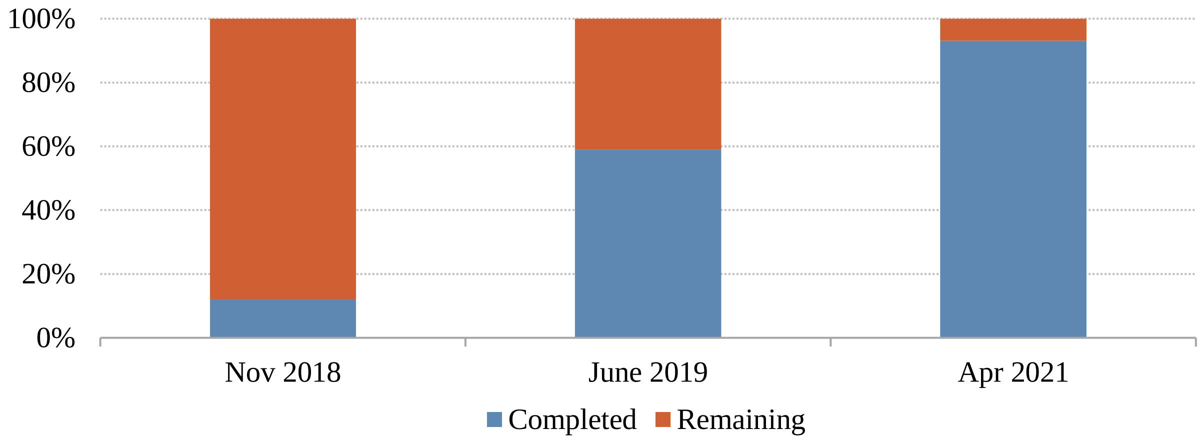
Table 5. Global market share

Commodity	Russia (2019)	Iran (2011)
Oil	12%	5%
Gas	17%	5%
Steel	4%	1%
Nickel	10%	<1%
Aluminium	6%	1%

Data for Russia for 2019 – pre pandemic, Data for Iran 2011 – pre first round of material sanctions
Source: BP, Word Steel, Statista, World Aluminum, Nation Master, TKB Investment Partners; May 2021

The launch of the Nord Stream-2 gas pipeline could be a trigger for the market to realise that Biden’s election has not changed the risk of material sanctions. As of the end of March 2021, around 95% of the Nord Stream-2 gas pipeline was completed. The pipeline is likely to be fully completed this year.

Graph 10. Construction of Nord Stream-2 (% of the total plan)



Source: Gazprom, FT, Andrey Illarionov, TKB Investment Partners; May 2021

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Conclusion

With a 50% overweight in commodities compared to the MSCI EM index, the Russian equity market gives exposure to possible global commodities market growth. During the previous growth trend in the commodities markets – 2000-2007 – the Russian equity market rose by more than 700% in USD terms. The Russian market's overweight in commodities is more diverse than in the past: 22% in materials and 28% in energy now vs 4% in materials and 30% in energy 10 years ago.

In addition, the Russian market is likely to benefit from high dividend yields, resilience to economic shocks and likely partial evaporation of sanctions risks.

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[1] Commodities: a powerful inflation hedge
[2] Commodities
[3] Policy Tracker
[4] Central bank policy rates
[5] The return of consumer spending
[6] Survey: US consumer sentiment during coronavirus crisis
[7] What will the consumer demand recovery from COVID-19 be like?
[8] Five reasons to believe in a new commodities super-cycle
[9] The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival
[10] World Economic Outlook Database