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Reasons to have an overweight in Russia in an EM equity portfolio

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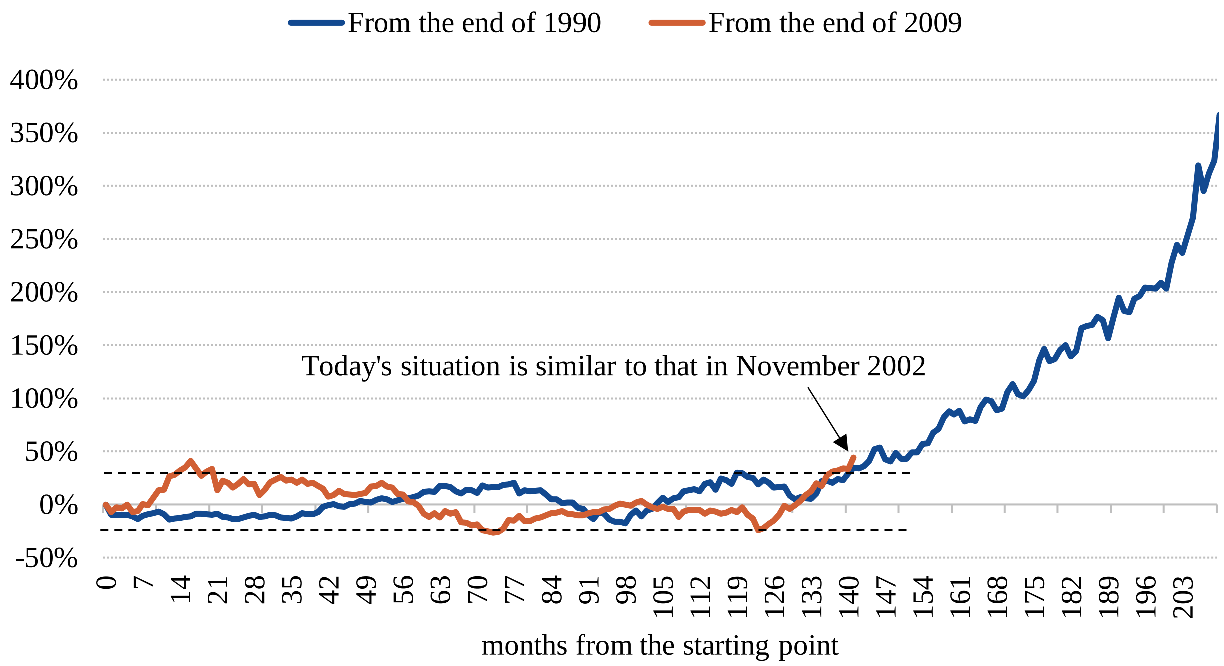
Imagine a tribe of creatures[1] whose only decision in life is where they should build their nests. They build nests, breed and then die. There are two options for where they can build a nest: in the valley or on the plateau. Each option is risky. If it rains, the valley can flood and all the creatures there drown. If there is a sunny day, all the creatures on the plateau die from thirst. The probability of a sunny day is 75%; for rain, it is 25%. Which is the optimum strategy for the tribe to follow? Evolution says that the best plan is for 25% of the tribe to build nests on the plateau, and for 75% to do so in the valley[2]. This is a probability-matching strategy.

Let us bear that in mind when we get back to real life. There are currently signs that commodities markets could be on a long-term growth trend similar to that seen during 2002-2007. Graph 1 below shows that today's commodities market is similar to that in November 2002, when commodities prices were entering new territory above the upper bound of a long-term flat trend. The Russian equity market is likely to significantly outperform broader emerging market (EM) equities on average if such a similar long-term commodities price growth scenario is realised. Between November 2002 and June 2008, the Russian equity market rose by 528% vs. 347% for EM (all figures in USD terms). **The larger the probability of the long-term growth trend in commodities prices, the larger the exposure to Russian equities in an EM portfolio should be from probability-matching strategy point of view.**

Graph 1. Bloomberg commodity spot index (cumulative growth, in USD terms)



For the data since the end of 1990 the period is up to the end of June 2008. For the data since the end of 2009 the period is up to the end of October 2021
Source: Bloomberg, TKB Investment Partners, October 2021

[1] We take the example from "Adaptive Markets: Financial Evolution at the Speed of Thought" by Andrew Lo
[2] Andrew Lo modelled how the situation could develop. The distribution with 25% on the plateau and 75% in the valley resulted in the largest number of creatures in the 25th generation

Probability of a long-term uptrend in commodities exceeds 12%

The base rate probability for long-term uptrend in the commodities market is close to 12%. In their analyses of commodities booms, the International Monetary Fund[3] and the World Bank[4] mention three periods during the last 100 years: Post World War II, the 1970s and 2003-2007. The post-war boom lasted around two years, the one in the 1970s ran for around 3 years and the most recent boom lasted for 6.5 years. This gives us a total of 11.5 boom years – an 11.5% base rate probability that at any given time the commodities market is in a long-term growth trend. To start forecasting from the base rate or "outside view" is advocated by Daniel Kahneman in "*Thinking, fast and slow*" and Philip Tetlock and Dan Gardner in "*Superforecasting: The Art and Science of Prediction*".

The current probability of a long-term growth trend in commodities should materially exceed the base rate. There are signs that the catalysts behind the growth trend in 2002-2007 are in play again now. The IMF and WB analysed the key factors behind the growth trend in 2002-2007 (see table 1). There are reasons to assume that at least five out of the six factors are likely to be relevant now.

Table 1. Drivers of commodities growth during 2002-2007

Factor	IMF	WB	Active now	Reasons
Strong global economy growth	+	+	At least in 2021-2022	During 2003-2007 global GDP growth was more than 4%. The IMF expects global GDP to grow by 5.9% and 4.9% in 2021 and 2021 respectively.
Speculation	+	+		There are trillions of USD floating around the global financial market, but it is hard to say whether they will have any material impact on commodities.
Lower than usual inventory	+		Maybe	There are signs that this is the case at least with energy products.
Lower than usual spare capacity	+		Yes	Long period of low investment in commodities producer sector preceded the boom in 2002-2007. We are seeing a similar situation now.
Fiscal expansion		+	Yes	Stimulus measures are in place in many countries.
Lax monetary policy		+	Yes	Low interest rates and quantitative easing in many countries.

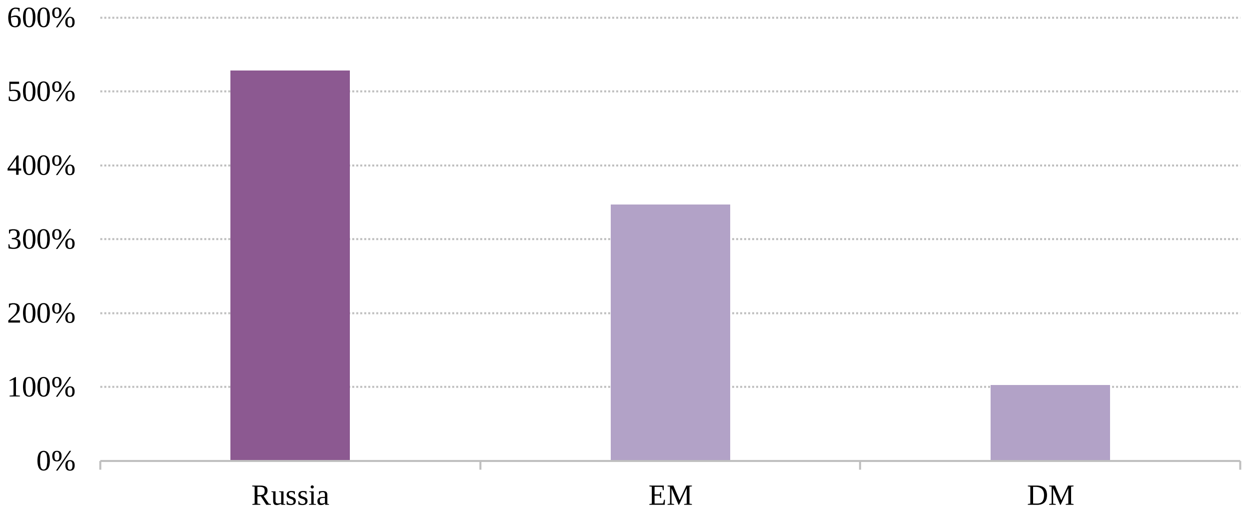
Sources: IMF, WB, TKB Investment Partners

[3] From here https://www.elibrary.imf.org/downloadpdf/books/081/09337-9781589067585-en/ch003.pdf
[4] From here https://openknowledge.worldbank.org/handle/10986/3855

The Russian equity market should outperform EM equities on average when there is a long-term growth trend in commodities

From the end of October 2002 to June 2008, the MSCI Russia index returned a cumulative 528% in US dollar terms vs. 347% for the MSCI EM index and 102%+ for the MSCI World (developed markets) index.

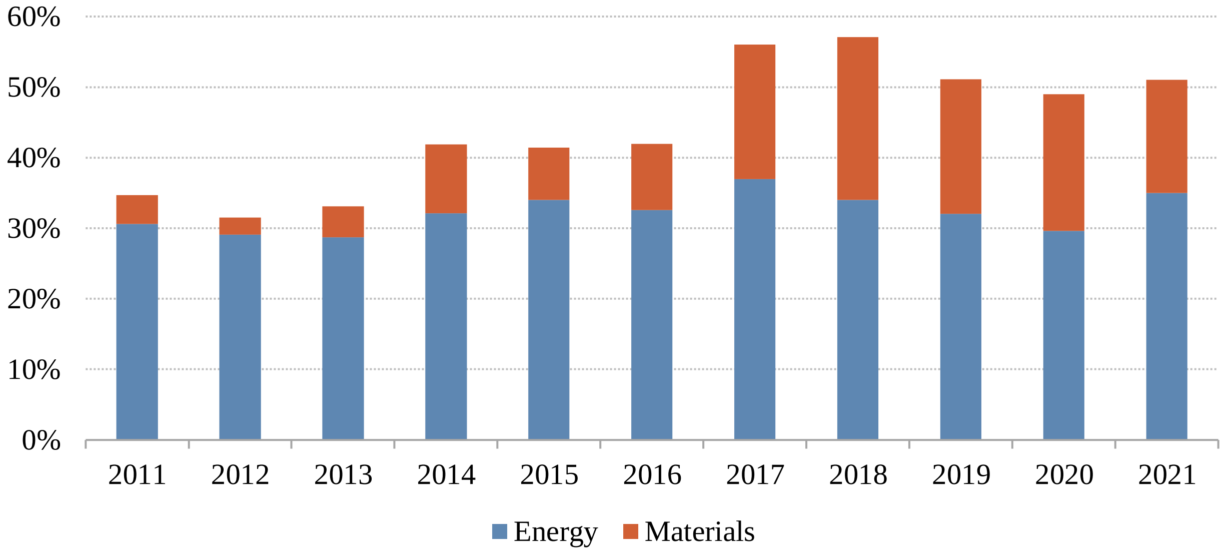
Graph 2. Russian market performance vs. EM and DM during the period of commodities price growth from end October 2002 to end June 2008



For MSCI indices; in USD terms; from end October 2002 to end June 2008
EM – emerging markets, DM – developed markets
Source: Bloomberg, TKB Investment Partners; October 2021

Russia continues to be a commodity play among EM. The Russian equity market has a 51% overweight in commodities compared to the broader EM index. It is an overweight that is more diverse than in the past: 16% in materials and 35% in energy now vs. 4% in materials and 30% in energy 10 years ago.

Graph 3. Overweight in commodities Russia vs EM*



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

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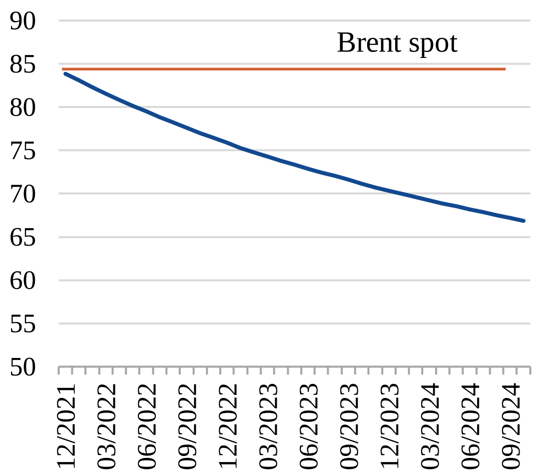
It is no surprise to us, therefore, that the Russian equity market has risen by 96% and outperformed the broader EM index by 38% since the current commodities market boom started in April 2020 (all figures in USD terms).

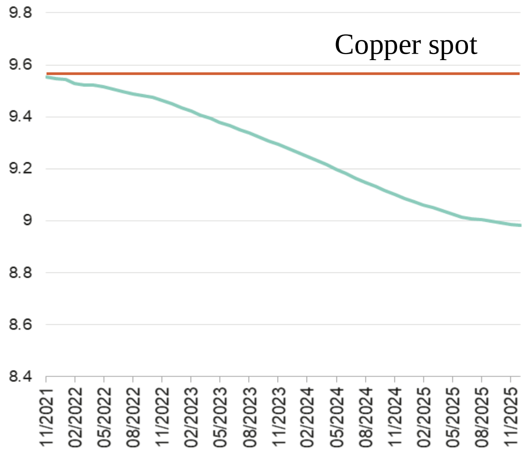
Moreover, we believe there is still further significant potential for a re-rating of commodities producers' stock prices. The new commodities super-cycle is still far from being the consensus view. We are seeing backwardation on the commodities futures market. A re-rating of **commodities producers'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

Graph 3. Brent oil price future curve (USD per barrel)



Source: Bloomberg, TKB Investment Partners, October 2021

Graph 4. Copper price future curve (USD thousands per tonne)



Source: Bloomberg, TKB Investment Partners, October 2021

Russia merits an overweight in EM equity portfolios

Russia has a 4% weight in the MSCI EM index[5]. A more than 12% probability that Russia will outperform EM over the next several years implies that it deserves a weight of more than 12% in EM equity portfolios from a probability-matching perspective. We do understand that most EM investors could perceive a 12%+ weight for Russia as excessive. However, **the higher than base rate probability of commodities' long term growth trend should at least support the idea of a substantial overweight in Russian equities.**

[5] Based on the data about iShares MSCI EM ETF here https://www.ishares.com/us/products/239637/ishares-msci-emerging-markets-etf

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