TKB INVESTMENT PARTNERS

Flash note
17 January 2022

January 2022 sanction fears – good entry point for the Russian market

Vladimir Tsuprov, CIO
Egor Kiselev, Head of International Business & Investment Marketing
Aleksandra Kuznetsova, Investment Specialist
Marina Tsutskiridze, Investment Specialist

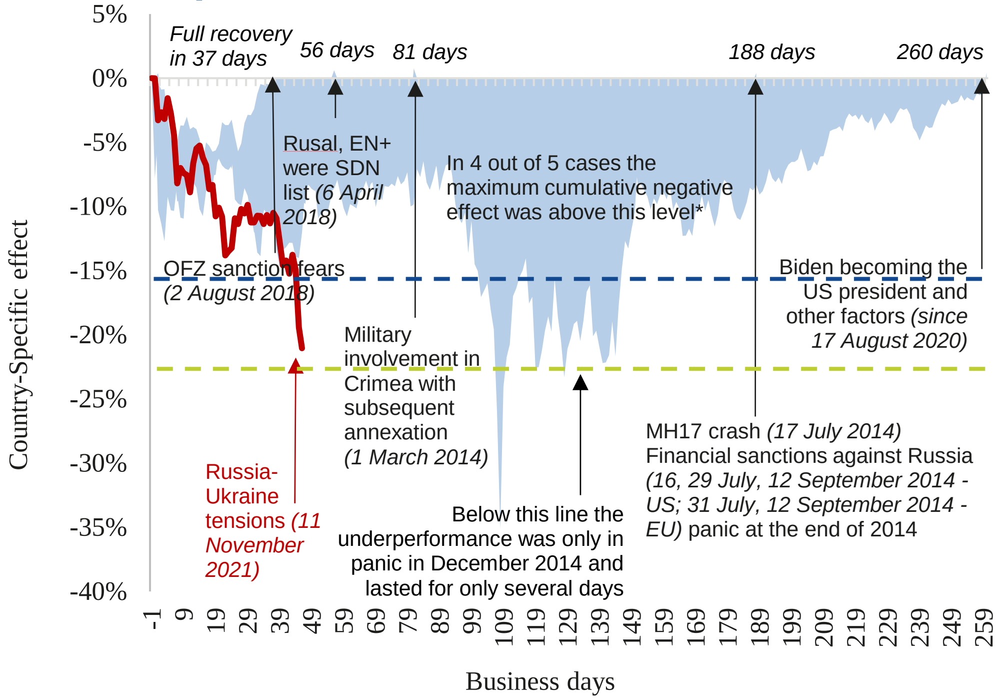
On 12 January, the US Senate Democrats presented a bill with a fresh package of sanctions targeting:

- Top Russian government and military officials, including the President
- Key banking institutions, such as Sberbank and VTB
- Transactions of Russia's primary and secondary sovereign debt
- Providers of specialised financial messaging services (e.g., SWIFT)
- The Nord Stream 2 pipeline, preventing it from becoming operational.

Beyond mandatory penalties, the bill would give the US president authority to identify sectors and industries that should be sanctioned in the interest of US national security, including oil and gas, coal and other minerals extraction and production.

On 13 January, Russian Deputy Foreign Minister Sergei Ryabkov expressed a negative view on the results of negotiations with NATO, saying that the US and NATO flatly refused to comply with Russia's demands for security guarantees at the talks. According to Ryabkov, Moscow sees no grounds for holding a new round of negotiations with the US on security guarantees in the near future.

Graph 1. Cumulative Russia-specific effect on excess return of Russian equities vs broader EM equities after sanction risk-related events



Note: To calculate the country-specific effect, we constructed an index from the EM sector indices with the structure of the MSCI Russia 10/40 index. For example, we took the MSCI EM Energy index and weighed it at 38%, the MSCI EM Materials index at 27%, etc. Therefore, the excess return due to Russia-specific factors equals the MSCI Russia 10/40 minus the constructed index. 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; Data as at 14 January 2022

This news has pushed the cumulative underperformance of Russian equities vs broader EM equities due to Russia-specific factors to 21%.

Since the end of 2013, a Russian equity underperformance of more than 15% has happened only once, at the end of 2014/early 2015. At that time, a chain of events related to the annexation of Crimea hit the market, and this was exacerbated by a strong drop in oil prices. This time, oil prices have not fallen.

This raises two questions:

- Why has Russia's cumulative underperformance vs. EM due to Russia specific factors reached extreme levels?
- What is the likely scenario looking ahead?

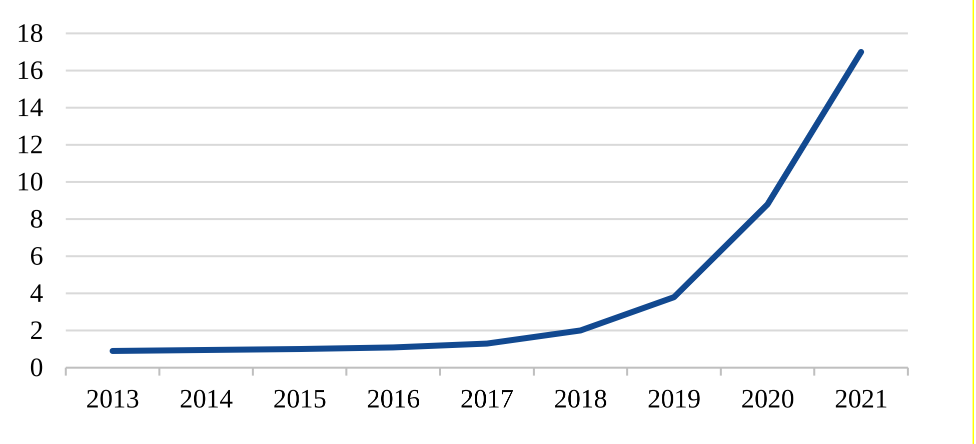
We believe that the more aggressive recent media language and Russian retail investors are the main reasons behind the recent sell-off.

<u>We are seeing more aggressive language used by the media.</u> Both Russia and the US/ NATO have strongly opposed views as to what they want the other side to guarantee. Russia's demands that there be no eastward expansion of NATO are seen as unacceptable by NATO. This resulted the media on both sides using unusually aggressive wording, even reminiscent of the cold war period between the then USSR and the US.

<u>We see retail investors as a new factor behind the size of the drawdown.</u> Over the last two years, net inflows from Russian retail investors into Russian equities have amounted to more than USD 10 billion. The number of retail investors rocketed to 17 million in 2021 from 2 million in 2018. Retail investors' share of the equity trading on the Moscow Exchange was 40% in 2021.

We believe retail investors have decided to fix some profits after the Russian equity market's strong performance last year. Most retail investors do not have experience of how the market usually reacts to sanction fears arising from events during 2014-2019. They have thus perhaps overreacted.

Graph 2. Number of individuals with brokerage account on the Moscow Exchange (millions)



Source: MOEX, TKB Investment Partners, January 2022

Movements of the value of the rouble also seem to support the assumption that Russian retail investors were the main driving force behind the sell-off. In previous cases of sanction fears affecting the Russian equity market, we saw the rouble fall by a similar amount as the Russian market in rouble terms, indicating capital outflows abroad. For example, when sanctions were imposed against Rusal and EN+, the Russian market contracted by 8.7%, while the rouble fell by 6.8% in just four days following the news. This time, on the day of the maximum negative impact from sanction fears (Thursday, 13 January), the rouble fell by less than half of the fall on the market (-2.3% for rouble vs. -4.9% for the market in rouble terms). This suggests to us that the market was likely influenced mainly by local investors. Additionally, the trading volumes that day of the largest Russian companies (Sberbank and Gazprom) showed more activity (about 90%) among ordinary shares rather than in depositary receipts.

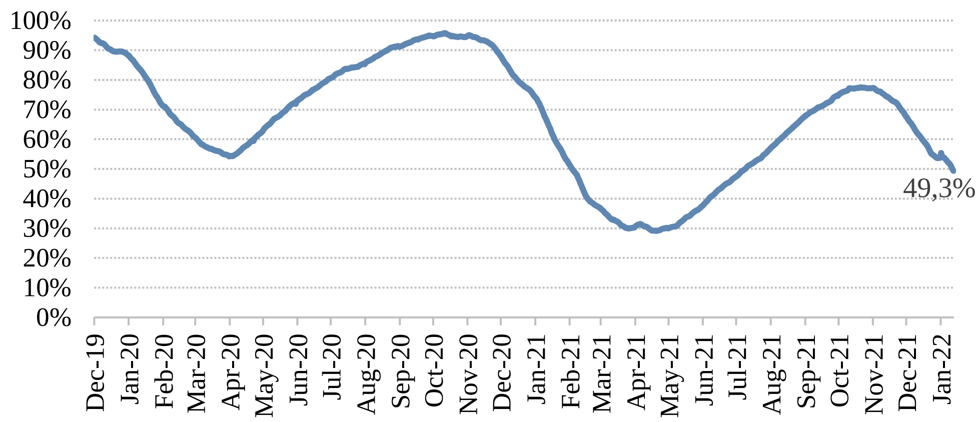
Is there any material downside left?

The downside in terms of Russia's relative underperformance vs. EM is limited. In previous cases, the cumulative relative underperformance broke the 23% threshold only once and only for several days, in December 2014. This happened on the back of a combination of events, including the annexation of Crimea, and followed the first imposition of sanctions.

We retain our view that the likelihood of material sanctions being imposed is low:

- The boomerang effect from material sanctions, such as reducing the export of raw materials, **has become even stronger due to the energy crisis escalation in Europe.** Gas storage has fallen dramatically in January 2022 to below 50%, while gas demand has proven resilient. According to Bloomberg, some European countries have already voiced their concerns to the US, stating that material sanctions against Russia may lead to a cut in crucial gas supplies and damage to their own economies, as Russia has a 50% share of overall gas exports to Europe

Graph 3. Gas storage in Europe, % of full



Source: Gas Infrastructure Europe, TKB Investment Partners, January 2022

- The US Treasury and State Departments have conducted two analyses that have shown that the sanctions with the most destructive potential for Moscow (in particular, against Gazprom or the Central Bank) **could lead**

to a significant increase in gas prices on the world market or disrupt trade and investment flows between Europe and Russia

- CNN reported that **some members of the Biden administration expressed concerns about the boomerang effect of such a course of action.** In their words, potential sanctions following the escalation of the Ukraine situation could damage the global economy.

Commodities markets are not pricing in material sanctions

Normally, commodities markets react when there is a risk of export disruption. In 2018, aluminium prices rose by 20% during the four days that followed the news of Rusal being added to the SDN list. Rusal is one of the world's largest aluminium producers with a global market share of about 6% in 2017. Two weeks ago, events in Kazakhstan, whose oil production is just one-fifth the size of Russia's, caused oil prices to rise by 6% over four days.

On Thursday 13 January, when the Russian equity market was hit the hardest following the sanctions news, there was no oil price rise reaction, despite Russia's 11% share of the global oil market. It appears investors in the oil market do not give credence to the possibility of material sanctions that might affect Russia's export capabilities (i.e. sanctions limiting or blocking SWIFT transaction operations in Russia).

In our view, the most likely scenario is that the current 21% cumulative underperformance of Russia vs. EM due to Russia-specific factors[1] will completely reverse over the next 12 months:

- In our view, the conflict was artificially created by both sides. From the historical perspective it was clear for us that Russian demands were not going to be accepted. We believe the rationale behind it was different - a long-awaited agreement on the Ukraine situation. This will give the US and NATO's an excuse why not to allocate its military at the Ukraine border. Additionally, the US will gain political points managing to ease the long going tensions with Russia. Meanwhile, Russia will get execution of Minsk agreement. We believe, that **as soon as solution is reached, there will be a reversal in the Russian equity market**, as currently investors do not price in such possibility.
- Since 2014, underperformance arising from initial sanctions concerns have always reversed within 12 months (in most cases within 90 days)
- There is a strong case for investing in the Russian equity market from a fundamental point of view:
  - It gives exposure to the potential long-term growth trend in global commodities. There are signs that the catalysts behind the commodities growth trend in 2002-2007 are in play again now: monetary and fiscal stimulus, the post-pandemic global economy recovery, lower-than-usual spare capacity (long-term low investment in the commodities producer sector). Today's commodities market is similar to that in January 2003, when commodities prices first moved above the upper bound of a long-term flat trend. Between January 2003 and June 2008, the Russian equity market rose by 530% vs. 330% for EM (all figures in USD terms)

[1] Since 11 November, when sanction fears started to affect Russia vs EM relative performance

- 'Cash cows' dominate the Russian market. The average expected free cash flow yield for the Russian market is 13% on average for the next three years, with an expected average dividend yield of 9%
- Sustainable macroeconomic situation. Russia's government debt is one of the lowest among its peers, at 17.5% of GDP. Russia's budget, current account and net international investment position are all positive. In addition, the National Wealth Fund had USD 185 billion, equivalent to 12.0% of GDP, in its reserves, as of December 2021.

The above-mentioned companies are for illustrative purpose only, are not intended as solicitation of the purchase of such securities, and does not constitute any investment advice or recommendation

TKB INVESTMENT PARTNERS

Flash note
17 January 2022

Contacts

For more information, contact:

TKB Investment Partners (JSC)
69/71, lit. A, Marata Street
St. Petersburg, Russian Federation

Tel: +7 812 332 73 32
Fax: +7 812 324 65 57
e.kiselev@tkbip.com
www.tkbip.com