

Russia

August 2008 – Author: Murray Davey, Managing Director and CIO, Global Emerging Markets

President Medvedev, 26th August 2008:

"We are not afraid of anything, including the prospect of a Cold War"

President Bush, 26th August 2008:

"We expect Russia to live up to its international commitments, reconsider this irresponsible decision, and follow the approach set out (in the cease-fire deal)"

There is no doubt that the relationship between the West and Russia has deteriorated in the face of Russian aggression in Georgia (our perspective) and NATO expansion into Eastern Europe (their perspective). The implications of this will be felt both politically and financially at many different levels. This note attempts only to review the potential medium term impact on the Russian stock market.

Increased geo-political risk = increased risk premium?

The conflict in Georgia came as the latest event in a bad summer for the Russian market. Investor sentiment, and equity prices, had already weakened due to the negative headlines generated by the escalating BP-TNK dispute, the fall in the price of oil from its early July peak and the Prime Minister's comments about Mechel and the implications for pricing across extractive industries. It is the total weight of bad news that has brought the market down 36% from its mid May high. Not surprisingly, markets don't like aggressive comments from political leaders and react badly when they are delivered, but, once the rhetoric dies down, they usually recover. It is difficult to see either side backing down from their current fairly hard-line positions in the run-up to the US Presidential election, so the market is going to have to live with a poor geo-political background for a few months. Rightly or wrongly, markets usually bounce back when the world's media moves on to another topic (we see no "India discount" due to tensions with Pakistan, no "Korea discount" due to the proximity of their bankrupt neighbour and no "Israel discount" due to the prospect of nuclear weapons in Iran). We would expect that pattern to happen again when the situation in Georgia stabilises. We see downside from a long running increase in the risk premium only if (as is possible) tensions increase over the installation of Patriot missiles in Poland (remember Cuba!) or NATO membership for Ukraine (where Russia still has a base in Sevastopol for its Black Sea fleet).

In summary, we think worries over Georgia are "in the price", but we are concerned about possible heightened tensions with regard to Poland and Ukraine in the next few months.

The economic impact of increased geo-political risk.

The next factor we consider is the actual economic impact of any increase in geo-political risk. Deferring Russia's membership of WTO would have a minimal impact on Russian companies and imposing duties on Russian energy exports would hurt Europe more than Russia, since any such threat would invite Russia to turn the gas taps off. Russia supplies almost 70% of European gas imports. Economic sanctions aimed at reducing the flow of foreign capital into Russia would also not help – indeed one of the key economic strategies of the Kremlin is to bring more of its own assets back into Russian control, so they probably would not really mind such a move. Russia has a massive current account surplus and even larger cash reserves, so a shortage of capital is not one of their problems.

In summary, in our opinion, the economy will not be affected by the crisis because sanctions are unlikely to be imposed and if they are they would not work.

Finally, a comment about the portfolio flow aspect of this situation. It is possible that formal or informal instructions to portfolio managers from their clients to reduce exposure will lead to a major mis-match in supply and demand for Russian assets. This has not happened yet and although the market is undoubtedly lowly valued (6x forward earnings), it is not so cheap when one compares stock-to-stock with similar stocks elsewhere.

Our high exposure to Russia (c12% vs benchmark of 8%) was one of our best calls of the last 18 months but some of those profits are now disappearing. From a "bottom-up" stock perspective, we want to maintain and indeed increase our exposure back towards our maximum of 15%. "Top down" considerations about the possibility of worsening tensions over Poland, Ukraine and Georgia in the coming months, together with the possibility of forced selling by US investors, point in the opposite direction. Our experience in Russia suggests that each time there is a conflict between cheap assets and perception of higher risk, it has been right to buy into large falls. This will be right again provided the Russian government is committed to long term reform of the economy and the rebuilding of Russia. We think it is. We will regularly run into periods of uncertainty and high market volatility along the way, but at the end of the day, the development of the Russian economy will continue. We are buyers on further weakness.