June 2019

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Our reflections on Russia

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Russia is an interesting market to analyse and invest in. The country runs a structural current account surplus (reaching 7.0% of GDP last year), and has exercised both impressive fiscal discipline and disciplined inflation-targeting monetary policy, leading to the sovereign foreign debt having an investment grade rating with each of the three main ratings agencies. Given these conditions, one might expect Russian financial markets to display low beta/strong dollar characteristics, like Taiwan and Malaysia, as opposed to high beta/carry-trade/weak dollar characteristics, like Brazil, Turkey and Indonesia. One would be wrong.

Russia has a high-beta, risk-on profile – in sovereign debt, in currencies and in equities. The MSCI Russia index has displayed a beta of 1.12 to the MSCI Emerging Markets index over the last five years, while volatility in the ruble and in Russian sovereign credit default swaps (CDS) has also been high over that period. There are two (related) drivers of this.

The first, unsurprisingly, is political and governance risk. This makes risk aversion particularly pronounced in Russian assets, especially when the risk seems systemic, as in 2014/15 when the US and EU were imposing sanctions on Russian companies and individuals in the wake of the Crimean conflict.

Secondly, and not unrelatedly, Russia has endemic capital flight, which amplifies in periods of risk-off as domestic depositors (remembering the twin economic crises of 1991 and 1998) dollarise their assets. In the five years to December 2018, Russia had an aggregate current account surplus of US$297bn and net FDI inflows of US$99bn, but foreign exchange reserves fell US$45bn in the period, reflecting the steady offshoring of capital.

Finally, the importance of energy to Russia cannot be overstated. Oil and gas make up more than 60% of Russian exports, more than 30% of GDP and almost 60% of the MSCI Russia index. Metals and mining is also a significant further contributor. This also gives the Russian economy, and Russian assets, great sensitivity to the oil price.

Russia: our assessment

These fundamentals in place, what do we see as the risks and opportunities of Russian equities for international investors? As always, we use our five-point framework to assess.

Growth: this remains disappointing in Russia. Real GDP growth has averaged 0.7% per year since 2012, one of the lowest growth rates in EM, and although there are some potential drivers for a higher rate, there is no immediate prospect for a shift to a much higher rate. Industrial production to May was +0.9% and nominal retail sales to April were +6.5%, while forecast real GDP growth for 2019 is only 1.4%. On the positive side, oil output has been running at near record levels of over 11m barrels per day (bpd) for the last year and oil prices have recovered from the 2015/16 low. There is also a potential boost to fiscal contribution in the second half of 2020, when the sovereign wealth fund reaches its target asset level of 7% of GDP, allowing domestic investment to recommence. The translation of this weak economic growth into earnings growth has been likewise disappointing, especially in some of the more domestic sectors. We are negative on the growth opportunity in Russia.

Monetary/liquidity/credit: this is positively affected by the Federal Reserve's expected move to easier monetary policy, by the legacy of the last few years' of hawkishness by the Central Bank of Russia (CBR, which we consider to be one of the finest central banks in the emerging world), but also by the liquidity implications of capital flight. The easier Fed allows emerging market central banks to cut rates (as many have in recent weeks, including the CBR), while Russia has policy rates of 7.5% and trailing CPI inflation of 5.1% (to May), allowing the CBR to continue to cut rates if inflation remains benign and the currency remain stable. However, the preference of Russian savers and investors to seek exposure outside Russia has meant that money supply growth (M2 +7.7% to April) and credit growth (total loans +13.5% YoY to April) have been modest. We are overall neutral on the Russian monetary/liquidity/credit opportunity.

Currency: here we are more positive. With domestic demand slow to recover, and with the step up in export revenues, the current account balance should remain strong, providing an underpin to a currency that already looked cheap. The historical relationship between the ruble oil price and the ruble disconnected in 2015 and has yet to recover. With yields seemingly heading down in developed economies, there is likely to be a continued bid for yielding assets, including the carry on emerging market currencies, including the ruble. The CBR has drawn attention to rising foreign participation in the domestic OFZ bond market, which indicates that this trend is already established.

Politics and governance: this has to be seen very negatively. Sensible and disciplined fiscal and monetary policy cannot offset the interlinked issues of highly compromised politics, extremely high levels of corruption, poor corporate governance, highly constrained media and civil society and difficult geopolitics. It is this last point where there has been the largest negative change in recent years. Assertive

Russian foreign/military policy, notably in Ukraine and Syria, has brought Russia into conflict with the US and the EU. The related sanctions have been a major risk that has had to be priced in to Russian markets, with the tail risk of sanctions on sovereign debt (which would be catastrophic) still a possibility. Minor positive shifts (such as new dividend policies at state-owned enterprises) are irrelevant beside these bigger challenges.

Valuation: conversely, this is highly positive. Russian equities have always looked cheap compared to EM (partly because of industrial composition, but if this adjusted for, also on a peer-for-peer basis), but that discount has widened in recent years, while falling bond yields and interest rates also serve to underpin valuations. In particular, we would highlight the peer valuation discount that exists in more normally highly-rated sectors such as technology and consumer, as oil and gas and mining stocks are cheap everywhere.

Overall, we find opportunities in Russian equities and have a small overweight there. The combination of very cheap stocks and currency, even if growth and liquidity are unimpressive, is one to we wish to be exposed. We believe that corporate governance and political risk is higher in the commodity names. We choose to own higher quality names, with relatively stronger return on capital and relatively stronger balance sheets. In addition, our expectations of a stronger ruble point us to domestic sectors; accordingly, we own a bank, an industrial transport company and an online service/e-commerce company. We would become more positive on Russia if the domestic recovery could become more established; conversely, we remain very sensitive to political/sanctions risk, which could cause us to turn more negative.

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