EMERGING MARKETS & CHINA STRATEGY

February 25, 2025

Russia: Three Years At War

In This Report

This week marks the third anniversary of Russia's invasion of Ukraine. America's recent pivot toward Russia represents a crucial turning point in the war. While the path to a peace deal remains highly uncertain, the prospect of a renormalization of U.S.-Russia relationship has suddenly improved. This raises the possibility of Western sanctions on Russia being lifted at some point – potentially making Russian assets "investable" again.

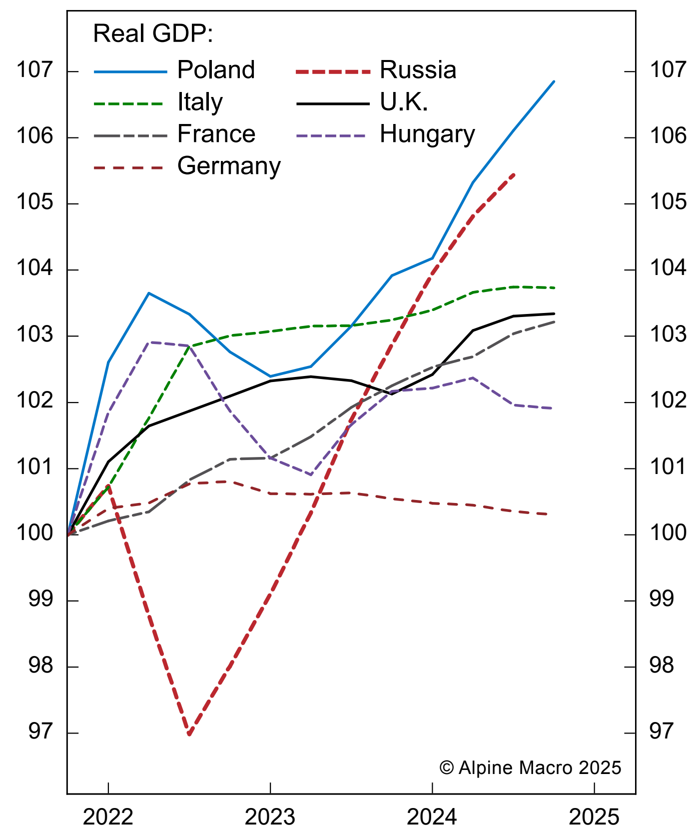
This report examines Russia's economic and market conditions, which have been largely overlooked by global investors over the past three years. The war has not materially damaged Russia's economy, and the growth outlook will likely improve further as resources shift back to productive sectors. Currently, Russian stocks and bonds appear very cheap. The ruble has become fairly valued after its recent rally.

An Overheated War Economy

The war has not led to the total economic collapse that many predicted at its outset. After a severe yet brief contraction in Q2 2022, Russia's GDP quickly rebounded and has outperformed many European countries over the past two years (Chart 1). The military conflict has largely taken place outside Russia's borders, which has limited direct economic damage. Additionally, several factors have contributed to the economy's resilience.

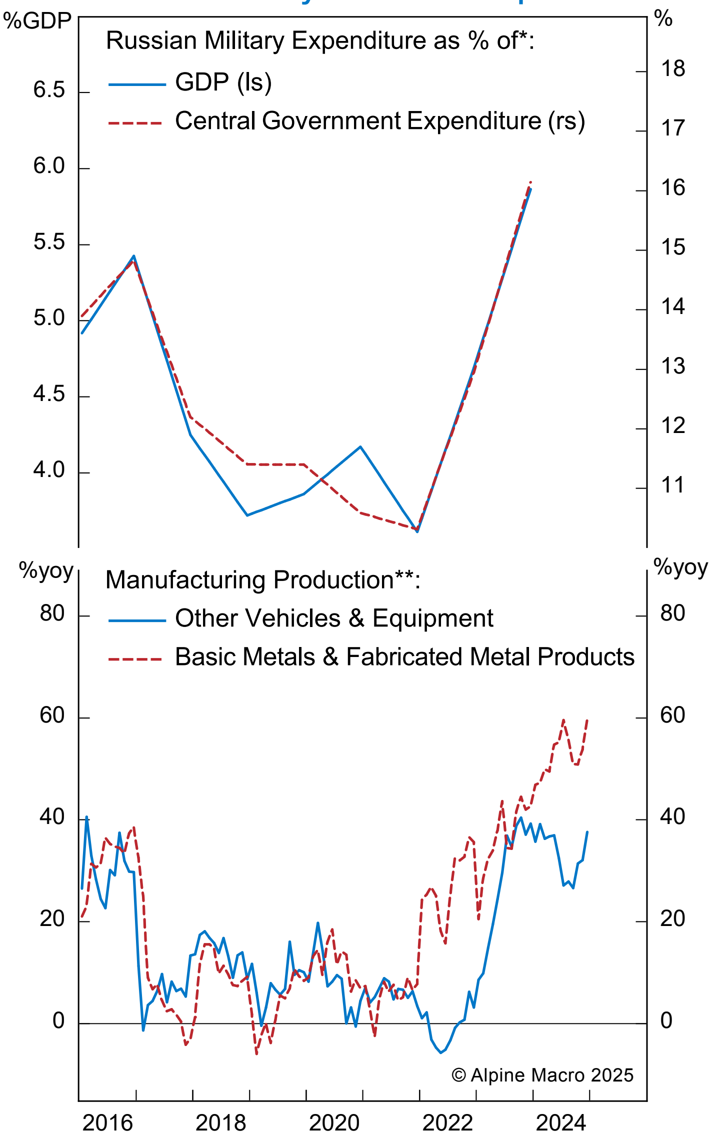
- Russia's industrial production has received a massive boost from war-driven demand and import substitution due to sanctions (Chart 2).

Chart 1 The Damage On Russian Economy Has Been Limited



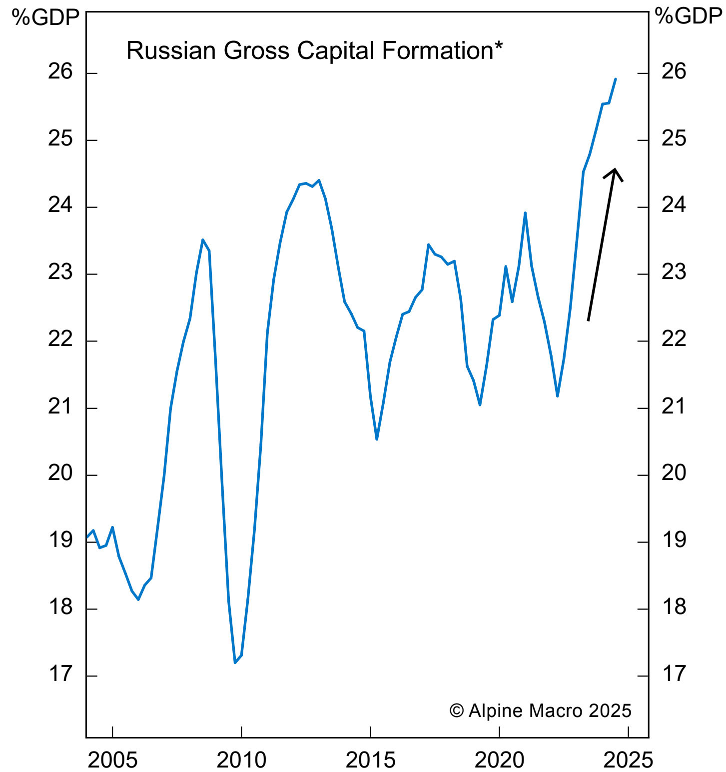
Note: All series are shown as 2-quarter moving average and rebased to Dec 2021=100; source: World Bank

Chart 2 War Expenditure Boosts Military-Industrial Complex



*Source: World Bank
**Both series are shown as 12-month moving average

Chart 3 Surging Investment



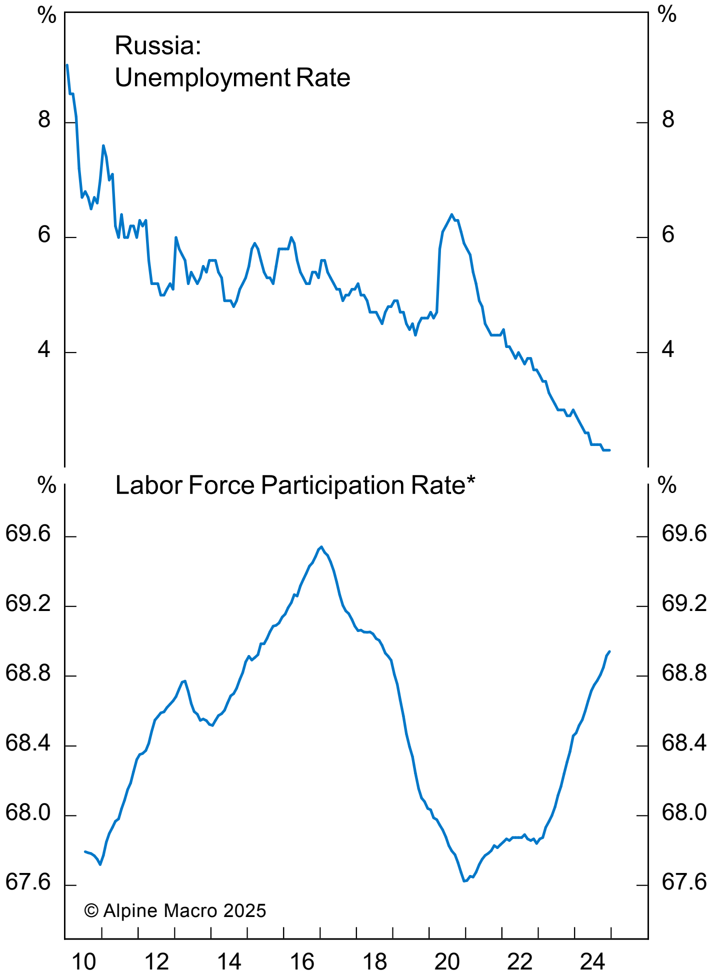
*Shown as 4-quarter moving average

Moscow's military expenditure, as a share of GDP, has surged to an all-time high, supercharging the country's extensive military-industrial complex. Production in other sectors has also ramped up as foreign companies exited the Russian market, creating opportunities for domestic firms to fill the gap.

- Rising demand and tighter capacity utilization have also boosted capital spending in both military and civilian sectors. Decoupling from the West has forced Russia to redirect its foreign trade to other countries, driving infrastructure investment. As a result, fixed asset formation as a share of GDP has jumped to record highs since the war began (**Chart 3**).

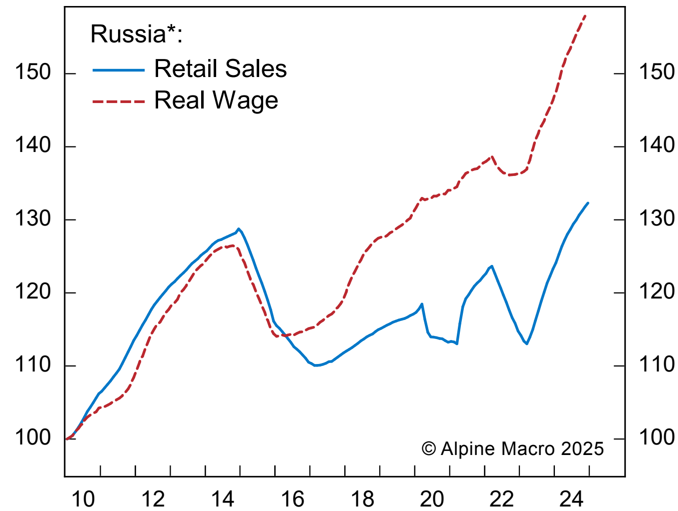
- Consumption has remained strong, driven by a tight labor market and rising wages. Increased domestic business activity has significantly tightened the labor market, pushing unemployment to record lows amid rising labor participation (**Chart 4**). Meanwhile, Moscow has offered financial incentives — reportedly far higher than regular

Chart 4 Strong Labor Market



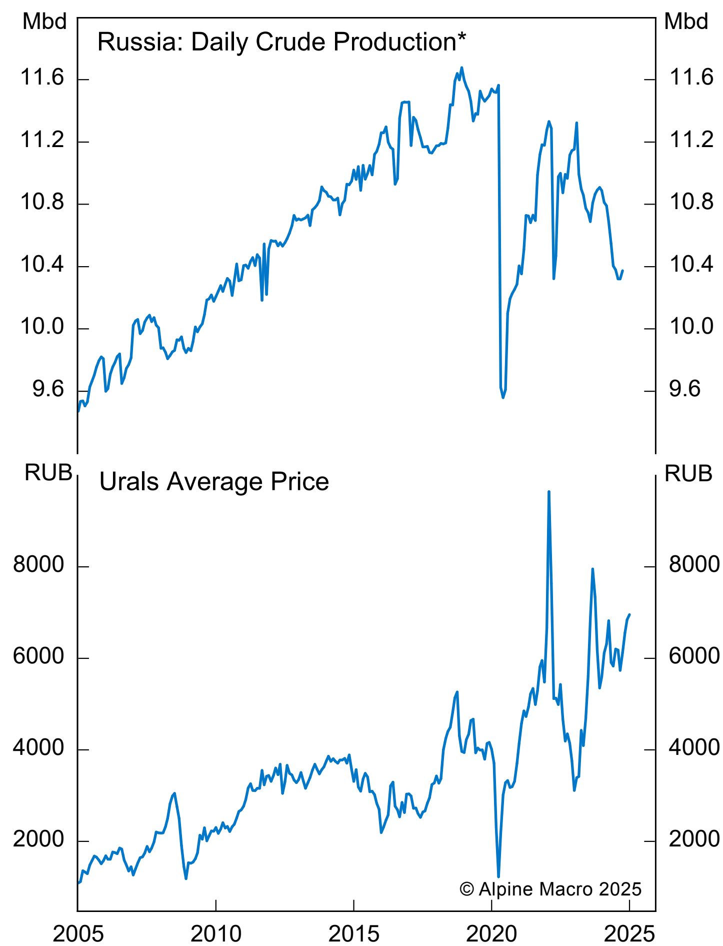
*Age from 15 to 72; shown as 12-month moving average

Chart 5 Rising Wages Boost Consumption



*Both series are calcuated from officially released year-over-year growth rate; rebased to Jan 2010=100

Chart 6 Still Plenty Of Windfall From Energy

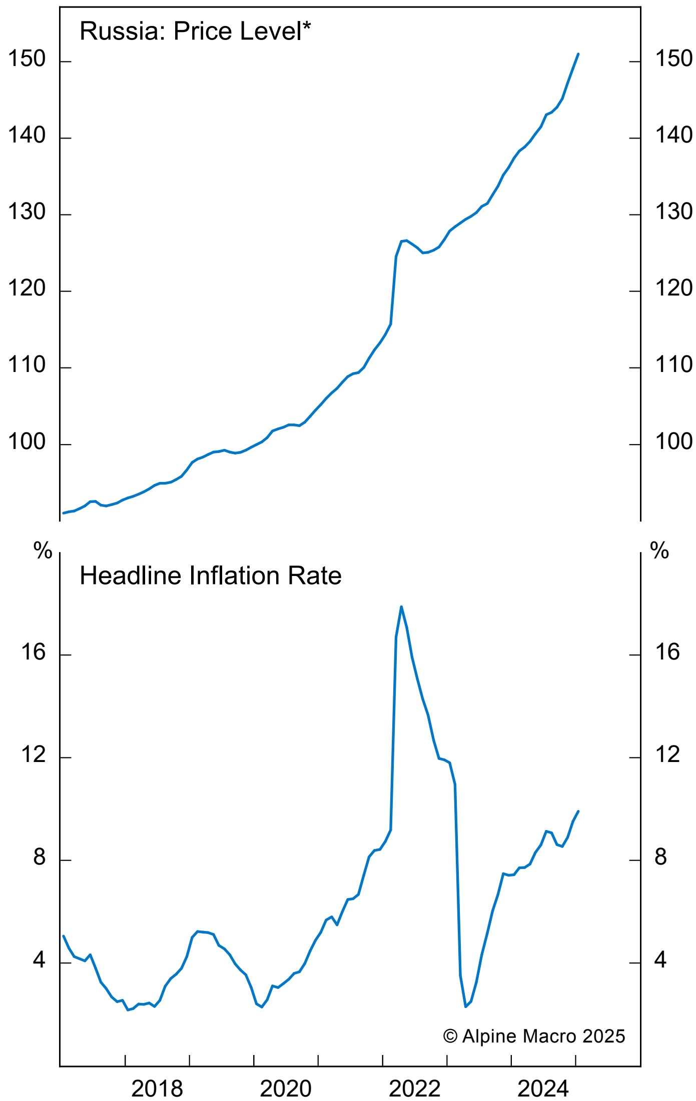


*Source: EIA

civilian wages – to recruit soldiers. This has exacerbated labor shortages, further driving up wages and boosting consumption (**Chart 5**).

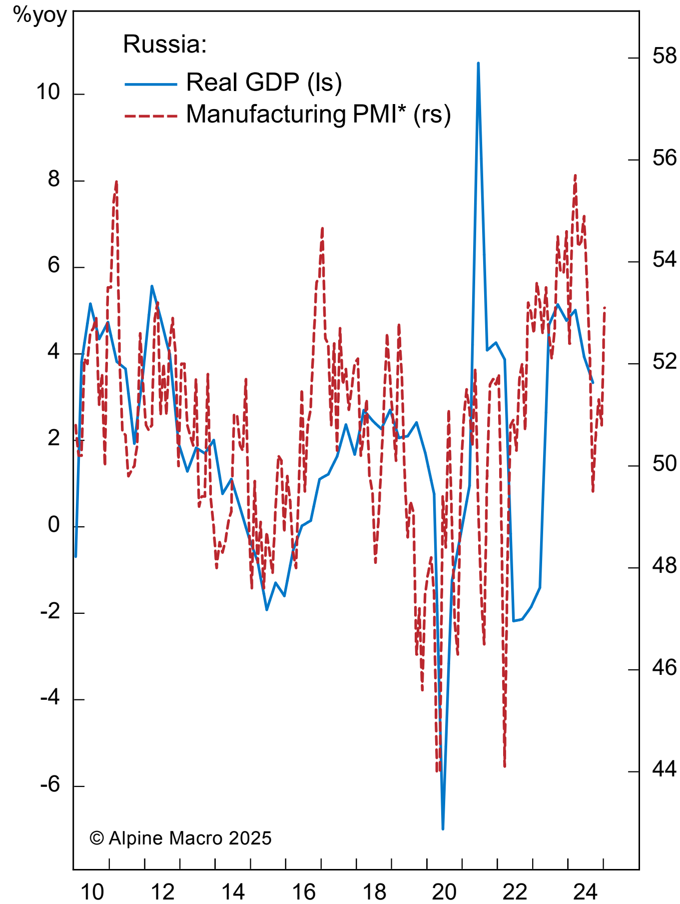
- As a major oil producer, Russia has also benefited from elevated energy prices. Although the country's oil output has declined since the war – due to a combination of its "OPEC+" quota obligations and Ukrainian retaliatory attacks on Russian facilities (**Chart 6**) – oil prices, especially in local currency terms, have remained strong. This has supported domestic oil companies and boosted fiscal revenue.

Chart 7 Sticky Inflation



*Rebased to Jan 2020=100

Chart 8 The Economy Remains Buoyant



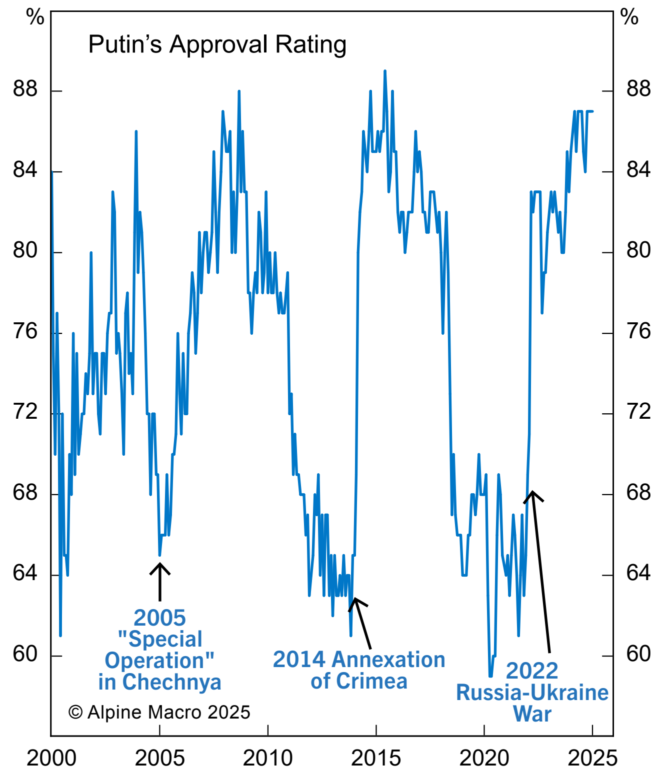
*Truncated at 44

Resilient growth and supply shortages have led to persistent inflation. Over the past five years, the economy has endured two consecutive inflationary shocks – the COVID-19 pandemic and the war – both of which have driven up domestic prices (Chart 7). Russia's headline CPI is currently running at nearly 10% annually, well above recent averages. This has forced the central bank to tighten aggressively, pushing policy rates – both in nominal and real terms – to multi-decade highs.

However, extremely tight monetary policy has done little to cool the economy. After a brief slowdown, both manufacturing and services PMIs have rebounded in recent months and now sit well above the expansionary threshold (Chart 8). This suggests that Russia's inflationary overheating is likely to persist in the near term.

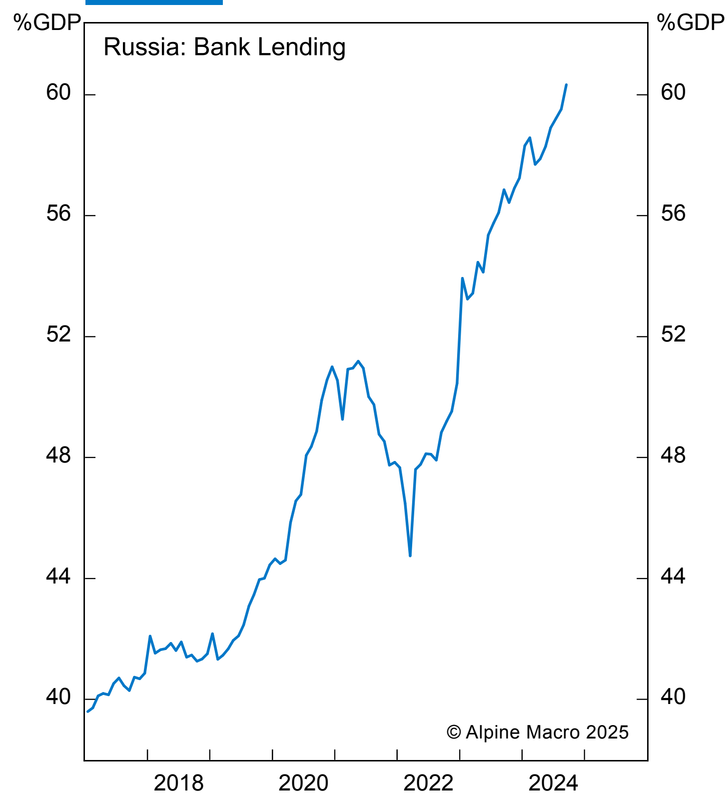
Russia's economic performance has likely helped sustain President Vladimir Putin's domestic approval ratings (Chart 9). His popularity surged at the onset of the 2022 invasion and has continued to rise over the past three years, now approaching its highest level since the war began.

Chart 9 President Putin Remains Popular



Source: Levada Center

Chart 10 "Hidden Costs" Of The War



The Structural Profile Remains Stable

Russia's economic resilience amid aggressive monetary tightening may be partly due to the massive expansion of "policy loans" – government-directed lending to select sectors at subsidized interest rates. These programs have helped insulate the country's military-industrial complex from the punitively high cost of borrowing.

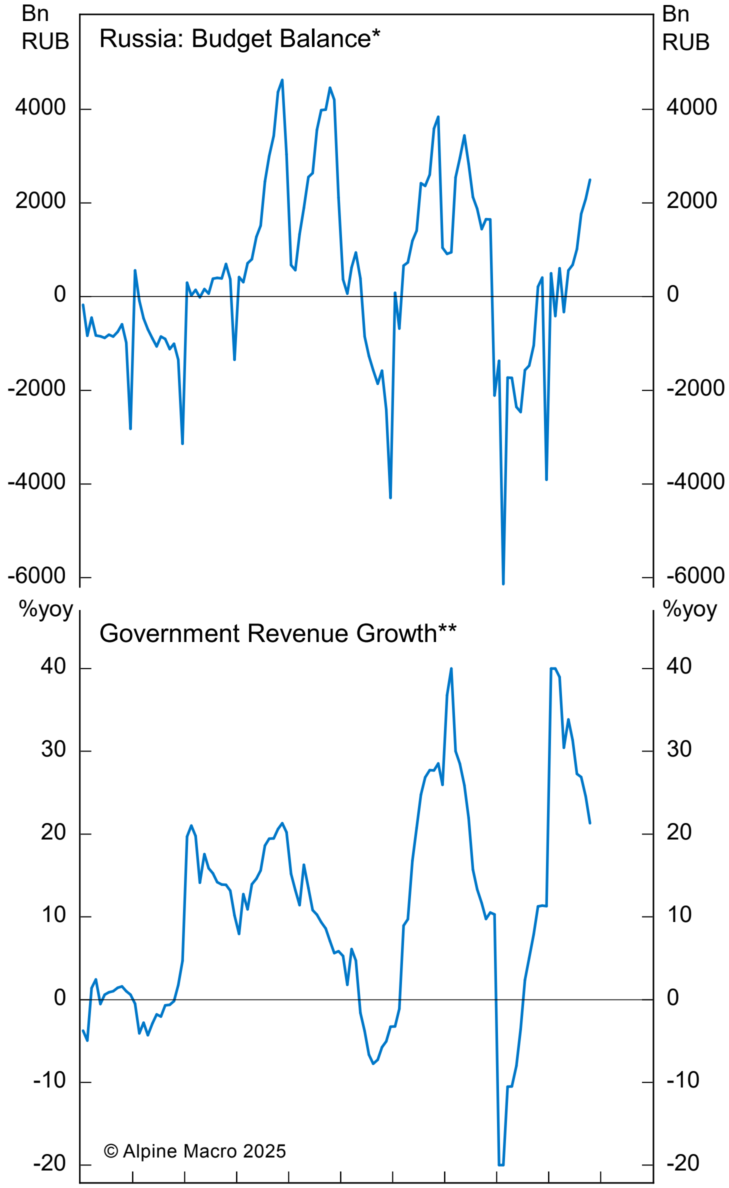
The opaque nature of Russia's war economy makes it difficult to precisely quantify these programs. However, bank lending has surged since the war, with particularly sharp increases in loans to manufacturing, construction, and transportation. Total corporate sector lending as a share of GDP has increased substantially in the past three years (**Chart 10**).

The explosive increase in bank lending underscores the hidden costs of the war, indicating that the real burden on government finances is far larger than the topline military expenditures suggest. If the war continues, the costs of subsidized "policy loans" could snowball into a systemic risk, threatening macroeconomic stability. This could provide Moscow with strong incentives to pursue negotiations to end the war.

For now, however, Russia's basic macro profile remains relatively stable.

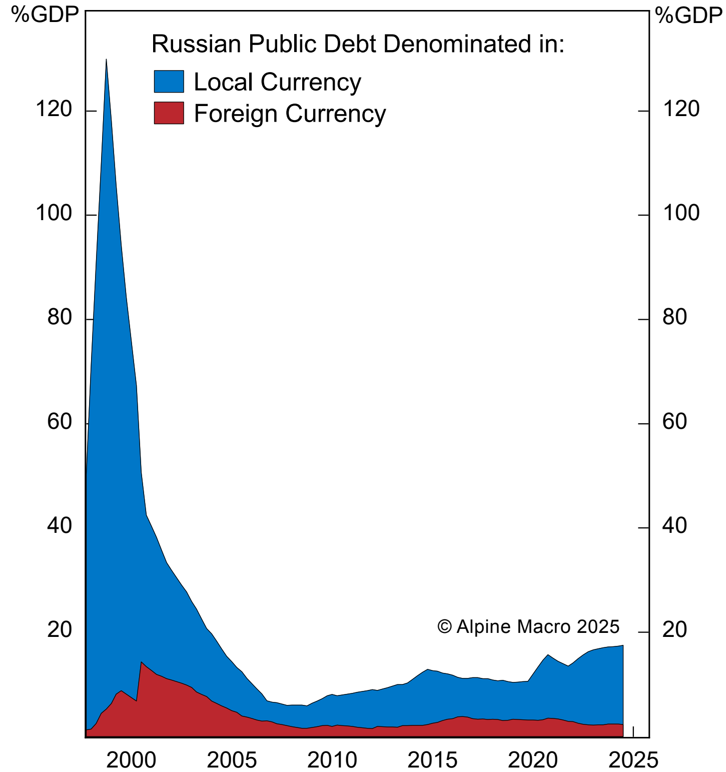
- Domestically, the Russian government continues to run a fiscal surplus, despite the increase in military expenditure. This is primarily due to a significant rise in revenue, driven by the overheated

Chart 11 **Fiscal Is Manageable**



*Shown as year-to-date
**Truncated at +40/-20

Chart 12 **Public Sector Debt Is Low And Stable**



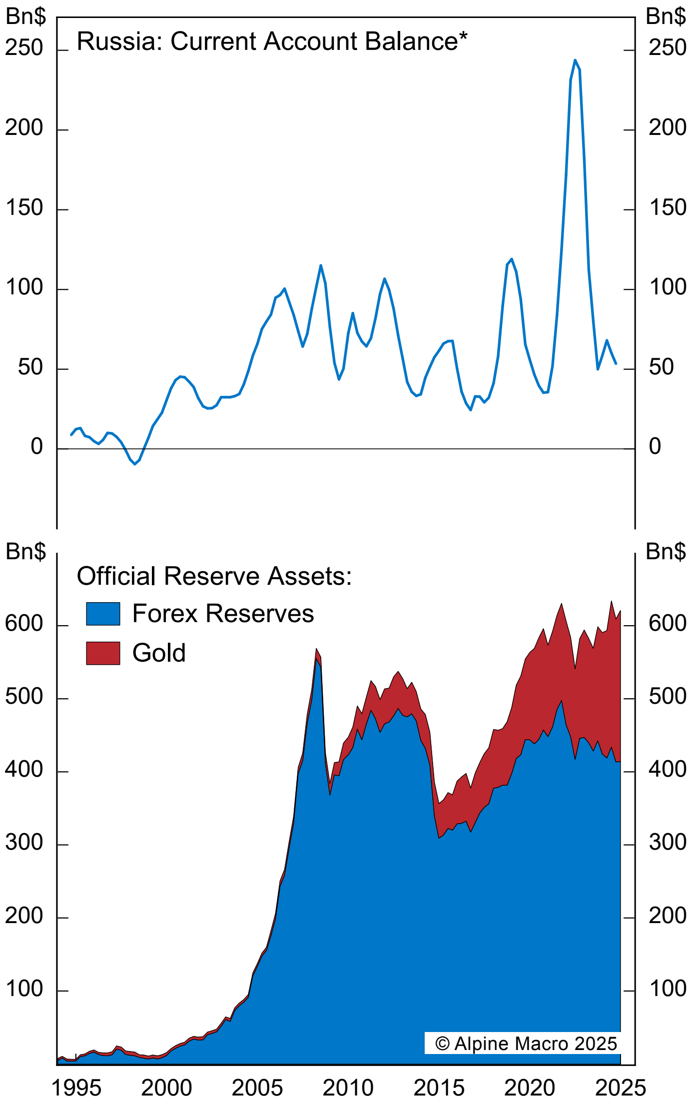
Source: IMF, BIS

economy (Chart 11). Tax and non-tax revenue have increased by 21% compared to last year, well above the 10% inflation rate and 4% real GDP growth. Even when factoring in the costs of "policy loans," the financial burden of the war does not appear overwhelming for the country's budget. Meanwhile, Russia's total public sector debt is only 20% of GDP, among the lowest in the world, with government debt denominated in foreign currency being essentially negligible (Chart 12).

- Externally, Russia continues to run a current account surplus despite the substantial increase in capital spending (Chart 13). Moscow has implemented capital control measures since the war, and Western sanctions may have also helped slow domestic capital flight, as Russian nationals fear their assets abroad could be confiscated. As a result, Russia's official reserves are hovering near all-time highs, with more than 30% in gold.

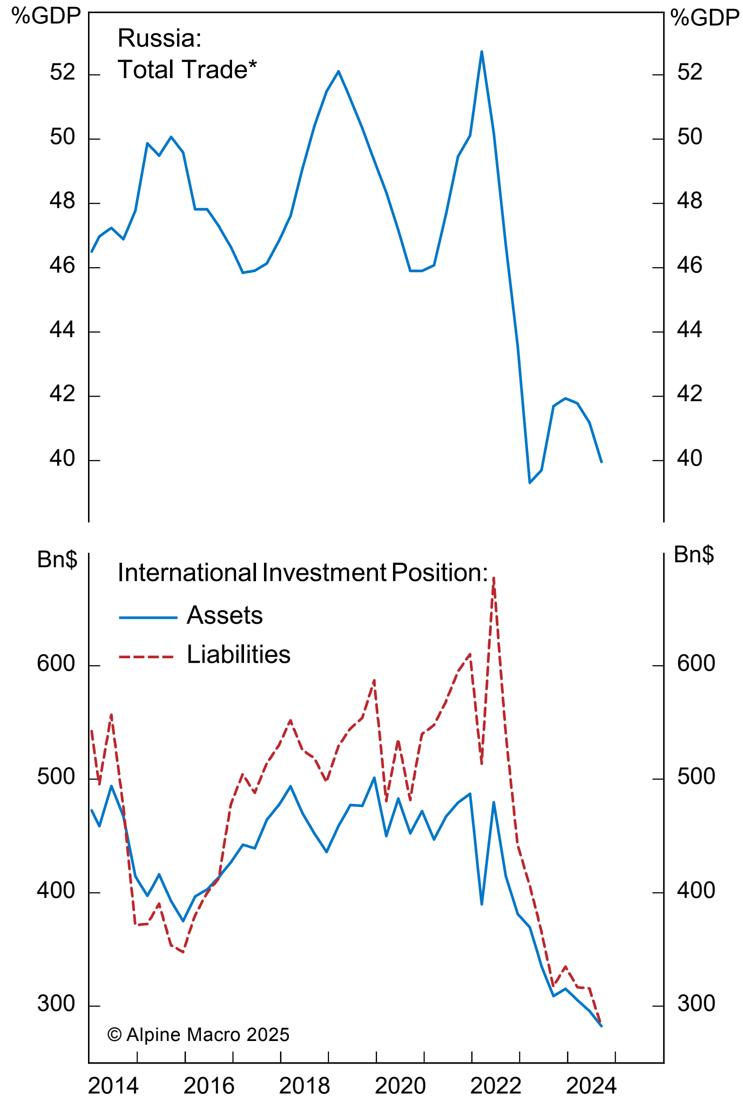
Taken together, Russia does not face any imminent fiscal stress or balance-of-payments pressure.

Chart 13 No Balance-Of-Payments Pressure



*Shown as 4-quarter moving total

Chart 14 The Economy Has Become More Closed



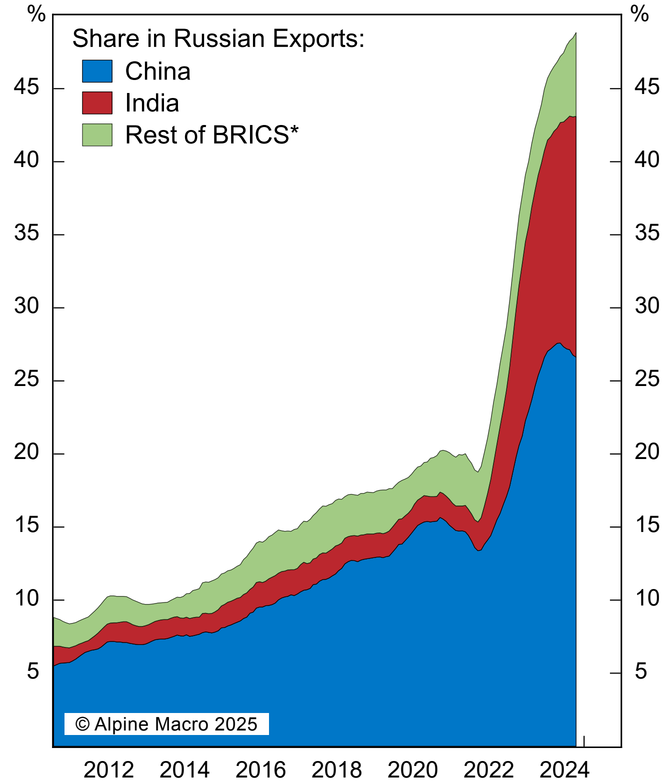
*Sum of exports and imports; shown as 4-quarter moving average

While inflation has been creeping higher, it is nowhere near the hyperinflation the country experienced in the 1990s, which led to the currency collapse and sovereign default in 1998. Unless oil prices experience a major crash similar to the 2014-2015 downturn, the risk of a financial crisis seems highly unlikely in the near future.

What Changes Has The War Brought?

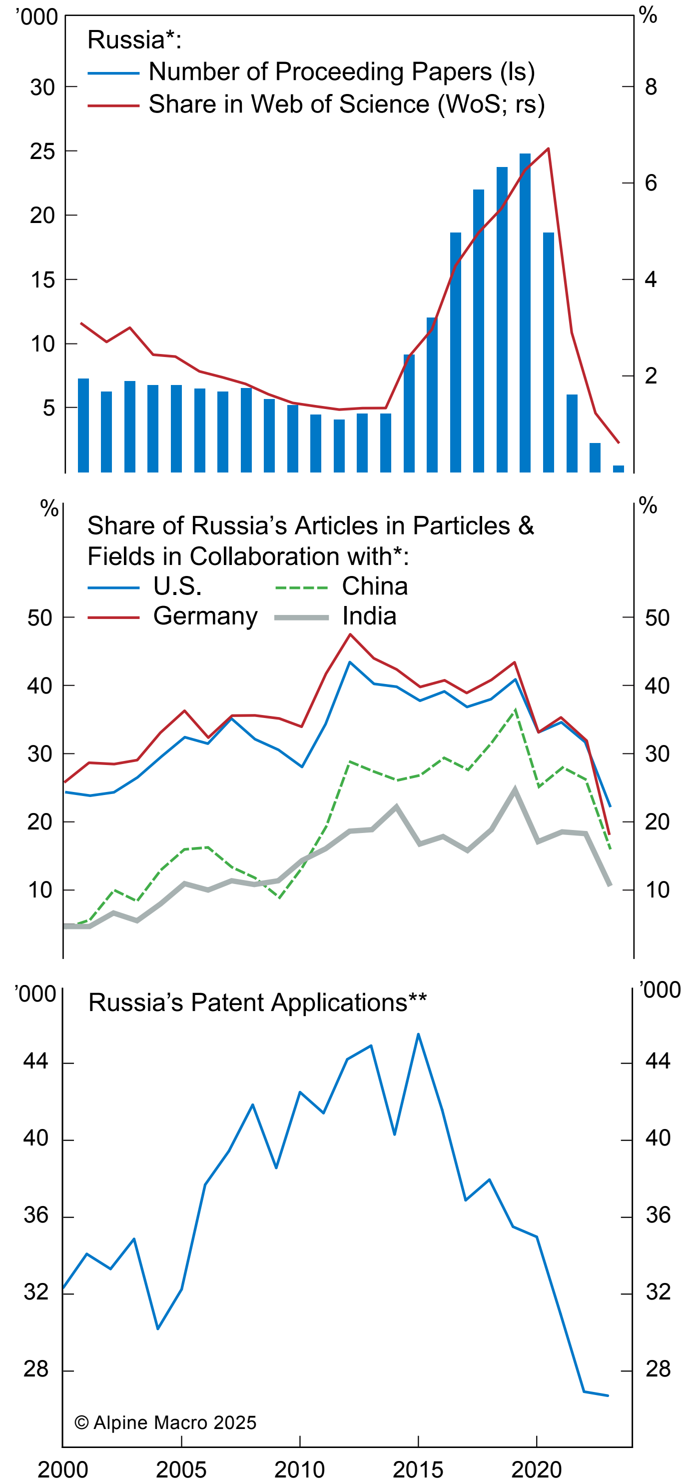
First, the Russian economy has become more closed (**Chart 14**). Total trade as a share of GDP has fallen sharply since the war, and the decline in imports is more pronounced. Cross-border investments, both to and from Russia, have also slowed substantially due to sanctions. Foreign trade and

Chart 15 Heavy Dependence On BRICS



*Includes Brazil, South Africa, Egypt, Ethiopia, Indonesia, Iran, UAE
Note: Shown as 12-month moving average; source: IMF DOTS

Chart 16 Research Capabilities Have Weakened



*Source: Zhang, Lin, et al. "The influence of geopolitics on research activity and international collaboration in science: the case of Russia." Scientometrics 129.10 (2024): 6007-6021
**Source: World Intellectual Property Organization (WIPO)

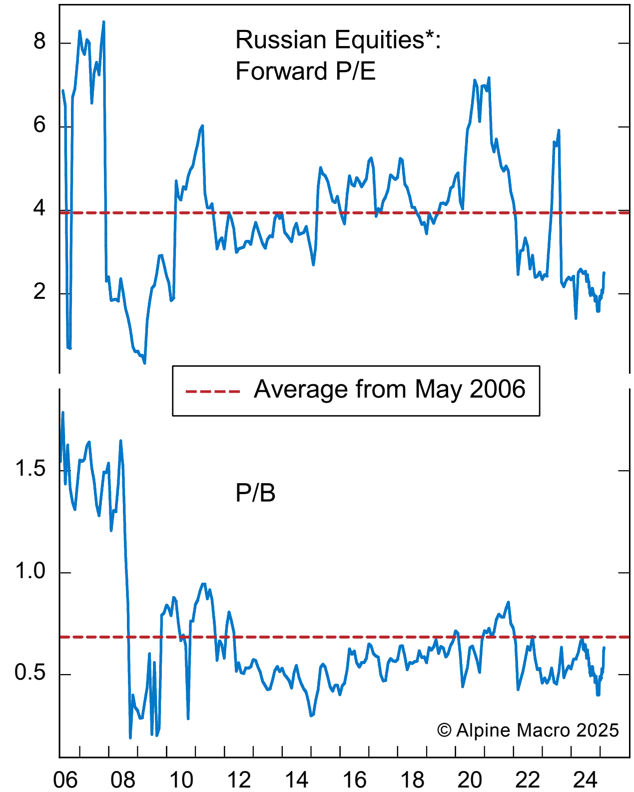
investment flows could stabilize and improve if and when the war ends, but it may take a long time for Russia to regain its previous significance in the global economy.

Second, Russia has become more economically integrated with the BRICS countries, particularly China and India (**Chart 15**). Russian exports to these countries have surged since the war, with sales to India increasing even more dramatically. However, the dependence is not reciprocal, as trade between other BRICS countries and Russia remains relatively insignificant compared to their global trade volumes. This suggests that Russia does not have strong economic leverage over these countries.

Chart 17 Russian Stocks Have Languished Since The War

*RTS Index; source: Moscow Exchange (MOEX)
**Source: MSCI

Chart 18 Equities Appear Very Cheap



*Data prior to May 2024 is sourced from the RTS Index via Bloomberg Finance L.P., data from May 2024 onward is calculated by Alpine Macro based on RTS equity benchmark performance

This also means that Russia is unlikely to realign toward the U.S. in the China-U.S. geostrategic rivalry, as its economy has become deeply integrated into China's economic sphere.

Finally, the war and global isolation have greatly hampered Russia's research productivity, making it harder to compete in science and high-tech industries. Russian research papers have largely disappeared from leading global platforms, and international collaboration in scientific research has essentially dried up, particularly in frontier fields (Chart 16). Russia's brain drain has also worsened, with some intellectuals deeply demoralized by the war, and it has become even harder for Russia to attract foreign talent. These factors will limit Russia's ability to move up the value chain, further concentrating its economy on natural resources.

Financial Markets Observations

Russia's overheated economic performance has not translated into higher stock prices. The market cap of the Moscow Exchange currently accounts for a mere 3% of GDP, down from 16% before the war (Chart 17). Russian stocks, historically tightly correlated with the global energy sector, have diverged dramatically in the past three years. Russian equity multiples have always been lower than global and EM averages, and the three-year bear market has pushed them even lower (Chart 18).

Chart 19 Russian Bond Yields Near Record High

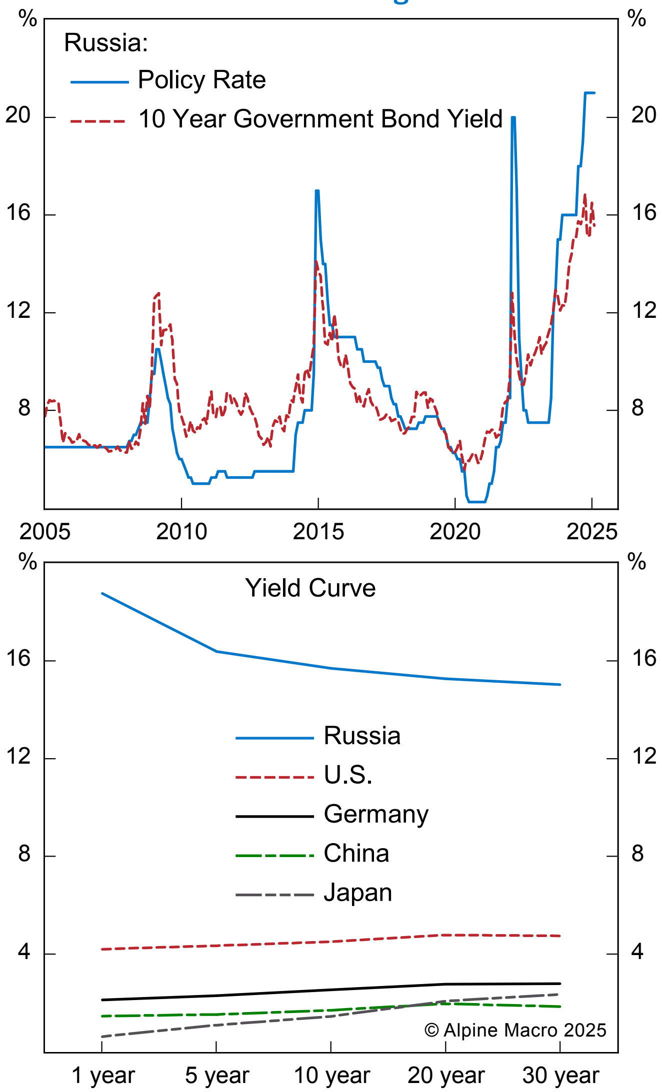
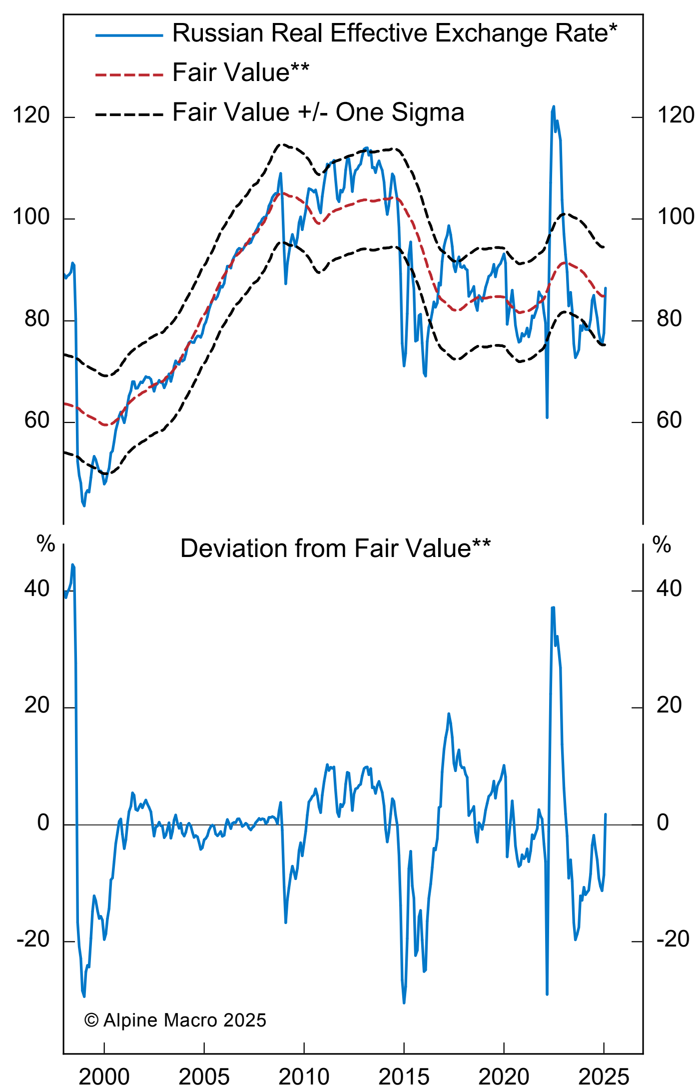


Chart 20 Ruble Has Moved Back To Fair Value



*Source: Bruegel
**Alpine Macro proprietary indicator

Our estimate shows that the Russian equity benchmark is trading at less than 3 times forward earnings and 0.6 times book value.

For fixed income assets, economic overheating and aggressive monetary tightening have pushed up Russian government bond yields across the curve (**Chart 19**). Currently, 30-year Russian government bonds are yielding over 15% in nominal terms, or 5% in real terms. These returns seem excessively high, considering the country's fiscal situation and low public sector debt. Such deeply depressed valuation indicators for Russian equities and bonds likely reflect extremely weak investor confidence in both the economy and the government. The market could see a major boost if the war ends and the economy normalizes.

The Russian ruble has experienced a rollercoaster ride against the dollar since the war's eruption, and has strengthened notably since the beginning of the year. Currently, the RUB is among the highest-yielding currencies in the world, surpassed only by the Argentine peso and the Turkish lira, despite Russia's much lower inflation. Following its recent strong rally, our model indicates that the ruble is now fairly valued in real effective terms (**Chart 20**).

Yan Wang, CFA
Chief Emerging Markets & China Strategist

Investment Recommendations

Strategic Positions (6 - 12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Colombian 10-year Government Bond, Currency Unhedged	11/21/2023		8.0%	Long Colombian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Greece Equity Index	11/21/2023		22.9%	Long MSCI Greece Equity Index in US$ terms; stop point at -10%.
Long Indian 10-year Government Bond, Currency Unhedged	06/04/2024		3.3%	Long Indian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Malaysia Equity Index	08/20/2024		-2.9%	Long MSCI Malaysia Equity Index in US$ terms; stop point at -10%.
Long BRL/MXN	09/23/2024		1.8%	Long Brazilian *Real* against Mexican Peso; stop point at -10%.
Short CNY/JPY	10/29/2024		2.7%	Short Chinese Yuan against Japanese Yen; stop point at -5%.

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long MSCI China Equity Index	02/20/2024		45.0%	Long MSCI China Equity Index in US$ terms; rolling stop point at -10%, or -10% from current level.
Long CSI 300 Index	02/20/2024*		9.1%	Long China A-shares Index in US$ terms; stop point at -10%. *Trade opened on Feb 20, 2024, closed on Sep 13, 2024 and reopened on Sep 24, 2024.
Short CNY/USD	10/29/2024		1.7%	Short Chinese Yuan against US Dollar; stop point at -5%.
Short THB/SGD	11/05/2024		-1.5%	Short Thai Baht against Singapore Dollar; stop point at -5%.

EM Equity Country Allocation

Strong Overweight	Overweight	Neutral	Underweight	Strong Underweight
	Chile China Colombia Greece Malaysia South Africa Indonesia Philippines Hungary Poland	India Peru Czech Republic	Brazil South Korea Thailand Mexico Taiwan Turkey	

EM Equity Sector Allocation

Strong Overweight	Overweight
	Health Care Consumer Discretionary Consumer Staples Utilities
Neutral	
Energy Communication Services Information Technology Financials	
Strong Underweight	**Underweight**
	Materials Industrials

EM Local-Currency Government Bond Allocation

Overweight	Neutral	Underweight
Indonesia Peru Brazil Colombia Chile India	Poland Hungary South Korea Malaysia Philippines South Africa Mexico	Czech Republic Thailand China Taiwan Turkey

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