27 February 2012

Why Are Russian Markets Flying?

In January of this year, the Russian markets rose the most of any stock market in the world: 14%

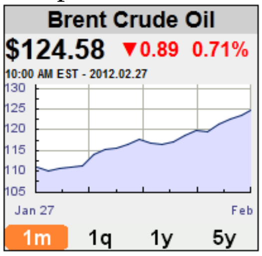
After last Friday, February 24, that ranking may be repeated for February, although at a lower level.

On that day, the dollar-denominated RTS rose 4.88%; the ruble-denominated MICEX rose 3.7%. It was the best performance of any stock market in the world on that day. Most markets were up slightly; the Down Jones fell slightly.

Why?

There are several reasons for these moves, some very short-term and some not.

First, oil has risen approximately 11% this year; it rose almost 2% last Friday. While high oil prices are generally good for Russia, the correlation between oil prices and the performance of Russian markets has become weaker over the past several years for a variety of reasons (high taxation of oil revenues, diversification of the economy, concerns about oil price stability, etc.). Still, there is a correlation and many investors still feel that the two are equivalent. In this case, perception *is* reality.



However, oils prices do not rise in isolation. Oil price increases are the result of other factors, some of which also have a direct impact on Russia.

Foremost among those factors over the recent short-term is, of course, Iran. With the US embargo of Iran widening in scope (*e.g.*, scheduled to extend to SWIFT transfers and all financial institutions that do business with Iran at the end of June) and the Europeans following suite, Iran itself cut off deliveries to France and the UK last week. While oil supply currently is actually matched quite closely to oil demand, oil pries are notoriously inelastic and any supply disruption – even a potential supply disruption – can cause a significant spike.

More importantly, there are longer-term factors that are putting upward pressure on oil prices, mainly Greece and the improving general economic outlook. **The February 20** (actually, about 2:30 a.m. on February 21) **decision to fund a second Greek bailout, while a long way from solving the Euro zone's debt problems, removed the immediate threat.** Plus positive indications from China, Japan and the US regarding assistance in funding a European safety net provided that Europeans can strengthen the firewall to prevent any future debt issues from spreading have significantly eased investor concerns.

Although the EU announced last week that it is now expecting a recession this year, it is very likely that, if it indeed occurs, it will be both mild and of short duration – and far from identical in scope in every EU country. **Very positive economic news out of the US (unemployment, housing sales consumer spending and confidence, etc.), along with positive economic news out of Germany, China, Indonesia and other, generally**

emerging, markets provide strong indications of an economic recovery – not a boom to be followed quickly by another bust, but a slower, more long-term recovery.

This optimism has both a direct spillover effect onto other markets, including Russia, and, as noted above, puts upward pressure on oil and other commodities.

Of course, to some extent the first factor (higher oil prices) and the third (positive economic news) contradict each other. High oil prices, of course, have a depressing effect on economic growth, so there are limits to how high oil can go without dampening growth prospects. We are probably close to that level now, at least in the short term. On the other hand, falling oil prices enhance the potential for economic growth, so there is clearly a **healthy dynamic tension** at play.

While rising oil prices, the decision regarding Greece and the prospects for an economic recovery have all helped push Russian markets higher, there is a fourth and final reason for Russia's excellent market performance: **decreasing uncertainty over Russian presidential elections**.

By definition, elections in any country mean uncertainty. After the disputed Duma elections in December of last year and the large demonstrations (both anti- and pro-government), concern spiked over the stability of the Russian government, particularly after the "color revolutions" of several years ago in some countries of the former Soviet Union and the "Arab spring" revolutions of last year.

However, three factors have muted the concerns regarding the upcoming presidential elections on March 4.

First, quite literally everyone, every speaker at the demonstrations and every political leader, has made it abundantly clear that **no one wants a revolution**, or even significant disruption, in Russia. Life in Russia is generally good and improving and the results of the recent revolutions, whether violent or otherwise, in other countries do not provide much to envy. Rather, opponents of the current government want to work within the system generally as it is.

As the sincerity of those sentiments has since become clear and as the actions of the opposition (and, no less important, of law enforcement authorities) have proven to be consistent with their words, concerns regarding violence and disruption, much less revolution, have evaporated.

Second, **Putin's government has done a credible, if far from perfect, job of reacting to some of the complaints expressed**, *e.g.*, direct election of governors, web cameras at polling places, easing requirements for parties to gain seats in the Duma, etc.

Third, two major polls have recently shown that **Putin is virtually assured of winning in the first round**. (Russia has a two-round presidential election system similar to that of France.) While his majority will likely be far less than the 80% of the vote he won the last time he stood for president, estimates are that Putin should garner somewhere between 55%

and 60% this time around: a respectable majority but hardly an overwhelming mandate or endorsement – which may well be the ideal outcome.

Stability is generally viewed by markets as a good thing and Putin has certainly given Russia that. The risk of stability turning into stagnation is not trivial, however, but Putin's reaction to the demonstrations has actually shown many that he is capable of being innovative, at least to some degree, if necessary – and the demonstrations have clearly shown the necessity.

Throughout the recent economic crisis, Russian companies generally did well (with some notable exceptions, mainly in the financial and real estate sectors); they certainly have thrived since the second half of 2009. But while most Russian companies have continued to grow, their stock prices plunged, pushing **Russian P/E ratios to ridiculous lows**. As recently as late last year, for instance, Gazprom had a P/E ratio of 3.1 (compared to a historical level of twice that).

Even with the recent increase in stock prices, **the P/E ratio of listed companies in Russia is currently less than 6.** The US S&P is 13.4; its 50-year historical average is 16.4. Prior to the recent economic crisis, the P/E ratio in Russia was 11 – at the time, the second-lowest in the world. (Only Thailand was lower as there was a threat of revolution).

Russian market indices are still at only 60% of their pre-crisis levels while the Dow Jones is less than 10% below its record high – even though Russian companies have far higher growth rates than the companies in the Dow. And even though, in some ways, the general economic climate in Russia is better, more diversified and more stable than it was pre-crisis.

Consider:

- Russia was the world's **third-fasted growing economy** in 2011
- Russian has all but completed the actions necessary to **join the WTO** (only Duma ratification is necessary, which is a foregone conclusion after the presidential elections)
- The Obama administration in the US has begun the fight to **repeal the Jackson-Vanik Amendment**, restricting trade with Russia. Ironically, if the US fails to repeal it, the *US* will be subject to penalties under WTO rules and US companies will be far less competitive in Russia
- Consensus estimates are that **oil prices will increase at least another 15% this year** – without any significant geopolitical factors such as Iran affecting supply
- Russian **growth is expected to be slightly higher in 2012** than in 2011

Thus, while potential risks and threats clearly remain, there are many more arguments for Russian markets to continue to rise in the immediate future than for it to fall. Investors seems to realize this more and more clearly, as the recent moves in the market show. However, the recent upward move does not in any way mean that the best of 2012 is behind us. In fact, the opposite may well be true as the fears of another economic crisis recede and investors again begin to concentrate on capital growth rather than capital preservation. Russia is clearly one of the best markets for equity capital growth in the world.