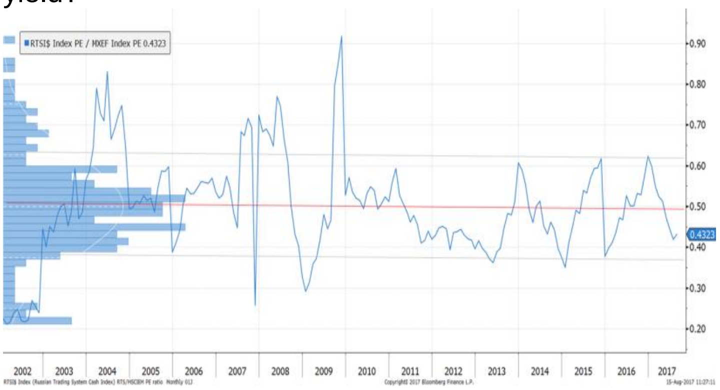
The Russian Economy and Investment Case

September 2017

Turning Point and Recovery - In 2016, Russia's equity markets rallied almost 60% and the local bond market returned 20.8% (in USD terms), while the economy emerged from a 7-quarter slumber. Russia was the proverbial '"high beta play"' on global growth and commodities. It was a year of turning points for the global economy, emerging markets, and Russia, in particular. Rates, currencies and commodities bottomed-out and began to recover, with oil prices rallying over 100% from the January low to the December high. The 6-year long under-performance of Emerging Markets (EMs) vs. Developed Markets (DMs) also bottomed.

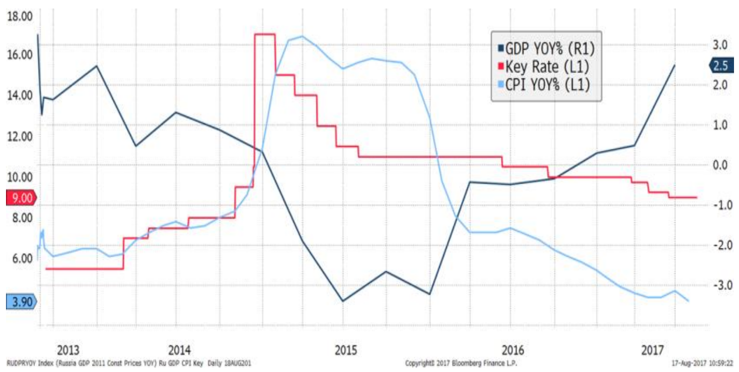
In 2017, these positive trends have continued, with three consecutive quarters of positive GDP growth. Russia has seen global capital inflows, a stronger ruble, declining inflation, rate cuts, solid corporate earnings growth and high dividend yields. But Russia's markets have not kept up with the good news and they remain significantly under-valued relative to other emerging markets (EMs)

Relative Value – Russia / EM - The MSCI Emerging Market Index has rallied 25% YTD and is trading on more than 16x earnings with a 2.3% dividend yield, while the RTS Index is down 9.1% YTD and is trading at 6.8x earnings with a 5.25% dividend yield. As can be seen in the chart below, the historical distribution of Russia's discount relative to EM peers, generally fits between 40% to 60%. The current 57% discount puts Russia firmly in the 'cheap zone' and the obvious question is, how much longer can investors continue to discount Russian equities by more than 50% to EM peers and ignore the more than 2X higher dividend yield?



Lower for Longer - The low-growth / low-inflation / low-volatility environment in developed markets has allowed the major central banks to maintain unprecedented ultra-accommodative monetary policy measures, and rate hikes have been pushed back into March of 2018 for the Fed and December 2018 for the ECB. This lower-for-longer paradigm should be constructive for global carry traders, emerging markets and commodity producing countries like Russia. The low rate environment should reflate hard asset values globally. "Jawboning", "taper-talk" and other commentary, are the only remaining policy tools of major central banks. The relatively dovish commentary from the Federal Reserve, compared with ECB comments, has caused the DXY trade weighted USD index to drop more than 9.5% so far this year, while the Euro has rallied 12%, which should support Russian exports to the EU. With $76bn in exports to the EU vs. just $14.5bn to the US in 2016, clearly the EU is economically more important to Russia, and Euro strength helps Russian exports.

Positive Macro Factors in Russia - The State Statistics Service, gave us a few more positive surprises last month. 2Q 2017 GDP was 2.5%, beating the 1.7% consensus forecast. CPI declined to 3.9% YOY at the end of July, below the CBR's YE target, and MOM CPI was only 0.1%, so there may be continued disinflationary pressures for the near future. This was followed by 4.6% YOY growth in real wages, the highest since April 2014, and 4.8% YOY 1H2017 growth fixed asset investments, implying 6.5% YOY for 2Q, the highest since 2Q2012. On the other hand, narrow money supply growth (M1) was only 5.9% in the last 12 months and retail sales expanded for a fourth month in July, but at just 1% YOY, while Industrial Production appears to be decelerating, with July at 1.1% YOY, after June's 3.5% YOY and May's 5.6%. This suggests that high real rates and low money supply are choking economic growth, and provides a strong argument for the CBR to cut rates in September.



Inflation's long decline from the peak levels of 1Q2015 to just 3.9% in July 2017, is the result of the CBR's prudent positioning over the last 2.5 years, which has instilled disinflationary expectations and stability in the ruble.

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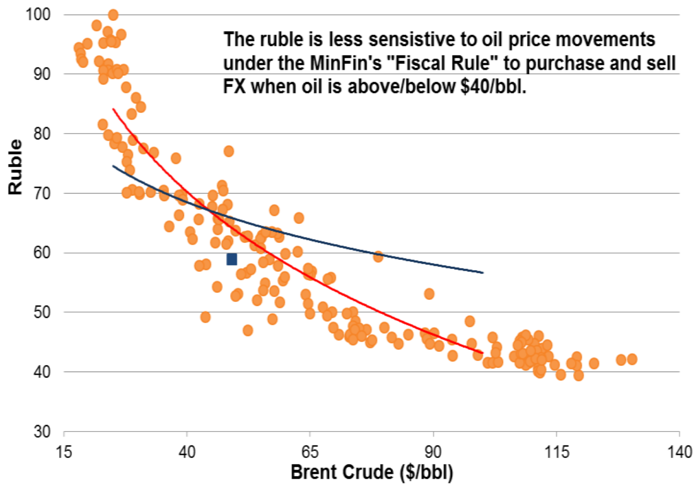
Ruble Stability - After the 100bps of cuts in the CBR's key policy rate to 9% so far this year, real rates continue to remain at quite high levels, and annualized 30 day ruble volatility has fallen to less than 8%. This low volatility combined with a high real rate has attracted capital flows from global carry-traders. The "Fiscal Rule", which is designed to reduce ruble volatility and build the CBR's FX reserves up to $500 billion in the next few years, authorizes FX purchases while oil prices are above $40 a barrel and FX sales when oil is below. It is worth noting that the CBR's FX reserves have grown from $376bn to $420b YTD.

Oil prices have lately recovered to $52/bbl, after recent meetings in the UAE reaffirmed commitments of the earlier production cut agreements, and if markets start to see better compliance, prices should be well supported in the second half of 2017. It is well known that there is a high correlation between the ruble and oil prices (R^2=0.90 over the last two years), and, given that many consumer goods are imported, higher oil prices, leading to a stronger ruble, will also help to reduce inflation.



Further confirmation of the economic recovery can be seen in nominal and real wage growth of 8.6% and 4.6% YoY in July, respectively. This has led to a stabilization in consumption, with real retail sales up 1% on 2016 YOY in July, from a low of -14.1% in December 2015. Fixed asset investments grew by 2.3% in Q1 2107 YoY and wholesale trade was up 5.4% YOY as of June. Speaking about the positive dynamics of industrial indicators, it is also worth noting that construction grew +7.1% YoY in July, from a June 2016 low of -9.9% YOY and cargo transport was up 6.2% YOY as of the end of July.

Market Risk Perceptions Have Improved - Global investor sentiment towards Russian risk has improved dramatically over the last 3 years. Still, at just under 150bps, Russian 5 year CDS are well above the pre-Ukranian crisis levels of 120bps, and the 2007 low of 38bps, when oil was on its way to peaking at $140/bbl.

Overall, the trend for investor sentiment toward EM risk is declining, as a function of declining global volatility, excess liquidity and as the hunt for yield pushes more investors into the EM asset class for which CDS are used as a hedge.

We think that fixed capital formation and lower rates will become a key factor increasing the potential output of the Russian economy. As mortgage rates declined from over 15% in 2016 to under 8% this year, we expect a surge in home building and buying due to the pent-up demand and low real estate prices, comparable with 2004 levels. With mortgages at just 5.1% of GDP, there is plenty of room for increased leverage and lower rates will be the trigger for increased loan volumes.

Leading Indicators Have Improved - The Composite, Manufacturing and Services PMIs all grew over the last 12 and 24 month periods, to 53.4, 52.7 and 52.6, respectively, all remaining firmly in the expansion zone. We think recent improvements in wages and inflation will lead to continued optimism.

Consumer confidence is at three year highs, after rising real wages and disposable incomes rose. Both, the OECD's measure and the Federal Statistics Service's index are close to 2014 highs. This will spill

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over into other sectors, particularly consumer durables and banks. The financial sector is likely to see earnings growth in excess of 15% and the oil and gas sector may have earnings growth over 25%.

Low Debt to GDP - Russia has a scarcity of bond supply and global investors just can't get enough. This has led to excellent returns, lower bond yields and a lower cost of capital for Russian issuers. With government debt to GDP about 14% and total debt to GDP around 38%, the fiscal budget can easily be financed with debt issuance and corporates have room to lever-up for higher dividends. The CBR is expected to cut rates by another 100bps to around 8% by year-end and is likely to continue cutting until it reaches a real rate of about 1% in the longer term. This rate cut trajectory would surely be supportive for domestic sector growth.

Market Outlook - Our base case scenario, developed at the end of 2016, seems to be intact. $53/bbl is slightly above the current YTD average and, according to our models, this would lead to GDP growth of 1.8%, a small but manageable budget deficit, a stable but slightly weaker ruble, with declining inflation and rates. The current consensus forecast of 2017 GDP is 1.4% and the Economy Ministry's GDP forecast for 2017 is 2%. Given recent positive momentum in the economy, there may be some upside to these forecasts.

Russian companies are feeling the benefits of recovery and stability, with a lower cost of capital and higher aggregate demand. Ruble strength has been a headwind, but upside to our DCF model 12 month target prices is still 25% to 35% for equities.

We also see PE expansion, with Russia's discount to EM peers closing from over 50% to 20% over the next 3 years. This, combined with, an EPS CAGR of approximately 15% over the next 3 years, supports a potential return of 30% over the next 12 months for equities.

Assuming oil prices of $50-$55 and no significant changes to our assumptions over the next 12 months, we see:

- 3%-5% total returns in Russian Eurobonds;
- 8-10% total returns in Ruble corporate bonds;
- 25%-35% total returns in equities.

Short term concerns include: potential liquidity problems in the banking system and possible negative news from court cases and corporate governance problems at Sistema. Medium term growth drivers may include: continued declining inflation, more rate cuts, further growth in real disposable income, credit expansion, privatizations, new issues and other factors.

The RTS Index is down 9.1% YTD and is trading at 6.8x earnings with a 5.25% dividend yield. Its discount to EM peers is at historical limits. To put this into another perspective, the market capitalization of the RTS Index, with Russia's 50 most liquid stocks, is only $154 bn, or just 18.6% of the Apple's $828bn market capitalization!

With the relative value and absolute upside potential of Russian markets, the obvious question is, how much longer before investors decide to take profits in over-valued US equities and re-allocate selectively into emerging markets, particularly Russia's? In our view, not much longer.

Tim McCarthy
Co-CIO and
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About VTB Capital Investment Management

With over $8 billion USD in AUMs, VTB Capital Investment Management is a key division of VTB Capital and of VTB Group, which is the second largest financial group in Russia. VTB Capital Investment Management offers professional investors world class investment solutions through its experienced and award winning portfolio management, venture capital and private equity businesses. The wealth and investment management team has extensive experience and knowledge of the specifics of asset management in Russia. Headquartered in Moscow, our integrated team of analysts and managers are in the midst of current events and know firsthand the business realities that take place in Russia. Meticulous research along with our ability to exploit Russian market inefficiencies have allowed us to exceed market returns and deliver superior results to our clients.

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