

Russian Stocks Attractive amid Growing Global Uncertainty

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The world has become uncertain and the trust is nowhere to be found. Nobody knows what currency exchange rates should be or what the fair value of stocks is. Some time ago investors believed the Fed's stimulus package could bring the world economy back on growth track. Unfortunately, the quantitative easing programs had virtually no effect on such indicators like GDP or unemployment rate. Now, we all have doubts whether the EU could survive with such an abnormal amount of sovereign debt.

Governments, companies and households have been borrowing money for the last thirty five years, so it is impossible to just have a fresh start right now. We are at the beginning of a long bumpy road of changing our principles of living, consumption and globalisation. The paradigm of economy has also switched from an industrial to informational one, so this requires new approaches to corporate governance and political negotiations.

The downgrade of the US and the euro crisis put strong negative effect on emerging markets. Stock indexes declined more than 30% from their highs of 2011, while the banking sector has lost more than 40% of its capitalisation. The Russian stock market saw outflows for 16 consecutive weeks. Foreign investment funds have withdrawn about \$3 bn since the end of June. Year-to-date, inflows into the category made \$0.4 bn, compared with \$2.5 bn for the same period of 2010.

I do not think that institutional investors will lose their interest to emerging markets and particularly to Russia in the next 12 months. Brent price is expected to stay above 90\$/bbl, and it assumes corporate profits to reach as much as \$250 bn in 2012. From the political stand point, the situation in Russia is more or less clear for international fund managers. Based on such fundamentals, the RTS index should be traded at 1900-2200.

Russian stock indexes have become less dependent on the oil price performance in 2011. Average Brent price is buoyant well above 100 \$/bbl this year, while stock indexes saw record

volatility levels. Equity prices follow the probability of European peripheral countries' sovereign defaults. In this light, investors have serious concerns about the Eurozone banking system. Due to its sovereign debt exposure, Eurozone bank equities are highly correlated with sovereign spreads of the EU's peripheral economies.

Russia has been consistently trading at a significant discount to MSCI Emerging Markets, and the recent downside correction has widened the discount to about 50%. It seems a little bit too much, especially taking into account that earnings forecasts for 2012 remain unchanged.

Russia is very close to joining World Trade Organisation (WTO). Despite the benefits of the WTO membership are yet to be seen, investors should cheer the country's steps towards the developed world. The deal increases competition, so companies should improve their efficiency. I do not expect an immediate increase of fund flows to Russian equities, but it will definitely help to improve the country's investment climate in the long run. However, heavily-weighted oil and gas companies will be unaffected, since they are not covered by the WTO rules.

Indeed, Russian stocks might seem cheap and probably they are undervalued, but unfortunately it makes absolutely no difference in times of economic slowdown. Investors are inclined to put their money in safe assets, so we can't know for sure when the upside potential of Russian stocks will start to bear fruits. It might take several months or even several years. Nevertheless, stocks became very attractive as a class of assets. Earnings yield soared to nearly 25% in the 3d

quarter of 2011, increasing its gap over the yield of Russia28 Eurobonds to 1700 pp.

STOCKS ARE VERY ATTRACTIVE AS A CLASS OF ASSETS

I would say that stocks of oil companies are a good bet for the next year. Russian oil & gas industry looks robust since the volatility of oil prices is less than that of any other commodity. Then, companies should benefit from new "60-66" tax regime and increase dividend payout ratios. Possible depreciation of ruble is also good news for profits of such giants as LUKoil or Rosneft.

Currency markets will remain on the radars of investment fund managers in the next year. Many of them have been keen on exposure to emerging markets because of low yields at home. But potential depreciation of currencies would mean losses on these investments, which could slow flows even more. Russian ruble has lost more than 10% last summer suffering from the "flight to quality".

Fortunately, Russian banks are less dependent on foreign capital than they were in 2008. They have virtually zero exposure to sovereign debt of peripheral Eurozone countries, having only 17% of securities in their assets. In contrast, European banks keep more than 40% of their assets in securities. That is why Russian banks are traded at 0.9-1.3 of their equity capital, while Eurobanks are traded at less than 0.4 times their book value.

Our base case scenario assumes modest growth of equities on the back of easing problems in the Eurozone. This forecast, however, is subject to significant downside risks, given the potential for further market volatility.

