



Out of the Red: Russian Markets Poised for Recovery

By John T. Connor*

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Russia's financial sector has not been spared by the financial crisis that ravaged stock markets globally. But, if the Russian economy demonstrates resilience in its biggest test since 1998, and if the government offers proper policy responses, on which they have made a good start by reducing the export oil tax and opening the Central Bank window, it would go a long way toward securing the country's long-term economic development and investment appeal. I just spent 10 days meeting with Russian business and Government leaders and was mightily impressed by the policy moves being implemented to deal with the current world wide crisis.

Russia's economy will take a pause, but my judgment is that the recovery will be swift.

Let's begin with some observations:

- As of the end of October the country's benchmark RTS index has fallen over 75 percent year-to-date; it fell 36 percent in September alone, making it one of the worst performers globally. The global macro issues – the liquidity crunch and falling commodity prices – as well as increased concern about Russia's risks – were the fundamental reasons for the sell-off. The apparently indiscriminate liquidation by funds and leveraged investors added fuel to the fire. While the worldwide flight to the dollar is causing the Ruble to depreciate after years of appreciation against the dollar, the reserves of the Central Bank of Russia are the third highest world-wide and ensure that the Ruble depreciation can be managed within a band and should not be severe. Russian exporters, of course, are delighted.
- At the beginning of the calendar year, Russia's aggregate P/E was 12x. Today it is approximately 4x. Russia now trades at a significant discount to the other BRIC countries: Brazil, China and India. Clearly, valuations in Russia look to me to be very cheap, and we are seeing the **best macroeconomic fundamentals** in years.



- Real GDP growth currently is running at 8% in 2008 and retail, measured in terms of PCE, is growing at 20%. The 2009 forecast calls for growth in the 3-5% percent range, but growth nonetheless at a rate that would thrill most countries, including the U.S.
- 85 million Russians qualify as middle class, comprising the largest middle class in Europe. Over the last ten years, Russia's middle class is moving up from 25% of the population and its sagging demographics are being aided by a baby boomlet in the making.
- There are no sub-prime mortgages in Russia and, in fact, there are few household mortgages of any kind. The consumers, the companies and the country are each under-leveraged!
- Although earnings forecast have been revised downwards due to expected reduced growth in the Russian economy, Russian companies are still projected to enjoy robust earnings in 2009, especially in comparison to what is happening elsewhere in emerging economies.
- Central Bank reserves approach \$600 billion, the: third highest after Japan and China. The Government's budget surplus should continue even if oil falls below \$50.

In short, based upon fundamentals, the market appears to be dramatically oversold.

Opportunities in Specific Companies

Many world-class Russian companies in the consumer, oil & gas, financial services, telecom, metals and mining sectors are trading at significant discounts to their global peers. We believe investors can benefit from the powerful forces of the under-leveraged and underserved consumers, natural resource demands from emerging giants such as China and India, and the massive infrastructure commitments projected, for the indefinite future.

Inflation Concern

This has been my concern this year. Earlier forecasts of 15% inflation have been reduced to below 10% for 2009. On the plus side, falling commodity prices and a rising focus on costs by major Russian companies seem to be reducing inflation to a more manageable number. And while decoupling from the fortunes of the U.S. economy or broader global economic models is impossible in these jittery



markets, I believe the resilience of the Russian economy and corporate earnings will ultimately be recognized by investors.

The Elephant in the Room

Massive columns have been written about the Georgian conflict, and I will not attempt to summarize these analyses here. Suffice it to say that bad public relations over perennial political conflicts has been supplanted by an actual military engagement. The best I have seen is Stratfor's George Friedman, which details Georgia's unprovoked incursion into South Ossetia with significant loss of life for Russian military personnel and the local civilian population. U.S. Ambassador to Russia John Beyrle has acknowledged that Russia was "clearly justified" in responding; though its response was disproportionate. My thought is to focus on the battle of conflicting strategic visions: the President of Georgia hopes to stampede President Bush into shoe-horning Georgia into NATO during his short time remaining in office. The Kremlin's air, land and sea forces response was meant to convey to NATO that getting involved in the Caucasus, given the involvement in the Balkans, Iraq and Afghanistan, was not something they want to do. My assessment of the Kremlin's dismal public relations capability is explicated in more detail in my book, *Out of the Red* (see link above). The Russian rendition of what actually happened in the conflict is beginning to appear in our press. But the Kremlin should have been making its case much earlier and investment there suffered mightily as a result of their ineptitude.

Recovery

The bottom line is that over time, markets with strong fundamentals and low valuations, such as Russia, generally recover after corrections. The hysterical forced-selling in September could be the harbinger that the market's true bottom is approaching.

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