



COMMENT: Russian market set to be one of world's best performers this year and next

Peter Halloran of Pharos Financial Group
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It seems that each year the Russian market finishes as either the world's best or worst performer. In 1998, it fell by 83% and promptly rallied 246% in 1999. With an estimated 2009 price/earnings of only 5.1 times, it ranks today as among the world's cheapest. After last year's complete freefall, we believe the Russian market is set to become one of the world's best performers both this year and next. Our conservative assumption is that 2009 earnings will drop by more than one-third from last year's level with ample room for growth to follow in 2010.

The drivers to this year's outperformance will be the perceived bottoming of the commodity markets together with the recognition that a newly competitive ruble has made Russia the low-cost supplier of gas, nickel, steel, aluminum, fertilizer and other metals. Meanwhile, the credit markets will spend 2009 in continued disarray, but could become a driver to domestic demand by 2010.

The investment case for Russia is quite straightforward. So long as the oil price is above \$41 per barrel then the fiscal budget balances, the current account is positive and the ruble is stable. Current market valuations discount far worse outcomes, to say nothing of the upside potential from a more broad recovery in commodity markets. While Russia needs badly to diversify its economy and reform its institutions for longer term prosperity, its near-term recovery is far more sensitive to outside factors.

Inevitable spikes

Having endured the crash of 1998, the Pharos investment funds have consistently pursued risk management techniques that reflect the inevitable spikes in volatility common to all emerging markets. Last year, we enjoyed a strong outperformance relative to the indices and our peers. In fact, our long-term performance tells a story of providing about half the market volatility while enjoying nearly all of the upside. Over the past five years, our annualized return has been 10.2% while the market has shown an annualized loss of 7.5%.

We have bought index puts during market rallies while selectively shorting overbought securities. Our gross exposure has tended to be around 110-130%. However, as last year's crisis accelerated, we understood that credit risk had become the bigger concern, as all counterparties had become unreliable. Shrinking the balance sheet became our priority both to contain existing credit exposures, but also to anticipate that leverage could itself become unavailable.

We also reduced our long exposure outright to reflect the increase in market volatility. One of the classic mistakes we witnessed among other investors was the failure to adjust their capital at risk despite a spike in volatility. Old guidelines for capital usage rapidly lose relevance when there is a prolonged increase in volatility, as much less capital becomes required to achieve healthy return targets. We expect volatility to remain at nerve-wracking levels for at least another year, as the market grinds higher from here. For Pharos, this is the ideal environment.

Meanwhile, our growing optimism toward the market comes not only from the improving debt spreads and commodity markets, but also from the unexpected savvy displayed by the Russian government during the crisis. The Putin administration earlier had squirreled away roughly all of Russia's oil price windfall - amounting to about \$750bn. Once the true nature of the global crisis became evident, Russia was among the first to announce sweeping plans to backstop its economy. The Central Bank of Russia injected liquidity into the banking system, while guaranteeing the interbank lending market. The fiscal budget was expanded while taxes were cut.

Most controversially, \$200bn was spent controlling the devaluation of the ruble. We believe much of that came as a transfer to the Russian private sector through the forex markets as they adjusted to the weakening ruble. Indeed, the correspondent account of Russian banks increased by about \$120bn during this period. Given the troubled history of the ruble, such a strategy has proved highly effective in averting a possible panic that could have undermined the broader financial system.

Challenges

While Russia is not currently facing any major systemic risks, it does have serious challenges to getting its economy back on track. For example, corporate indebtedness to foreign lenders increased dramatically since 2006 creating a legacy of redemptions coming this year and next. So far, the willingness of these lenders to restructure this debt has been a positive catalyst to the markets from these depressed levels. Nevertheless, the debt markets will remain a drag on economic growth for the remainder of the year, and will almost certainly provide some headline-grabbing defaults along the way.

There are other risks that remain as relevant today as ever, such as the increasing role of the state in the economy and the inadequate protection of property rights. However, with the Kremlin's liberal reform team having gained much credibility from its handling of the crisis, Russia may be ready to embark upon a new period of reform. Indeed, every crisis since 1991 has been followed by a period of meaningful reform, which offers us a good reason to be optimistic toward Russia over the longer term.
