Global Outlook

Region In Focus Q1 2015

Standard Life Investments

Region In Focus

Not Russian for the exit

The Russian economy is reeling from the slump in the oil price and Western sanctions - but opportunities exist for the long-term investor.

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As the Russia-Ukraine crisis enters its second year – and with few signs of tensions easing – both nations are increasingly feeling the economic strain. Russian third-quarter GDP growth was the slowest since 2009, as ever-more stringent Western sanctions took their toll. The oil price – Russia's main export along with gas – has tumbled around 40% since June. On current estimates, oil at this level will the cost the country some $100 billion a year, while sanctions will account for a further $40 billion. At the present rate, the Russian economy will slip into recession in 2015.

Capital is also fleeing the country as domestic investors shelter their cash overseas. According to the Central Bank of Russia (CBR), outflows will total around $85 billion for 2014. The slump in the rouble against the dollar has prompted some market Cassandras to predict a re-run of the 1990s, when financial panic, hyperinflation and a currency meltdown brought the former superpower to its knees.

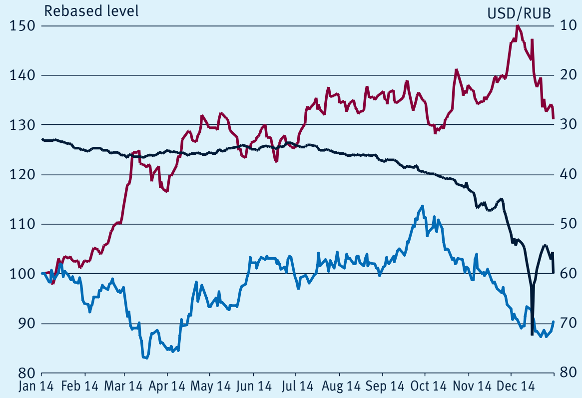
For some investors, then, the former Soviet state is to be avoided at all costs. In our view, however, the picture is far more nuanced – with winners and losers to be found.

Russian resolve

In general, concerns about economic collapse are overdone. For one thing, the increasingly autonomous central bank has made financial stability its number-one priority. It has aggressively hiked interest rates to try and protect the currency and keep a lid on rising inflation. The CBR's surprise decision to allow the rouble to free-float next year – which will make it potentially more costly to speculate against – should also help stabilise the currency in the medium term.

Meanwhile, President Putin remains more popular than ever with his domestic audience: his approval rating is at an all-time high of 86%. By appearing to stand up to the West, Russians feel Putin is helping to restore the country's standing on the world stage. For many, such a nationalistic goal is worth a bout of short-term economic hardship – for now. Lastly, Moscow is seeking to strengthen strategic and economic ties with China and Asia to offset increasing isolation from the West. This included a $400 billion agreement to supply China with gas from western Siberia. Further deals in the region are likely, including for energy, armaments and space technologies.

Chart 1
Gems in the rouble



Stock performance relative to Russian MICEX index in US dollar terms, rebased at 100 as of 1 January 2014: — Norilsk Nickel — LSR
— Russian rouble to US dollar exchange rate (R. H. Scale, inverted)
Source: Datastream (as of 31 December 2014)

Currency winners

Of course, not everyone is lamenting the fall of the rouble. One company in particular that is thriving is Norilsk Nickel (see Chart 1), Russia's largest mining company. It produces 17% of the world's nickel and 41% of its palladium, the vast majority of which is sold overseas. These metals are priced in dollars, which means the greenback's strength against the rouble is a boon for Norilsk's operations and profits.

Somewhat counterintuitively, the currency is also helping a number of Russian housebuilders. Since the financial crash of 2008, the country's real estate market has been in the doldrums, with numerous construction programmes shelved. Excessive bureaucracy and overly strict mortgage-lending criteria have further depressed the market. Since then, demand for new housing has grown, notably among those generations still residing in Soviet-era housing. Importantly, incomes and savings have been on the rise; mortgage borrowing requirements and costs have eased.

It has taken the plunge of the rouble, however, to unlock this demand. Faced with capital erosion, Russians are ploughing their long-held savings into physical assets, notably new properties. St Petersburg-based housebuilder LSR is well-placed to benefit from this pick-up in activity.

Finally, the current economic climate – not to mention Putin's retaliatory ban on Western foodstuffs – is also re-shaping the retail environment. One notable standout is Magnit. It has steadily been gaining market share over its rivals thanks to its competitive pricing power and the sheer number of its stores. This dominance look set to continue as Russian shoppers increasingly feel the squeeze.

Looking long term

At Standard Life Investments, we believe that by analysing what is changing in a market from a company perspective we can identify attractive investment opportunities, despite what may appear to be universally challenging overall fundamentals. In this way, our *Focus on Change* process allows us to find long-term investments that might otherwise be lost in the short-term noise. It is for this reason that it is a mistake uniformly to avoid Russian equities.

Important Information

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