EAST CAPITAL

Macro Monitor
December 2012

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Russian equities struggling, but things are beginning to change.

Compared to its peers in the emerging markets, the Russian equity market massively underperformed during the first 11 months of 2012. It is currently valued 50% lower than the other BRIC markets. That is despite high oil prices, dividend payouts and an improvement in public sentiment during the second half of the year. East Capital's chief economist, Marcus Svedberg, explores why the Russian market has underperformed despite proving to be so resilient during the global slowdown.

There is probably no single reason behind the underperformance of the Russian equity market and the valuation discount, but the most likely culprit is arguably governance. There is a prevailing view that there is a deep governance deficit in Russia, in the public (politics) as well as in the private (corporate governance) sectors.

A number of assets

The question is not so much if this is true, but rather if it warrants such a large discount/underperformance and if things are changing? The general perception, very much nurtured by the western press, is that it is not only true, but that the situation has even become worse since Putin resumed the presidency earlier this year. We agree that there is a big governance problem in Russia, but do not agree that it is twice as bad in Russia than in other emerging markets, which is what the market is saying through its valuation discount. Moreover, Russia has a number of assets in terms of resilient economic growth (compare with Brazil), excellent public finances (compare with India) and a large and increasingly politically assertive middle class (compare with China) that it should be getting some credit for. But perhaps most importantly, we do believe things are changing, slowly and not always in a straight line, but nevertheless changing. Let's go through some of the changes related to governance this year.

Improved economic governance

Recently, the focus has been on the developments within the energy sector and investors have voiced concern over the emergence of state capitalism. We share this concern, but also believe there have been improvements in other parts of the economy.

Russia officially became a member of the World Trade Organization (WTO) on 22 August, having first applied for membership way back in 1993. WTO membership will stimulate Russian growth over the long term and remove some trade and investment barriers. The fact that Russia will now have to observe the same rules as everyone else in the WTO will benefit its economy and should also improve its reputation. Studies show that the economy will grow up to 1 percentage point more annually as a result of WTO accession, primarily because consumption is expected to increase. The effects will be unevenly distributed though, with those importing goods benefitting, while domestic companies that become exposed to greater competition from foreign companies are more likely to lose out initially.

WTO accession is, however, not the only economic reform that's been pursued by the government. Monetary policy has already changed a lot, with the currency trading in a wider band, making it almost floating, and the central bank targeting inflation more ambitiously. They are also implementing a budget rule that will help to reduce the fiscal dependence on the oil price. The entire financial infrastructure is being reformed through a stock market merger, the introduction of a central depository and regulatory improvements, including dividend targets for SOEs and mandatory IFRS accounting standards. The Sberbank SPO this autumn illustrated that the government is serious about its privatisation program, although it seems to favour a selective approach.

The business district Moscow City is one of the fastest growing areas in Moscow. Photo: Emil Holmström, East Capital

... and maybe also better public governance

Corruption is a huge problem in Russia – although not necessarily so much bigger than in some other emerging markets – and it has been a long-standing source of disappointment. There is, however, reason to be cautiously optimistic, as Russia is becoming more integrated in global institutions like the WTO and has signed up to the OECD anti-bribery convention. Russia has also taken legislative steps domestically that target corruption, not least related to procurements. And the anti-corruption drive seems to have intensified in November, with parliament passing a new regulation that monitors income and expenditure of government representatives. There has also been a number of high-profile dismissals lately, including Defense Minister Serdyokov, the General Director of RosCosmos, the Head of Rosavtodor, and the CEO of MRSK Center.

Public dismissals of high-ranking officials are likely to be more effective than conventions, as this sends a message to other officials that even people at the top level can be fired and prosecuted if abusing power. The firing of former Moscow Mayor Luzhkov and subsequent legal proceedings against his family last year could be seen as the starting point.

Russia will change

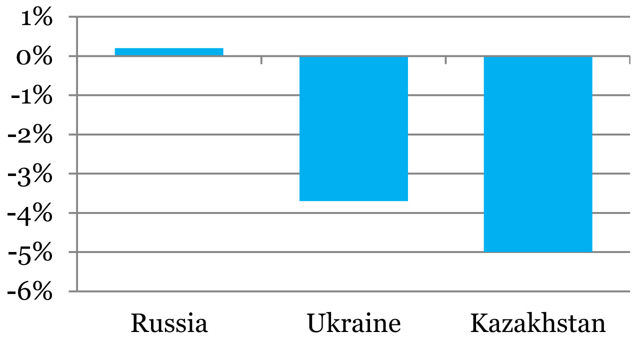
Tackling the poor private and public governance is not only important for economic and financial purposes but it has wider social implications as it is an important and unifying demand in the protest movement and is possibly also the single biggest discount factor for Russian equities. There is obviously a long to-do list and one should not be naïve in thinking that things will change dramatically in the short term. But it would be similarly mistaken to conclude that nothing is changing or only bad things are happening in Russia.

The WTO accession was almost completely overshadowed by the Pussy Riot case whereas the anti-corruption drive in November was either ignored or even painted in a negative light by some of the international press. Russia already moved up six places in the World Bank's annual business survey this year and ten places in Transparency International's corruption perception index that was released in early December. These improvements arguably come from a low base but also happened before the positive effects of the WTO accession and the recent anti-corruption drive could be measured.

Marcus Svedberg
Chief Economist

Hesitation

November 2012 performance (USD)



Source: Bloomberg

The lack of direction in Eastern European equity markets continued in November. Ukraine and Kazakhstan resumed the underperformances that have characterised much of the year for these frontier markets, whereas the Russian market stayed flat. The news flow in Ukraine was dominated by the economic issues following the elections. The speculation over a deal with IMF intensified after the Prime Minister resigned towards the end of the month (see following story).

The Russian markets gained a modest 0.2%, but the news flow was anything but flat, as a number of large deals were implemented (see following story). The government also stepped up its anti-corruption drive, while President Putin had to cancel a number of meetings due to back problems. On the market, the energy sector slightly outperformed, whereas financials underperformed. The RUB appreciated somewhat against the USD and oil prices moved marginally higher.

Russian deals

The IPO of Russia's second-biggest mobile phone operator Megafon went smoothly, but was no big success.
Picture: Scanpix

While the Russian political scene was characterised by the recent anti-corruption drive in November (see editorial), the corporate world was busy making big deals. The Sberbank SPO and TNK-BP deals earlier this autumn were followed by a series of large-scale and high profile deals in November, including Megafon, Freight One and VSMPO-Avisma.

The USD 1.7bn IPO of telecom giant Megafon went well but was no outright success, as it was priced at the lower end and even traded lower the first day (even though it later recovered). But the big achievement was the fact that the long-overdue listing actually took place and was not a disaster, as some had predicted. Russian Railways' USD 1.6bn sale of the remaining 25% of its subsidiary Freight One received less attention, but was an important part of the state's privatisation program. The state's USD 970m sale of VSMPO-Avisma, the largest titanium company in the world, was less straightforward, as the state will keep some control of the firm.

A PM for IMF in Ukraine

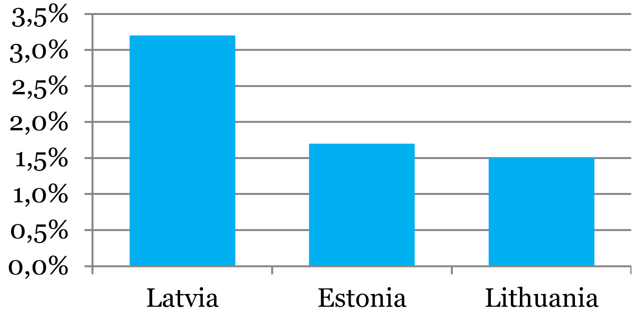
The resignation of Ukraine's Prime Minister, Nikolay Azarov's, opens up for a new recommencement with the IMF.
Picture: Scanpix

Ukraine has a balance of payment problem and there are two ways to solve it. The first is to resume the program with the IMF, but that requires raising domestic gas tariffs, which the government under Prime Minister Azarov has promised not to do. The second option is signing up to the customs union with Russia, which would reduce the price for imported gas significantly and most likely also lead to soft loans. The problem is that President Yanokovych does not want to become too dependent on his powerful neighbour.

The solution was thus easy. As soon as the parliamentary election was out of the way, Azarov resigned and thereby opened up for a resumption in talks with the IMF. The economy is slowing down and may even dip into recession while the currency is under pressure, but there is no immediate rush to raise capital and the country is also tapping the Eurobond market. But there is a lot of debt maturing in 2013 and Kyiv is unlikely to raise all the capital in the market.

October uncertainty

November 2012 performance (USD)



Source: Bloomberg

"When in doubt, buy the Baltics" seems to have been a theme this autumn. The lack of direction in Eastern European equity markets in November did not affect the Baltics negatively, with Latvia, Estonia and Lithuania gaining 3.2%, 1.7% and 1.5% respectively.

The three countries continue to surprise on the upside in terms of economic growth, and Estonia is the second best market in Eastern Europe so far this year.

No single sector really stood out in terms of performance, but industrials were the strongest in general, with Tallink, the Estonian shipping company, particularly strong. The stock gained 12% after reporting a 22% growth in the bottom line, a substantial decrease in the Net Debt and a promise of dividends for the near future.

Upgrading Latvia

Economic growth in Latvia is the fastest in the EU.
Picture: Karl Lans, East Capital

Latvia seems to be doing everything right at the moment. Economic growth keeps surprising on the upside and is the fastest in the EU. The country has been praised by the EU Commission for its fiscal work and both S&P and Fitch upgraded Latvia's long-term foreign credit rating from BBB- to BBB in November. This is in sharp contrast to Hungary, which was downgraded even deeper into junk status during the month and whose economy is in recession.

The reason behind the success is a combination of hard work, determination and base effect. The economy is still below its pre-crisis levels and thus still enjoys some catch-up momentum. But growth is increasingly broad-based, and policy makers are keen to join the Euro zone in 2014, which keeps them on track.

Centre of excellence

Estonia is one of the most IT-savvy countries in emerging Europe.
Picture: East Capital

One of the re-occurring battles within the EU is the decision as to what country gets the honour of hosting new agencies. It is not dissimilar to the race to host the Olympics, only smaller and less transparent. Hosting the agencies is prestigious and creates high-end jobs, although it can be a drain on the host country's budget.

Estonia was awarded the agency dealing with large IT systems for home affairs, which was launched at the end of November. The actual work is fairly technical and highly important, as it will be responsible for the IT infrastructure of Schengen. And one can think of no better place than Tallinn to place such an agency. Estonia has not only proven to be one of the most IT-savvy countries in emerging Europe, but the public sector there is more connected than most of its peers in the union as a whole.

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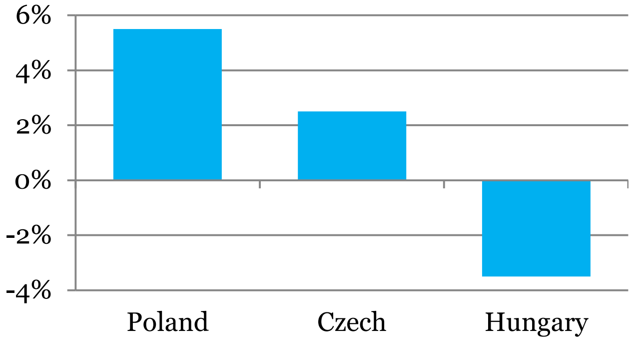
Wait and see

November 2012 performance (USD)



Source: Bloomberg

Developments on the Central European equity markets changed between October and November, illustrating the lack of general direction in the market. Poland, which was the worst of the trio in October, with negative returns, was the second best market in Eastern Europe in November, gaining 5.5%. Hungary moved in the opposite direction and dropped 3.5% in November after having gained more than 4% in October. The Czech market was the most stable, gaining a few percent in both months.

The news flow was rather thin and primarily political (see following stories). One of the strongest performers on the market was Polish energy company PGNiG, which gained 12% after reaching a favourable gas price cut of around 10% on its long-term agreement with Gazprom..

Fidesz under pressure

Former Hungarian Prime Minister Gordon Bajnai became the largest opposition force after his comeback.
Picture: Scanpix

November was not a good month for the Hungarian government. Rating institute S&P downgraded the country's sovereign credit rating from BB+ to BB, which means the country is falling deeper into junk territory, as it is two notches below investment grade. The government responded by saying that the rating institutes are agents of speculators, while S&P subtly argued that the policy predictability has deteriorated while economy has weakened.

The second blow was delivered by former Prime Minister Gordon Bajnai, who announced a political comeback at the end of October and quickly became the largest opposition force. Bajnai does not even have a formal party yet, but is focusing the centrist opposition around the umbrella Together 2014 organisation. It is still early days, but the ruling Fidesz is being fought on several fronts.

Blessing in disguise

Deputy Prime Minister and Minister of Economy Waldemar Pawlak announce his resignation from his posts in Sejm.
Picture: Scanpix

Few seemed to have cared, but the resignation may have been a blessing in disguise for Waldemar Pawlak. The Polish Minister of Economy and Deputy Prime Minister resigned in November after he was replaced as the head of the Peasants Party, the junior coalition partner in the government dominated by Civic Platform. He played second violin to the well-known and respected Minister of Finance from Civic Platform anyway, and leaves at a point when the Polish economy is starting to slow down.

A little more than a week after his departure, Polish growth for the third quarter came in worse than expected, at 1.4% year on year. This is in contrast to years of outperformance and quarters of better-than-expected growth rates. The state of affairs is still better than in the neighbouring countries, but Pawlak might well have enjoyed the happiest days in government.

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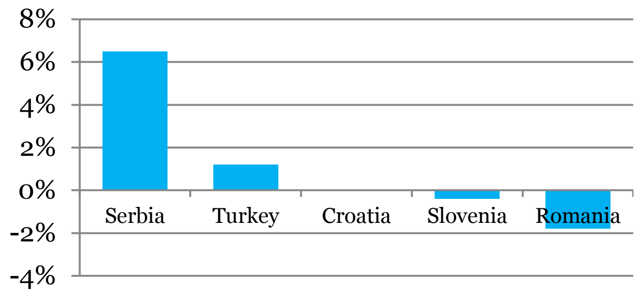
Southeastern European Markets

Serbian rally

November 2012 performance (USD)



Source: Bloomberg

The Serbian market, which started to perform in October after a longer period of underperformance, gained 6.5% in November, making it the best market in Eastern Europe during the month. The performance is obviously coming from a low base, but it is nevertheless very positive that the frontier markets in Southeastern Europe have started to catch up. Slovenia performed very strongly in September and has managed to hold on to those gains. Romania was the weakest market in the region in November, dropping 1.8%, but is still the second best market year to date, second only to Turkey.

The gain on the Istanbul market was a modest 1.2% in November, but it is up more than 50% year to date, making it one of the best markets in the world. The successful soft landing of the economy combined with a credit rating upgrade (see following story) are the main reasons behind the rally.

Finally — upgraded credit rating

Turkey's long-term foreign credit rating is upgraded by Fitch.
Picture: Ilze Johnston

It was arguably long overdue, so the decision by Fitch to upgrade Turkey's long-term foreign credit rating to BBB- in November was broadly welcomed.

The upgrade means Turkey is now investment grade, and it should help make the country more attractive for investments, despite the other institutes remaining below the magic threshold. The main reason behind the upgrade is the soft landing of the economy, but Fitch also highlighted the declining government debt burden and the sound banking system, together with a favourable medium-term growth outlook and a relatively wealthy and diverse economy.

The upgrade primarily relates to the bond market, but should have positive implications for equities as well.

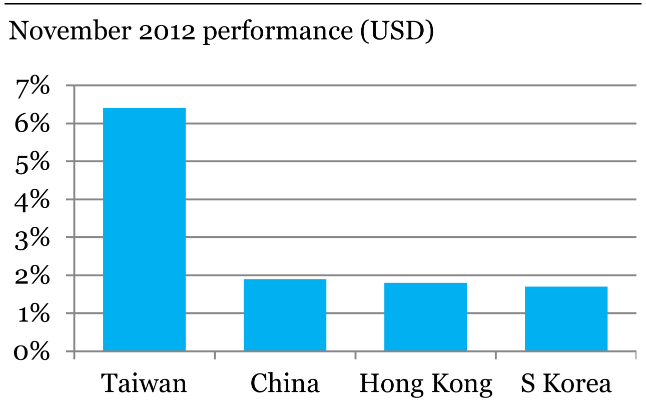
Tough job for new president

Slovenia's former Prime Minister, Borut Pahor, won the presidential election in the beginning of December.
Picture: Scanpix

Former Prime Minister Borut Pahor unexpectedly won the presidential election in Slovenia. He surely knows what he is letting himself in for, but it is not going to be an easy job. Slovenia is one of the weakest economies in the Euro zone at the moment and there are recurring discussions about asking the Euro zone for a bailout.

The current government, which took over from Pahor, needs to implement tough austerity measures that already have caused large demonstrations, and the new president has wowed to cooperate with the government. There is also a long to-do list in terms of overdue structural reforms - most importantly privatisation - that are politically difficult to implement. The presidency has weak formal powers, but Pahor may nevertheless prove useful in giving the government badly needed support.

Rally in Taiwan



Source: Bloomberg

Asian markets were strong on the whole in November, with gains throughout the region. Taiwan, which has lagged the other markets this year, was the strongest during the month, advancing 6.4%. The other markets gained slightly less than 2%.

The markets generally got support from macro data, with economic indicators continuing to point to a recovery in China (see next story). The HSBC November manufacturing PMI hit 50.5, a 13-month high. While we have witnessed a small rally in many Hong Kong-listed stocks since September, the A-share market continues to trend lower. Another notable event for Asian equities is the new 15% stamp duty on foreign buyers of Hong Kong property, which is likely to cool the residential Hong Kong property market somewhat

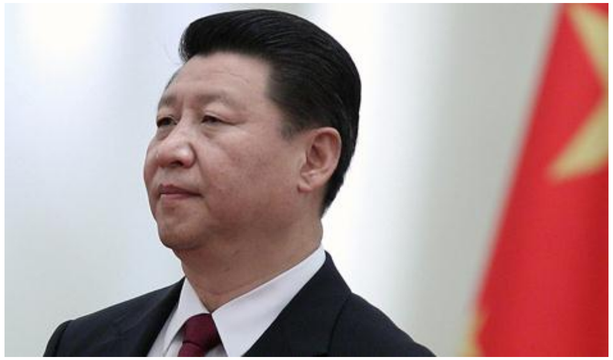
Rebound in China

Domestic demand is high in China, and retail statistics remain relatively strong.
Picture: Daniel Ljungel, East Capital

The Chinese economy appears to be rebounding. Macro statistics were stronger for October, while inflation stayed low, at 1.7%. Moreover, exports increased from 9.9 % to 11.6%, while value added industrial production continued upwards to 9.6%, with a robust increase in earnings for the manufacturing industry, at 20.5%. Retail statistics also remain relatively strong, at 14.5%. PMI for November continued upwards, at 50.6 compared to 50.2 in October, and we expect annual GDP to land at around 7.7 %.

Imports from Japan have been hurt from the on-going dispute regarding the Senkaku/Diaoyu islands, falling by 11%. Chinese maritime surveillance vessels keep provoking Japanese coast guards and there is no imminent solution to the dispute. Instead, China is now acting assertively towards its South China Sea neighbours and India by issuing a new passport with a map of China including disputed areas.

Xi is on



Xi Jinping was appointed new general secretary of the Communist Party of China in mid-November.
Picture: Scanpix

The highlight of the Chinese political calendar occurred in mid-November, when the new Politburo Standing Committee (PBSC) was presented. Xi Jinping was appointed new general secretary of the Communist Party of China, and the former president, Jiang Zemin, showed that he still has a lot of say in Chinese politics. Jiang was sitting next to Hu Jintao during the Party Congress and managed to get five of his loyal men into the PBSC.

Some observers have interpreted this as being a sign of more conservative forces moving into the centre of power. But it is rather the opposite, although the focus is likely to stay on economic reforms rather than political reforms as some Western analysts were hoping for. Under Jiang, China entered the WTO, carried out huge reforms of its state-owned enterprises and opened up to the Internet. We thus expect more economic reforms during Xi.