Russia and the 2018 FIFA World Cup

Russia's long-term growth is promising. An increase in government expenditure on investments in healthcare, education, and housing may prove valuable in the long-run. The 2018 FIFA World Cup will help change towards a more positive market sentiment of Russia and prove valuable in the long-run, by giving investors more confidence to engage in higher levels of foreign direct investments.

However, in the short-term, there are complexities that Russia must maneuver through. Among these are infrastructure difficulties, monetary and fiscal policy execution, sizeable output and wealth gaps, and sanctions. In light of the July meeting between Mr. Trump and Mr. Putin, we believe this topic merits a discussion. This meeting parallelizes our views of low expectations for resolution, but with gradual steps in a positive direction.

As a result, we conclude Russia is an investment consideration in the long term. The opportunity is found alongside increasing domestic investments and a more positive market sentiment which can drive positive growth and minimize the "Russian Discount" we see priced in the market today.

To understand where Russia might go, we must first understand where it currently is. Today, Russia's equity market is heavily discounted—relative to the U.S. and other emerging market equities. RSX, an ETF which seeks to replicate as closely as possible the price and yield performance of the MVIS Russia Index, includes companies posting single-digit price to earnings ratios and 5.72% dividend yields[1], on average. Additionally, its earnings per share growth is similar to the S&P 500 and 8% higher than the MSCI emerging markets index. These measures reflect that investors are discounting Russia's equity market. Conversely, this may be reflecting deep value.

Source: Bloomberg

	S&P500	EEM	RSX
P / E [2]	16.49	11.09	6.51
EPS Growth [3]	27.60%	19.74%	27.79%
PEG	59.74	56.18	23.43
Dividend Yield [4]	1.96%	2.52%	5.72%
Oil & Gas	5.07%	6.79%	36.03%

[1] Bloomberg
[2] P/E = 2019Y estimated
[3] Estimated growth from actual value to fund 12 month estimate
[4] Projected 12 month
5 "Russia's World Cup Will Pay Off. Just Not Today" – Moscow Times

The Thinking Man's Approach

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Ignacio Pakciarz, CEO
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Russia's pension age increase and the Value-Added-Tax hike are set to fund Russia's $126 billion spending program on healthcare, education, and housing.[5]

We anticipate that FDIs will be made in its oil and gas sector, which accounts for more than 35% of the Russia's equity index and slightly above 16% of GDP.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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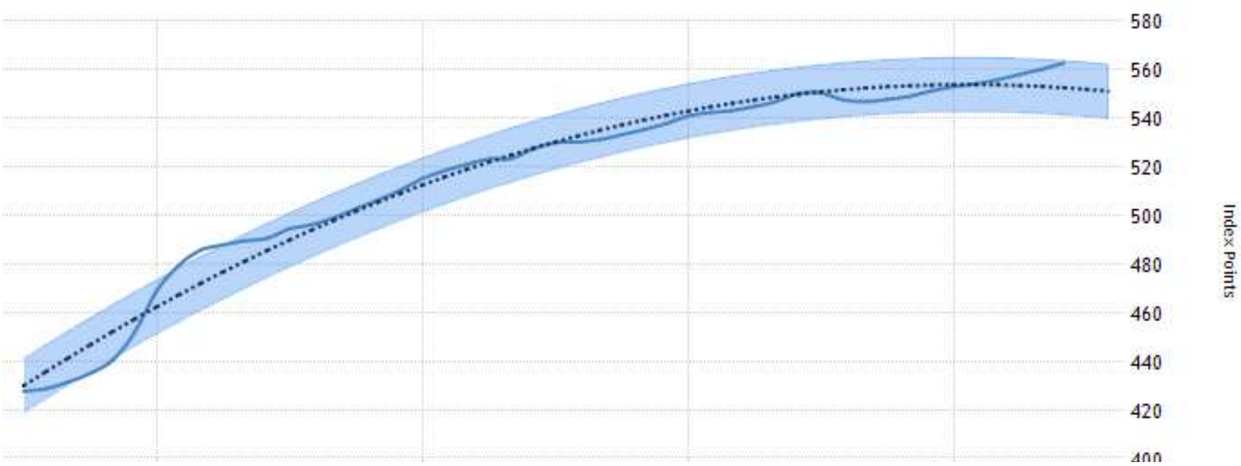
The Short-Term

There is no foreseeable catalyst that will propel Russian equities upward. Moreover, we anticipate high correlation, low liquidity, and higher volatility amongst emerging markets and difficulties Russia must face in the short term.

Among these difficulties include: complexities of infrastructure development, balancing monetary and fiscal policies, addressing a large output and wealth gap, and the effects of sanctions. Infrastructure investments in Russia are expensive and complex. It costs about 10x as much to build in Russia as it does to build in Europe[1]. This is not just a result of political unscrupulousness; it is because there are no detailed maps of what lies underneath the Soviet-era infrastructure. Also, Russia must carefully balance its monetary and fiscal policies. In regards to inflation, there was a slight decline. Inflation fell -0.2% yoy; however, it was offset by higher non-food goods, particularly oil prices. It was also offset by a weaker Ruble. Since recent inflation has maintained at +2.4% yoy, Central Bank of Russia is expected to firmly keep their benchmark rate on hold while the impact of the VAT (or sales tax) hike will raise inflation towards their 4% target.[2] Figure 1, below, shows Russia's Consumer Price Index (CPI) and it's tend and consensus forecast. It's also important to note that Russia faces large output and wealth gaps. Simply put, in Russia, the wealth of the top one-tenth of 1% of the population is equal to that of the bottom 90% of the population.[3] As a result, the economy performs in two significantly different ways for the two different social classes. The tension between the two social classes, and therefore economies, make it more difficult for pension, healthcare, and debt promises to be met. Furthermore, the effects of technological changes on employment and the wealth gap are likely to intensify in the short and medium term.[4] Recent developments suggest the risk that these gaps are to be closed through fiscal easing rather than monetary easing.[5] Finally, the sanctions on Russia have affected the share prices of Russia's largest companies, further adding to its lower multiples. It is for these reasons, we believe the downside risks outweigh upside risks for Russia in the short-term.

Russia Consumer Price Index (CPI)



Source: Federal State Statistics Service

Figure 1

[1] "Russia's World Cup Will Pay Off., Just Not Today."— Moscow Times
[2] "Russia: CPI Inflation Falls but Surprisingly to the Upside"- July 2018. Goldman Sachs
[3] "Economic Factors or Russian Inequality"—International Journal of Environmental and Science Education
[4] "Our Biggest Economic, Social, and Political Issue"—Bridgewater Daily Observations
[5] "Russia: CPI Inflation Falls but Surprisingly to the Upside"- July 2018. Goldman Sachs

The Long-Term

The long-term presents a different opportunity arising from increasing pension age, VAT hikes, and higher levels of foreign direct investments (FDI). An increase of pension age addresses the wealth gap problem Russia currently faces. The pension age increase will reduce budgetary transfers that are estimated to be about 2% of GDP to cover pension shortfalls.[6] Similarly, the value-added-tax increase will provide the country with additional capital for other investments that are estimated to lift growth by early next decade by encouraging investment and innovation.[7] This type of tax serve as an advantageous tool of fiscal policy because it can be adjusted almost immediately after it is announced and can influence spending behavior instantly to generate revenue for the government at little or no cost to the government. Russian domestic investments are expected to increase due to increases in pension age and value-added tax. Both the pension age increase and the VAT hike are set to fund Russia's $126 billion spending program on healthcare, education and housing. In addition, FDI in Russia can increase in response to a positive change of investor sentiment. Figure 2, below, shows Russia's FDI- Net Flows and its trend and consensus forecast. The FIFA World cup may also add to the shift to a more positive investor sentiment. Of the +1 million World Cup visitors, 60% were first time visitors to Russia and almost half were from a western culture. More specifically, we anticipate that FDIs will be made in its oil and gas sector. This sector accounts for more than 35% of the Russia's equity index and slightly above 16% of GDP.[8] With the U.S. placing sanctions on Iran, oil and gas supply must come from another source; possibly Russia.

Conclusion

In conclusion, we will keep a watchful eye for investment opportunities in Russia. While there are anticipated headwinds in the short-term, long-term opportunities remain. Russian equities are not expensive relative to earnings and they are offering relatively large dividends. Increasing domestic investments and an inflow of FDI can be the catalysts that Russia needs to establish sustainable long-term growth. [9]

Russia Foreign Direct Investment – Net Flows

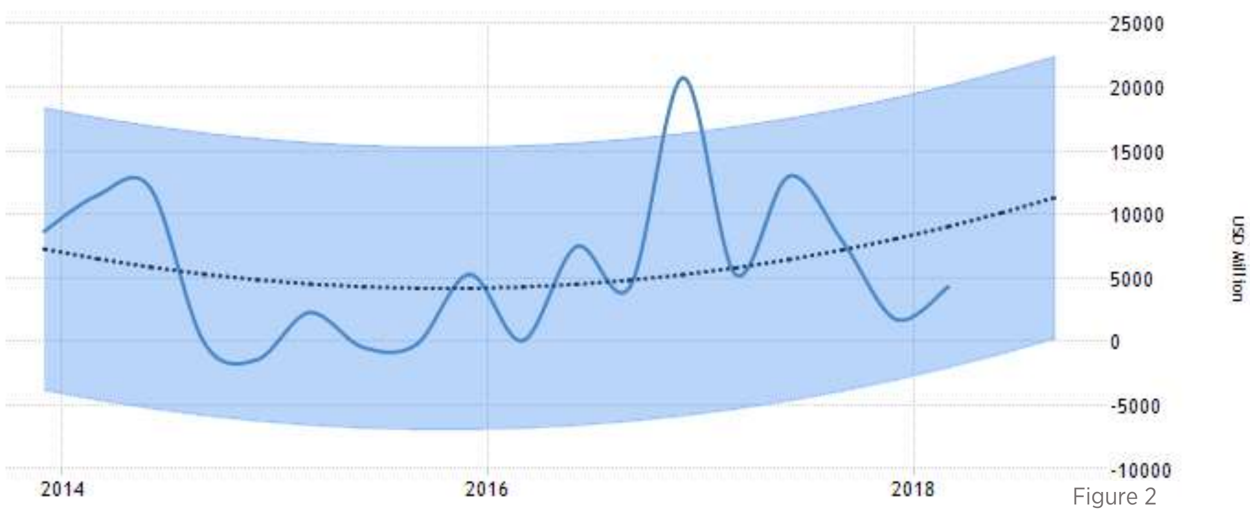


Figure 2

Source: The Central Bank Of The Russian Federation

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[6] "Emerging Europe Oil and Gas Insight "- February 2017. BMI Research
[7] "OECD Economic Outlook", Volume 2018 ISSUE 1- OECD
[8] "Russia Economic Report" – April 2016 World Bank Group
[9] The Central Bank Of The Russian Federation

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