

EMERGING MARKETS

EMERGING MARKET MONITOR

Four reasons why Russia will shrug off the latest round of US sanctions

May 2018

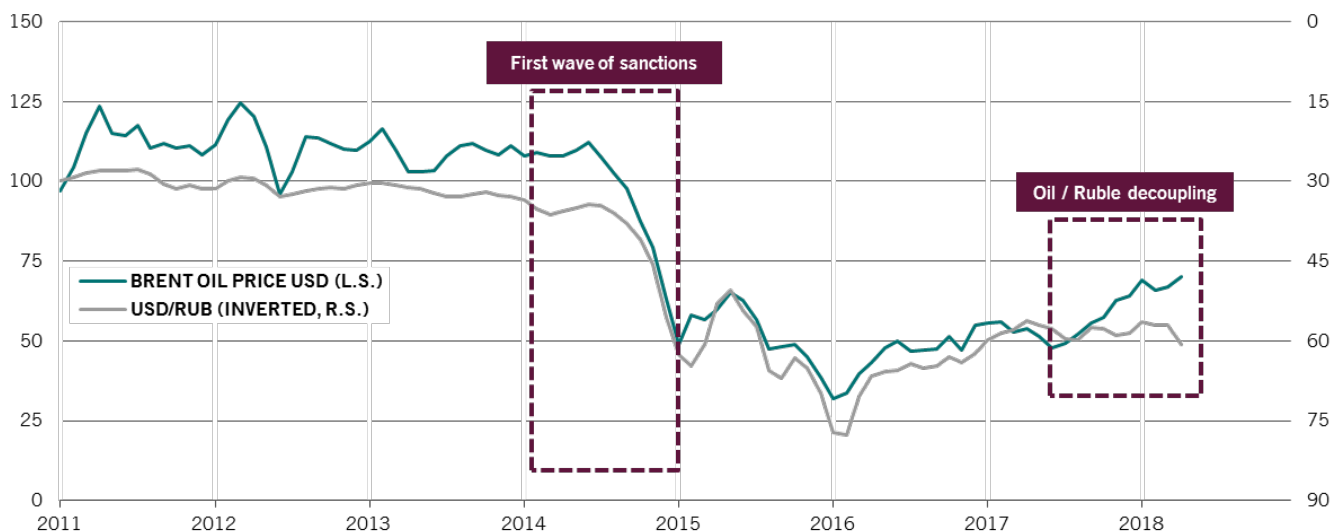
Patrick Zweifel, Chief Economist, Nikolay Markov, Senior Economist

We look at why the latest US sanctions are unlikely to be as harmful for Russia as the 2014 ones, reinforcing the investment case for Russia.

1. Decoupling between oil prices and the ruble

US sanctions in 2014 occurred at a time when both oil prices and the ruble were declining. This time, rising oil prices have decoupled from a falling ruble (Fig.1). This is exceptional.

FIG.1 - OIL PRICE & RUBLE EXCHANGE RATE



Source: Pictet Asset Management, CEIC, Datastream. Data as of May 2018.

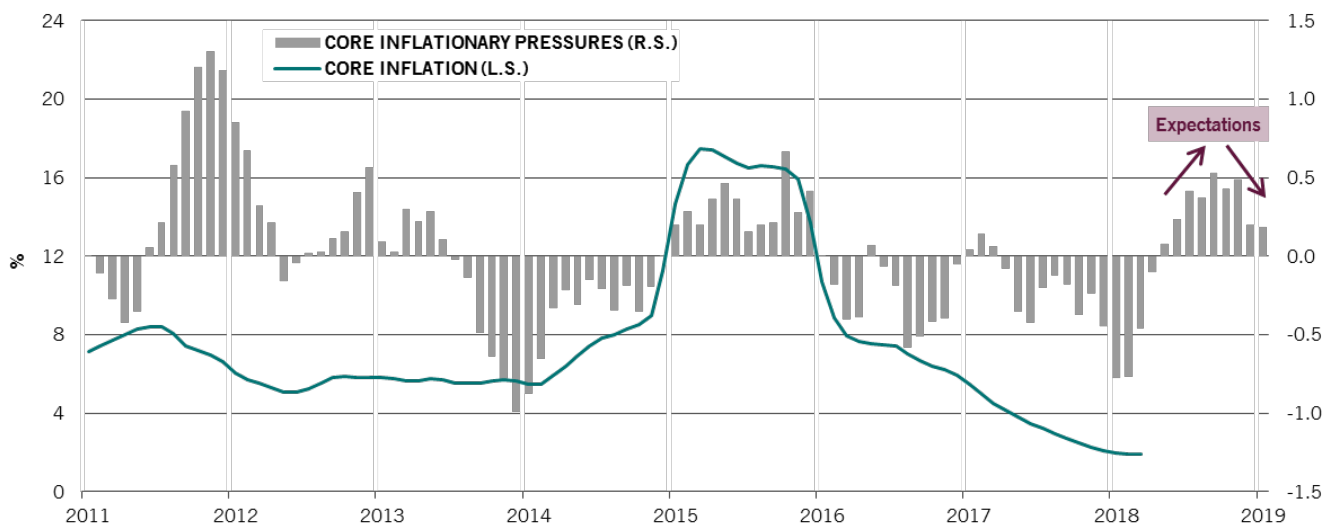
Strong global demand and an extension of the OPEC production cut have lifted oil prices.

Meanwhile, the already undervalued ruble acted as shock absorber of the new sanctions, depreciating 6.2 per cent in April against the US dollar, but just 0.3 per cent in nominal trade-weighted terms¹.

2. Contained inflationary pressures

Short-term inflationary pressures have increased but we expect them to fade towards the end of the year and into early 2019 (Fig.2 below).

FIG.2 - CORE INFLATION & CORE INFLATIONARY PRESSURES

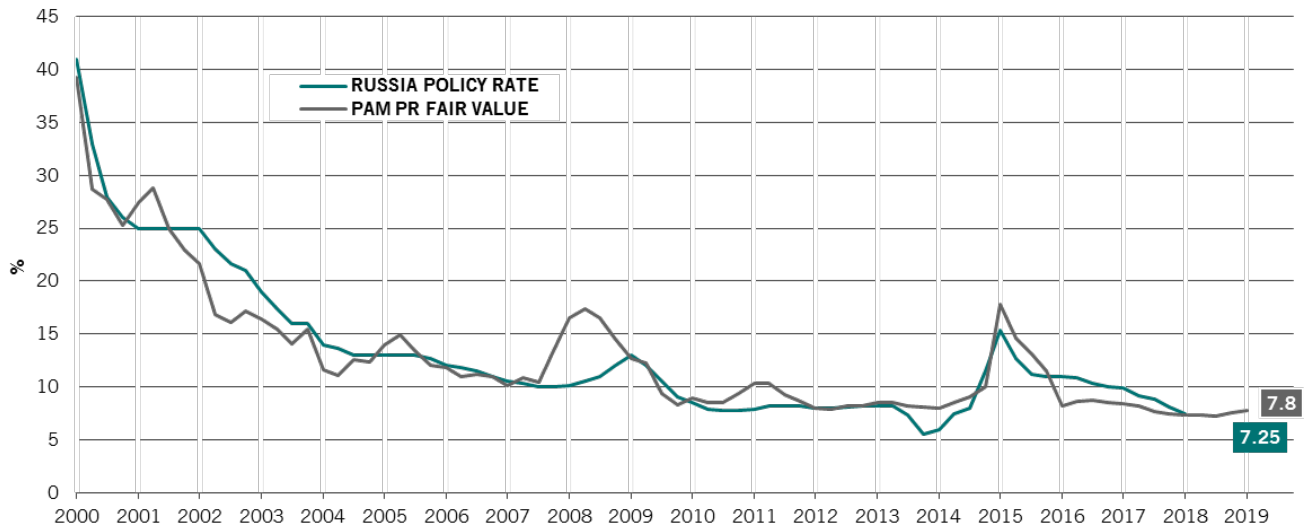


Source: Pictet Asset Management, CEIC, Datastream. Data as of May 2018.

Although moderate, inflationary pressures are likely to impact monetary policy, marking a pause in the current easing cycle and implying more limited interest rate cuts in 2018.

The current policy rate of 7.25 per cent is in line with our estimate of fair value (Fig.3). It leaves limited room for interest rate cuts in 2018, especially given the need to reduce households' inflation expectations. These remain above target at 7.8 per cent according to the latest Central Bank of Russia (CBR)'s survey in March and may increase due to the sanctions.

FIG.3 - RUSSIA POLICY RATE & FAIR VALUE (Q2 2018)

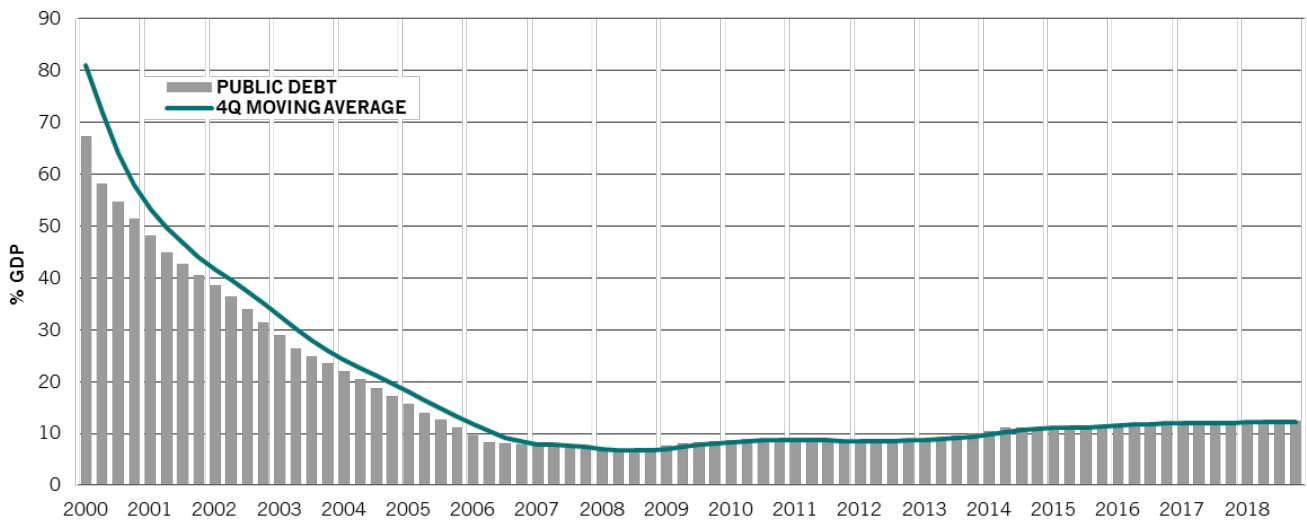


Source: Pictet Asset Management, CEIC, Datastream. Data as of May 2018.

3. Russia's economic strength

As illustrated in Fig.4, Russia's public finances are in excellent shape. As a net creditor vis-à-vis the rest of the world, the country also runs a large current account surplus which provides a sufficient cushion to absorb the sanctions impact.

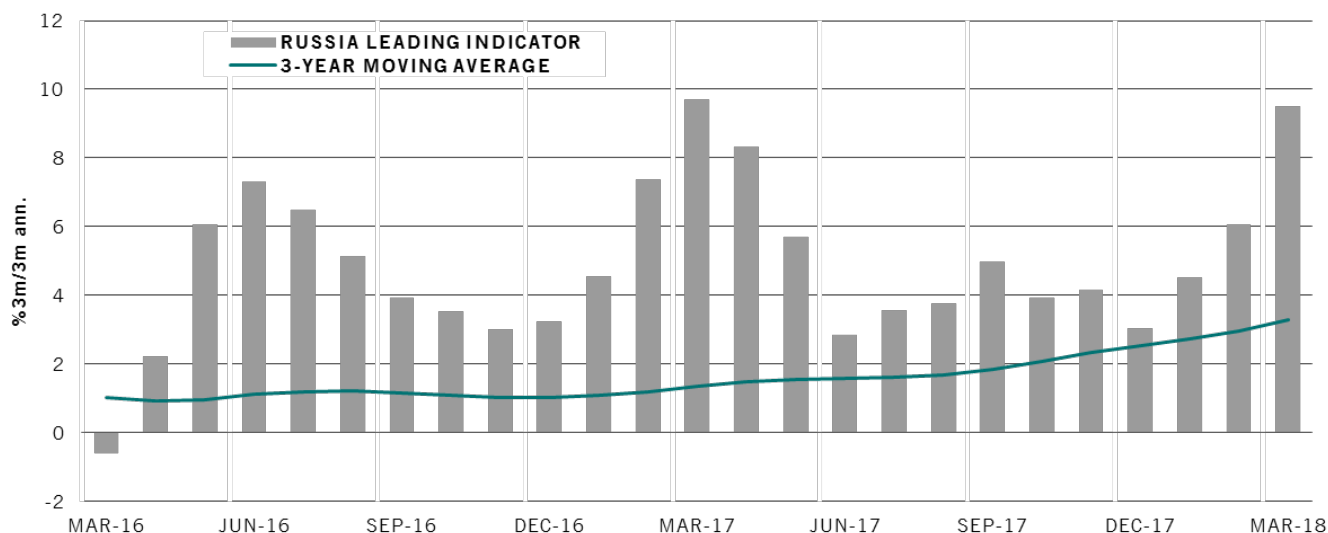
FIG.4 - GENERAL GOVERNMENT DEBT TO GDP RATIO



Source: Pictet Asset Management, CEIC, Datastream. Data as of May 2018 with expectations to the end of the year.

Our leading indicator also points to strong GDP growth ahead (Fig.5), driven by the energy sector, as well as improving labour market and industrial production.

FIG.5 - PICTET SEQUENTIAL LEADING INDEX GROWTH (%3m/3m ann.)



Source: Pictet Asset Management, CEIC, Datastream. Data as of May 2018.

4. Football world cup

By boosting spending, the football World Cup in June should also help counterbalance the sanctions.

FIG.6 - FOOTBALL WORLD CUP IN RUSSIA - A FEW FIGURES



Source: Pictet Asset Management, Reuters, The Guardian. Data as of May 2018.

*We expect the bulk of the contribution to GDP to be concentrated over the last 4 years to the World Cup.

[1] Source : Pictet Asset Management, CEIC, Datastream, May 2018

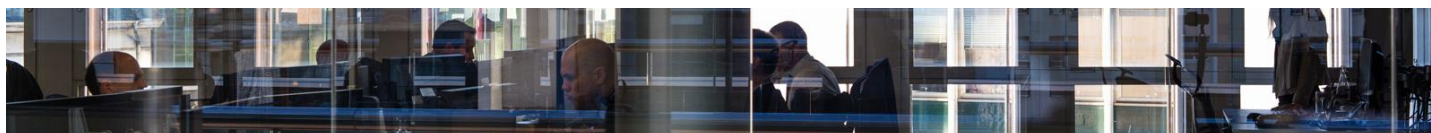


CHART OF THE MONTH BY OUR EMERGING CORPORATE BONDS TEAM

By Karen Lam, Senior Client Portfolio Manager

Russia’s strong position can also be observed in the corporate bond space. Russia index spreads, as represented by the JPM CEMBI BD Russia index, have only widened by c.60 basis points since the sanctions were announced.

We do not think that Russian eurobond prices will deteriorate significantly from the current levels because the original panic seems to have faded and the market is relatively small and shrinking, with limited scope for new supply. In fact, we believe demand from local investors will absorb any supply from forced US sellers, thus providing further support for the market.

FIG.7 - JPM CEMBI BD RUSSIA SPREADS



Source: Pictet Asset Management, Bloomberg. Data as of May 2018.

CHARTS OF THE MONTH BY OUR EMERGING MARKETS EQUITY TEAM

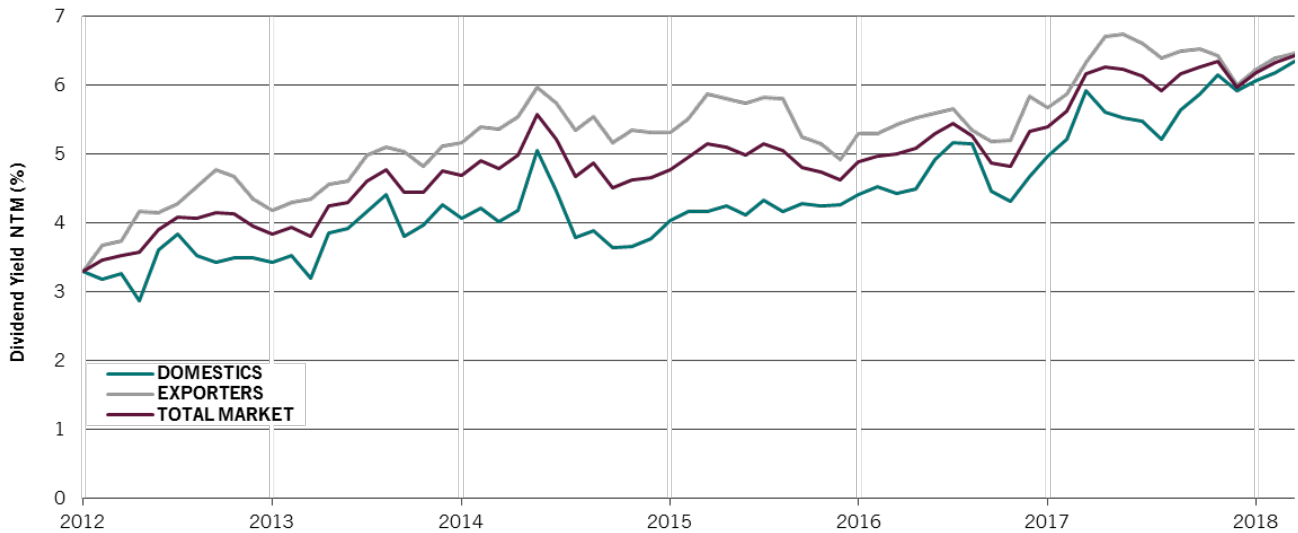
By Hugo Bain, Senior Investment Manager
and Christopher Bannon, Senior Investment Manager

Russia - all about the equity risk premium

In the same way as Russia is proving strong faced with the latest US sanctions, the country's companies are showing resilience. Forced to decrease their reliance on western capital over the past years, we believe this trend will continue, despite many of them already having no debt at all.

We also think that they will continue to pay dividends which, in the case of some companies, are at extraordinary levels. As Fig.8 shows, Russian companies are already offering record high dividend yields. Unlike the previous crisis in 2015, both domestic firms and exporters are offering high dividend yields, indicating all parts of the market are attractive.

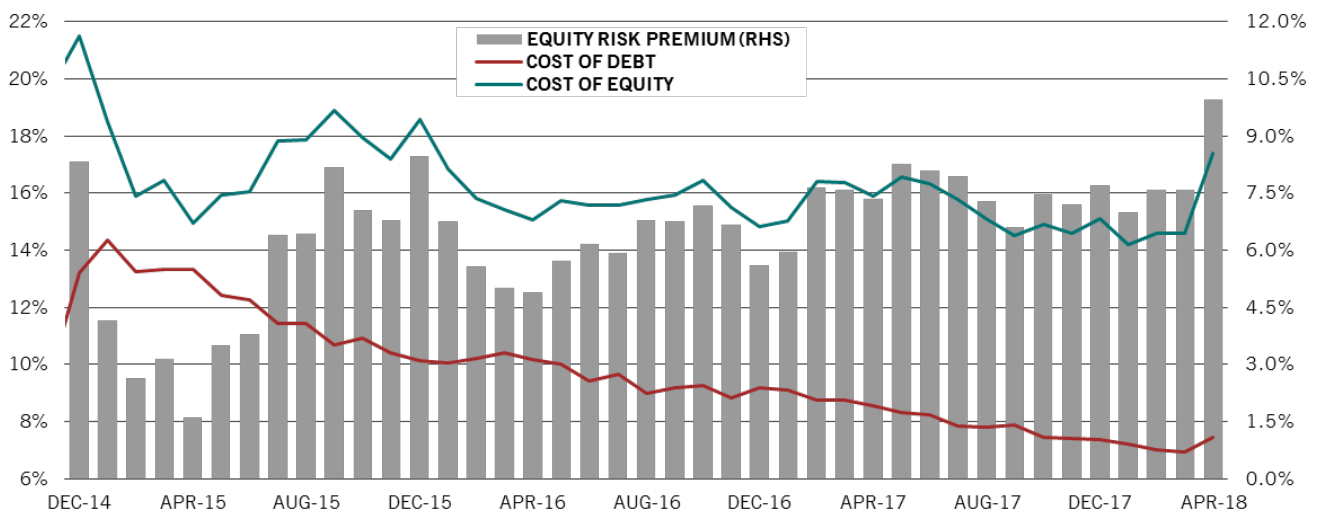
FIG.8 - RUSSIAN COMPANIES RETURNING RECORD HIGH YIELDS



Source: Pictet Asset Management, MSCI Russia 10/40, Bloomberg. Data as of May 2018.

We suspect we may be at ‘peak sanctions’, and even a minor contraction in the Russian equity risk premium (Fig.9) could bring about significant outperformance.

FIG.9 - RUSSIAN EQUITY RISK PREMIUM



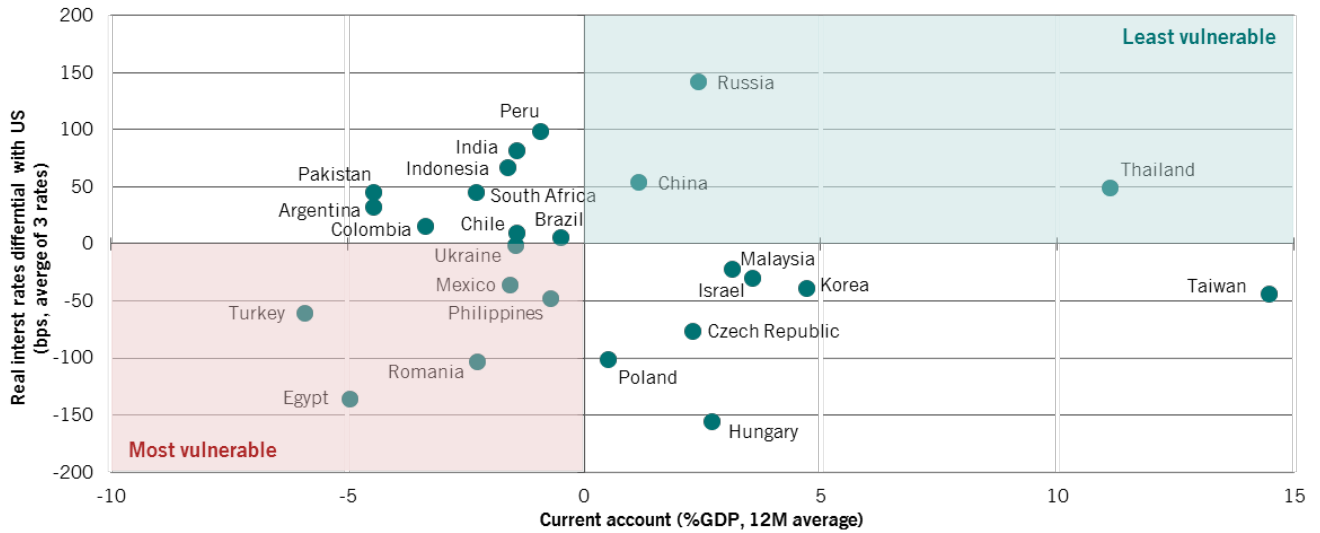
Source: Pictet Asset Management, Sberbank, as at 10th April 2018 (two days post OFAC sanction extension). Cost of equity is the forward earnings yield, and cost of debt is the average yield of RUB and USD bonds and loans.

IDENTIFYING EMERGING MARKETS MOST VULNERABLE TO SHOCKS

By Patrick Zweifel, Chief Economist

A simple way to identify the emerging markets most vulnerable to shocks is to look at their external financial needs, via their current account positions (risk proxy) and an average of real interest rates (return proxy). As Fig.10 below shows, emerging markets are extremely diverse, thus still providing a wealth of investment opportunities.

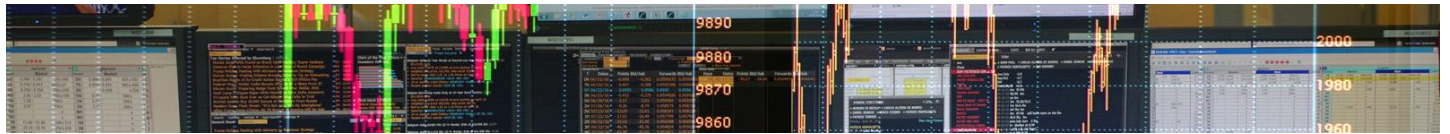
FIG.10 - EM CURRENT ACCOUNT (RISK PROXY) & REAL RATES (RETURN PROXY)



Source: Pictet Asset Management, CEIC, Datastream, Bloomberg, May 2018

Looking at a broader set of 10 risk factors (e.g. excess debt, hard currency debt & FX reserves) shows that Argentina, Turkey, Colombia and South Africa would be other markets at risk. In fact, Argentina was recently forced to hike rates to 40 per cent to defend its currency, a 12.75 per cent rise in just a week.

A point to note is that unlike 2013, the largest emerging markets (BRIC) seem much less vulnerable this time.




MARKET WATCH

| EQUITIES | 1 mth (%) | YTD (%) | 1 yr (%) | 3 yrs ann. (%) | 5 yrs ann. (%) | 10 yrs ann. (%) |
|-----------------------|------------------|----------------|-----------------|-----------------------|-----------------------|------------------------|
| MSCI EM | -0.44 | 0.97 | 21.71 | 6.00 | 4.74 | 2.17 |
| MSCI EM Value | 0.88 | 2.51 | 18.20 | 3.80 | 2.74 | 1.30 |
| MSCI EM growth | -1.75 | -0.55 | 24.95 | 8.06 | 6.62 | 2.95 |
| MSCI AC Asia ex Japan | 0.71 | 1.38 | 24.01 | 6.96 | 7.97 | 4.77 |
| MSCI Brazil | -3.99 | 7.89 | 21.38 | 9.39 | -1.38 | -3.29 |
| MSCI China | -0.02 | 1.79 | 35.27 | 4.96 | 11.07 | 4.46 |
| MSCI India | 4.12 | -3.12 | 12.60 | 8.09 | 7.85 | 2.29 |
| MSCI Russia | -7.43 | 1.24 | 11.89 | 7.29 | -0.36 | -5.07 |
| MSCI EM Europe | -4.75 | -2.79 | 10.67 | 3.12 | -2.83 | -4.76 |
| MSCI World | 1.15 | -0.15 | 13.22 | 7.55 | 9.28 | 5.48 |

| BONDS | 1 mth (%) | YTD (%) | 1 yr (%) | 3 yrs ann. (%) | 5 yrs ann. (%) | 10 yrs ann. (%) |
|---------------------------------------|------------------|----------------|-----------------|-----------------------|-----------------------|------------------------|
| JPM EMBI Global Diversified | -1.45 | -3.17 | 1.27 | 4.70 | 3.78 | 6.78 |
| JPM GBI-EM Global Diversified | -2.96 | 1.36 | 8.38 | 3.39 | -1.92 | 3.33 |
| JPM ELMI+ | -1.88 | 0.59 | 6.32 | 2.17 | -0.73 | 0.63 |
| JPM CEMBI Broad Diversified Composite | -0.66 | -1.78 | 1.84 | 4.20 | 3.77 | 6.29 |
| JPM Jade Broad Asia Diversified | -1.31 | -0.47 | 6.03 | 2.45 | 0.93 | - |
| Chinabond composite | 0.38 | 5.83 | 13.24 | 2.86 | 3.54 | - |
| JPM GBI-EM Global Latin America | -3.07 | 3.04 | 6.33 | 4.28 | -2.21 | 3.64 |
| JPM EMBI Global Diversified Europe | -1.03 | -2.62 | 1.89 | 5.64 | 3.95 | 6.85 |
| JPM Global All Mats | -1.82 | 0.31 | 4.30 | 2.31 | 0.76 | 2.42 |


| COMMODITIES | 1 mth (%) | YTD (%) | 1 yr (%) | 3 yrs ann. (%) | 5 yrs ann. (%) | 10 yrs ann. (%) |
|-------------------------|------------------|----------------|-----------------|-----------------------|-----------------------|------------------------|
| S&P GSCI TR | 5.04 | 7.33 | 22.14 | -5.92 | -10.14 | - |
| S&P GSCI WTI TR | 5.82 | 14.85 | 35.78 | -11.37 | -15.52 | - |
| S&P GSCI Brent Crude TR | 8.73 | 14.83 | 48.49 | -4.94 | -11.52 | - |
| LBMA Gold pm | 1.74 | 1.72 | 3.69 | 3.62 | -2.22 | - |

| CURRENCIES | 1 mth (%) | YTD (%) | 1 yr (%) | 3 yrs ann. (%) | 5 yrs ann. (%) | 10 yrs ann. (%) |
|-------------------|------------------|----------------|-----------------|-----------------------|-----------------------|------------------------|
| USD/BRL | -4.70 | -4.89 | -8.28 | -4.91 | -10.53 | -6.98 |
| EUR/BRL | -2.99 | -5.47 | -17.34 | -7.26 | -8.95 | -4.59 |
| USD/RUB | -6.75 | -7.66 | -8.52 | -5.83 | -12.85 | -9.16 |
| EUR/RUB | -5.08 | -8.22 | -17.55 | -8.16 | -11.32 | -6.82 |
| USD/INR | -2.27 | -4.36 | -3.61 | -1.64 | -4.19 | -4.87 |
| EUR/INR | -0.52 | -4.95 | -13.13 | -4.08 | -2.51 | -2.43 |
| USD/CNY | -0.84 | 2.63 | 8.71 | -0.75 | -0.57 | 0.97 |
| EUR/CNY | 0.94 | 2.01 | -2.02 | -3.21 | 1.18 | 3.56 |
| USD/ZAR | -5.09 | -0.83 | 7.21 | -1.43 | -6.37 | -4.91 |
| EUR/ZAR | -3.38 | -1.44 | -3.38 | -3.87 | -4.72 | -2.46 |

 Top performer among the EM indices or currencies shown in this table, for the corresponding period.

 Worst performer among the EM indices or currencies shown in this table, for the corresponding period.

 Developed markets.

 Source: Datastream, Bloomberg, data as at 30.04.2018 and in USD. Equity indices are quoted on a net dividend reinvested basis; bond and commodity indices are quoted on a total return basis. The currency rates evolution is treated as a performance calculation based on FX rates.

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