Why foreign investors should not write off Russia

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A postcard from... Russia: We reflect on a recent visit to the country and find plenty of reasons for optimism.

The most surprising thing I gleaned on my recent investment trip to Russia was how calm the business community was.

Calm after the storm

Since my last trip in July, the rouble had fallen 60%, $120 billion of private capital had apparently left the country, oil prices were at $50 per barrel from $110, and the conflict in eastern Ukraine was raging. Thinking logically about the situation in Russia—and reading the Western press—I had expected a sense of utter panic. Instead, it felt like the calm after the storm. As a colleague told me, “Russia has just been seriously tested. And we survived. It will still be a very hard year, but we’re used to hardship and we’re ready.” Why?

Whether to invest in Russia

My goal of this trip was to try to reassess our framework for how to invest—or not invest— in Russia after the "Black Swan" events of 2014. I have travelled to Russia several times a year for 22 years. No one that I know predicted a year ago that Russia would be engaged in a proxy war with Ukraine; that oil prices would have plummeted so far so fast; or that Russia’s economy, banking system and asset prices would be so badly impacted.

Foreign stock and bond investors face two basic questions. First, should Russia just be ignored altogether as an investable market? And if not, then when is the right time to invest?

On the first question, it is very difficult to simply ignore Russia’s markets. Russian stocks and bonds have significant weights in emerging market indices. Ignoring Russia outright would potentially mean large deviations in performance for fund managers from standardized benchmarks.

It is also difficult to exclude Russia because of disapproval of its foreign policies in Ukraine. Emerging market indices include many other countries with controversial regimes, such as China, Turkey, Venezuela, Saudi Arabia, and Angola. At least conceptually, the role of foreign capital is to help promote market discipline and good policies everywhere, with the hope that greater economic integration can ultimately lead to stronger economies and more democratic political systems over time.

When to invest in Russia

So, if a foreign investor is willing to invest in Russia, when is the right time?

My meetings affirmed that investors should focus on three areas. The first is **oil**. Analysts have been warning for years that Russia was vulnerable to a fall in oil prices and that Russia should prepare by diversifying its economy. This crisis has demonstrated that oil is still the lifeblood of Russia’s economy. When prices were high, oil revenue trickled down through the economy via government wages, pensions, credit and large investment programmes. Now that prices are low, the reverse is happening. Russia’s economy is experiencing a sudden stop in easy money. The market knows this: oil prices will have a huge positive, or negative, impact on Russian asset prices for the foreseeable future. Plain and simple.

The second area is **geopolitics**. During my trip, it was evident that the crisis in Ukraine has become so charged that it is difficult to have a rational conversation. For Russia, the crisis is about feeling encircled by the US over the past 15 years. For Ukraine and the West, the crisis is about Ukrainian sovereignty. Russia is playing hockey against an opponent who is playing football—they are on the same field but playing different games with different rules. Because the sides are so far apart, investors should prepare for this crisis to last a long time. Because political decisions are ultimately un-analysable, investors should also prepare for further unpredictable turns. But the big question is whether all sides will be willing to escalate to the point of severing oil, gas, trade and financial ties? While the future is uncertain by definition, I think the incentives and therefore probabilities ultimately favour them not stepping over the brink.

The third area is Russia's **macro-economic policies**—fiscal, monetary and banking. These are better than widely perceived. In fact, Russia is financially a good credit. It has both the ability and willingness to repay its debts, and most large public and private companies do too.

Russia's debt backdrop

Russia entered the crisis with one of the lowest levels of sovereign debt globally at 16% of GDP and a fiscal deficit of only -1% of GDP. These numbers would be the envy of most western governments. Russia also had a substantial stock of foreign currency reserves that it has spent to allow corporates and banks to repay their external debts. This means that the $120 billion of private capital outflows was not entirely capital flight, as in 1998, but also forced repayments of private external debts funded by official reserves as western credit markets closed to Russian borrowers

This policy demonstrates that Russia is willing to repay its debts. This willingness is actually quite sensible. Since Russia's debts are held by Asian as well as Western investors, a voluntary default by Russia would be a sure path to isolation and a reversal of the path of integration that Russia has pursued over the last 20 years.

Reasons for calm

So what do these three areas—oil, geopolitics and macro policies—tell us about why the business community was so calm? Because over the last six months the country has learned that it "ultimately has a sustainable economic system, even under stress", in the words of one Russian banker. Russia is ultimately a large, serious country with a government committed to long-term growth.

Therefore, there are value levels at which foreign investors are—and are not—compensated for the probability-weighted risks of oil price fluctuations, geo-political tensions, and the use of foreign currency reserves. But global investors who seek the risk-return profile of emerging markets should not write off Russia in its entirety as an investment destination.

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