

Bonds That Heal: Why Russia's Deficits Are Good for Investors

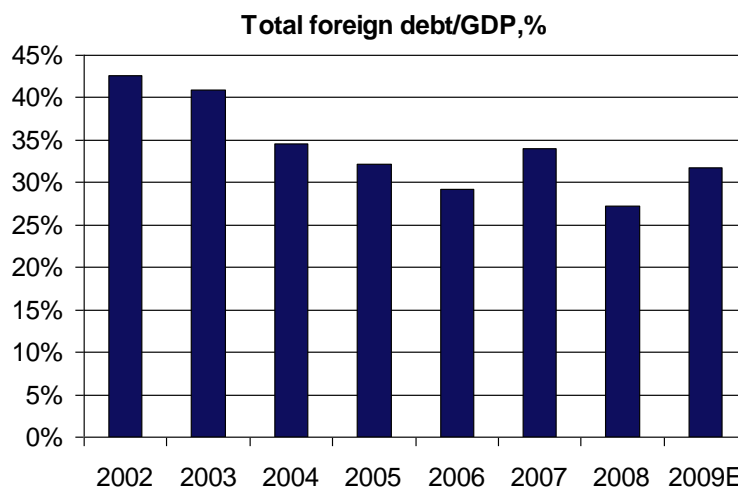
This paper will argue that Russia's unprecedented swing from considerable budget surpluses to nagging deficits will not pose a threat to the country's fiscal sustainability, but will instead mark a sea change for international investors. Why? The Kremlin will be forced to become far more investor friendly in order to court the massive amounts of foreign capital sorely needed to finance the economy - if not necessarily by the State, but by the more heavily indebted Russian corporate sector. The end result will be a substantial contraction of political risk and ensuing major re-rating of Russian financial assets, which currently trade at a fraction of their emerging markets peers.

A Fortress Balance Sheet Despite Massive Drop in Revenue

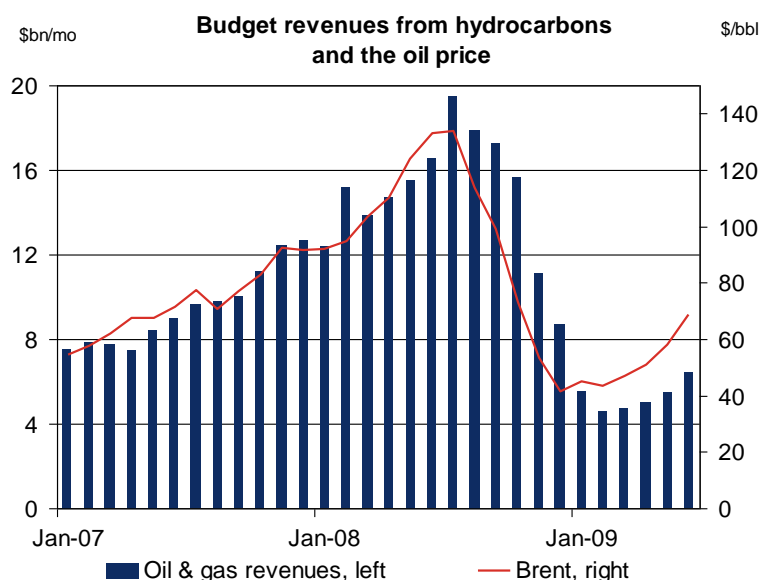
One of Putin's greatest legacies undoubtedly is his success in prohibiting a 1998-style default a decade later, when the global financial system – and Russia's life-blood, crude oil – collapsed last fall. Russia ran an unbroken series of fiscal surpluses from 2000 to 2008, at times reaching 7.5% of GDP. The surplus was used to halve the stock of outstanding federal debt from around \$185bn to \$90bn today and to accumulate assets in the newly-created Reserve Fund and National Wealth Fund. At the beginning of 2009 these funds held a combined total of approximately \$225bn, which were mainly funded from – in UFG's view – excessive - taxation on the oil industry.

During Putin's second term, bending to popular demand, the Russian government relaxed its strict fiscal conservatism by doubling public sector salaries and embarking on so-called "National Projects" to improve the country's fast-dilapidating Soviet era infrastructure.

This goldilocks scenario was reversed by the 2008-09 crisis at breakneck speed, with a magnitude that can only be compared to the vastness of the country itself. With federal revenues falling by 30%, the State balance swung from a 7% surplus to a 4% deficit in the first half of 2009. It is remarkable, however, that this deficit will not initially be covered by domestic or international debt issuance, but instead by exhausting the above mentioned funds over the coming 18 months. While it has become a standard response by G7 countries in the current crisis to widen budget deficits substantially, this is a new found luxury available to Russia. Neither the IMF nor World Bank are demanding Kremlin budget cuts or austerity packages as they have with many Eastern European and even EU countries. The new budget plan based on new economic realities makes a very interesting read, with repercussions which will reverberate deeply into the realms of foreign policy and global capital markets.



Source: Troika Dialog



Source: Goldman Sachs

2010-2012 Budget Plan

According to the Russian Ministry of Finance, led by fiscal hawk Alexei Kudrin, the government expects a budget deficit of 8.6% of GDP for FY 2009. Since Russia's spending process is highly seasonal, with most expenditures occurring in the second half of the year, the deficit will be rising strongly this fall (and likely driven even further by the expected recapitalization of the banking system, which could possibly push the deficit toward 10%). The government intends to reduce this deficit to 3% by 2012, based on a conservative oil price forecast of \$55-\$57/bbl and tax revenue of 15.5% of GDP.

According to the budget plan, the projected deficit for the next two years will be 6.5tr roubles (\$210bn USD), which is about 84% of the two oil-built sovereign wealth funds' peak value. The Reserve Fund will be exhausted by 2010 and the National Wealth Fund is already pre-committed to finance the transition to a fully funded pension scheme by 2012.

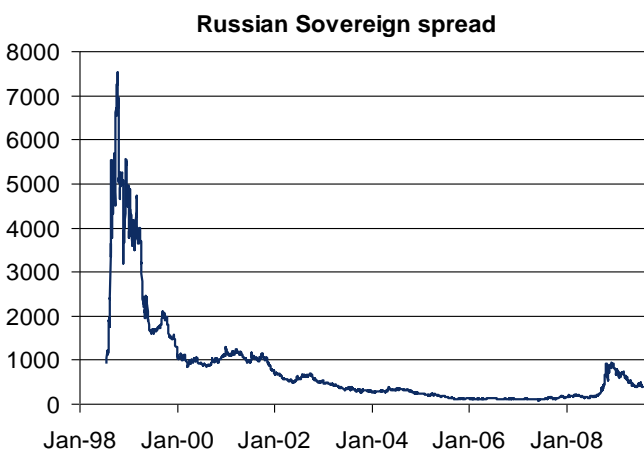
External hard-currency borrowing is set to grow from zero since 1998 (i.e. no debt issuance whatsoever over the past decade) to \$18bn in 2010, \$21bn in 2011 and \$20bn in 2012. The composition of this debt will be a combination of small direct commercial borrowings, with the remainder in sovereign Eurobonds. Even though these numbers are pale in comparison to the issuance of \$150bn in US Treasuries per month, they are unprecedented in a foreign currency for a developing economy, and will instantly transform Russia into the single largest emerging market debt issuer.

A bizarre feature of the borrowing program is the Ministry of Finance's fear of relying more on the domestic Russian bond market, which has never recovered fully from the 1998 GKO default. Rouble-denominated state debt issuance was later quite literally drowned in liquidity by the Central Bank of Russia's policy during Putin's second term, which built up hundreds of billions of dollars in hard-currency reserves by simply issuing roubles into the system in exchange. Thus genuine private capital was crowded out – "drowned out" would be a better phrase – and for the few long-term rouble debt issues it undertook, the Ministry of Finance began to rely on captive buyers such as domestic pension funds and large government owned domestic banks. An increase in borrowing on the domestic market would entail paying market rates, which would lead to significant mark-to-market losses at these institutions. We at UFG are at a loss to explain why the government refuses to tap the rouble bond market and regard it as a severe policy mistake. The domestic pension industry is in desperate need for high quality assets (State-owned VEB bank's assets yielded just 3.2% in the first half of this year; inflation is currently 11%) and a proper risk-free curve would give the Central Bank much more flexibility in conducting open market operations.

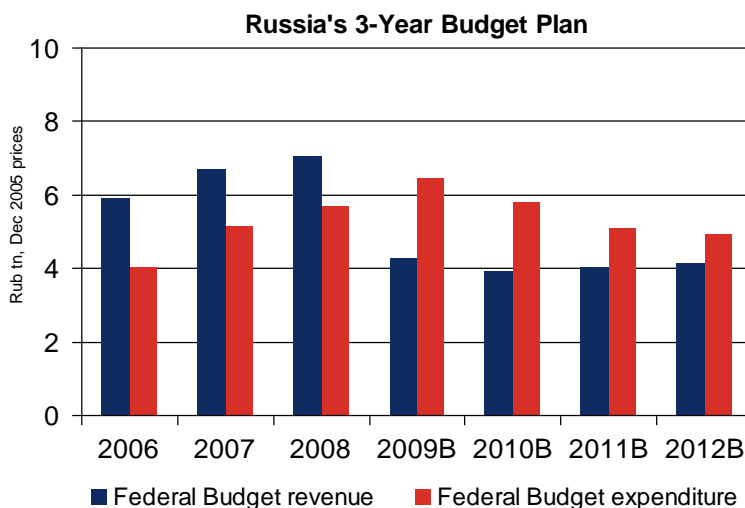
While the absolute amount of international debt issuance will strongly depend on future oil prices (we doubt Russia will have to issue as much as is currently budgeted), the implications are profound even if the Kremlin were not to issue at all.

Implications

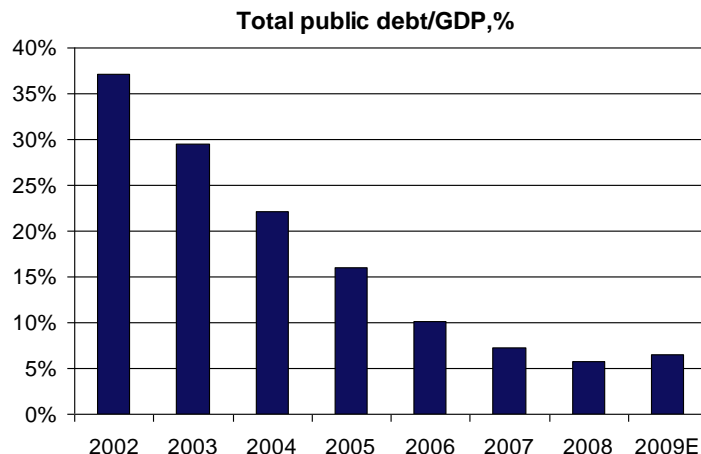
The quick, some will argue rushed, return to fiscal austerity is bullish for Russian credit spreads. This should ensure that even the maximum amount of planned issuance will be placed without problems, as Russia's public debt in percentage of GDP currently stands at a paltry 10%.



Source: Troika Dialog



Source: Goldman Sachs

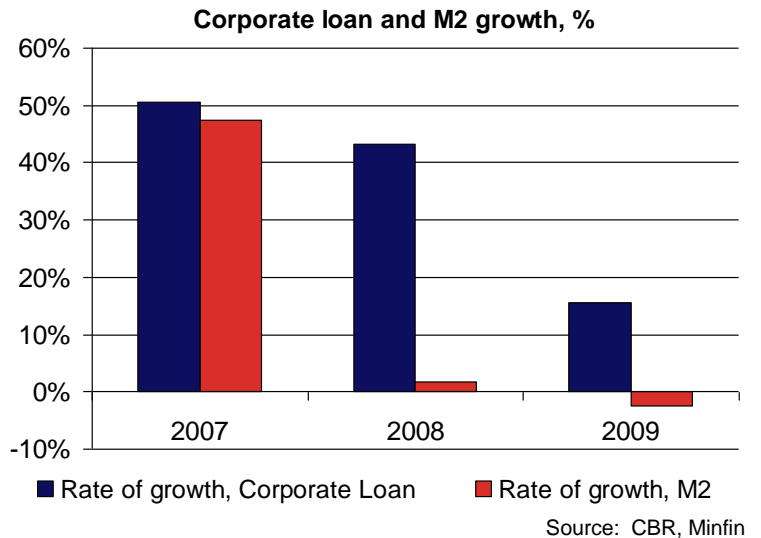


Source: Troika Dialog

At first glance, Russia's failure to stimulate the economy further during times of duress may look bearish for equities. We disagree with this however. There is an easy argument to make that the government should use the slack in construction spending to build up much needed infrastructure and increase the country's long-term productivity. Even in the present so called anti-crisis budget, federal road and transportation spending amounted to just a bit more than 1% of GDP. Hardly the amount needed to stimulate demand and have a qualitative and quantitative impact on what in Russia is commonly called a road, but amounts to nothing more than decrepit concrete slabs. Also, the multiplier on government spending is frightfully low due to bad bureaucratic decision making and "losses" during the execution of projects. The increase in spending this year was also not really aimed at boosting final demand, such as cash for clunkers for example, but more aimed at preserving stability by preventing bankruptcies converting privately held debt, i.e. private banks, into State owned debt. Russia's growth recovery will be slow and will depend on global demand. Domestic demand will remain weak, the culprit, however, is a massive domestic credit crunch combined with a massive swing from negative to real interest rates, but not for lack of public spending.

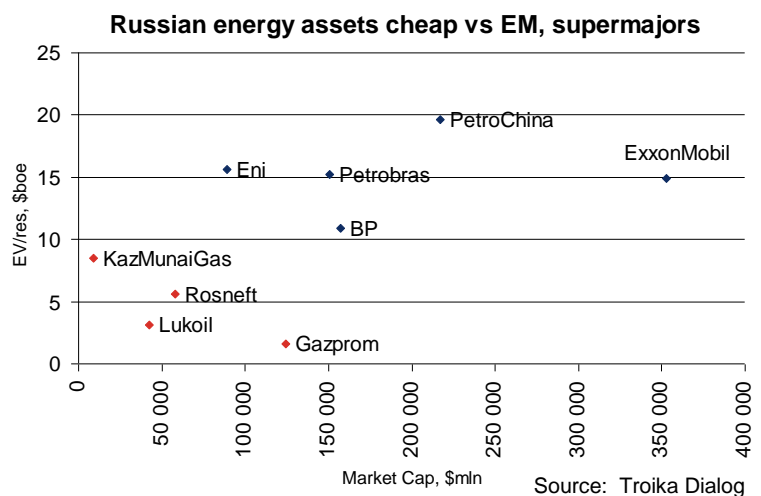
Handcuffs of Gold

The above, however, comes with a significant caveat attached: with hat in hand, in need of hard currency finance, the Russian government will again answer to the court of Western public opinion. Cutting off European gas customers, armed conflict in the Caucasus, and lashing out at foreign strategic investors will soon become things of the past; the international capital markets will simply be closed for Kremlin business otherwise. Good foreign relations will be even more important to the private sector. With the Russian private financial system broken, foreign capital will be sorely needed – and in UFG's opinion, courted – to refinance outstanding corporate debt. For example, Evraz Group, the indebted steel company, properly addressed longstanding balance sheet issues last month by raising \$900m in a combined equity and convertible offering supported by its core shareholders (as well as two UFG investment funds). We believe this to be the beginning of a trend that will accelerate when risk appetite improves.



Historically, Russian financial assets have performed best when relations with the West have improved, the most notable period being from 2001-2005. While the winter ahead will undoubtedly bring some sort of a gas dispute with Ukraine, UFG believes this event has already been discounted by the market. Military adventures in the Caucasus look remote, as Russia's own Muslim-dominated border regions remain unstable, to say the least, with the pacifying impact of oil priced at half of its value a year ago. With Russia trading at the bottom range of its historical discount to emerging markets (forward P/E of the MSCI Russia index stands at 7.8x vs over 13x for global EM), even a slight improvement could have a very significant impact on asset valuations.

Moreover, to most international investors Russia remains an energy play which in itself is derivative on global growth (domestic institutional investors remain a negligible force, as they own less than 20% of the country's free float). With commodity prices stabilizing and Russia's energy stocks trading at the lower range of their historical large discounts per the chart to the right, we doubt that these energy names can be ignored for long by traditionally weary American investors (many of whom have had a near-insatiable appetite for all things China). The key to unlocking this value will be the re-rating of Russian political risk brought on by the upcoming Kremlin goodwill offensive, a move necessary to finance the aforementioned massive pile of international corporate and government debt issuance.



History Does Not Repeat, But it Rhymes

To conclude, we would like to take a brief look back at Russia's short stock market history: Russia has performed best when relations with (or its perception in) the West have improved. The two hallmark events were when Putin firmly aligned Russia with America after the September 11th attacks of 2001, and a few years later when Russia abolished Gazprom's two-tier share structure (the "ringfence") in 2006, granting foreign investors official access to the natural gas giant's cheaper domestic shares for the first time in Moscow's 15-year equity market history.

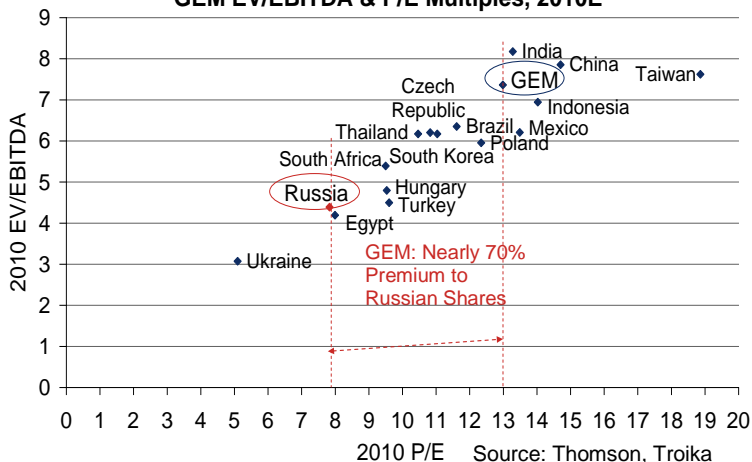
The outperformance of Russian financial assets post-September 11th was part of a broader reassessment of post-Yeltsin Russia. Putin's tough stewardship of national interests was also initially seen in the West as a welcome chance to bring order back to Russia that had seemingly become ungovernable in the 1990s free-for-all under Yeltsin. As odd as it seems now, Putin was viewed by most investors back then as an ideal solution to Russia's problems, and not as the neighborhood bully of today. That in September of 2001 a former KGB spy would immediately ally himself with the US at a time when America was experiencing one of its worst domestic attacks since Pearl Harbor led to massive change in investor sentiment. One of the reasons why the Kremlin only a few years later has become such an obstinate interlocutor is the wide perception within Russia's elite that the US, and especially the Bush administration, had tried to exploit Russia's weaknesses rather than to give credit to the multiple concessions granted by Russia back in the dark days and weeks that followed 9/11.

In 2003 international investor concerns about Russia's commitment to private property and the rule of law rose again with the sham bankruptcy case against Yukos Oil and its subsequent Kremlin-sanctioned asset liquidation, which wrought profound losses on international investors. During those years – and even today – UFG believed that Putin had no choice other than to bring the defiant oligarchs to heel. For our argument, however, what followed is far more important. Shocked by the bankruptcy and the harsh treatment rendered upon Yukos majority owner Mikhail Khodorkovsky, foreign investors left Russia in droves. The Russian government, however, reacted proactively by suddenly lifting the Gazprom ringfence – something that foreign investors had demanded but only dreamed of becoming reality for years, leading to massive profits and a multi-year bull market in Russian stocks.

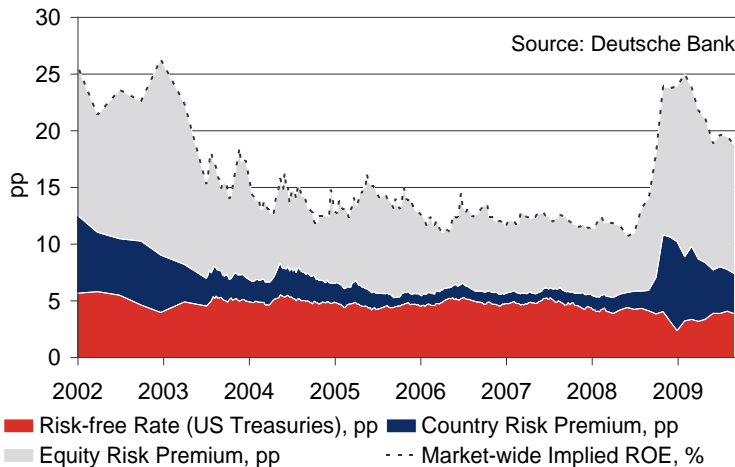
Following the war in Georgia's break-away provinces in August, 2008, US-Russia relations fell to a new post-Cold War low. We doubt that the situation is much different today, although the recent Obama-Medvedev summit in Moscow this July certainly helped begin a thaw that both Washington and Moscow clearly welcome. But rather than look into Mr. Medvedev's (or indeed Mr. Putin's) eyes, we at UFG would rather argue that with Russia's corporate sector indebted as never before to Western creditors, and with upcoming Kremlin budgets highly dependent on unprecedented levels of external sovereign borrowing, Russia will be forced to improve relations with the West.

The direct byproduct of these "bonds that heal" will be a re-rating of political risk, which as of today is the main reason why Moscow's financial indexes trade at such a large discount to their emerging markets peers. Provided oil stays roughly within its recent range of \$50-\$80/bbl, the current rebound in Russian asset prices is not only sustainable, but has a massive, multi-year second leg forthcoming.

GEM EV/EBITDA & P/E Multiples, 2010E



Russian Equity Risk Premium



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