# Russian Equity Market:
## Current Crisis and Outlook

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# Content.

1. Key facts.
2. Factors which caused stock market crash.
3. Valuation of Russian stock market.
4. Possible stock market scenarios.
5. Closing remarks.

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## Table 1. Dynamics of BRIC and Leading World Indices in 2007-2008.

| Index | Value | 52 Week High | 52 Week Low | % Change |
|---|---|---|---|---|
| RTS | 1058.84 | 2498.10 | 1058.84 | -57.6% |
| MICEX | 853.93 | 1970.46 | 789.19 | -56.7% |
| FTSE Russia Index | 328.22 | 753.21 | 328.22 | -56.4% |
| Shanghai Composite Index | 1895.37 | 6124.04 | 1802.33 | -69.1% |
| Bombay Sensex | 13162.73 | 21206.70 | 12514.90 | -37.9% |
| Bovespa Index | 45908.51 | 73920.30 | 45859.00 | -37.9% |
| DJIA | 10609.66 | 14198.10 | 10595.90 | -25.3% |
| S&P 500 | 1156.39 | 1576.09 | 1155.88 | -26.6% |
| FTSE 100 Index | 4912.40 | 6751.70 | 4883.30 | -27.2% |
| DAX | 5860.98 | 8117.79 | 5818.36 | -27.8% |
| Nikkei-225 | 11489.30 | 17488.90 | 11301.40 | -34.3% |

Source: Bloomberg.

## Chart 1. Dynamics of RTS Index in 2004-2008.


**Source: Bloomberg**.

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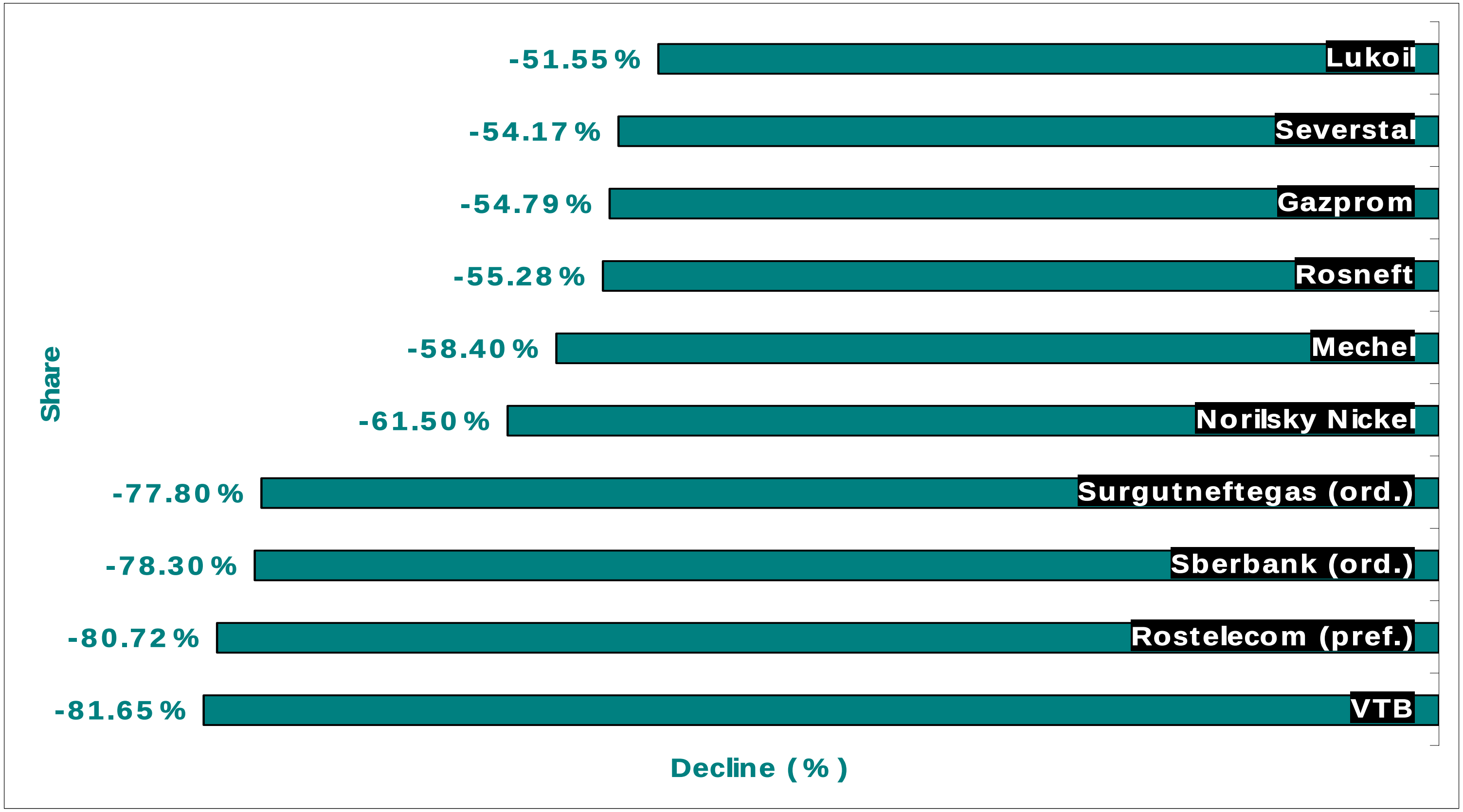
# Some Essentials of Russian Stock Market Downfall.

- Russian stock market experiences one of the most drastic plunge: third after Ukrainian (- 70.6%) and Chinese stock markets (- 69.1%).
- Russian stock market decreased in a short period of time – 86 trading sessions.
- The market broke all key levels of support without any significant upward rebound: 2065, 1870, 1595, 1327 and the last 1069 (RTS marks).
- The fall was even worse than in 1997, though today Russian economy and companies fundamentally are in a much better shape.
- As a result, the capitalization of Russian market declined to 610.7 billion dollars or to 42% of Russian GDP.
- Different stocks plummeted as almost the companies were going to bankruptcy:
    - ✓ VTB share price decreased by 81.6% form peak - more than shares of Lehman Brothers or AIG.
    - ✓ Some of the stocks fell below their book values (Gazprom, Surgutneftegas, Sberbank, VTB).
- Russian regulators have intervened:
    - ✓ Federal Financial Markets Service closed exchanges for a while, forbade marginal trading and short selling.
    - ✓ CBR cut reserve requirements.
    - ✓ President and Ministry of Finance promised to support stock market.
- S&P revised long-term sovereign credit rating of Russian Federation and some banks to stable from positive.

Figure 1. Decline of Some Russian Stocks from Their Price Peak for September 17, 2008.




Source: Bloomberg.

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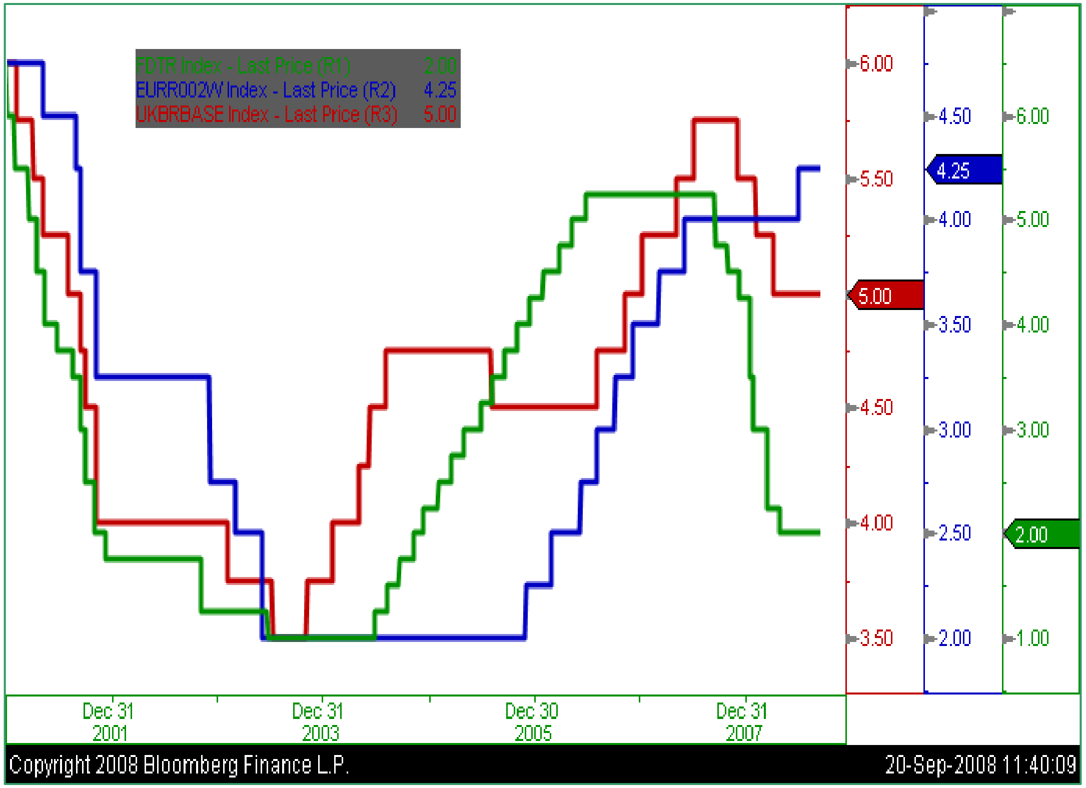
# Global Factors Which Caused Stock Markets to decline.

- **Tightening of monetary policy by leading central banks in 2004-2007 led to:**
  - ✓ **Rising borrow costs.**
  - ✓ **Relative shrink of global liquidity.**
- **As a result, major world economies experienced a deceleration of economic growth since 2005 and some of them (Germany) got negative figures for second quarter of 2008.**
- **Markets began to price in future recession.**

**Chart 2. FRS Federal Funds Rate, ECB Refinancing Rate and BoE Official Rate in 2001-2008.**




**Source: Bloomberg.**

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- **Mortgage and credit crisis** in the USA and Europe caused additional pressure at world stock markets including emerging ones due to severe liquidity problems in a leading American and some European banks and financial institutions.
  - ✓ S&P/Case-Shiller home price index decreased by 18.5% since its peak in 2006.
  - ✓ Rising homeowners defaults and foreclosures.
  - ✓ Amounting credit losses and writedowns (table 2) led to periodical government-led risk plans for different financial institutions in the USA.
  - ✓ Rising borrow costs despite injunction of additional liquidity by the central banks (recent overnight dollar LIBOR jump from 3.1% to 6.4%).
  - ✓ CDS market is at stake.

Table 2. Writedowns and Credit Losses Versus Raised Capital, billions of dollars.

| Area | Loss | Capital | Deficit |
|---|---|---|---|
| Worldwide | 514.90 | 363.10 | -151.80 |
| Americas | 260.60 | 184.10 | -76.50 |
| Europe | 230.10 | 156.90 | -73.20 |
| Asia | 24.20 | 22.10 | -2.10 |
| Total | 1 029.80 | 726.20 | -303.60 |
| Banks | | | |
| Citigroup | 55.10 | 49.10 | -6.00 |
| Merril Lynch | 52.20 | 29.90 | -22.30 |
| UBS | 44.20 | 27.60 | -16.60 |
| HSBC | 27.40 | 5.10 | -22.30 |
| Wachovia | 22.70 | 11.00 | -11.70 |

Source: Bloomberg.

- **Declining commodity prices:**
  - ✓ Oil (Brent) - 37.6%.
  - ✓ Nickel - 67.5%.
  - ✓ Copper – 21.4%.
  - ✓ Steel - 30.9% .
  - ✓ Aluminum - 23.5%.
  - ✓ CRY-Reuters Index - 27.9% from its peak.
- **Stock markets absorbed negative commodity price expectations.**
- **Risk Aversion caused emerging markets capital outflow and flee to quality.**

**Chart 3. Dynamics of Oil Prices, MSCI EM, S&P ADR and RTS Indices in 2006-2008.**


Source: Bloomberg.

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**Chart 4. CBOE Volatility Index (VIX) in 2006-2008.**

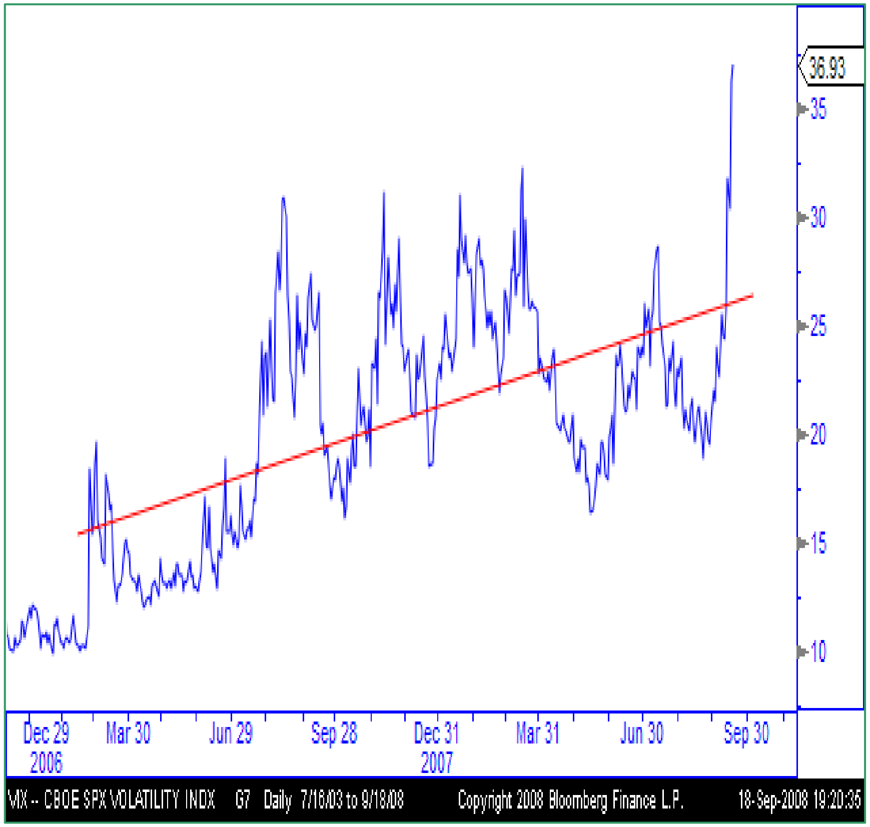


**Chart 5. The Dynamics of Russian, Turkish and Brazilian Credit Spreads in 2008.**


**Source: Bloomberg**.

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**Chart 6. MSCI BRIC Index, 2006-2008.**


Source: MSCI, Bloomberg.

**Table 3. Global Emerging Market Fund Flows in June-September 2008.**

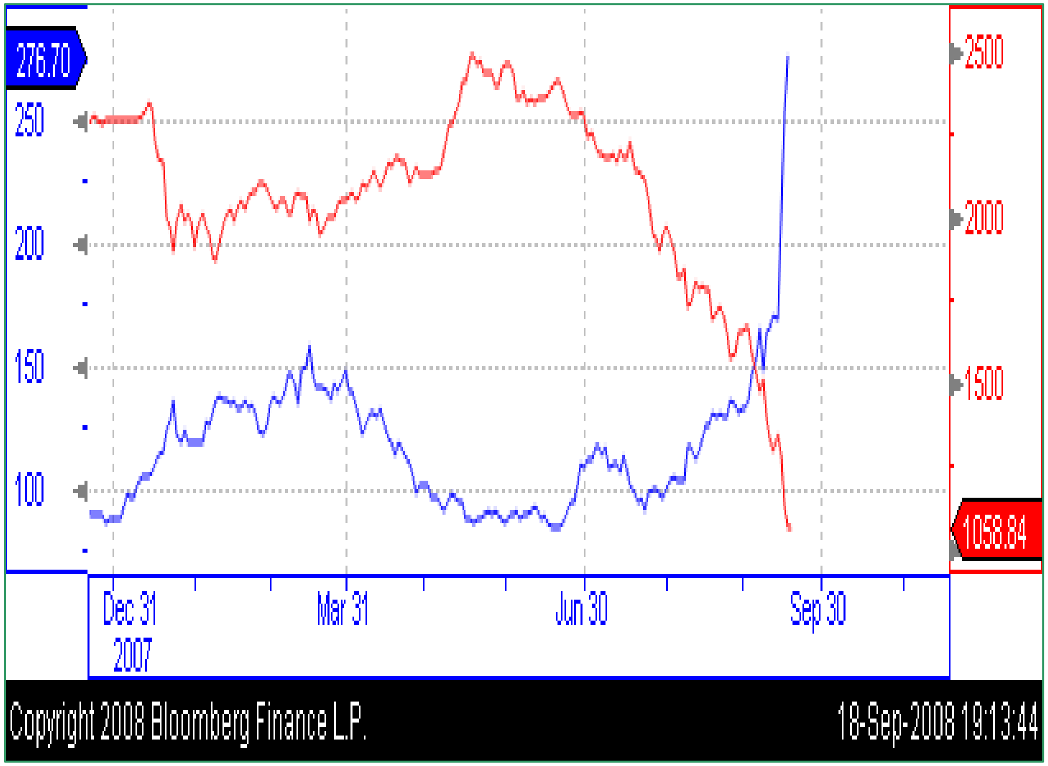
| | Brasil | Russia | India | China | Emerging Markets |
|---|---|---|---|---|---|
| June | -157 | 562 | -425 | -1,603 | -3970 |
| July | -247 | -429 | -533 | 911 | -1179 |
| August | -192 | -385 | -4 | 161 | -362 |
| September | 1 | -103 | -129 | -335 | -452 |
| Total | -595.00 | -355.00 | -1,091.00 | -866.00 | -5,963.00 |

Source: EPFR Global.

# Domestic Factors Which Led to Stock Market Crash.

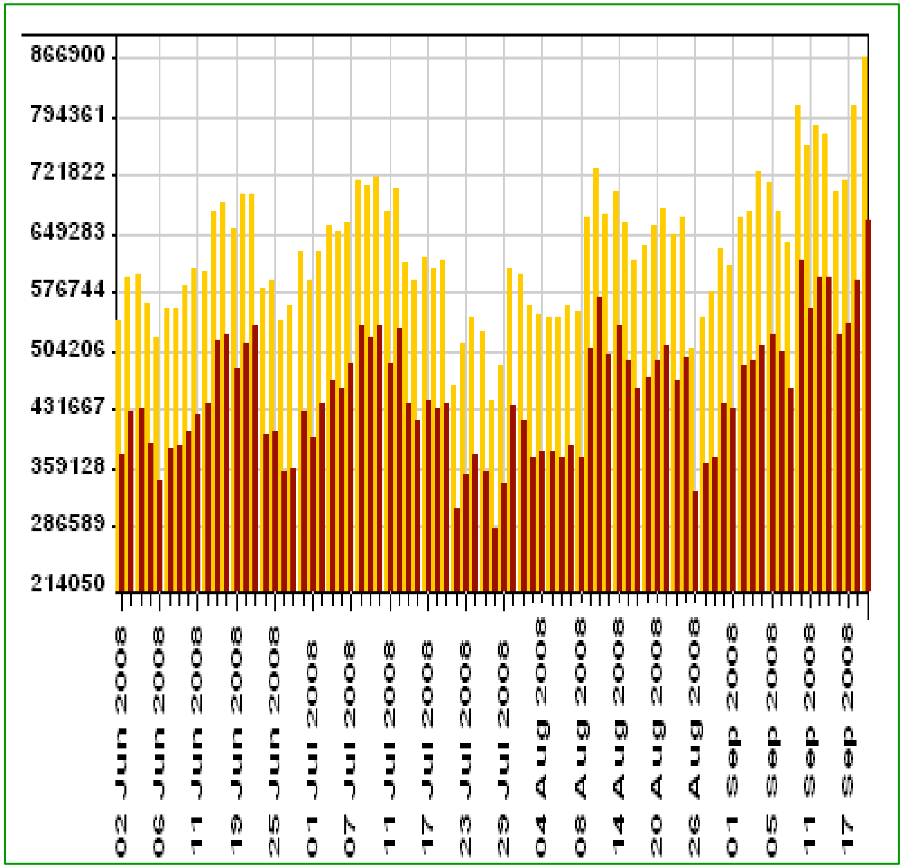
- **Political risks:**
  - ✓ War in Georgia.
  - ✓ Current standoff between Russia, on the one side, and the USA and European Union, on the other side.
- **Liquidity:**
  - ✓ In January-August 2008 M2 grew by 7.1%.
  - ✓ Correspondent accounts balances of credit institutions in the CBR increased by 21.6% in 2008.
  - ✓ While Russian CDS as well as interbank, REPO and credit rates are rising:
    - Climbing inflation led to negative real yield in almost all segments of financial markets.
    - Some banks failed to meet REPO obligations.
  - ✓ In a narrow market any considerable sales of stocks by foreign portfolio investors and unit investment funds creates downward pressure.
  - ✓ Margin calls.

Chart 7. Russian Credit Spreads Versus RTS Index in 2008.



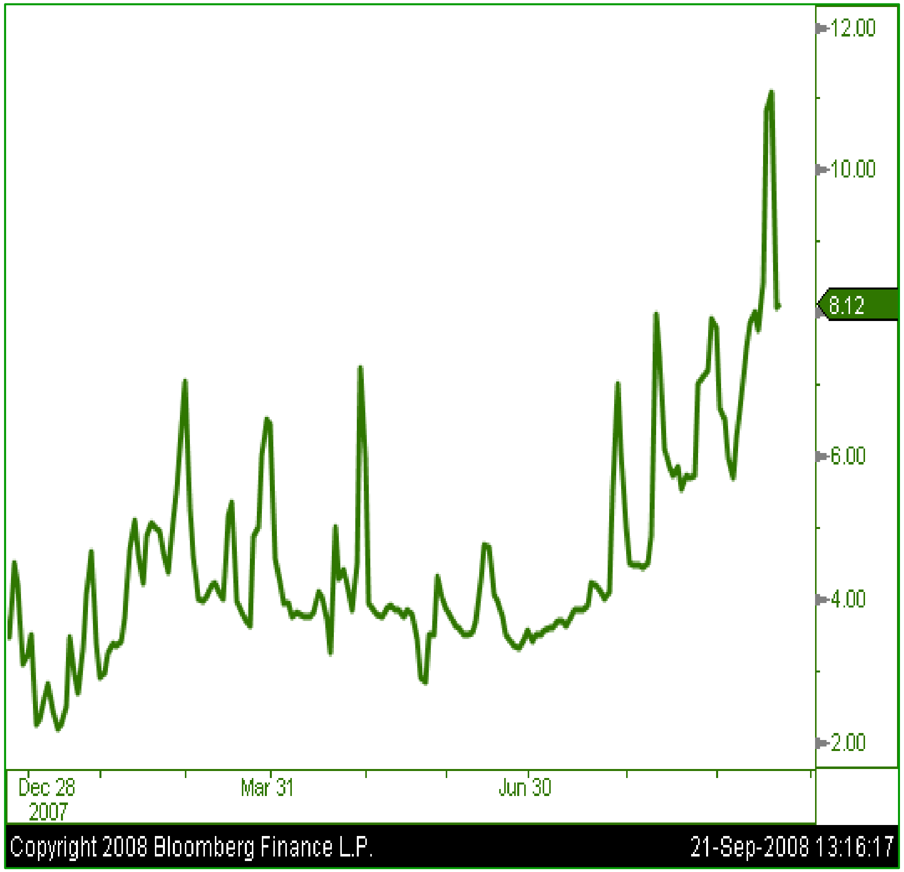

Source: Bloomberg.

**Chart 8. CBR Correspondent Accounts Balances in June-September 2008.**



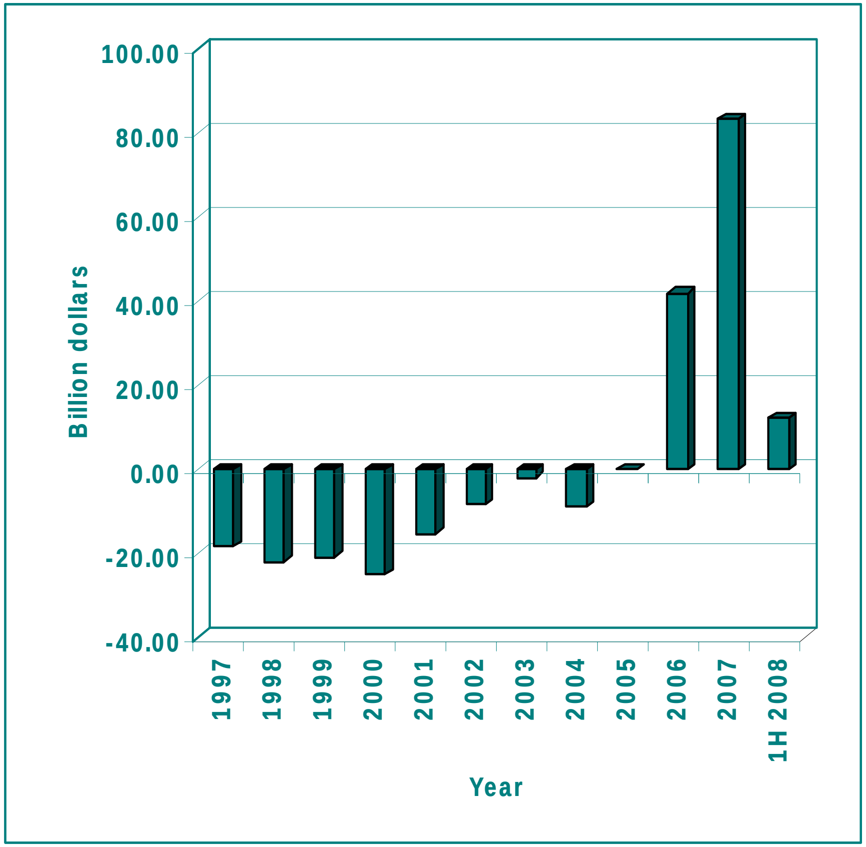

Source: Central Bank of Russia.

**Chart 9. Dynamics of MOSPRIME Overnight and One Day CBR REPO Rate in 2008.**



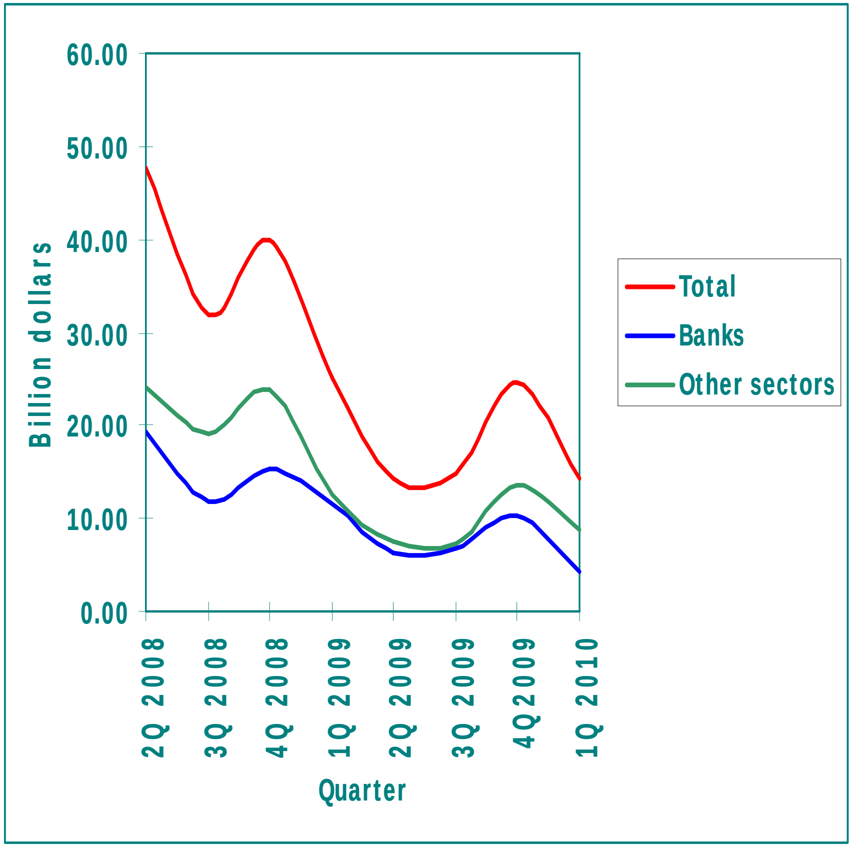

Source: Central Bank of Russia, Bloomberg.

Chart 10. Net Capital Export / Import by Private Sector in 1997-2008.




Source: Central Bank of Russia.

Chart 11. Russian Foreign Debt Payments in 2008-2010 (based on a schedule on April 1, 2008).




Source: Central Bank of Russia.

## ❖ Economic risks, which could lead to worsening economic situation in Russia:

- ✓ Simulative monetary police, which caused economic expansion at initial stage of recovery (1999-2004), today, when industrial capacities are almost at full use, causes inflationary pressure and leads to some economy overheating.
- ✓ Negative changes in the structure of Russian GDP (share of corporate net income is declining since 2004 while share of profit and import duties is rising – reflection of increasing state interference and tight fiscal policy).
- ✓ Lack of capital, machinery and skilled labour are becoming an obvious constraints of economic growth.
- ✓ Despite low level of foreign debt gross foreign debt of Russian companies and banks was rising quite fast (though it was hedged by their growing assets outside the country).
- ✓ Export growth was supported by rising commodity prices while there was physical growth of import followed by increased prices.
- ✓ Falling commodity prices caused a shrink of balance of payments surplus.
- ✓ Productivity is on rise, but it's growth rate is lower than growth rate of disposable income.
- ✓ Inflation is becoming more and more a critical problem.
- ✓ Slow structural reforms.
- ✓ All these problems combined with current credit squeeze in Russia could cause a cyclical slowdown of Russian economy.

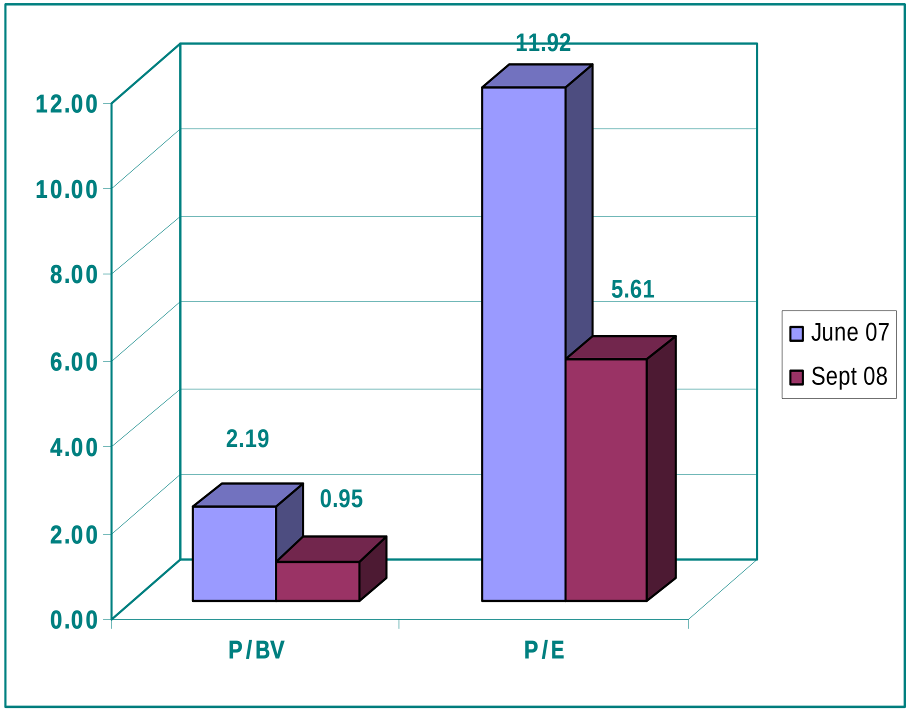
## ❖ Growing corporate risks:

- ✓ TNK-BP and Mechel cases.
- ✓ Low level of corporate governance in Russian companies.

# Valuation of Russian Stock Market.

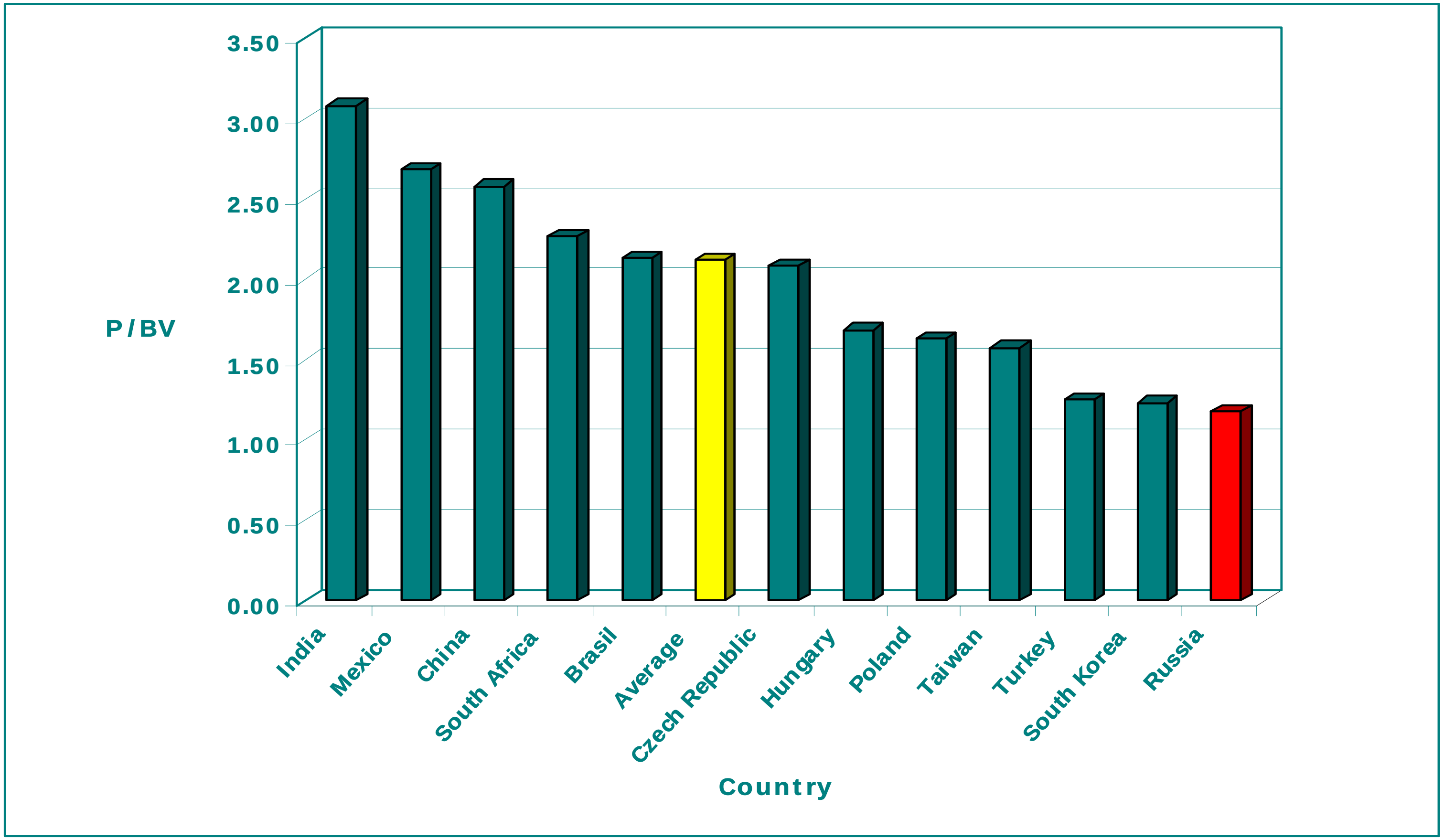
- Drastic decline of Russian stock market fundamental values (P/BV and P/E).
- Russia became one of the cheapest emerging markets.
- Ratio valuation:
    - ✓ P/BV of 1.5 is equal to RTS index about 1667.
    - ✓ P/E of 8.5 is equal to 1603.
- Statistics:
    - ✓ Linear regression analysis – 1639 (RTS).
    - ✓ Rising standard deviation in 2008 and high correlation with MSCI EM and S&P ADR Indices and Russian Eurobond spreads imply high volatility.
- RTS fair value 1897.

**Figure 2. Dynamics of Russian Stock Market P/BV and P/E in June 2007 – September 2008.**




**Source: Bloomberg.**

**Figure 3. Comparison of Emerging Stock Market Indices by P/BV, September 22, 2008.**




Source: Bloomberg.

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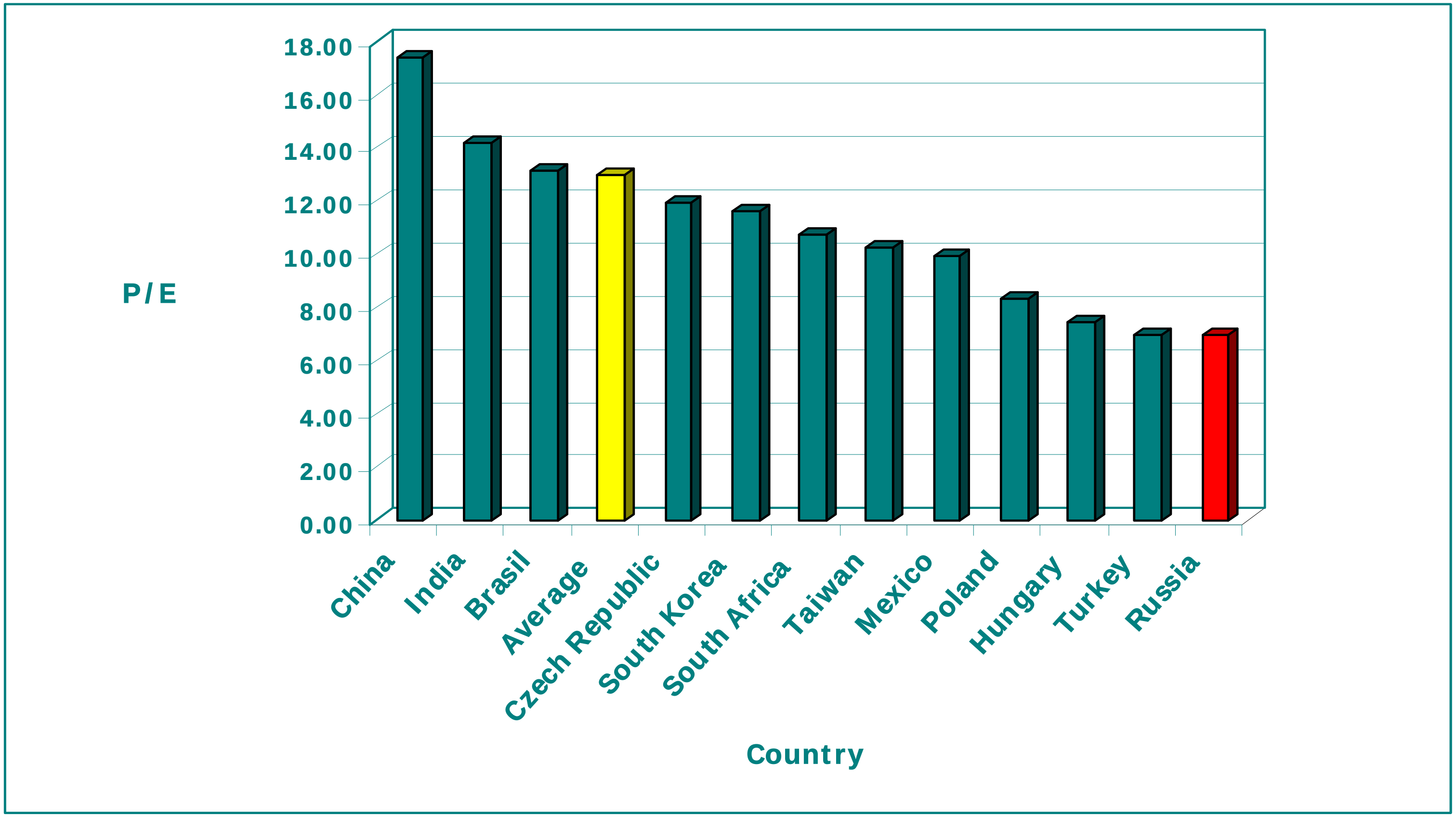
**Figure 4. Comparison of Emerging Stock Market Indices by P/E, September 22, 2008.**




Source: Bloomberg.

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# Technical analysis

- ❖ The long-term (since 2001) and mid-term (since 2005) upward trends were broken in July-August 2008.
- ❖ There is a short-term downward trend:
  - ✓ Current support levels (RTS index): 1178, 1060.
  - ✓ Current resistance level (RTS index): 1370, 1430, 1560.
  - ✓ Exponential moving averages.
    - RTS Index 21-day – 1413.
    - RTS Index 60-day – 1718.
    - RTS Index 200-day – 1935.
  - ✓ Current volatility range: 1178-1567.
- ❖ It's a bear market.
- ❖ So far – no indications of possible switch of downward trend due to:
  - ✓ Investors are overburdened by expensive long positions.
  - ✓ Low trading volumes near dips.
  - ✓ Negative sentiments.
  - ✓ No sign of divergence.
- ❖ There is an opportunity of upward correction to a level of 1370-1390 in RTS index in a short run.
- ❖ Downward targets: 960-1060.

# Scenarios

(based on combined fundamental, statistical and technical analysis for next 12 months)

1. <u>The worst-case scenario</u> – RTS index target <u>840-890</u> (- 35.1%):
   - ✓ Political tension between Russia and NATO will grow.
   - ✓ External economic environment will worsen (continuation of mortgage and credit crisis combined with a recession in the USA and EC).
   - ✓ Russian macroeconomic situation will worsen (GDP annual growth about 3%, disposable income will have a growth rate below 5%, diminishing surplus of balance of payments and federal budget).
   - ✓ Prolonged credit squeeze in Russia.
   - ✓ Oil prices will fall to a level of 60 dollars per barrel. Falling metal prices.
   - ✓ M2 annual growth – less than 15%.
2. <u>Neutral scenario</u> – RTS index target <u>1640-1690</u> (+ 30.5%):
   - ✓ Political tension between Russia and NATO will grow.
   - ✓ Mortgage and credit crisis in the USA and Europe will fade away. Mild or no recession.
   - ✓ Russian GDP annual growth rate 5-6%, disposable income 7-8%, balance of payment and federal budget surpluses will remain stable).
   - ✓ Oil prices will be above 70 dollars per barrel, stable metal prices.
   - ✓ M2 annual growth – 25%.
3. <u>The best-case scenario</u> – RTS Index target <u>1980-2030</u> (+ 56.7%):
   - ✓ Political stability and improved relations with the USA and EU.
   - ✓ GDP growth rate – 7%.
   - ✓ M2 annual growth – 30%.
   - ✓ Oil price – 80 dollars, stable metal prices.

# Closing Remarks.

- Stock market crash in Russia had not fundamental macroeconomic causes.
- The CBR intervention will maintain liquidity in financial system and help to stabilize a situation in the banking sector.
- Intervention of Russian regulators will support Russian stock market in a short-term period of time and will be short-lived.
- In turbulent international environment it will not help to stop exodus of portfolio investors, if the confidence does not restore and investment climate in Russia worsens.
- Administrative rules (like prohibition of short sales) in a long run will artificially cut volatility and lead to diminishing turnover in Russia and will increase ADR trading volumes in London.
- Possible buybacks and substitution of foreign investors by residents (like at GKO-OFZ market in 1999-2001) will help to switch downward trend.
- The crisis helped to discover risk-management problems in Russian financial institutions and the constrains of existing stock exchange technologies.

**“The best way out is always through.”**

**Robert Frost**

# About IC RUSS-INVEST.

- ❖ Established in December 1992.
- ❖ Moscow-based company engaged in dealing, brokerage, custodian, trust, asset-management operations and corporate finance projects (holds five licenses issued by Federal Financial Markets Service in Russia).
- ❖ IC RUSS-INVEST is a member of RTS and MICEX stock exchanges.
- ❖ Net assets of IC RUSS-INVEST are equal to 174 million U.S. dollars (mid 2008).
- ❖ IC RUSS-INVEST has been among top 20 Russian investment companies in 2002-2007 in term of:
    - ✓ Equity & Reserves (2-3).
    - ✓ Net Income (1-3).
    - ✓ Assets (5-20).
- ❖ Credit rating (Fitch):
    - ✓ Long-term – “B”.
    - ✓ Short-term – “B”.
    - ✓ National long-term – “BBB-” (rus).
- ❖ Credit rating (National Rating Agency) – “AA-”.
- ❖ In 2007 IC RUSS-INVEST has been listed among top 500 Russian companies in terms of market capitalization (173) according to Expert Rating Agency.
- ❖ According to survey of “Expert” magazine IC RUSS-INVEST is one of five the fastest growing Russian companies.
- ❖ IC RUSS-INVEST was named as TOP-1 for the best corporate governance practices of Europe (small/medium cap) by technical criteria in 2006 edition of IR Global Rankings™.

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