Russia Equity Strategy

Russian equities performed strongly in the first five months of 2021. MSCI Russia was up 14.1% and despite strong performance Russia remains in a deep value territory. Equities in the RTS Index still trade on the aggregate PE multiple of 7.1x 20201 earnings offering 48% discount to EM peers on the aggregate PE basis. Dividend yield of the RTS index is enormous 6.9% and 3 times higher than MSCI EM index dividend yield. A 24% EPS growth projection for Russia for 2021 makes 2022 multiples look even more modest and valuations supremely attractive.

There are plenty of top interest domestic themes behind equity performance:

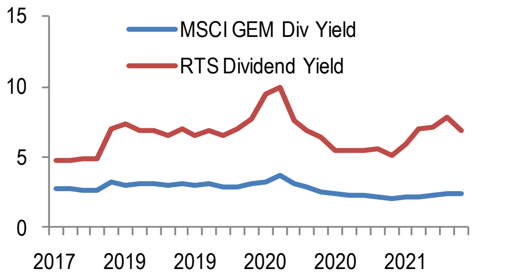
- Returning activity in the ECM sector, healthy IPO pipeline and the most successful ever Russia IPO of OZON which was up 34% in the first few days of trading
- Emergence of domestic retail investors and consumer credit expansion backed by lowest ever interest rate environment and by subsidised mortgages program
- Increased profitability of resource companies on the back of higher oil price and higher metals prices
- Improved corporate governance which is most acutely manifested in generous dividend distributions
- ESG initiatives, which place Russia well ahead of its peers (e.g. Brazil, China and South Africa) in addressing environmental problems
- Timely development of domestic vaccine Sputnik V which places Russia among only 3 other major countries able to respond to COVID 19 threat with its own vaccine development
- CBR timely policy or rising rates which serves to create additional margins for Russian banks due to favourable balance sheet dynamics
- Favourable political environment, some successes in Nord Stream 2 developments and upcoming meeting between the US and Russia political leaders

Russian market is not immune to events unfolding on the international markets. With plenty of positive domestic catalysts, unfortunately, whatever happens to Russian equities in the medium term (in the second half of 2021) mostly depends on events developing on the international markets.

International markets have been cheerful in the first five months of 201. MSCI World index is up 10.8%. Best global markets tracked by MSCI aggregates are MSCI EUROPE +12.7%, MSCI USA +11.02%, MSCI FM (FRONTIER MARKETS) +10.9%. Slightly lagging, but also in positive territory YTD MSCI EFM ASIA +6.5%, MSCI EM LATIN AMERICA +6.6%, MSCI EM Index YTD posted 7.7% gain which is only a half of Russian performance.

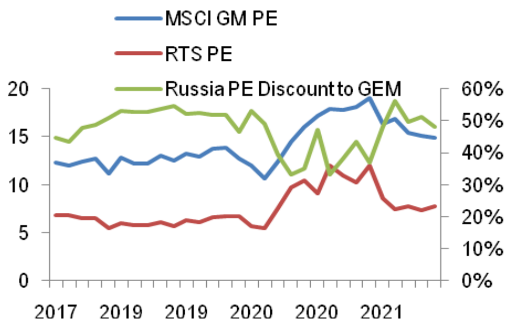
Yet despite this strong performance, international markets are at cross roads. The scenario of economic recovery, returning demand and unlocking travelling is the key idea for investors. However other scenarios have also surfaced.

RTS and MSCI GEM Divided Yield %



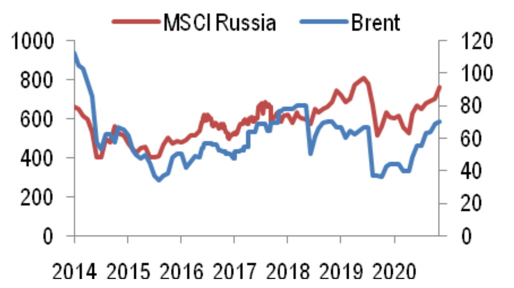
Source: Bloomberg

RTS and MSCI GEM PE Fy1x and Discount %



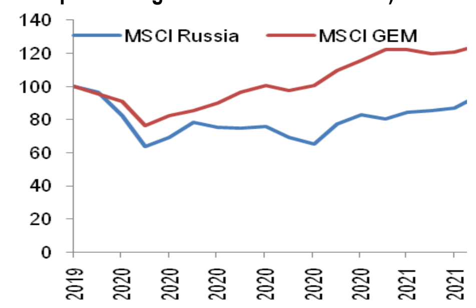
Source: Bloomberg

MSCI vs. Brent oil price



Source: Bloomberg

MSCI Russia vs. MSCI EM Index (Russia underperforming measure from Jan 2019)



Source: Bloomberg

A topic which gets most focus in the investment world if the current market levels are sustainable, stable and have more room for growth.

Global investment themes focus on economic recovery, rising inflation, higher treasury yields, higher asset prices, higher commodities levels and higher equity prices.

Except for inflation which is not immediately bad for equity markets, there are no other alarming signs of possible turnaround in the current trend.

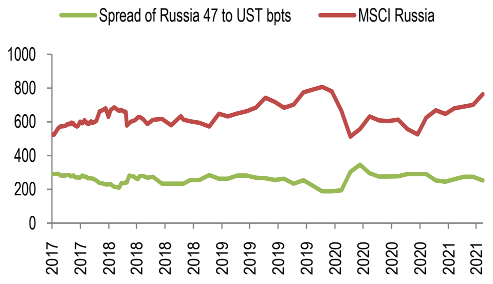
Higher inflation could eventually become harmful to equity valuations through cost pressure, higher risk free rates, higher equity risk premium and higher debt servicing costs.

Rising benchmark rates and falling bond prices is never a good support for broader equity asset class.

But real rates levels - the key risk factor. In the negative real rates environment reflationary pressures and restocking will still act as positive drivers.

Worries aside, the Fed is not ready to chase positive real rates. Probability of Fed rate hike increased from nil levels in the beginning of the year to only 3% for the June 16 meeting (according to CME)

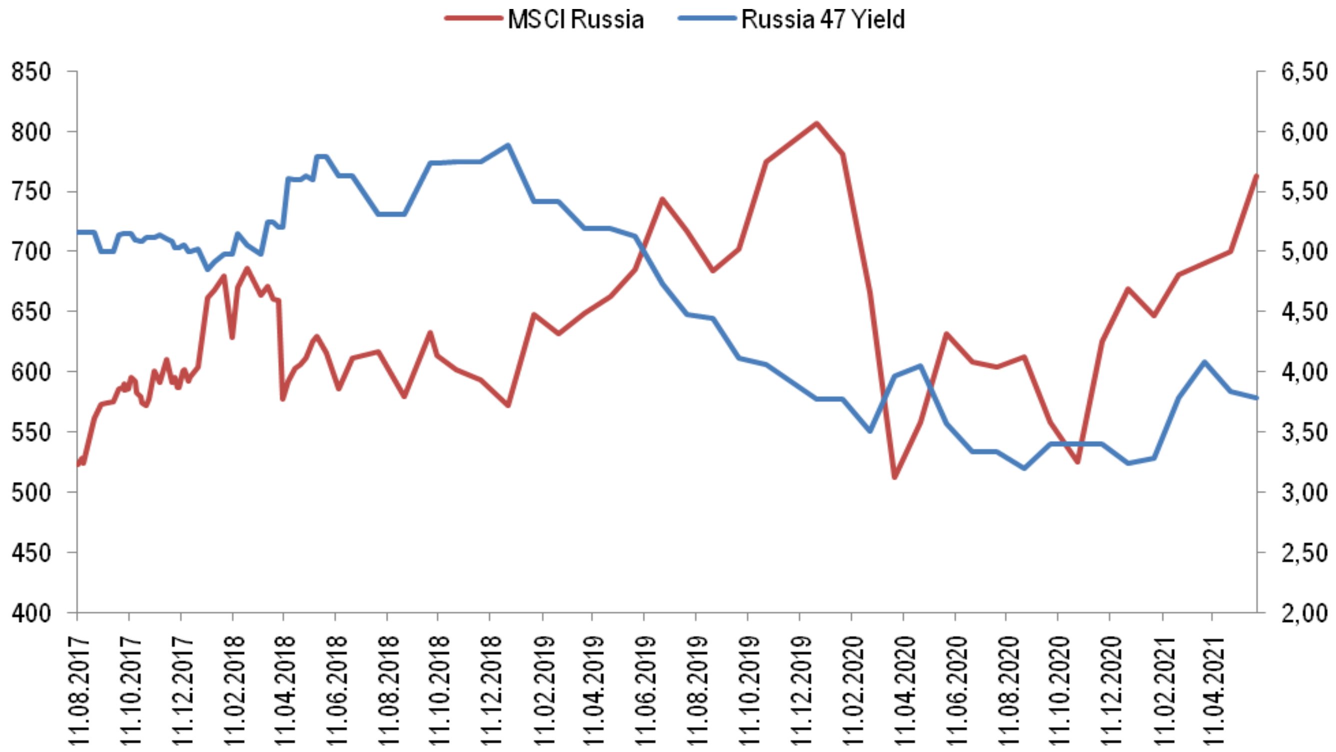
Russia/US Bond Spreads and Equities



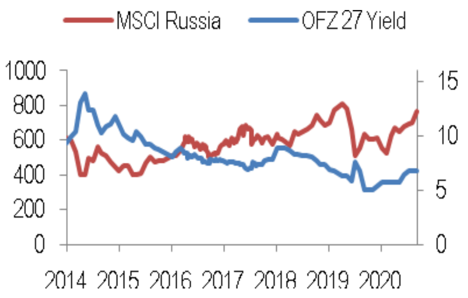
Source: Bloomberg

Inflation in the US

Source: Trading ecoomics



MSCI Russia vs. OFZ Yield (%)



Source: Bloomberg

Scenarios for international markets and Russian market in the second half of 2021

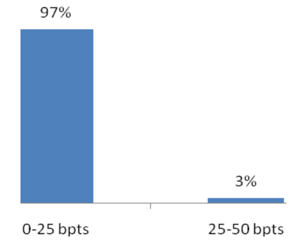
Scenario 1: International markets continue upward. In this case Russian markets will continue outperform emerging and developed markets.

Scenario 2: International markets run out of steam and start consolidating but maintaining the YTD gains. In that case Russian markets could become uncorrelated with their international peers on a day to day basis. Russia specific positive catalysts could become investors' focus providing more fuel for growth.

Scenario 3: International markets start selling off in a spree of profit taking or even worst on the back of some damaging news and events. In this scenario Russian markets will not be immune to global sell off. Some support may be found in dividend income. But in general equities will be hit badly.

Scenario 4: Russian markets sell off on Russia specific news (i.e. something bad happens in August). A set of defensive names can provide some shelter, but overall the price action could become negative.

Target probabilities for FED June 16 meeting



Source: CME

Scenarios for international and Russian markets in the second half of 2021

Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**
Further economic recovery Subdued inflation	Moderate Inflation Small correction in bond markets	Higher Inflation Substantially higher US Yield Rising dollar yields Falling Eurobond prices Stress in the emerging markets debt	Destabilising sanctions Drop in oil price
Evidence: Higher economic growth, Better employment, IP growth, travelling unlocked, stable bond markets, weak dollar, marginal inflation	Stronger dollar, higher US yields, moderate inflation, economic recovery, travel unlocked, bond markets lower but stable,	Very strong dollar, emerging markets bond crisis, emerging markets crisis, higher inflation	Sequence of Russia specific events leading to crisis
Probability 60%	Probability 33%	Probability 7%	Probability 5% (uncorrelated with the rest of scenarios)
Action -accumulate Higher beta names PIK, AFLT, Novatek, Gazprom, Sberbank, laggards	Careful stock picking Value names – dividend picks, materials, financials and consumer staples sectors	Reduce Stick to defensive names: RTKM, MTS, gold names	Reduce Stick to defensive names: RTKM, MTS, gold names