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Emerging Markets Update – Russia: Why we are not there

Russia finally decided to "fully" invade the Ukraine on 25 February. This sent shock waves through global capital markets over late February and early March, as highly punitive sanctions were unleashed on the rogue state. Russia's stock market crashed -35% over February. Northcape has zero holdings in Russian equities, which has been the case for nearly a decade due to its rigorous approach to assessing EM sovereign risks.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Market Review

Sadly, Russia finally decided to "fully" invade the Ukraine on 25 February. This sent shock waves through global capital markets over late February and early March, as highly punitive sanctions were unleashed on the rogue state. Russia's stock market crashed -35% over February. However, this substantially "understates" the situation as Russia's bourse in Moscow was closed on the final day of the month (and remains so at the time of writing).

Based on the massive slump in Russian ADRs on London and New York exchanges (which did trade on 28 February) it seems the Russian equity market was totally obliterated – down an unprecedented -80 to -90% over February.

The EM index fell -3.1% (in US$) but based on Northcape's calculations this is understated by about 200bps due to closure of the Russian equity market (i.e. the underlying decline in the index was around -5% in US$).

In terms of equity markets, Eastern European markets were also hit hard as contagion risks from the Russia-Ukraine war came to the fore; witness Hungary (-27%), Poland (-12%) and the Czech Republic (-3%). The China H-share index continued to drop (-3.9% over February) reflecting concerns over the higher oil prices, weak property sector and underwhelming results from the large internet companies (such as Alibaba).

Northcape (and the Warakirri Global Emerging Markets Fund portfolio) has zero holdings in Russian equities, which has been the case for nearly a decade now due to a rigorous approach to assessing EM sovereign risks. As such the manager will avoid the painful unrecoverable capital losses that now confront foreign investors in Russian equities.

Note: MSCI announced on 3 March that Russia will be removed from the MSCI EM index effective 9 March 2022. Thus paving way for another wave of debt and equity capital liquidations as EM passive index investors are forced to flee (if they can). MSCI (and FTSE) will delete Russia from its indices at zero price, which is effectively write-off Russia from the index.

Russia – Why we were not there

"*I cannot forecast to you the action of Russia. It is a riddle wrapped in a mystery inside an enigma"* – Winston Churchill

How true is this! Although even the great Winston Churchill would say this quote understates the gravity of the current situation, while casting light of the horrid tragedy that is now unfolding.

From our standpoint, Russia is a country richly endowed in natural resources and with no shortage of human intellect and capability. It holds huge potential. But, yet again this vast country has been shot in the foot (indeed both feet) by its ruling elite, leaving its hapless population so much poorer in many ways. And this time it looks like the grim consequences will last a very long time.

Importantly for our investors, we have not owned Russian equities since 2014. Moreover, none of our portfolio companies have material exposure to the country through operations based in Russia. Additionally, we have no current direct holdings in what we describe as "bystander-at-risk" EMs at present, such as Poland, Hungary, and Czech Rep.

On a longstanding basis, under our sovereign country risk ranking system, Russia has been assessed as high risk and as such sits in the "Least Preferred" category – see Exhibit 1 on the following page.

Our high risk rating on Russia is on account of its rigged political system (and all the negative ESG risks that emanate from this) and ongoing risks of very punitive financial, trade and investment sanctions post the annexation of Crimea in 2014. Specifically, following Crimea, a full invasion of Ukraine was not improbable in our view, and sadly this has now come to pass in awful, brutal fashion.

This has led to a massive, unprecedented increase in sanctions, including removing the Russian banking system's ability to access the SWIFT global interbank messaging platform. These sanctions are very unlikely to be removed until the Putin regime has gone, and some sort of government, which conforms and abides to international laws, is firmly in power for some time.

On top of Ukraine, Russian meddling in US elections, cyber-attacks on US and its neighbouring states, weak commitments to net zero emissions, very poor track record on human rights, no real freedom of press and no ability to prosecute corporates in an independent judiciary, have all also necessitated the need have a very high-risk premium.

On the latter, there have been numerous examples where shareholders in Russian companies have had significant amounts of value confiscated by the state, and/or state sponsored individuals of the Putin regime (e.g. Magnit, Yukos). And there has been absolutely no ability to prosecute this behaviour and recover stolen funds and/or assets. This needs change for the better - much better.

Consequently, the equity risk premium we apply to Russian equities is very high (circa 20% +). This valuation discount is very deep and has effectively eliminated the ability for Northcape to own shares in any Russian company.

Further, despite its US$650bn of foreign reserves, increased sanctions (some of which apply directly to its central bank by way of freezing its hard currency assets) have forced Russia to erect tight capital controls in order to prevent a total collapse in the Ruble and its domestic banking system.

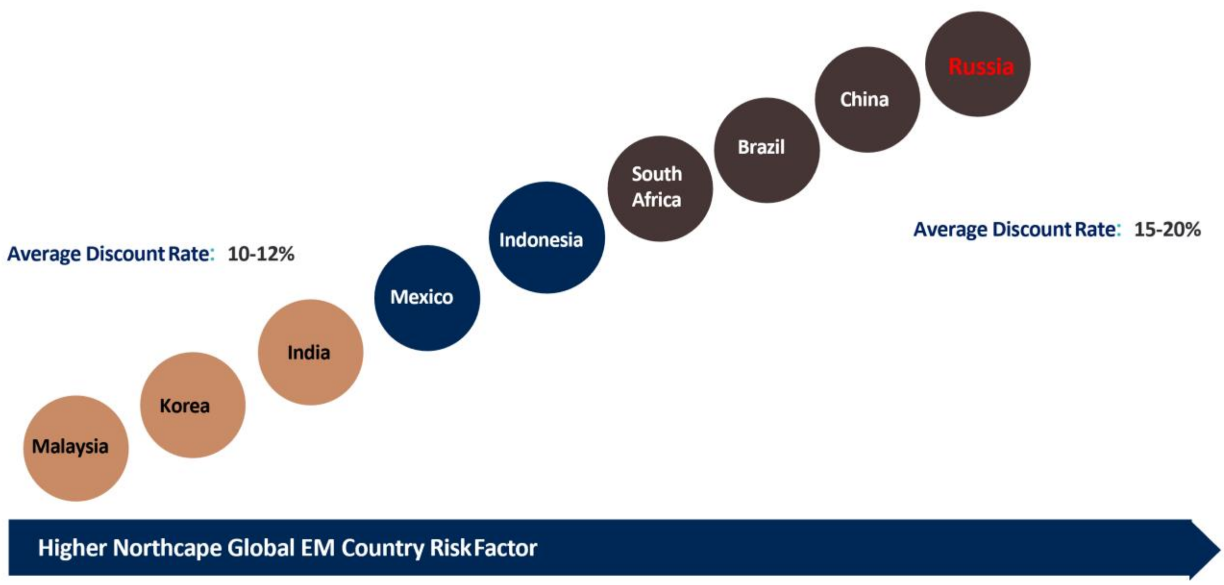
In short Russia has become totally un-investible under our investment process.

Russia was a Classic Value Trap

- Russian equities have looked cheap for a decade, and hence the market lured in investors who lacked an appropriate process for evaluating sovereign risk.
- In fact, according to JP Morgan data, Russia was the biggest overweight amongst active EM funds prior to the 2022 Ukraine crisis.
- As a consequence of our proprietary sovereign risk overlay, Northcape has had zero exposure to Russia for the past decade.

Russian Equities Valuation Relative to MSCI EM

Exhibit 1: Northcape EM Sovereign Discount Rate Rankings – Russia has the highest risk premium



Outlook

The horrific collapse of Russia is a salutary reminder of the severe dangers of investing in passive or “broadacre” index hugging EM strategies. Acutely active strategies, such as the Warakirri Global Emerging Markets Fund with 35 hand-picked stocks backed by deep fundamental research, which integrates EM sovereign and political risk into the investment process, helps avoid such catastrophic blow ups. And thus protects client’s capital.

Northcape continues to highlight China as a high-risk EM. As such, the manager applies a very high discount rate on valuing Chinese equities and accordingly is deeply underweight this market. Unfortunately, at many institutional, political and governance levels, China in recent years has become very similar to Russia, in Northcape’s assessment.

One positive that may come out of Russia’s collapse is that it should send a very dire warning to China if it attempts to take over Taiwan. The devastation on China’s economy from sanctions (especially limiting its ability to access hard currency FX reserves) would be enormous. President Xi has to consider this, according to Northcape. This is potentially positive for improving economic and capital markets stability throughout EM.

It is now very clear that conventional central banks in EM (and finally DM) are moving to aggressively to quash risks of a “de-anchoring” of inflation expectations. The question remains is whether even more needs to be done in light of the pending boost to global inflation from Russia’s invasion of Ukraine? Whilst policy rate increases in the US are currently expected to be as many as six in 2022 – taking the Federal funds rate to about 2% – Northcape has some concerns that the Fed may be less aggressive in light of the economic disruption risks from the implosion of Russia’s capital markets and economy.

On balance, inflation is likely to stay elevated for longer than expected in the manager’s view. A long, drawn-out war is very possible, but what will inevitably occur is the sourcing of alternative supplies away from Russia for commodities and/or demand destruction from higher pricing.

According to Northcape, all things equal this should create an opportunity for inflation risks to steadily dissipate once the initial shock is absorbed and demand/supply eventually balances. In fact, 10 year bond yields over late February have come down a bit reflecting this potential outcome. Again, due to the fact that most EMs have already undertaken much more aggressive policy rate tightening versus DMs, suggest EM may well be better positioned to contemplate easing monetary policy earlier, according to Northcape.

With the recent correction in markets, the manager sees a number of companies currently trading in its own portfolio at valuations at more than 50% below their DM peers, even though the companies have similar growth rates. This highlights the extent to which EM valuations have become cheap relative to DM, according to the manager.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au