Comment on Russia – November 2020

The election of Joe Biden as U.S. President will present new challenges for Russia, but on the whole we think it is positive. Facing a new U.S. administration that does not recognize a Russian right to dominate its neighbors, President Vladimir Putin will have to choose between his dream of rebuilding an empire and domestic economic priorities, which require trade with and inward investment from the West. Biden is likely to quickly restore relationships with America's European allies and pay more attention to their views, presenting Russia with a more united front. When the Kremlin's ambitions are constrained this way, we find that they and we experience better economic and market results.

Also on the plus side, it seems that Russia avoided material interference with the U.S. elections, beyond the usual propaganda on its state-affiliated media and web trolling. It is unclear whether Russia's inactivity was due to deterrence by the U.S. defense and intelligence agencies, more vigilance from the social media companies like Facebook, or their lack of a strong preference for the winner. While Putin may view Trump as having been helpful in some ways, such as weakening Western alliances, the U.S.' actions have only resulted in a stronger European commitment to NATO. And the deliverable that was near the top of the Kremlin's list – removal of sanctions – has actually worsened under Trump, and even converted from executive orders into laws that would be harder to reverse. Whatever influenced Russia, there seems no basis for any extra U.S. sanctions because of the elections.

We believe that Biden, in fact, has a greater chance of another "reset" with Russia than a second term Trump would have had. Given Trump's tainted relations with Russia, any positive U.S. response to a new Kremlin outreach would have been viewed skeptically by Congress and the public. As a known critic of Putin's, Biden could well have a "Nixon in China" moment – that is, if Russia wants one and is willing to take concrete steps the West wants. As Covid disruptions go on and damage the global economy on which Russia still largely depends, its need to regain its prior standing in international capital markets and the G8 will grow.

As president, Biden will also benefit the cause of reform in Eastern Europe, as would-be autocrats in several countries, including Hungary and Poland, will no longer be able to look to an American leader who supports their versions of "illiberal democracy". Ukraine's President Zelensky, who entered office with such high expectations, has barely kept hopes of reform alive, working against Trump and his intermediary Rudy Giuliani, whose involvement has been malign and who appears to serve oligarchs trying to preserve the corrupt system. Biden knows Ukraine, has been there many times, and will push it in the right direction.

The Russian stock market has had a tough year, with the MSCI Russia Total Return Index down over 20%. It has been pressured by geopolitical concerns – the U.S. election and conflicts over the poisoning of opposition leader Alexei Navalny and the Nordstream 2 pipeline – and even more by the Covid-related global recession and consequent decline in the prices of oil, gas, and other commodities. These are Russia's primary exports, and resource companies still comprise most of the stock market index. More generally, economically sensitive stocks worldwide recently reached the highest discount to "growth" in decades.

Positive Underlying Trends

Despite this gloomy picture, there are underlying trends that give reasons for optimism. In the short term, Pfizer's announcement last week that its vaccine had 90% efficacy sparked a terrific rally in cyclical stocks, such as Lukoil in Russia, which gained over 25% in a week. The Good Judgment Project (aka The Superforecasters) now assign a 90% probability to there being a widely distributed vaccine in the U.S. by March 31, 2021. We note that in the last comparable flu pandemic, in 1957-58, the U.S. stock market bottomed six months before the distribution of a vaccine, even as the cases and deaths were at their worst.

A longer-term trend is that the Russian capital markets are showing more positive effects of four and a half years of low inflation and falling interest rates. Lower rates have supported fixed income issuance, allowing companies to refinance their foreign debt into rubles. They have also caused retail investors to shift bank deposits into brokerage accounts, to generate a return on their money. Enabled by easier opening procedures on banks' mobile apps, active accounts have quadrupled over the last 18 months. More local participation has already reduced market volatility: in March 2020, when foreign investors sold *en masse* as Covid broke out, local buyers stepped in, arresting a drop that would likely have been much worse even two years ago.

Interrelated to the growing technological savvy of the population is wider digitalization of the economy. Sberbank has gone from a sleepy Soviet-style institution ten years ago to a technologically advanced juggernaut with an AI-powered ecosystem that puts most Western banks to shame. Moscow Stock Exchange, a beneficiary of the explosion in retail brokerage, continues to launch new products, such as trading of international stocks and a retail deposit marketplace. Yandex, the Google and Uber of Russia, competes at a global level in numerous areas, including self-driving technology and car sharing. Yandex has its own version of Alexa, Alice, who was incidentally taught the Russian language via the inputting of classic literary works by Dostoyevsky, Tolstoy, Gogol, and others. She had to be reprogrammed because her initial personality was deemed "too depressing".

In e-commerce, Covid has accelerated development by several years. The best-managed Russian retailers are adapting quickly, such as #1 operator of groceries X5, which in two years overtook competitors to become #1 in online food as well. X5 is going further and launching an online marketplace that sells groceries and other products out of its Perekrostok supermarkets and dark stores. Even the resource companies realize that their future includes a heavy digital component – in the words of Severstal, it is no longer just a steel company but is embarked on a "significant transformation … into a customer-centric innovative solutions provider" deploying a range of "digital services … more typically offered by B2C companies". Not your grandfather's Soviet metal-basher anymore.

Trading at the low end of its historic valuation range based on estimated 2021 earnings and dividends, the Russian stock market has short-term catalysts related to vaccines and global recovery, and longer-term ones related to the modernization of Russian business and the inevitable shift in the composition of the main indices toward a newer economy.

152 WEST 57TH STREET, 24TH FLOOR, NEW YORK, NY 10019 TEL: 212-698-9260 FAX: 212-698-9266
FIREBIRD@FBIRD.COM WWW.FBIRD.COM

FIREBIRD MANAGEMENT LLC

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