



Oil Will Fuel Russia's Growth Buy-and-Wait Strategy Could Pay in Long Term

By Levi Folk, October 2009



When Tolstoy said "the two most powerful warriors are patience and time," he could have been referring to Russia's equity market -- **if you throw in the fact Russia still has one of the most undervalued stock markets in the world.** It will take several years for Russia to recover its trend rate of growth after a painful recession, but low historical valuations suggest investors will get paid to buy into and wait on Russia's stock market.

Russia unfortunately brings to Canadian investors all the diversity of a Zimbabwean election. The economies of Russia and Canada are both dominated by resources and banking; those sectors comprise more than 80% of the MSCI Russia index and 77% of the S&P/TSX composite index.

What Russia offers Canadian investors is low valuations and above-average long-term growth potential. The country is home to undervalued oil assets and a banking sector that could expand at very high rates over the next two decades.

Russia is now the biggest oil producer globally, thanks to OPEC production quotas that have fallen squarely on the shoulders of Saudi Arabia. That fact brings the influence of oil on Russia's economy sharply into focus, and it dominates the picture. Therefore, investors in Russia will live or die by the long-term price of oil.

The collapse in oil prices last year devastated Russia's economy and stock market. GDP contracted more than 10% in the first half of the year and the stock market fell 75% from peak to trough. The country is only now turning the corner from

economic recession to recovery, yet economic output will remain below trend for the next several years. The government is attempting to make up for the shortfall by spending its way out the crisis.

"I expect acceleration of growth most importantly due to fiscal stimulus because 40% of government expenditure is back-ended to the fourth quarter of 2009," says Julia Tsepliaeva, an economist at Merrill Lynch, reached in Moscow. Fortunately, the government has the fiscal latitude to increase spending because foreign holdings of sovereign debt are a mere 3% of GDP, Ms. Tsepliaeva says.

Economists have been ratcheting up their forecasts for economic growth in Russia for next year, says Ms. Tsepliaeva, who optimistically raised her numbers for GDP growth to 3.9% for 2010.

The expected growth recovery will lead to a significant earnings rebound that could propel the stock market higher. Company earnings will grow at a 60% compound annual growth rate between 2009 and 2011 according to Goldman Sachs, which sees 40% potential upside to equity indices based on an oil price forecast of US\$110 per barrel oil in 2010.

The investment opportunity in Russia is buttressed by fact that the cheapest oil assets in the world are not in the ground but on the country's stock market.

"Oil is very interesting because energy companies in Russia are the cheapest globally, and demand from emerging economies is going to be higher," says Ghadir Abu Leil-Cooper, head of Europe Middle East and Africa equities at Barings, reached in London. **Economic stimulus in China is focused on infrastructure spending that is pushing up commodity prices and directly benefiting Russia,** Dr. Abu Leil-Cooper says.

Higher oil prices act like fertilizer on the entire economy, enabling the growth of other industries. The opportunity in banking is significant given low credit penetration across Russia's economy. Mortgages account for only 2.5% of GDP, a number that stands to grow with rising incomes over the next two decades. As a point of comparison, mortgage penetration in the United States is close to 75% of GDP.

As the credit crisis slowly releases its grip on Russia's economy, one of the hardest hit last year, **investors will revisit the**

the long-term opportunity for investing in Russia's stock market.

They will be attracted to undervalued energy assets and the long-term growth potential in banking, and they will need Tolstoy's two warriors, patience and time.

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