

Review of Emerging Markets

September 2010

Focus - Russia

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Highlights of the month

- Collectively, emerging markets outperformed developed markets during August. However, most emerging markets lost ground in absolute terms
- In a reversal of trends seen in July, there were growing fears over the possibility of a “double dip” recession in the US and other major economies
- The People’s Bank of China announced new arrangements that will give particular foreign banks the opportunity to participate in China’s inter-bank bond market for the first time
- Official statistics showed capital inflows into India had weakened, at a time when that economy was slowing anyway
- The Bank of Korea faces something of a policy dilemma as it acts to fight inflationary pressure, at a time when the global economy may be weakening
- South East Asian economies continue to grow strongly
- Russia’s Finance Minister indicated that the government is planning to sell minority stakes in a variety of State Owned Enterprises



Statistical summary

Stock market Indices	1 month	3 months	6 months	12 months
Emerging Markets	-2.15%	4.71%	3.65%	15.56%
Eastern Europe	-3.88%	2.60%	-2.75%	13.70%
Russia	-3.86%	2.36%	-2.04%	20.72%
Arabian Markets (Ex Saudi)	2.08%	2.76%	-1.09%	-8.14%
Latin America	-2.47%	5.37%	1.72%	20.51%
Brazil	-3.58%	4.7%	-1.48%	18.22%
Asia Pacific Ex Japan	-2.06%	5.37%	1.67%	11.24%
China	-2.76%	2.37%	0.32%	6.87%
India	-1.55%	2.89%	5.06%	20.16%

Sources: Bloomberg/MSCI/Barra

Global emerging markets in August

In most emerging markets, stocks fell during the month of August. As the table on the front page of this report shows, the only regional index to rise during the month was that of the Middle East (excluding Saudi Arabia). Collectively, though, emerging markets outperformed developed markets during the month.

In essence, the main trends which had dominated global stock markets in July went into reverse during August. Particular pieces of data from the US (such as the weaker-than-expected housing sector data that was released towards the end of the month) raised widespread fears over the possibility of a “doubledip” recession.

The US Dollar rose against other major currencies (other than the Yen). In developed countries (other than Portugal, Greece, Ireland and Spain), benchmark government bonds performed well in an environment of risk aversion.

Various official announcements towards the end of August highlighted how policy-makers in emerging markets are having to deal with various challenges that have arisen as a result of, or that have been exacerbated by, the slowing in the global

economy. In India, the Reserve Bank said that the country's current account deficit had grown to 2.9% in 2009-10 from 2.4% in the previous year. Subir Gokarn, the Deputy Governor of the Reserve Bank of India, said that he had detected risks with global capital flow volatility. He added that there had been "a sharp change in the global scenario with a flight to safety [resulting in capital] exiting from India and other emerging markets." India's foreign exchange reserves, a cushion against volatile capital flows, have fallen over recent months to US\$278bn from a high of US\$315bn in May 2008. The decline in reserves prompted some senior policymakers to call for action to reduce India's current account deficit. This at a time when India's economy is slowing anyway.

Official statistics showed that India's industrial output grew by a lower than-expected 7.1% in June from a year earlier. The slowdown in industrial production, from a revised 11.3% expansion in May, reflected a sharp fall in capital goods growth. India's capital goods output grew just 9.7% year-on-year in June, sharply down from 34% year-on-year in May and 69% year-on-year in April.

In Brazil, the latest figures indicated that the nation's current account deficit widened to US\$43.76bn, or about 2.24% of Gross Domestic Product (GDP). Official data showed that Brazil has suffered a steep fall in foreign exchange inflows.

Separately, in South Korea, Bank of Korea Governor Kim Choong Soo warned that policymakers' 0.25% increase in interest rates to 2.25% in July "may not be sufficient" to control inflation.

South Korea's currency, the Won, rose 0.5% against the US Dollar to 1,190.03. (The Won has depreciated by 2.2% to the US Dollar this year). In mid-August, the People's Bank of China said that it had launched a pilot project to allow more foreign access to China's largely-closed domestic inter-bank bond market.

Foreign central banks, lenders in Hong Kong and Macao that already conduct Renminbi clearing, and overseas banks involved in Renminbi cross-border trade settlement will be allowed to participate in the inter-bank bond market.

The authorities in Beijing are trying to encourage the use of Renminbi for trade as part of a longterm plan to promote it as a reserve currency and reduce China's exposure to the US Dollar, now used for most Chinese trade.

Separately, McDonald's Corporation -the world's largest restaurant chain - placed 200 million Yuan (US\$29 million) of 3% bonds in Hong Kong, becoming the first foreign nonfinancial company to sell Yuan-denominated bonds in the Special Administrative Region. The US company said that the money raised would provide working capital for expansion in China, where it will open as many as 175 restaurants this year. Meanwhile, particular countries in South East Asia continue to grow rapidly.

In Thailand, for instance, official data revealed a better-than-expected 9.1% year-on-year increase in second quarter GDP. Indonesia's year-on-year GDP growth reached 6.2% in the second quarter and was up a seasonally-adjusted 1.6% from the previous quarter. The figures were better than had been expected.

Region in focus: Russia



The general case for emerging markets investment revolves around a number of propositions. Typically, emerging markets can sustain higher economic growth than can developed markets.

Superior economic growth is normally consistent with higher Returns on Equity (RoE) and commensurately greater return to shareholders. More often than not, the governments of emerging markets are committed to structural reform and other measures that will reduce investors' exposure to risk: this is consistent with a re-rating of assets.

Of all the emerging markets, Russia stands out because it meets all these requirements, and at a time when its economic fortunes are improving dramatically.

Through early 2010, forecasts of GDP growth for both this year and next have been revised upwards sharply.



As a major exporter of energy (and other raw materials), the country's economy – and perceived prospects – suffered severely when global trade slumped in the wake of the global financial crisis which reached its climax nearly two years ago.

The subsequent recovery has had a huge impact. Russia's GDP contracted by around 8% in 2009 and is expected to grow by about 5% this year. The difference – of around 13% - represents a greater improvement than that which is expected for any of the larger emerging markets. For Mexico and Taiwan, for instance, the corresponding figures are approximately 9%; for India and China, around 2%.

Over the nine years to the end of 2009, Russia sustained real economic growth, of about 5.4% per annum on average. By this measure, it performed better than Poland, Turkey, South Africa, Israel and the Czech Republic, all of whose economies grew by 3-4% per annum, and Hungary, whose economy expanded by around 2.5% per annum.

More crucially, economic growth in Russia was driven by household consumption to a much greater extent than in the other countries. Of the 5.4% average annual growth, 3.9 percentage points came from rising household consumption.

Elsewhere, household consumption contributed 2-2.5 percentage points, except in the Czech Republic and Hungary, where the corresponding figures were 1.5 and 1.7 percentage points respectively.

Indeed, the latest turnaround in Russia's fortunes is also being driven by a massive improvement in household consumption.

Through the first two quarters of 2010, the largest contributors to recovering economic growth have been exports and a rebuilding of inventories after an extremely challenging year in 2009.

During the second two quarters of this year, it seems likely that the main sources of growth will be household consumption and, probably, inventories. Household consumption shrank by nearly 8% over the course of 2009. It is expected to rise by about 4.5% this year and by 6% in 2011. Already, retail sales in Russia are clearly growing again, after a year of contraction in 2009.

The recovery in consumption spending has been driven by strong growth in nominal and real household incomes. As of mid-2010, nominal wage growth was running at around 10% year-on-year. Pension incomes were about 30% higher than they had been in mid-2009. Combined wages and pensions were up by around 13%. In real terms, wages have grown by 6% in Russia over the last year or so. This is far greater than the rise in real wages in any of the other emerging markets mentioned above.

Interestingly, total numbers of employed people has remained stable in Russia over the last 12 months. It has increased by 1.5-2.0% in Israel, Turkey and South Africa, but has fallen in the other countries. (Within Central and Eastern Europe, Hungary stands out because real wages have shrunk by 1% and total employment has contracted by 2%).

It may be that consensus estimates of the growth in Russian household consumption spending are overly conservative.

Households can spend more than they earn if they borrow. Relative to their counterparts in the other countries mentioned above (and most developed countries), Russian households have relatively low levels of debt. Interest payments represent just 2.5% of household disposable income in Russia. In South Africa, by contrast, the equivalent figure is over 8%. In Russia, household debt is a mere 15% of household income. This compares with figures of 60% in Israel, over 60% in Hungary and nearly 80% in South Africa.

In short, Russia's economy is relatively likely to have some resilience in the event of any deterioration in the global environment. Exports amount to about 30% of GDP; exports and imports combined, to around 60%. By contrast, the corresponding figures for Hungary are around 80% and 150%.

Except for Turkey and, arguably, Romania, the economies of all other countries in Central and Eastern Europe are far more integrated with the rest of the world than Russia. Russia also stands out for the low level of public debt. One legacy of the financial crisis of 1998 is that the Russian government has not enjoyed good access to global capital markets. As a result, it has a low level of borrowing. The government's domestic borrowings amount to around 7% of GDP. Foreign borrowings are minimal. Domestic and foreign public debt, therefore, amounts to about 10% of GDP. The equivalent figure is around 80% for Egypt, Israel and Hungary, about 50% for Poland and Turkey and over 20% for Romania, South Africa and the Czech Republic.

It should be noted, though, that Russia's public finances have deteriorated over the recent past. The government ran a budget surplus from 2000 to 2008. In 2009, though, the government ran a deficit that was equivalent to almost 9% of GDP. At this stage, we anticipate that the deficit will fall relative to the size of the overall economy, but that it will still amount to almost 5% of GDP in 2012. The main problem is that government expenditures have continued to grow, even as revenues have collapsed.

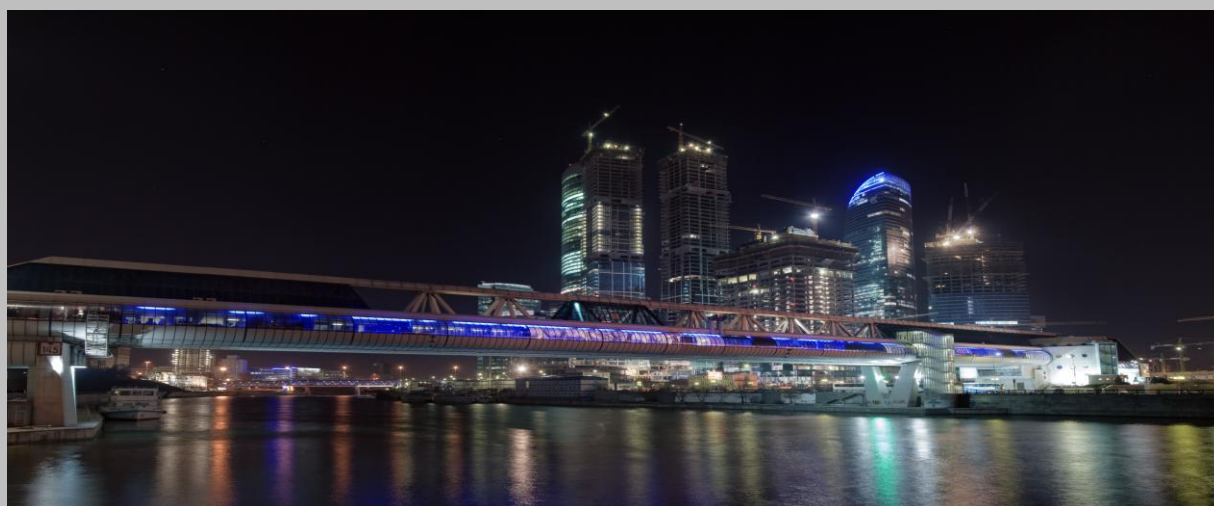
In 2008, mineral extraction taxes amounted to 1,309 billion roubles out of total revenues of just over 3,000 billion roubles. In 2009, the corresponding figures were 681 billion roubles and about 2,100 billion roubles.

Even if the economy as a whole is unlikely to be affected by the changing fortunes in the rest of the world, government revenues are influenced heavily by energy prices. At the current oil price of around US\$74 per barrel, the government can easily fund its deficit by drawing down on its Reserve Fund and by selling bonds in the domestic market. The government would only have to borrow from foreign creditors in the event that the oil price fell below US\$50 per barrel.

Emerging markets debt market participants are relaxed about the government's financial position. In the extremely volatile conditions that prevailed in late 2008, when the global financial crisis reached its critical phase, Russian sovereign Credit Default Swaps (CDS) reached over 1,000 basis points (10%). In early 2010, Russian sovereign CDS were trading at around 200 basis points (2%), or broadly in line with most other Central and Eastern European CDS.

In any event, the latest indications are that the government is committed to privatisation and reform. At the end of July this year, Finance Minister Alexei Kudrin said that the government plans to sell minority stakes in a range of state owned enterprises (SOEs). The list of SOEs has not yet been finalised, but the list of candidates includes Rosneft, Sberbank, VTB Group, Rosselkhozbank, RusHydro and Transneft.

The government believes that it can, through privatisations, raise around 300 billion roubles (or about US\$10 billion) annually for each of the next three years. By comparison, the entire Russian stock market, as measured by the RTS Index, is currently capitalised at about US\$760 billion.



We believe that this is a welcome development for two reasons.

Firstly, if they go ahead, these new share issues should help to broaden and deepen the Russian stock market. They should, therefore, increase its attractiveness to foreign portfolio investors.

Secondly, we believe that further structural reform, and a clear commitment to good corporate governance, will be essential if the government is to attract sufficient overseas interest to make these issues successful. Slow progress in these areas has held back economic development in recent years: convincing evidence of reforms would be welcomed by the international investment community.

Finally, we note that stock market valuations in Russia, as in much of Central and Eastern Europe, are undemanding. It seems to us that much of the risk has been properly discounted by investors. For much of the time from the beginning of 2003 to early 2008, Central and Eastern European stocks were priced at 2.5 times (or more) their book value. The Price/Book ratio fell to a little over 1.0 times in the wake of the global financial crisis, but has since risen to 1.5 times.

Stocks in the region are, generally, trading on Price/Earnings multiples that are in single digits: by this measure, too, they are cheaply valued in the context of the last five years. Most encouragingly, it seems that the profitability of listed Russian companies is very likely to rise. Over the last six years, the RoE of listed companies (on the basis of historic earnings) has moved in the range 10-20%. At present, RoE is about 10%.

Baring Asset Management is positive on the prospects for the Russian stock market, and are overweight, relative to the benchmark index, in their global emerging markets portfolios. The substantial discounts on which Russian stocks are trading, both relative to historic norms and to their peers in other countries, are excessive. As noted above, the economy is on track to maintain steady growth over the medium term, thanks to increasing household consumption spending.

The household sector in Russia is benefiting from higher incomes and has substantial capacity to borrow. In a sense, Russia has been a beneficiary of the softening in energy prices in 2009, in that its economy has become more diversified. Although the Russian government is running a sizeable deficit, its finances are in good shape.

Baring Asset Management Limited 155 Bishopsgate London EC2M 2XY
Authorised and regulated by the Financial Services Authority
Homecroft Cavendish Lamborn Place, 26 High Street Banstead Surrey SM7 2LJ

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