

State Of the Markets: Macro Commentary

Position For A US Slowdown: Buy Russia

This commentary is the companion piece to the SOM I sent out last week on Russia. The basic idea is that Russia is a DM being priced as an EM because of a mispricing—in my view-- of Russian political risk. Accordingly, Russian provides an asymmetric upside both absolutely and versus other EM as events unfold that diminish Russian political risk

My Fundamental Economic Framework

First, look at table 1 below where I illustrate the point that Russia is not an EM based on their potential economic risk.

Table 1.

Country	5-yr Sov CDS (bps)	FX vs USD Since 2014 (%)	10-yr Sov Local Currency Yield	Proj CPI (%)	Unemp Rate (%)	2018 Economic Data (% of GDP)						
						Current Account	Gov Balance	Gov Debt	Exter Debt	FX Reserves	National Investment	National Savings
South Africa	180	-33	9.10	5.3	27.5	-3.3	-4.4	57	47	14	18	15
Brazil	167	-72	8.91	3.9	12.2	-0.7	-7.0	88	34	20	15	15
Mexico	110	-44	8.03	3.1	3.4	-1.8	-2.3	54	29	15	23	21
Indonesia	97	-24	7.61	3.6	5.3	-3.0	-1.8	29	38	12	35	31
India	72	-16	7.39	4.1	8.5	-2.5	-6.6	70	19	15	32	29
Average Non Russia	125	-38	8.21	4.0	11.4	-2.3	-4.4	60	33	15	24	22
Russia	131	-82	8.25	4.9	4.9	7.0	2.8	14	28	31	23	30

To me at least, I look at this table and argue the Russian economy and their financial conditions is an outlier versus other EMs. In contrast to every other high yielding EM:

- A current account and government surplus
- A fraction of the government debt to GDP
- A ratio of FX reserves to external debt is greater than 1
- A savings rate amongst the highest of all the EMs

Yet, sovereign yields and CDS are priced in the same range as major EM countries. Clearly, the reason is that Russian political risk offsets the lower economic risk versus other EMs. Of course, the reason is political risk. One only has to point to the aftermath of the 2014 sanctions, as well as the current potential risk given Russian activities, e.g. Venezuela. I am not dismissing the potential of further sanctions for Russia. Rather I argue that if another round of sanctions are imposed on Russia, the impact on Russian asset prices will be substantially less than what happen in 2014 both because a significant political event is already reflected in current pricing and there are mitigating factors that would suggest a similar event would have less than the same impact as in 2014.

First, as shown in Table 2 below, the Russian economy is in much better shape than where it was in the

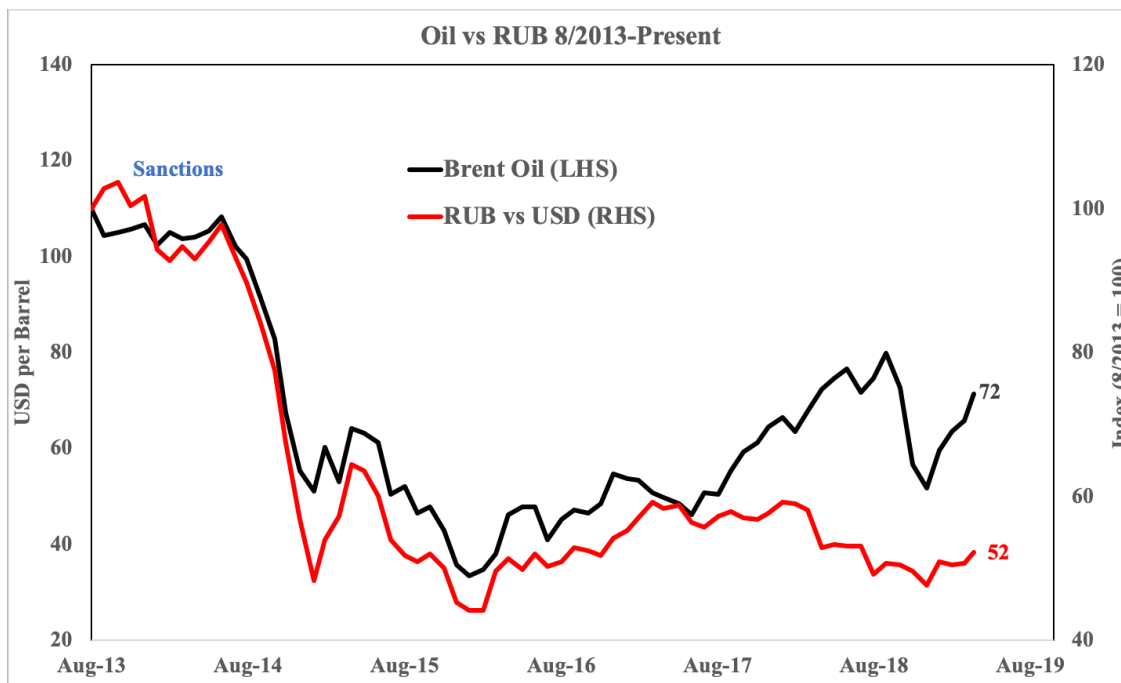
Table 2

	Jan-14	Apr-19
CPI	7%	5%
CA (% of GDP)	1%	7%
Government Bal (% of GDP)	-1%	3%
FX Reserves/External Debt	62%	111%
National Savings Rate	24%	30%
Unemployment Rate	5.9%	4.9%
Brent Oil	\$ 110	\$ 72
RUB vs USD	32	64

onset of the 2014 sanctions. Second, as shown in Figure 1 below, the drop in oil prices in 2014 was the repricing event for Russian assets not the sanctions. Further, a significant political risk event is already reflected in pricing given that the RUB has lagged the move up in oil prices. It would seem that markets could be pricing in an even bigger impact for further sanctions given that the improvement in the Russian economy. Their economy could also improve if oil prices are sustained

at current if not higher levels.

Figure 1.



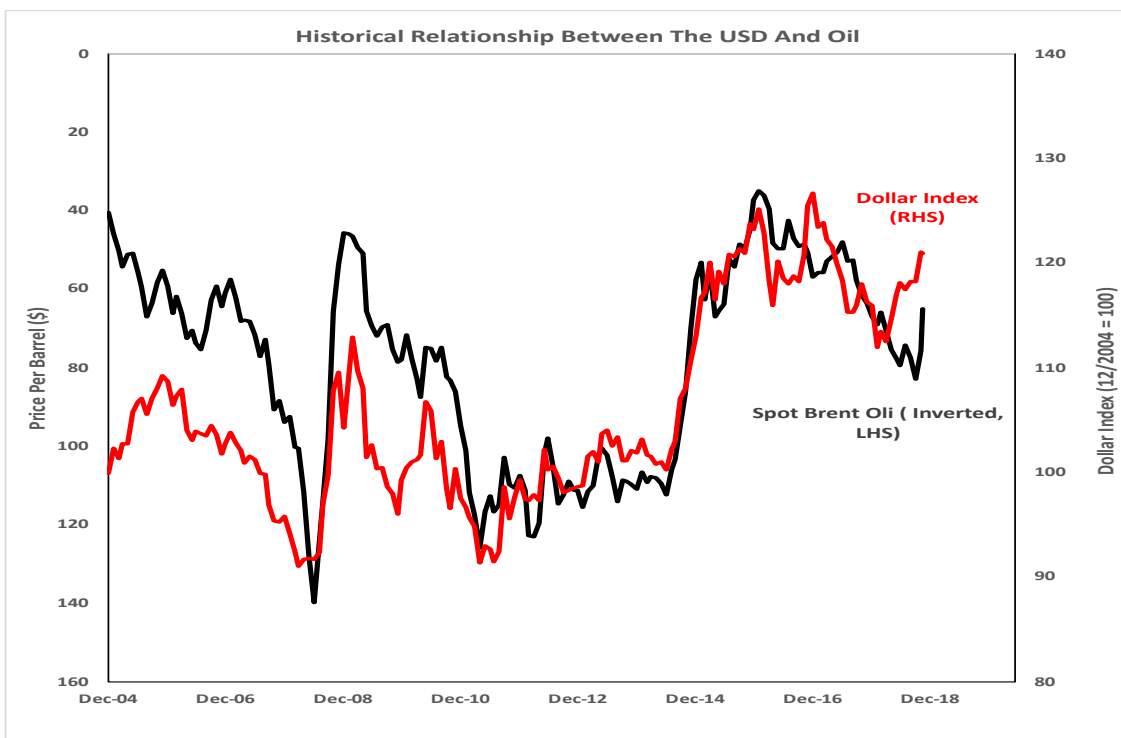
Finding Potential Catalyst

I believe there are at least two catalysts that would turn an investment in Russian assets into an asymmetric trade vs just a carry trade. The first is that other EM experience political turmoil and Russian debt gets a bid from an asset reallocation. Plenty of candidates for these events:

- In Brazil, Bolsonaro attempt to reform pensions and economic reforms fail.
- In Mexico, Obrador becomes more radical pushes a socialist agenda, for example pushing their Central Bank to become more accommodative unleashing inflation.
- In South Africa, Ramaphosa attempts to reform their economy, removing a decade of corruption collapses, and he turns to more populism-based reforms such as land distribution and a national minimum wage. This push their economy into a recession.
- In Indonesia, Jokowi and his new government pushes a more radical religious agenda.

The second catalyst is the USD and oil prices. As I argue in a recent piece, I am positioning for a Fed rate cut/easing of monetary policy in the face of slowing US growth. In this scenario, it is likely that the USD weakens. As shown in Figure 2 below, this could imply that oil, and other commodities, appreciate. This would clearly provide a tail wind for Russian growth and the Ruble.

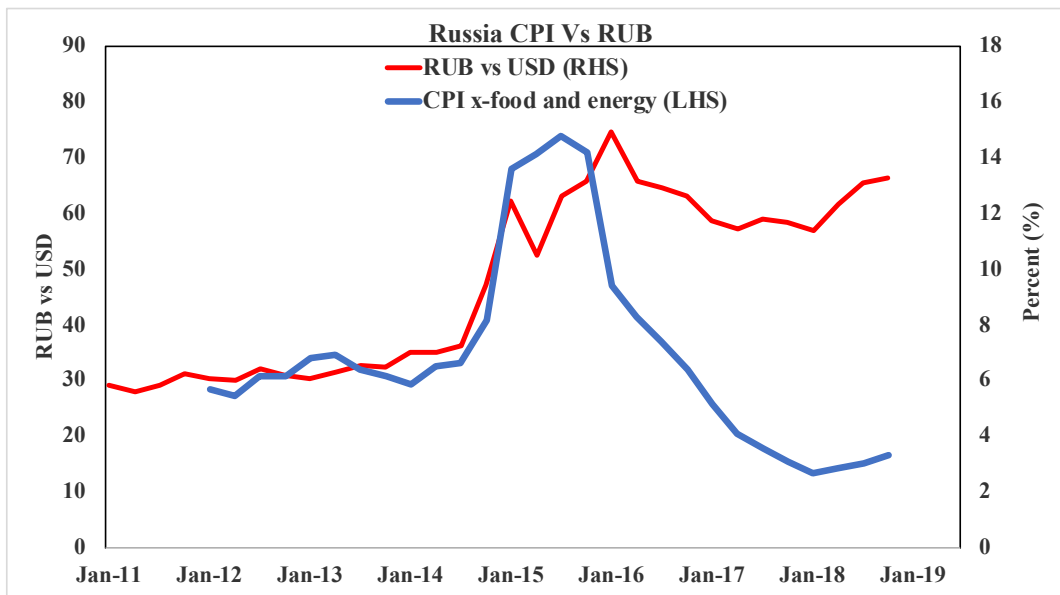
Figure 2.



Asymmetric Trades

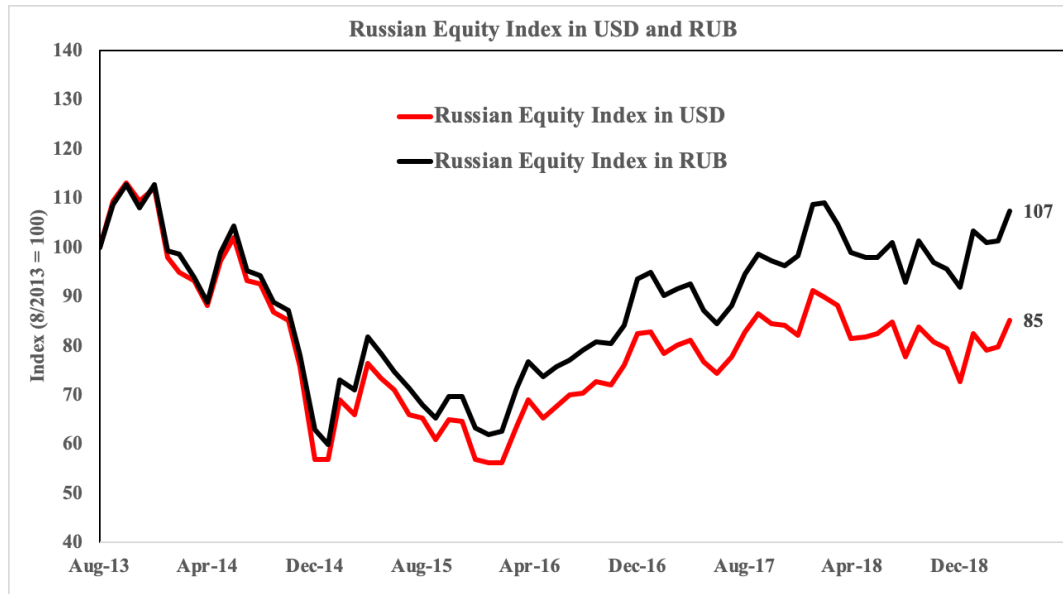
In this thesis, I am pitching two trades. The first is the Ruble vs the USD and the second is buying long duration local currency Russian sovereign debt (OFZ). I would look at my SOM of last week for a much more complete description of the trades. I want to make a couple of comments. First, I am arguing for owning the longer duration because the debt could rally as inflation falls with the rise in the Ruble. The reverse of what happened in 2014, Figure 3.

Figure 3.



Second, another possibility is to buy Russian equity in USD terms. As shown in Figure 4, the equity market trade is really a leveraged Ruble trade, with the Rub denominated index already reflecting the stronger economic data. However, I lean towards the debt trade because I would rather have the debt and get the carry.

Figure 4.



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