

From Russia with Love...and a Gun

A home trip sheds some light on the reality behind the Russian story

Polina Kurdyavko, Co-Head of Emerging Markets

Firstly, an anecdote. My four year old daughter loves paintings. We stopped at an art fair in London before going to our annual Easter trip to Moscow. The minute we walked in, she went straight to the painting below and stared in admiration. "It's really beautiful - can we buy it?" I couldn't refuse her. Even though my daughter can't yet read, for both of us there was a connection.

Painting "From Russia with Love and a Gun" by Diego Farnetti



As we were boarding the plane to Moscow, I reflected on the title of the painting. A few things came to my mind: a 1960s Bond movie "From Russia with Love", Cold War memories, priceless American chewing gum and 24 hour queues to buy a mere umbrella, from my Soviet childhood.

We were going for a family reunion. A great opportunity to see and feel what's behind the macro numbers showing a steady recovery. The IMF has upgraded Russia's GDP growth to 1.4% in 2017 from 1.1%. Real wage growth has increased over eight consecutive months. Car sales in March were up +9.4% year-on-year for the first time in four years. The Russian macro story remains solid with lower inflation, stable unemployment, a growing current account surplus and a reduction in the fiscal deficit. Did it feel that way too?

1. Talent pool continues to leak

The Russian intelligentsia is a talented, yet pessimistic bunch. Whilst prepared for a fair slice of scepticism, I wasn't expecting to find some of my friends giving up on Russia. A friend, who has developed a Russian version of Netflix, is emigrating to Israel after two years of trying to grow

the business under sanctions. Those who don't have an emigration option feel more frustrated than ever before. Anecdotal evidence of budget cuts on foreign drugs for cancer hospitals is sad. Evidence of talented people being replaced at government-run companies is worrying. Inequality of lifestyle increases, while freedom of speech is going in the other direction.

A house in my sister's neighbourhood versus a house in my brother's neighbourhood



2. External pressures are building

Some individuals in the Ministry of Internal Affairs were surprised by the Western interpretation of the Putin/Trump relationship. Russia conducts its external affairs using 19th century strategic thinking. This makes Donald Trump's 21st century communication style at the very least confusing. There are a number of external conflicts which remain unresolved - Ukraine and Syria to name but two. Economic interests are driving increasing defence budgets instead of capital expenditure programmes (as the graphs below demonstrate).

Gazprom declining capex trend (USD bn)

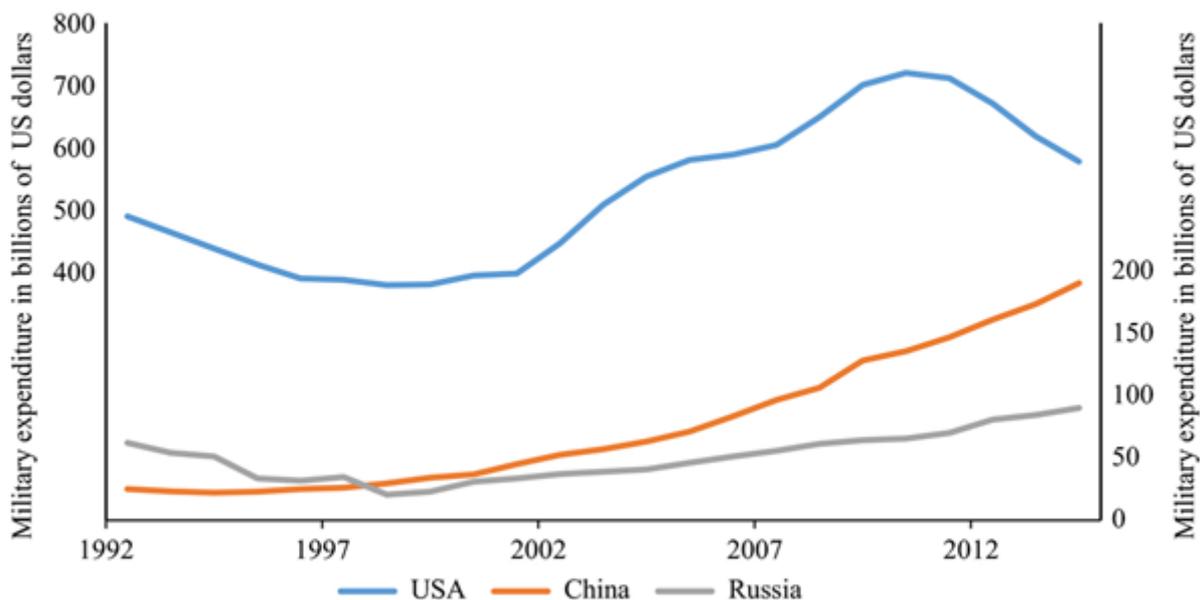
Gazprom Group capex¹, USD bn



¹ Calculated using average exchange rates for the periods.
Source: Company data, management estimates

Rising military expenditure (USD bn)

Military Expenditure Trends for 1960–2014 and What They Reveal



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3. Stellar performance of Russian credit is unlikely to be repeated going forward

Russian US dollar corporate credit has delivered over 12% return over the last twelve months compared to a 8.5% return of the index (JP Morgan CEMBI). It is also among the best-performing credit markets over the last three years. We don't think it can continue to outperform the index, despite solid macro data. We are more constructive on local currency corporates. This is due to double-digit yields, positive inflation dynamics and the best liquidity among EM local currency corporate markets.

We are marginally underweight Russian corporates in hard currency (USD) across our EM corporate long only portfolios. We see more value and have exposure to local currency corporates in Russia across all our portfolios.

There is a note of optimism however. A friend of mine, who is a professor at a local university, is optimistic on the new generation. His 18-year old students are free from the Soviet past and stigma, they are willing to build a new future; the caveat is it might take them twenty years. It reminds me of a song my sister sang at Easter: "*Our time will come; you just have to believe and wait*".

A slogan "Fair Russia"



I returned home from an emotional trip. Eager to review my notes, I got my iPad out only to realise that all my Russian notes were not there. It has never happened to me before. Be it a James Bond movie or a Red Notice book influence, I found it too unusual to be a coincidence...

Polina

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