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growth prospects remain

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Robert Parker, Vice Chairman of Credit Suisse's asset management business, explains why he believes the Russian investment case remains intact.

In just five months the Russian stock market has tumbled by almost 70% to levels last seen three years ago (see panel, below). In a very short time, the country has gone from being the darling of emerging market investors to the thorn in their side.

There is a view that investors have overreacted to the conflict in Georgia, driven more by sentiment than by economic reality. Economic development in Russia has been rapid – growth rates have been consistently above 6.5% in recent years and it is estimated that by 2025 Russia could be the fifth largest economy in the world.

What has caused Russian share prices to fall so much further than others? In our opinion, there are seven key reasons behind the market falls:

- the rapid reversal in oil and commodity prices
- geopolitics following the armed conflict in Georgia
- concerns over government intervention into the pricing policies of domestic companies affecting their profitability
- concerns over government intervention into foreign owned companies, thereby discouraging foreign direct investment
- concerns over the viability of the Russian banking system and its vulnerability to the credit crunch
- both foreign and domestic investors exiting the Russian market
- deleveraging by domestic investors with clear evidence of stop loss selling

While inflation is an issue, policy flexibility, together with current account and budget surpluses, make Russia better positioned to deal with inflation than many other emerging markets. At the same time negative real interest rates matched with a strong economy continue to support the long-term investment case for Russian equities.

real value

At current levels, Russia is one of the cheapest markets worldwide. The market, which had been trading on a price/earnings ratio of 14 to 15 for some time, is now being valued at less than five times earnings. The last time it was trading at such low valuations was during the Yukos crisis in 2004, after which the market re-valued and we saw 100% gains in a short space of time.

opportunities

With regard to the oil price, this is likely to remain volatile in the months ahead, with the price driven down by demand slowdown concerns and then driven back up by supply shortage issues. Looking ahead, there could be insufficient new supply forecasted to meet even modest demand assumptions and hence the market could tighten once again. This environment will give rise to many longer-term investment opportunities, such as in exploration, production and service related companies. Finally, although there remains an element of geopolitical risk being factored into the current oil price, we believe that oil prices above $80 a barrel are needed to maintain consistent long-term supply.

Government intervention in strategic sectors is likely to continue, but elsewhere we do not foresee any major problems for foreign direct investment. Within banks, we may well see the central bank allow the weaker banks to be taken over by larger players such as VTB and Sberbank.

Overall we are likely to have seen the bulk of selling by both foreign and domestic investors. One can never pick a 'market bottom' precisely and it is more than likely that the Russian stock market will remain volatile in the months ahead. However, for medium- to longer-term investors, current market levels provide an attractive entry point.

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