

Wary of Sanctions, Foreigners Reduce Russian Holdings

By [The Moscow Times](#)

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LONDON — Foreign equity and bond investors who had tentatively ventured back into Russia after a huge early-2014 selloff are again slashing their holdings for fear of being caught in the crossfire of Western sanctions.

Russia has fared worst among the big emerging equity markets this year, with dollar-based losses of 13 percent.

The ruble is down 5 percent against the dollar, second only to the Argentine peso, and investors are demanding a 2.8 percentage point premium to U.S. Treasuries to hold Russian dollar bonds, 80 basis points higher than January.

While sanctions already bar some Russian firms from Western capital markets, Washington's assertion that the Kremlin supplied artillery to Ukrainian rebels who are blamed for last week's shooting-down of a Malaysia Airlines passenger jet may bring another wave

of sanctions that could cripple the economy.

Some analysts say sanctions may not in the end be tightened, but many investors have not waited to find out.

"We took a decision to sell up our position. It's more to do with risk management rather than fundamentals," said Aymeric Forest, who runs a \$5 billion multi-asset fund at Schroders.

That's a U-turn for Forest, who added to his Russia position after the Crimea crisis earlier this year because of high corporate dividends and cheap valuations. He said the decision to sell was made as soon it became clear Washington would ratchet up the sanctions.

Under existing sanctions, both U.S. and European investors are barred from buying new securities issued by some Russian companies that have a significant state shareholding or are seen as close to the Kremlin. Many such as Forest fear these restrictions may soon extend to existing stocks and bonds, forcing investors into a firesale of the assets.

"Legal and political risks have escalated ... we had a small position and we liquidated completely," he added.

On Russian equity markets, where freely traded shares make up 29 percent of the capitalization, foreigners' share is 19 percent, down from 21 percent in December, according to the Macro-Advisory consultancy in Moscow.

June fund flows data from Boston-based fund tracker EPFR showed emerging market investors who had been pessimistic on Russia since the start of the year had actually swung to a big overweight — meaning they held more Russian stocks than the country's 5.4 percent weight in the MSCI index.

That was due to easing tensions since end-May when Russia struck a more conciliatory tone towards Kiev. But many of those positions will have been washed out in July as the crisis escalated, said Bank of America Merrill Lynch equity strategist Wesley Fogel.

EPFR data for the past week showed investors pulled \$172 million from Russia funds, the biggest outflow in six months.

Fogel advises clients to buy Russian equities at current prices — relative to expected earnings over the next 12 months they trade at about half the emerging markets average.

But his view hinges on a positive outcome to the crisis, without further sanctions.

"People are underweight Russia but that doesn't mean more selling cannot happen, because investor confidence is quite fragile," said Michel Danechi, portfolio manager at Swiss fund manager EI Sturdza.

While share valuations and dividends are attractive in Russia, Danechi says he is staying away from companies that are under sanction, such as energy firms Rosneft and Novatek.

There Are Alternatives

Salman Ahmed, global fixed income strategist at Lombard Odier, also reckons both sides will take a step back, meaning sanctions are unlikely to be tightened further. But his fund remains underweight in Russian ruble debt relative to its 10 percent weight in the benchmark GBI-EM index for local currency emerging debt.

Ruble debt was until recently seen as attractive because of its 8 percent-plus yields — boosted further by the central bank's half point rate rise on Friday — and JPMorgan's latest client survey, conducted before the air disaster, showed a tiny 0.7 percent overweight.

On dollar debt and the ruble, most funds are underweight, JPMorgan found. The bank advised clients not to exceed index weight on ruble bonds and to use credit default swaps to hedge risk.

Similarly Morgan Stanley said it was downgrading Russian corporate and local bonds to underweight.

"Anyone involved in Russia must be cognizant that there will be periodic blow-ups and short squeezes," Ahmed said.

"If you look at it from a relative asset angle, you will be giving up 8.5 percent yield, but in South Africa or Turkey you can capture similar yield with lower volatility."

Long-Term

Like Ahmed, many others see the West as reluctant to hurt their economic interests by cutting off trade and investment ties with Russia. President Vladimir Putin too will seek to avoid conflict that may wreck Russia's economy, they say.

But that does not make them keen to venture in. For one, Russian firms must repay \$160 billion in the next year. Morgan Stanley calculates. State-owned banks, which the EU is proposing to ban from capital markets, have around \$33 billion coming due.

Few expect default but the situation carries risks for Russia's \$475 billion reserves war chest.

Second, the economy is flirting with recession and capital flight has already hit \$75 billion this year.

Michael Cirami, co-director and portfolio manager at Eaton Vance Investment Managers' global fixed income division, believes the EU is unlikely to take any drastic measures but that has not changed his pessimistic view on Russia.

"Ukraine is not the problem. Ukraine is the symptom of the problem," Cirami said. "We've been bearish on Russia since 2010. Oil dependency is huge ... there is a broken growth model."

See also:

[EU Sanctions on Russian Banks Would Stifle Investment, Lending](#)

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