GMO Emerging Equity Insights

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Russia: A Riddle, Wrapped in a Mystery, Inside an Enigma

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Bob Dylan once sang, *"Something is happening here, but you don't know what it is, do you, Mr. Jones?"* That's what it kind of feels like today. There's something going on behind the scenes in Russia –something we're not privy to.

On the heels of new U.S. sanctions and a chemical weapon attack in Syria, the Russian market fell 10% on April 9th, a much larger reaction than expected. It's not clear that the two situations are linked, but it suggests to us that the market perceives the risk of a major blowup with Russia, possibly taking the form of Iran or North Korea-style sanctions, has dramatically increased. We don't buy it.

Our Washington sources tell us that the new sanctions, and their timing, were a complete surprise to everyone in Congress and that this was purely a White House operation. Given the fact that Mr. Oleg Deripaska (who is closely associated with Mr. Paul Manafort) and the companies he controls were the primary targets, one might draw a conclusion that there's a political dimension to this. If the intent was to hurt Russia economically, sanctioning companies such as Gazprom and Sberbank would have had a much more profound impact. Our sources in Moscow suggest a similar view.

The new risk is that the White House is now actively involved with day-to-day Russian policy and everyone is uncertain as to what Mr. Trump might tweet tomorrow.

In short, we don't think the U.S. is exercising the "nuclear option" of trying to tank the Russian economy. While it will cause pain in certain areas, we do not think this action will have a profound impact on the Russian economy. As a result, we are quite comfortable with our overweight in Russian equities in the GMO Emerging Markets Strategy, as these positions continue to be extremely cheap in our view.

Within the Russian market, Gazprom fell 8% while Sberbank fell almost 22%. As the supplier of 30% of Europe's natural gas, Gazprom is unlikely to be sanctioned or suffer significant negative effects.

On the other hand, we believe Sberbank's dramatic fall reflects the fact that it is the most foreign-owned and most liquid Russian stock (the GDR trades an average of $100 million daily in London alone) and was hard hit for liquidity, rather than for fundamental reasons. Only 3% of Sberbank's assets were exposed to sanctioned companies. Furthermore, it is Russia's largest bank, with 20,000 branches and 65% of the country's deposits. It trades at 5 times current earnings and 1.3 times book value while earning 23% return on equity. It is one of the largest positions in our portfolio and we are adding to it. We've always said that you make more money when things go from truly awful to merely bad than when they go from good to great. Russia's relationship with the world is now approaching truly awful.

Arjun Divecha. Mr. Divecha is the head of GMO's Emerging Markets Equity team and a member of the GMO Board of Directors. Prior to joining GMO in 1993, he spent 12 years at BARRA directing software development, marketing, client service and emerging markets research and development. Mr. Divecha holds a Bachelor of Technology in Aeronautical Engineering from the Indian Institute of Technology, Bombay and an M.B.A. in Finance from Cornell University.