Russia

US-IRAN BYSTANDER RISK: RUSSIA

Christopher Granville

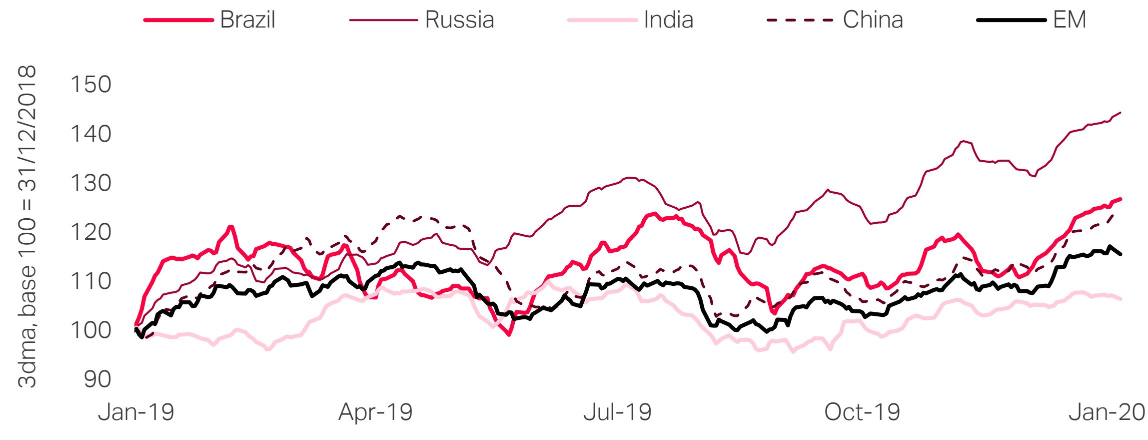
- **Likely further US casualties caused by Iran - bad for Russian assets . . .**
- **. . . as this will lower the political bar to new US sanctions against Russia**
- **Stellar Russian market performance is otherwise well based**

Collateral damage from escalating tensions can often be more quickly visible and, in investment terms, more actionable than the impacts on the parties directly involved. Take, for example, the US-China 'trade war': the belligerents have suffered less than some bystanders like Germany and EM as regards the immediate negative impact on economic growth and asset price performance. This lesson looks equally applicable to the search for specific investment implications – as opposed to general 'risk-off' – from the escalation of America's undeclared war against Iran in last Friday's assassination of Qassem Soleimani.

A vulnerable bystander that we would highlight is Russia. Our reasoning here has two parts:

- No amount of armchair strategizing will help predict the nature, timing and effects of Iran's specific retaliation against the US. Iran has a track record of springing surprises, such as last September's drone attack on Saudi Arabia's main oil processing facility. Pending such set-piece Iranian strikes, however, the main day-to-day focus of Iranian policy is all too predictable. This will be to make life ever more uncomfortable for the US military on the ground in Iraq and eastern Syria (the pre-existing crisis in Iraq is the key to understanding this prospect, and we will be looking more closely at this in a note in our Global Political Drivers series tomorrow).

Stellar Russian equity outperformance in 2019



Source: Bloomberg, TS Lombard

This publication is part of our EM service. Click here for more details.

- Whatever else happens, the US will have to respond to the more hostile environment in Iraq and Syria. Any such response would typically include political as well as purely military components. One of the more obvious political side-effects would be to lower the bar to a renewed escalation in sanctions against Russia. This conclusion about heightened sanctions risk does not depend on any assumptions about specific Russian action or inaction in response to the 'Soleimani crisis'. For both the Congress and the Trump administration it could well be enough that Iran is causing further US military casualties, and that Russia is aligned with Iran in the theatres concerned.

This sanctions threat assessment offers a good opportunity to take stock of the past year's stellar performance of Russian assets – in particular the world-beating Russian equity market (see chart on previous page). There have been three main drivers at work here.

First comes the **impressive macroeconomic policy adjustment** to the twin oil price and geopolitical shocks of 2014. The story here is not just cyclical in the sense of the heavy monetary and fiscal lifting having been largely completed by 2018, allowing ample headroom for stimulus that the authorities started last year to exploit – but cautiously, so there is room for more. In addition, this policy framework has built some innovative features onto a conventionally orthodox foundation. The single most important of these – and one which we have been covering intensively in our specialist Russia research service – is a new FX intervention component of the fiscal rule ('FXFR'). This has succeeded in decoupling the ruble's real exchange rate from oil price movements, with the incidental effect of boosting the profitability of exporters – including the oil companies that account for over half of the equity market capitalization.

The second driver has to do with **corporate governance** – especially the increasing readiness of Russian companies' controlling owners (both private and state) to distribute those profitability gains as dividends.

The outlook for these first two bullish drivers remains positive. Surging share prices have meanwhile produced no more than a modest narrowing of long-standing deep valuation discounts to EM peers. The FT's Lex Column reacted to the Soleimani assassination by singling out Russia as a safe haven, offering attractively valued exposure to the resulting higher oil price – and at a safe geographical distance (from the Strait of Hormuz in particular). But this is to reckon without the third driver.

The last of the three reasons for Russia's outperformance has been an easing of the US sanctions pressure that had a big negative impact on the ruble and asset valuations in 2018. The risk of this driver going into reverse on the back of near-inevitable escalation of US-Iran clashes is all the greater as, by coincidence, the legal foundation for this happened to be revived last month. This takes the form of a long-pending piece of draft legislation called the 'Defending America Security [against] Kremlin Aggression Act' (DASKA). Approved by the Senate Foreign Affairs Committee on 18 December, DASKA has not found favour with the White House. It would not take many more US casualties in Iraq and/or Syria for the administration to lift its objections.

Just as this latest Middle East flare-up may yet offer buying opportunities in global markets as a whole, the same could equally well go for Russia. The 2018-vintage US sanctions 'bazookas' turned out to be damp squibs in the end. But regardless of the economic impact of aggressive new sanctions, the Russian market would still be battered by the spectre of a new spiral with an unknowable end point. We advised last month against chasing the stunning Gazprom rally. Likewise now for the whole Russian market, we favour keeping powder dry ahead of downside over-shoots as the drama surrounding Iran – including the related new US sanctions against Russia – plays out.

Authors

Christopher Granville
Managing Director,
EMEA and Global
Political Research