Global Economic Policy Lab

Russian Grit: Assessing the Impact of Western Sanctions on Securities and Investment Prospects

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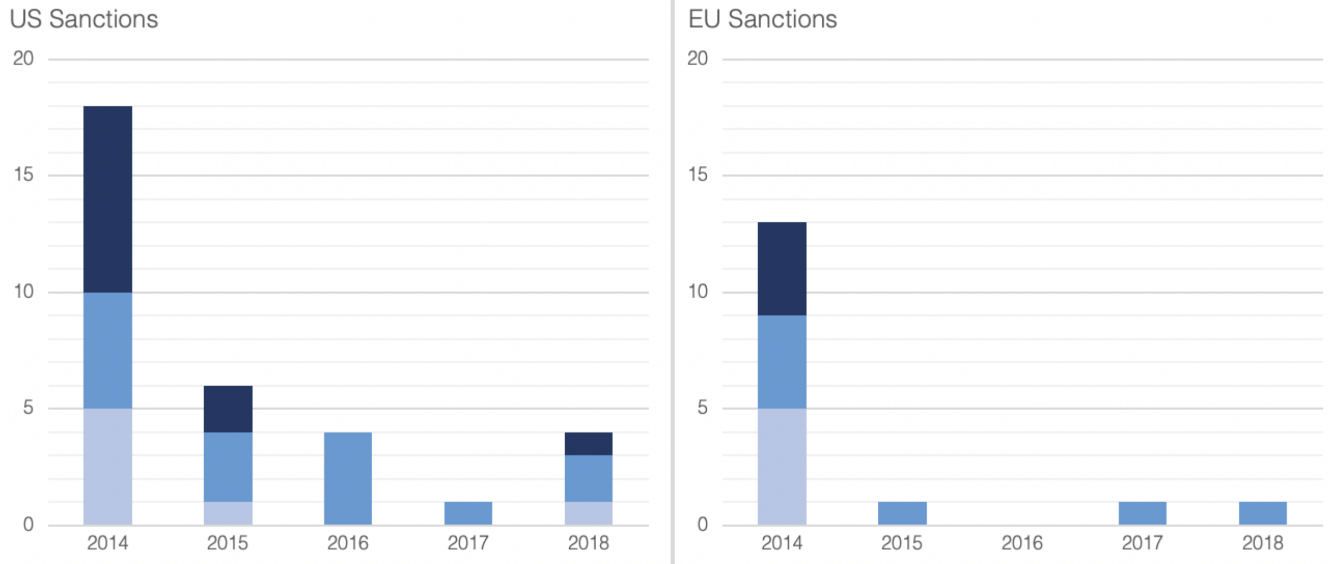
- The effect of Western sanctions and Russian counter sanctions on the Russian economy has been significant, but their impact on economic and historical stock market performance has been mixed
- Economic adaptation measures since 2015 partially counteract country risk associated with sanctions in Russia
- Russian securities are attractive due to low valuation and high dividend returns
- There is less value at risk for investors compared to 2015

Overview
Western Sanctions and Russian Counter Sanctions, 2014-2018

While the conduct of Russian foreign policy has undergone several 'phases' since Vladimir Putin's first term as President, the domestic imperative of maintaining political stability has remained a constant. This manifested in the early 2000s as a willingness to engage with the West, particularly as Putin managed Russia's economic revitalization amidst an oil boom. As this faded in the late 2000s and political crises began to manifest in Russia's periphery, Putin has increasingly relied on stoking nationalism to legitimize his rule. Culminating in the annexation of Crimea in 2014, this approach led to the imposition of American and EU sanctions on the Russian economy, as well as on selected government officials. These sanctions are notable for one simple reason: Russia is the largest economy against which sanctions of this scale have ever been imposed. However, the full macroeconomic impact of these sanctions is somewhat difficult to assess, given the fact that they coincided with a drop in the price of crude oil.

In response to these sanctions, Russia imposed restrictions of its own on the importation of foodstuffs from the sanctioning countries, primarily the EU. Despite these sanctions correlating with Russia's economic strategy of import-substitution, this appears to have led to a great deal of "re-exporting" – firms based in Russia's non-EU trade partners have simply repackaged agricultural goods from the EU as being of their own country of origin before exporting them to Russia, with Belarus and China being notable examples. This practice is due to the fact that domestic producers have been unable to fully compensate for this drop in imports from the EU, although domestic agricultural production did increase as a result of these counter-sanctions. While their direct impact is difficult to assess, counter sanctions are estimated to have decreased the average Russian's consumption of the banned items by 2000 rubles (USD 26.19) a year, and to have reduced real incomes by 2-3 per cent between 2014 and 2018.

A total of 49 economic, financial, and corporate sanctions were imposed from 2014 to 2018 by the US and the EU. These included such measures as bans on trade and investment in Crimea, restrictions on the export of oil and gas goods and technologies to Russia, and the prohibition of long-term financing for Russian banks and institutions.



Source: MDPI, GEPL Calculations

While the effectiveness of international sanctions in changing a state's international behavior is debatable, their effect on Russia's economy and on its stock market performance has been undeniably significant, insofar as the Russian banking system has largely been shut out of global capital markets. Financing has become difficult for state-owned enterprises to secure, in turn depressing both FDI and domestic investment.

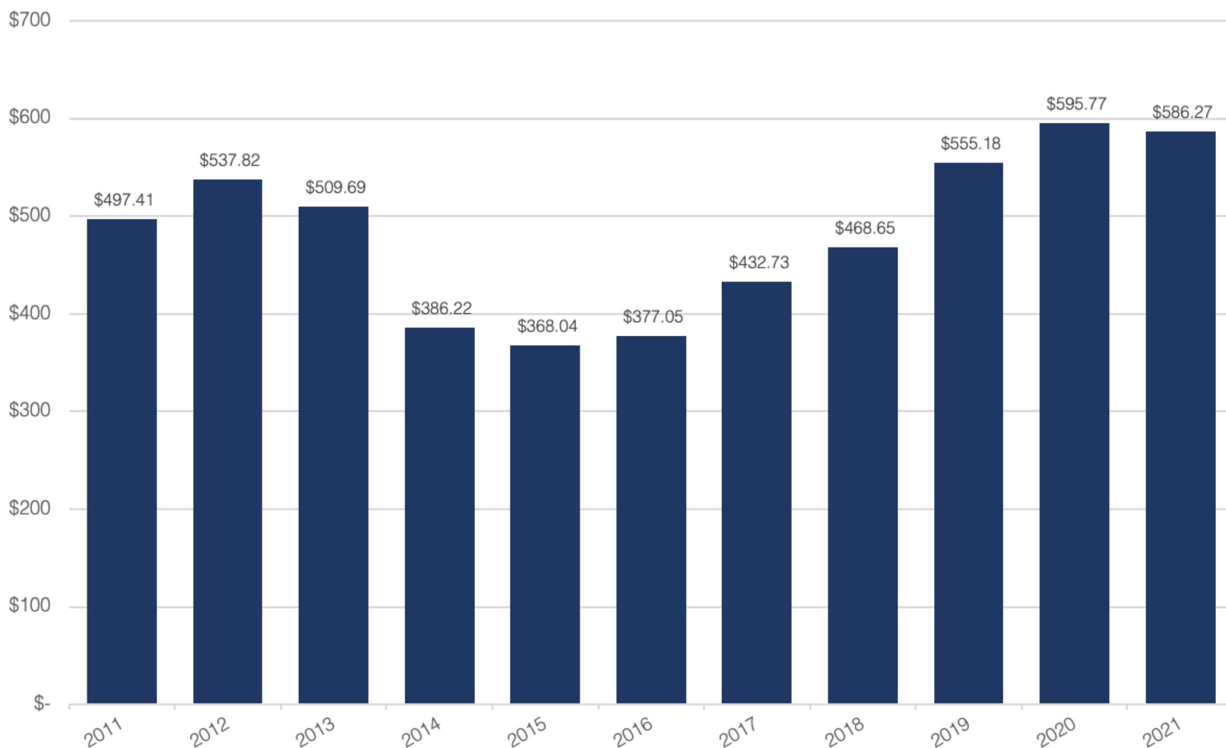
However, the resilience of Russia's real economy to these exogenous shocks appears to have grown in recent years, despite their historical and potential effect on business sentiment and both foreign and domestic investment. Further sanctions – already ineffective with regard to changing Russian international behavior – will have a minimal effect on the Russian economy unless critical sectors are targeted. Nevertheless, GEPL expects further sanctions to follow in the years ahead, given hardening attitudes in the EU and the US, and the long-term consequences of technology transfer bans on Russia's energy sector - which have impeded attempts at deep sea and Arctic exploration - remain to be seen.

Economic Impact of Western Sanctions on Russia's Economy

Even though Western sanctions on Russia coincided with the 2014 oil crisis and the subsequent Russian financial crisis, they played an important role in weakening an already suffering Russian economy. In 2015, the IMF estimated that initial Western sanctions and Russian counter sanctions had reduced Russia's real GDP by 1–1.5%. Prolonged sanctions led to an even greater cumulative output loss that lowered the country's growth rate by 0.2 percentage points every year between 2014-2018. This external shock, combined with low oil prices, had a considerable impact on the Russian economy. It triggered a protracted drop in the value of ruble, with the RUB depreciating from 33.8 rubles per 1 USD on 1 July

2014 to 83.6 rubles on 22 January 2016. The RUB has yet to regain its former value prior to the Crimean annexation (currently valued at 76.3 rubles per USD as of 3 April 2021).

Between 2014 and 2015, Russia experienced capital outflows of over USD 40 billion. This is particularly important when considering Russia's decision to lift capital flows' restrictions against the backdrop of a weak ruble and forgone investments (resulting from an inability to borrow and finance projects). Meanwhile, Russia's Central Bank was forced to dip into their foreign exchange reserves in order to boost its fragile economy; reserves shrank by about 25% during the 2014-2015 period, and only returned to pre-crisis level in 2019 (see below).



Source: Central Bank of Russia, GEPL Calculations

When sanctions were first announced, the exchange rate for the ruble depreciated causing significant short-term changes in exchange rate returns. The long-term impact on financial markets was notable as well: economic sanctions, surprisingly, had a negative effect on exchange rate returns, but *positive* effects on RTS returns (perhaps due to policies undertaken by the Russian government to counteract Western sanctions); financial sanctions had a positive effect on exchange rate returns and a negative effect on stock price returns; and corporate sanctions negatively affected exchange rate returns.

Russia's counter sanctions in the form of a ban on food imports from the European Union was a political and protectionist move that highly favoured national agricultural production, which has been booming ever since. However, it also had the dramatic effect of increasing domestic food prices. For instance, the Russian consumer price index experienced an abrupt 10% increase in 2015 as basic foodstuffs sharply appreciated. Given that interest rates tripled and inflation doubled in 2015, it is fair to say that the Russian

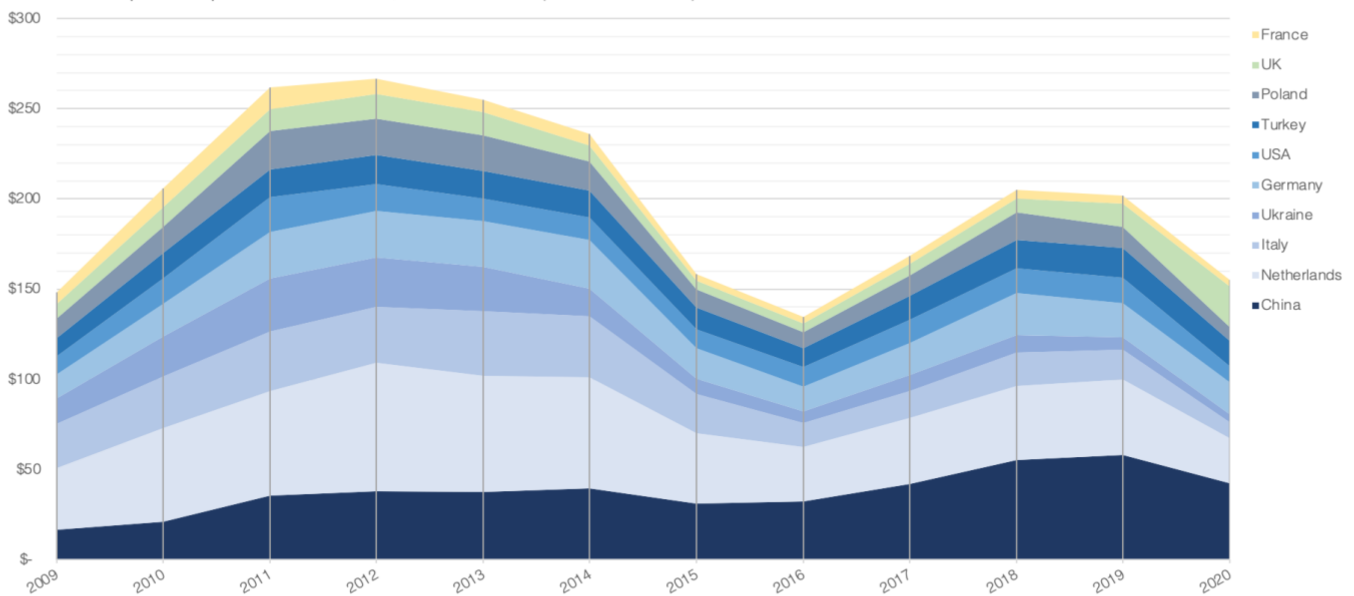
middle and lower-income class, especially those living in Russia's poorest regions, suffered the most from Western sanctions and domestic counter-sanctions.

The Prospect of Future Sanctions

In early March 2021, the US, with support from the EU, announced their first sanctions against Russia under Joe Biden's presidency. These were initiated in response to the attempted murder and unlawful detention of Russian opposition and anti-corruption leader Alexei Navalny. These sanctions directly targeted senior Russian government officials, as well as governmental entities. Moreover, the Biden administration announced that those were to be the first in a long list of sanctions directed at Moscow, which has been declared guilty of infringing on US national security. These infringements included the SolarWinds cyberattack against US government agencies and businesses, as well as the 2020 interference in the US elections. Russia has also been blamed for the alleged cash rewards offered by Russian officers to Taliban fighters for killing US soldiers in Afghanistan. On a related note, the US is also trying to halt or at least postpone the construction of Nord Stream 2 project, over concerns that the pipeline will increase European dependency on Russia.

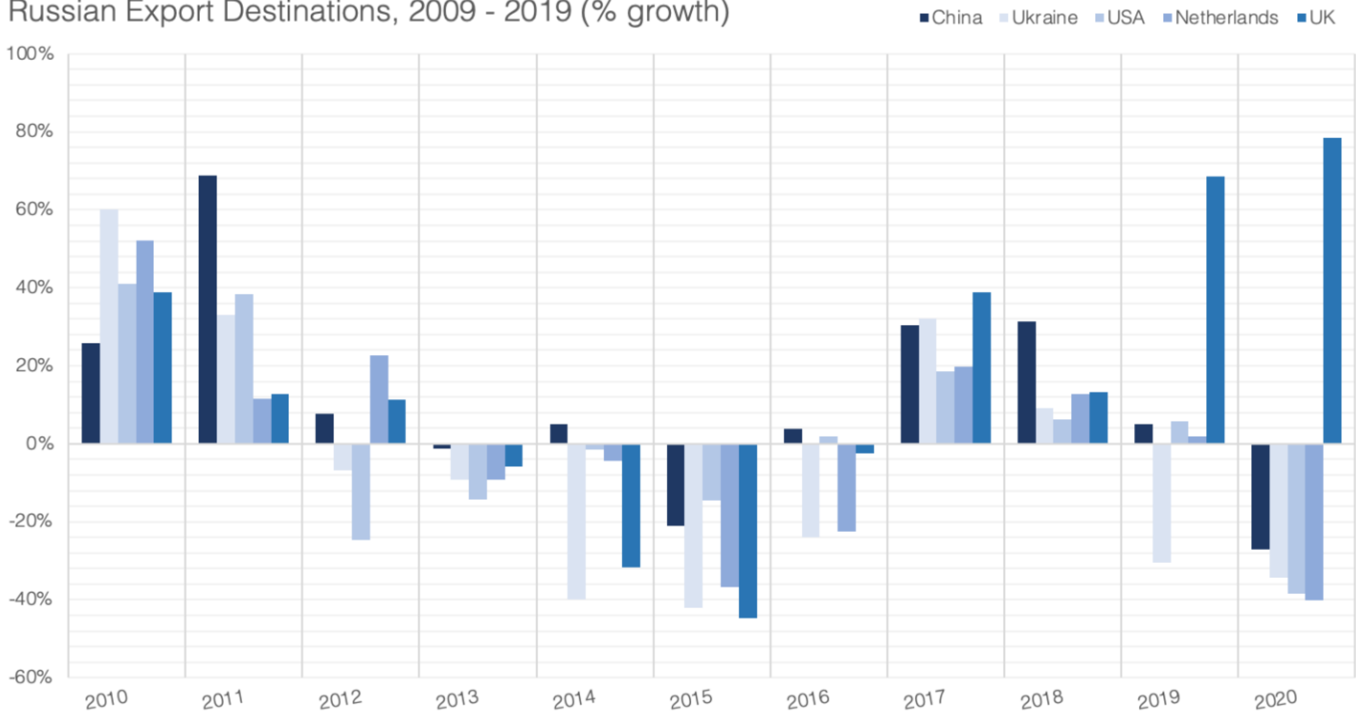
Despite Biden's intentions to punish Putin, GEPL believes the effect of new sanctions will be more muted than they were in 2014. This is because the current macroeconomic outlook of Russia is the opposite of what it was after the invasion of Crimea. In fact, seven years ago, the oil as well as the Russian financial crises had just started, and western sanctions inflicted the final blow on a weakening Russian economy. Today, Moscow has almost fully recovered from the oil war with Saudi Arabia as well as the pandemic, and it is expected to experience 4.2% GDP growth in 2021. Moreover, the US cannot fully count on Europe for joint sanctions against Moscow, as shown by Germany's willingness to continue with the Nordstream2 project, or by the resurgence of Russia-UK trade following the finalization of Brexit in late 2019.

Russia's Top 10 Export Destinations, 2009 - 2019 (billions $USD)



Source: OEC, GEPL Calculations

As illustrated by the graph showing Russia's top export destinations, the Sino-Russian trade relationship did not suffer in the long-term following the annexation of Crimea in 2014. In fact, China superseded the Netherlands as Russia's top export destination. This trend is likely to continue in the event of further Western sanctions on Russia. Therefore, in the short-run, the US will not be able to target Russia's supply-chain of oil and natural gas into Europe. In the long run, the Biden administration could strategically target Russian agriculture, which has experienced rapid growth in recent years. However, this seems to be unlikely given that Russian agricultural exports to the US represent only 0.3% of Russian exports in 2019.



Source: OEC, GEPL Calculations

Investor Valuation of Russian Securities

Economic Adaptation

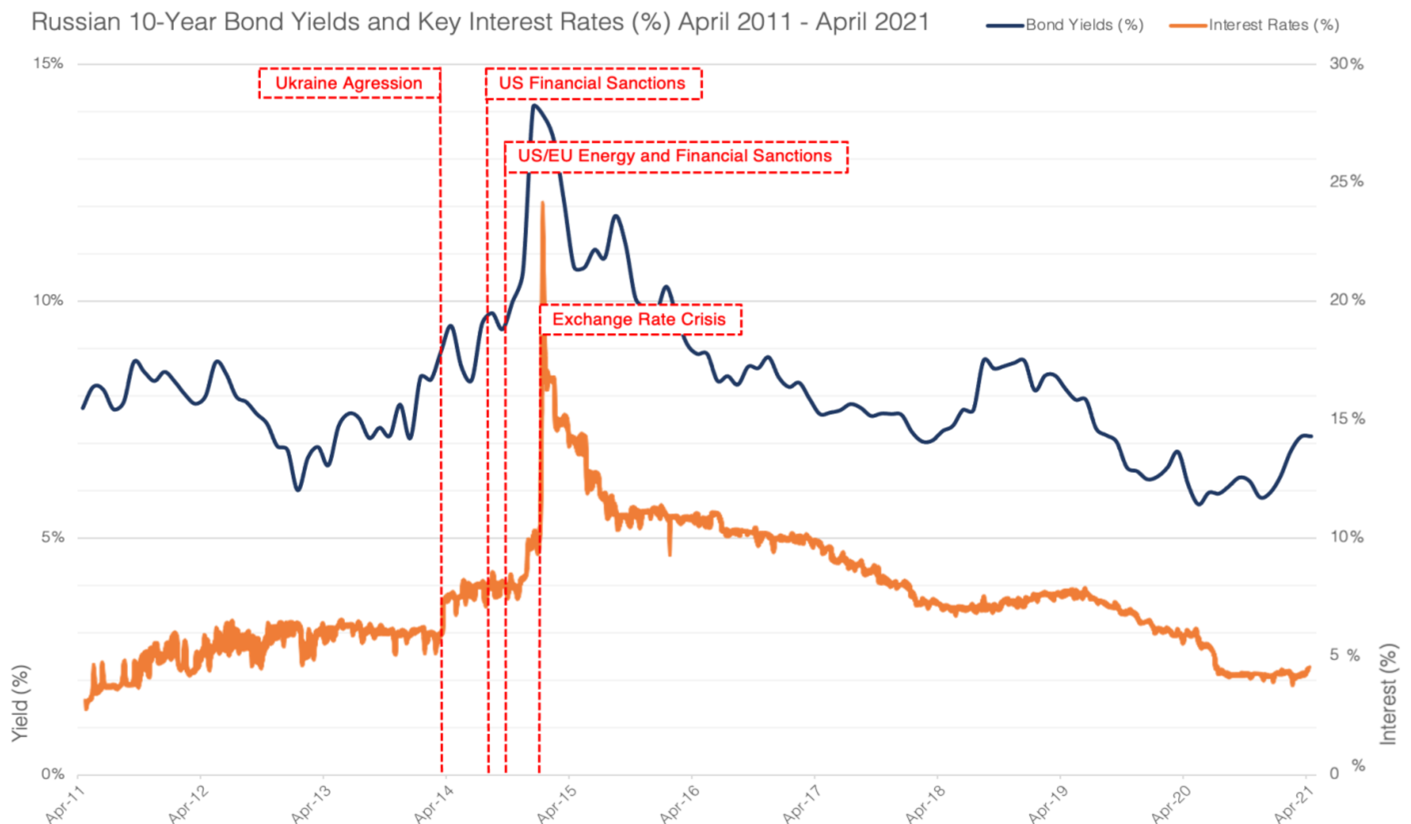
Russia's economy is far more resilient today than it was in 2015. Its government ran a budget surplus in 2018 and 2019, and the country's national debt was about 18.94% of GDP in 2020 (the EU average was placed at 89.8% in Q3 of 2020). This recovery was made possible through prudent fiscal policy and cuts to public spending. The depreciation of the RUB affected production levels in sectors dependent on imported components; however, the Kremlin has since spent trillions of rubles on programs to create local substitutes for imported goods, while simultaneously banning food imports from the EU to simulate domestic production.

Perhaps the most important adaptive measure has been the steady growth of Russian foreign currency reserves, which have risen by almost 62% between 2015-2020 (USD 368.04 billion to USD 595.77

billion). This policy was complemented by the creation of a USD 124 billion sovereign wealth fund that is sustained by income from Russia's considerable energy exports. Together, this macroeconomic framework serves to insulate Russia from the impact of further sanctions and oil shocks. Ironically, the biggest danger to the Russian economy today would be if sanctions were suddenly lifted – there would be a massive inflow of capital that would spike the value of the RUB and consequently derail Kremlin's policies.

Country Risk

An interesting byproduct of sanctions was their role in increasing uncertainty. The threat of further sanctions and reputational risk led to rising precautionary savings (often in foreign currencies) and higher risk premiums, which reduced foreign direct investment and slowed consumption in turn. These concerns contributed to significant capital outflows during the first quarter of 2015 (approximately USD 7.8 billion) and the downgrading of Russia's sovereign rating. This uncertainty also led to market panic and the sales of securities by many investors, as illustrated by the sharp rise in Russian 10Y bond yields and key interest rates in early 2015.



Source: Central Bank of Russia, GEPL Calculations

Russia's confrontational stance with the West has not changed since 2015, and neither has the threat of further US-led sanctions under the Biden administration. The country risk associated with sanctions remains essentially the same; however, the inherent volatility is now somewhat counteracted by the aforementioned economic adaptation measures.

This relative balancing, translating to a return of investor confidence in the long term, is reflected by recent developments in Russian 10Y sovereign bond yields. These spreads have gradually stabilized since 2015, while remaining attractive to foreign investors. High bond yields, backed by the country's growing international currency reserves, low national debt, and ability to withstand oil price volatility (see Russia's Macro Resilience to Exogenous Oil Shocks), strengthens the viability of Russian local currency debt as a lucrative investment.

These factors extend to listed equity. The prospect of new Western sanctions targeting Russian industries, financial institutions, and individuals are of considerable risk for investors, especially for those looking to invest in fledgling sectors with long-term potential for high growth (e.g., tech). However, the perceived lack of unity between the US and EU over imposing further sanctions and the continued construction of energy and mining infrastructure (e.g., Nord Stream 2) may mean that some of these risks are overblown. This has not gone unnoticed either in the market. After plunging 30% due to the pandemic, Russian stocks (measured by the MOEX Russia Index) rebounded 100% by August 2020 (S&P only rose by 74% in comparison).

Russian equity in the energy and mining sectors is relatively 'future-proof'. From an investment perspective, these stocks are attractive due to their low valuations and high dividend returns. Russian equity is undervalued relative to stocks in other regions and emerging markets. This valuation is complemented by high dividend yields with the potential for further growth. For instance, Gazprom and Lukoil, both large energy corporations, offer enticing dividend returns (as of 3 April 2021) of 6.67% and 6.49%, respectively.

Value at Risk

When investing in Russia, GEPL believes there is less value at risk (VaR) compared to the 2014-2015 period. Adaptation measures partially offset the ever-present country risk associated with sanctions. If the estimated return of a two-year hypothetical investment in the Russian energy sector was USD 10 million with 25% volatility in 2015, the VaR (calculated to two standard deviations) would be USD 7,071,067. The return on risk-adjusted capital (RORAC) would be 1.4%. GEPL believes that Russia's recent economic adaptation measures, alongside external market forces, reduce this inherent volatility by at least 5%. If the same investment with 20% volatility were calculated today, the VaR would be placed at USD 5,656,854, with a RORAC of 1.8%.

For a risk-tolerant investor looking to diversify their portfolio, Russian securities should not be overlooked. Investment, owing to the notion of further sanctions and country risk, should be nevertheless compact (1-2% of total global portfolio) and limited to the short-medium term.

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