RUSSIA TRADING AT STEEP DISCOUNT TO PEERS

Jeremy Schwartz — Global Chief Investment Officer
08/20/2013

Two themes have dominated much of the positioning in both the global equity and fixed income markets in 2013: 1) Fears of a China slowdown have hurt the emerging markets and all commodity-related sectors and countries. 2) Speculation about the Fed tapering bond purchases sent long-term bonds considerably higher, leading many to question their positioning for a rising interest rate environment. Russia has been one of the most severely depressed markets. MSCI Russia trades at a 50% discount to MSCI Emerging Markets (EM) on 12-month forward-looking P/E ratios. These valuations are historically cheap, with levels not seen since the first quarter of 2009, the bottom of the global bear market. Since mid-June, Russia has displayed some relatively strong performance compared to its emerging market peers. We believe this rally was underpinned by attractive Russian equity valuations, but we also note that the performance coincided with a recent rise in U.S. interest rates. Below, we explore why rising interest rates may coincide with a relatively strong performance for Russia. Additionally, the high beta of Russian equities may lead to a cyclical rebound that is greater in magnitude than that of its peers. In Table 1 we look at MSCI Russia's outperformance against MSCI EM after MSCI EM's lows of March 2009. We note that in all three periods, MSCI Russia outperformed MSCI EM in its one-year forward returns: by 24.90%, 17.17% and 3.86%, respectively.

Table 1: 12-Month Forward[1] Total Returns Post-MSCI Emerging Market Lows[2]

	MSCI Russia	MSCI Emerging Markets	Outperformance of MSCI Russia - MSCI EM
March-09	105.98%	81.08%	24.90%
June-10	44.97%	27.80%	17.17%
May 2012- July 2013	11.81%	7.95%	3.86%

Is the Recent Rebound Credible? The recent rally in Russian equities is testimony to the ability of its local markets to thrive in an environment of rising U.S. bond yields. With an encouraging second-quarter gross domestic product (GDP) out of the U.S. and a sanguine July Federal Open Market Committee (FOMC) outlook, markets are widely anticipating tapering to occur as early as the fourth quarter this year. While policy rates will remain accommodative for a longer period, steady improvements in the U.S. economy may result in a further increase in treasury yields. On a relative basis, this may position Russia to perform better than its emerging market peers. From a macroeconomic perspective, Russia has a healthy current account surplus of 2.6% and is thus less dependent on foreign inflows. Many emerging market nations, such as India, South Africa and Indonesia, run large current account deficits and rely on foreign inflows to fund them. Russia's current account surplus is especially important in a time of rising U.S. yields. The EM block has experienced outflows, partly due to the narrowing yield gap between the U.S. and the rest of the emerging markets. The closing of this gap renders the EM block less compelling from a yield perspective. However, we feel that Russia is well positioned to withstand the storm, as it is less reliant on external funding and thus better able to keep its monetary policy loose (i.e., low interest rates), while other EM nations tighten their monetary policy—which can slow down their economies—in order to attract foreign flows. Further, we find that Russia's equity markets—and the energy sector in particular—are positively correlated with U.S. interest rates[3] (10-year yields). • Emerging market stocks have been positively correlated to U.S. interest rates over longer periods (three, five and ten years), but Russian stocks have been more positively correlated. • While emerging market stocks were negatively correlated to U.S. 10-year yields over the last one-year period, Russian stocks (and especially Russian energy stocks) were positively correlated over the same period. • Given that roughly 50% of Russia's market is composed of energy stocks, it is not surprising that the overall Russian markets exhibit positive correlations to bond yields. • The positive correlation between Russian energy sector and interest rates seems to be explained by a connection between higher interest rates and stronger global economic growth, which is supportive of energy prices and the Russian markets. **Table 2: Russian Stocks Display Higher Correlation to 10-Year**

Bond Yields Than MSCI Emerging Markets[4]

Analysis Period	Energy Sector		Broad Markets	
	MSCI Russia Energy	MSCI EM Energy	MSCI Russia	MSCI EM
1 Year	0.49	-0.12	0.17	-0.27
3 Year	0.62	0.40	0.52	0.37
5 Year	0.36	0.26	0.34	0.19
10 Year	0.21	0.21	0.23	0.20

Example to illustrate the numbers: The 10 year treasury's correlation to MSCI Russia energy over the 1 year period is 0.49.

Positioning for Emerging Market Rebound and Rising Rates Sentiment towards emerging markets has been very negative in 2013. If this trend reverses, we believe Russia might be a prime beneficiary. Given that the other major theme dominating the focus of investors is how to position portfolios for a rising-interest-rate environment, the historical correlations of Russian equities to U.S. interest rates—combined with their steep discount to other emerging markets—make them a potentially attractive option for emerging market portfolio allocations. [1]12-Month Forward - 12 month returns post the low points indicated in the table [2]Sources: WisdomTree, Bloomberg, as of 7/31/2013. [3]Sources: WisdomTree, Bloomberg, as of 7/31/2013. [4]Sources: WisdomTree, Bloomberg, as of 7/31/2013.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

MSCI Russia Index : Index weighted by float-adjusted market capitalization designed to measure the performance of the Russian equity market.

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

12-month forward return : Returns for the 12-month period following an observed trailing 12-month dividend yield.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Current account : The difference between a nation's total exports of goods, services and transfers, and its total imports of them.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.