

Russia Equities

2020 recap**Market Recap**

Equity markets in 2020 were key beneficiaries of the 22 tln\$ in global monetary and fiscal accommodation that were introduced to support economies struggling with consequences of the Covid-19 pandemic. Based on investor hopes of fresh reflationary policies in the US, positive news on effective vaccines, the prospect of further QE from the Fed and ECB, and very distant interest rate increases from the main central banks, global equity markets and oil prices have enjoyed a sizeable rally since the start of November and in many cases have made new highs (S&P 500 +17%, NASDAQ +43%, MSCI Emerging Markets +16%, MSCI World +14%, etc.).

The Russian stock market, though, was a laggard in 2020. It fell sharper than peers in March on the back of the Covid-19 outbreak and the subsequent collapse in oil prices. Despite a strong final quarter performance, it has failed to close the gap so far. However, while the MSCI Russia closed the year down 17.2%, the iMOEX rouble-denominated index ended up 8% and hit its highest ever, which shows the heavy impact of rouble depreciation (RUB:USD -16% yoy) on the performance of Russian stocks last year.

Oil prices plunged from \$70 /bbl (Brent) at the beginning of the year to \$20 in April, then started to recover swiftly in May, stabilizing around \$40 until the end of October before surging again above \$50 in November-December, as OPEC+ countries were reaffirming their commitment to production cuts. The Brent price per bbl averaged \$43 in 2020 vs \$64 in 2019 (-32% yoy) and ended 2020 at \$51 vs \$66 at the end of 2019 (-23% yoy).

Over a 10Y period, we see that it took until the end of 2019 for Russian stocks, which had tumbled in 2014, to catch up with their emerging peers, before underperforming again in 2020 (Fig.1).

Fig.1 – MSCI Russia vs World vs EM in 2020



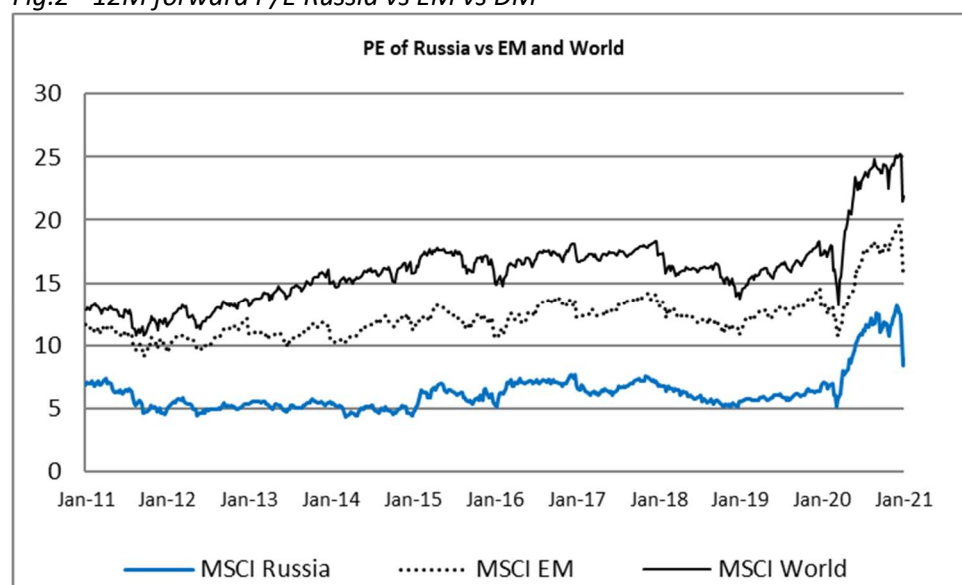
Source: Bloomberg

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Overall, Russian companies remained profitable in 2020, thanks to their low levels of leverage, low capex engagements and cheap cost base supported by the weaker rouble. But according to Russia's Federal Statistic Service (Rosstat) the coronavirus crisis has cost Russian companies (ex-financial sector) 5.2 tlnR (68 bln\$) in lost profits over the 10M20 period. Russian companies earned 8.4 tlnR in 10M20, well behind the 13.6 tlnR they had earned over 10M19 (-62% yoy). The most affected sectors were transportation (-60%), retail and wholesale trade (-53%) and utilities (-51%). Mining and manufacturing earnings were down by 34% and 36%, respectively, while earnings in the agriculture and construction sectors bucked the negative trend, gaining 60% and 54%, respectively. Russian companies emerged from the crisis at the end of June, following the major lockdowns and quarantines that took place in April and May. Corporate profitability recovered most of the ground lost to the crisis in July and August and the companies were earning the same as they earned in summer 2019. However, due to the money that was lost in the first half of the year, and despite the rebound in oil and other commodity prices at the end of the year, the cumulative profits for the full year 2020 are still expected to be much lower than in 2019.

Eventually, after underperforming their emerging peers, Russian stocks increased their discount in terms of valuation. As measured by the P/E ratio for example (Fig.2) Russian stocks are now more than twice cheaper compared to emerging ones, and three times cheaper than developed ones.

Fig.2 - 12M forward P/E Russia vs EM vs DM

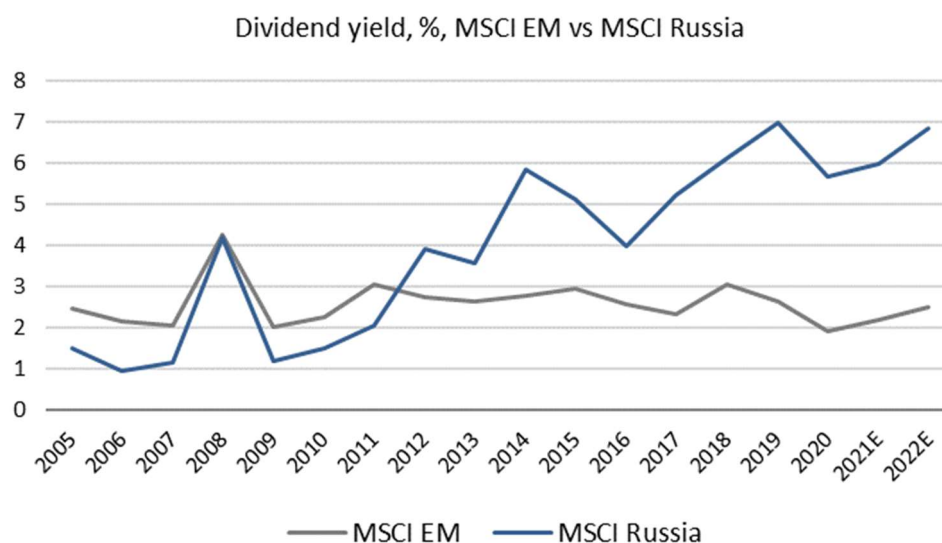


Source Bloomberg

Although the pandemic forced most companies to postpone or reduce dividend payments, Russian stocks remain much more attractive than their emerging peers by the measure of their dividend yields, which reached 7.0% on 2021E earnings (Fig.3). Moreover, appealing share buyback programs (Lukoil, Novatek, Rosneft, MTS among others) kept supporting stock prices and increase return on shareholder capital throughout 2020.

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Fig.3 – Dividend yield in %, MSCI Russia vs EM



Source: Bloomberg

As in previous years, the correlation of Russian stock prices to exogenous parameters remains high, the oil prices and geopolitical factors (sanctions) being the main external risk factors.

Falling oil prices were the main reason for Russia's underperformance last year. Sanction risks remained in the background too, as far as we were getting closer to the election of US President Joe Biden, a notorious Russia antagonist. According to the CBR, the share of non-residents on the OFZ market declined to 24% in October; that was the lowest level since December 2018 and reflected foreign investor concerns about a possible increase in sanctions risk. But following the US election, CDS contracts (which can be considered a measure of sovereign risk) compressed 25-30 bps.

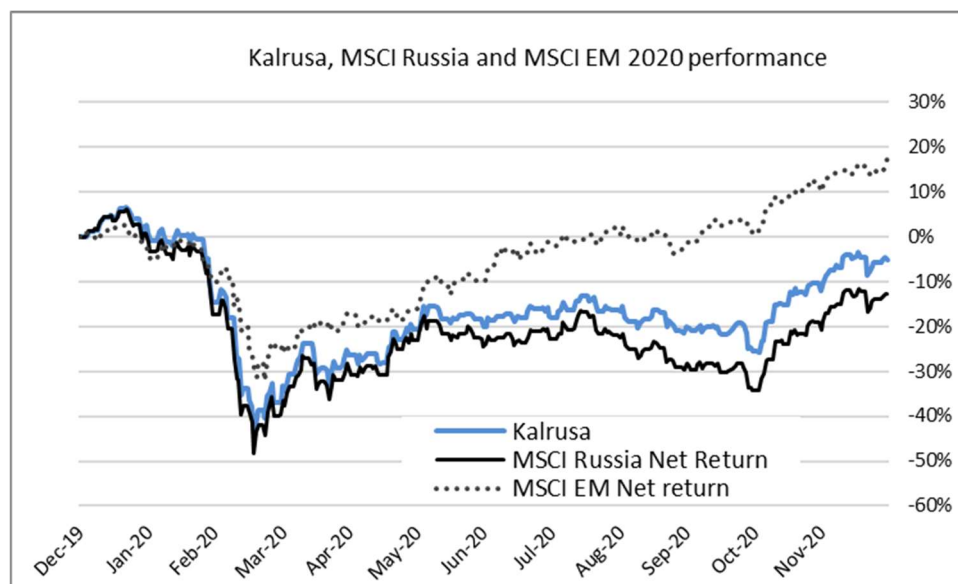
Six years after Russia's annexation of Crimea and occupation of Ukraine's Luhansk and Donetsk regions and despite the persistence of sanctions from the US and the European Union, Russia nevertheless continues to attract sizeable carry trade flows, as observed into Russia's fixed income markets. At the end of 2020, foreign investors held 3.1 tlnR in Russian local currency sovereign debt accounting for 29.4% of the OFZ market. US investors are estimated to account for a third of these holdings. Foreigners also had no hesitation to participate into last December's IPO of Russian e-commerce platform Ozon, which raised as much as 1.2 bln\$ on the NASDAQ.

Due to lower oil prices (Brent price averaged \$43 /bbl in 2020 vs \$64 /bbl in 2019) oil & gas names saw their profits decrease and underperformed (Tatneft -46%, Gazprom -31%, Lukoil -30%, Rosneft -21%, Novatek -18%, Surgutneftegas -14%). The best performing stocks could be found in the Internet sector (Yandex +58%, Mail +17%) as well as among the mining and steel companies (Polyus +79%, NLMK +20%, MMK +10%, Phosagro +9%, Norilsk +1%, Alrosa -2%,) and retail and consumer stocks (Detsky Mir +13%, X5 +6%).

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In 2020, Kaltchuga Fund – Russia Equity outperformed its benchmark (Kalrusa class A USD -5.1% vs MSCI Russia Net Return -12.5%), mostly thanks to its underweight allocations in oil & gas (32.2% vs 43.6%) and also in Sberbank (9.1% vs 17.2%).

Fig.4 – Kaltchuga, MSCI Russia Net return, MSCI EM Net return 2020



Source: Bloomberg

Global macro

According to the World Bank, the world economy, shaken by the lockdowns that were introduced to fight the Covid-19 pandemic, contracted by 4.3% in 2020 after growing 2.3% in 2019. The United Nations estimate that global merchandise trade contracted by 5.6% in 2020 after growing 1.4% in 2019. The 15.4% yoy decline in global services trade is much greater though, this plunge being driven by a considerable decline in travel, transport and tourism activity.

In 2020, Europe's economy contracted by 7.4% and the US by 3.6%. So far, China has been the exception in that it was the only major economy to enjoy an economic recovery last year, one which was mainly sponsored by deliberate credit expansion and targeted fiscal measures. The Chinese economy shall have grown by 2.0% in 2020 after 6.0% in 2019. Aside from China, following the slump of 2Q20 (as much as 30% in annualized GDP for the US economy), the summer economic recovery in most economies never regained the pre-Covid-19 peak in activity, and while less momentous compared with the second quarter, the winter dip in activity has been taking its toll too. For the Eurozone, real GDP is expected to have fallen by 2.3% in the fourth quarter.

In the Eurozone, the quick recovery in demand for goods after the first wave, together with the continued recovery of export demand, has helped industry to diverge from the weak service sector performance so far. At the end of 2020, production was less than 1% below pre-coronavirus levels.

Trade in goods resumed growing in May, as restrictions were relaxed in China and other countries. International trade volumes reached their pre-Covid-19 levels in 3Q20, just before many European countries went back into lockdown. Industrial production and household spending on consumer goods, both recovered quickly, boosting demand for imports.

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To support their economies, central banks across the planet remained on the easy mode and real interest rates are set to remain negative or close to zero in developed economies. As a result of the total of global negative-yielding sovereign debt is at a record high of 18 tln\$ and US real interest rates remain negative.

The price of most commodities fell because of the subdued growth outlook that emerged on the back of the pandemic. After recovering from their slump of March (-70%) with OPEC+ countries (including Russia) agreeing for further production cuts, we expect Brent prices to remain in a \$50-60 range in 2021.

We now enter 2021 assuming that though lockdowns in the major economies could extend to March-April quite easily, massive vaccination and reflationary monetary and fiscal policies will provide for a strong economic rebound by the end of the year.

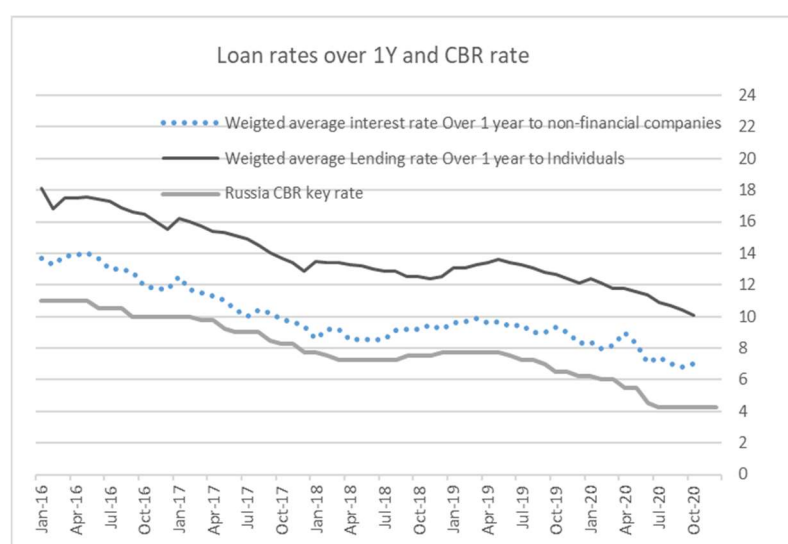
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Russia also suffered from the Covid-19 pandemic, with the national economy contracting by 3.1% in 2020, which is the worst result since the 2008-09 crisis. However, authorities' behavior has been different from their former typical crisis pattern. For example, the Central Bank of Russia (CBR) cut interest rates rather than hiking them, while the government readily increased expenditures to support a wide range of economic agents (from large corporates to unemployed individuals) and to finance them via borrowings on the open market. In combination with the prevailing fiscal rule, these efforts helped to minimize the negative consequences of Covid-19 as well as to reduce the volatility of the exchange rate.

Rosstat reported a 3Q20 GDP contraction of 3.4% yoy (9M20 GDP -3.4% yoy), following -8.0% yoy in 2Q20. Industrial production decreased by 2.9% in 2020.

The Central Bank of Russia cut the key rate four times in 2020, from 6.25% to 4.25% (Fig.5), but marked a pause at the end of the year. In December, annual inflation accelerated to 4.9% yoy (Fig.6), which is the upper level of the CBR's updated inflation target range for 2020. That said, the pressure at the end of the year fully came from the food segment, where prices posted a 6.7% yoy increase (vs 2.6% in 2019). This suggests that once the situation in the food segment is under the control the CBR could possibly resume its cutting cycle. We believe there is room for a further 25-50 bp easing in 2021.

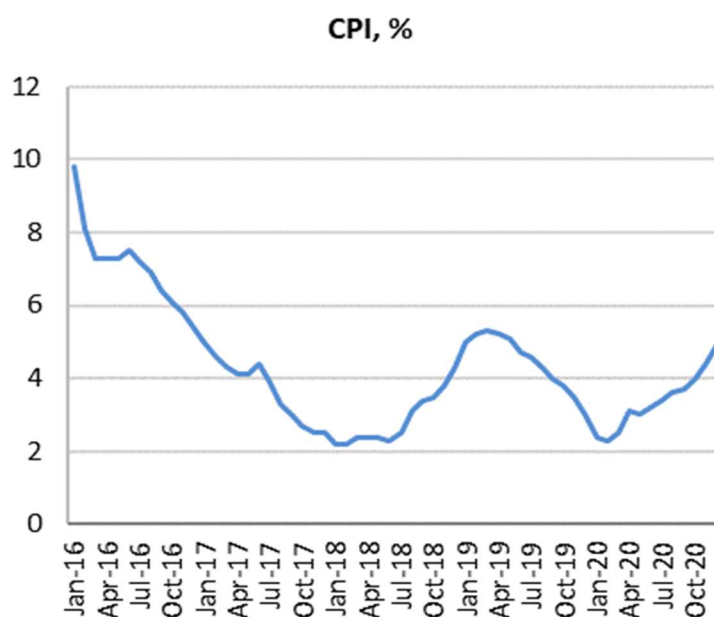
Fig.5 – Weighted average lending rates over 1Y and CBR rate



Source: Source: CBR

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Fig.6 – Russian CPI inflation

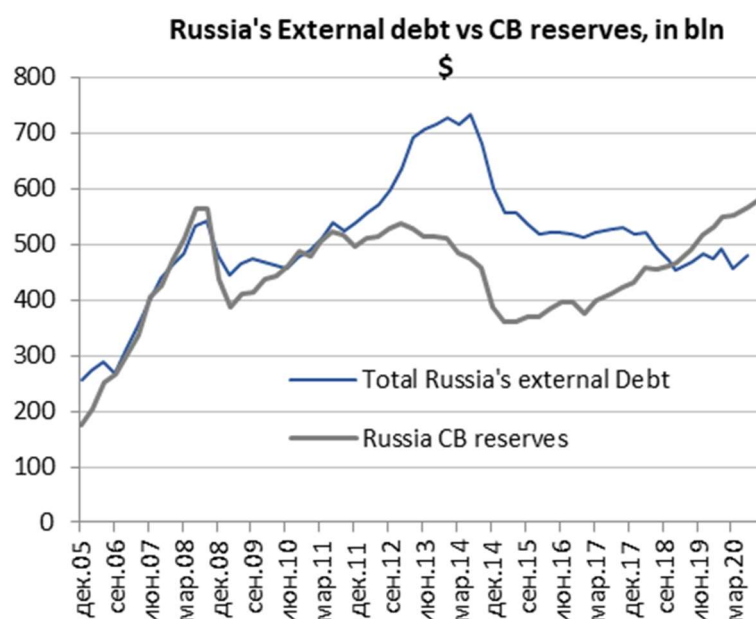


Source: Source: Rosstat

During this crisis year Russian authorities decided to use borrowing on the open market as the main source of budget financing. As a result, the total amount of rouble sovereign placements reached 5.1 tlnR, which is more than double the 2019 figure. In 1H20 there was high demand from international investors, while in 2H20 local banks dominated the primary market. The OFZ curve moved down in line with the decline in the CBR key rate (-200 bps yoy) (Fig.5). Further contraction of rouble bond yields in 2021 is possible as supply is expected to be more moderate (3.7 tlnR planned), while carry trade opportunities look attractive for both local and international investors. Russia's sovereign debt at the end of 2020 remains low at less than 20% of GDP, and the country's overall external debt is lower than the CBR reserves (Fig.7).

Fig.7 – External debt vs CBR reserves

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Source: CBR, Rosstat

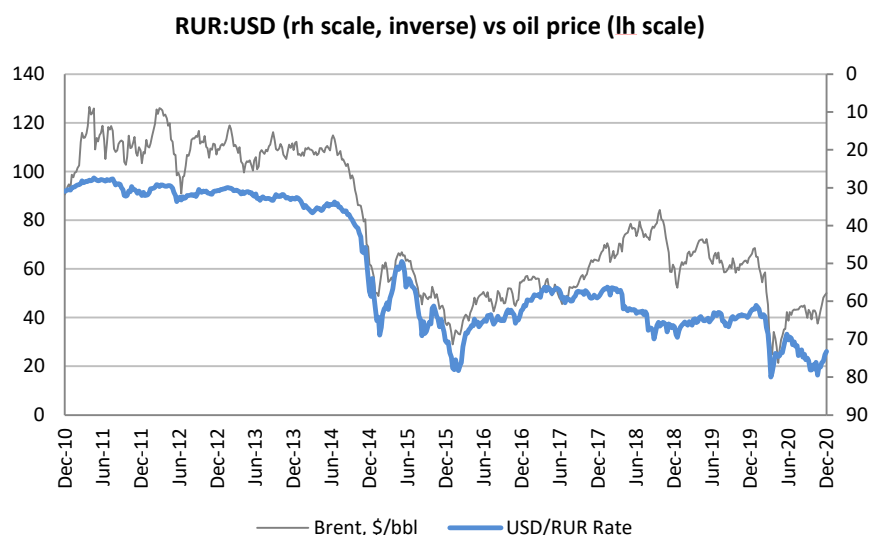
Reserves at the CBR increased by 41.4 bln\$ (+7.5%) in 2020 to 596.8 bln\$ (Fig.7). The increase was split between gold reserves, which value increased by 28.4 bln\$ (+26% and 69% of total reserves increase) to 133.8 bln\$, on one hand, and FX reserves, which value increased by 13 bln\$ (+3% and 31% of the total increase) to 444 bln\$, on the other hand.

The increase in the value of gold reserves is mostly due to the surge in gold prices (+24% yoy). Indeed, after being the world's largest gold buyer for a number of years, Russia suspended gold buying in March 2020 at the height of the pandemic. Central Bank chief Elvira Nabiullina said in July that after the extensive purchases of recent years, she was satisfied with Russia's level of gold reserves. At the end of 2020, gold represented 23% of Russia's total international reserves, ahead of the 22% in held in USD. The euro remains Russia's top reserve holding, with more than 29% of total holdings.

Although it was a volatile year for the rouble, the national currency lost only 16% of its value to the USD yoy, whereas Brent prices collapsed by 33% yoy (Fig.8). The rouble dropped by more than 25% in 1Q20 on the back of the radical drop in oil prices but managed to partially recoup its losses in 2Q20. Then, in the second half of the year, fears regarding potential new sanctions against Russia saw the national currency test new lows for 2020. The rouble exchange rate is actually on a floating regime, which helps the economy adjust quickly to negative changes in the external environment. Moreover, from 2017 Russian authorities restored the so-called fiscal rule, which sees the government accumulate additional revenues in the National Wealth Fund during periods of high oil prices and sell these reserves when oil prices are low. This mechanism allowed for an increased supply of FX in 2020 on the open market and helped minimize exchange rate volatility and for a certain length prevent excessive rouble devaluation. In 4Q20, the CBR was selling 80 mln\$ of foreign currency per day to support the rouble. In January 2021, the Ministry of Finance switched back from FX sales to FX purchases. This shall mitigate the appreciation potential of the rouble caused by the rise in oil prices.

Fig.8 – RUB:USD vs oil prices

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Source: CBR, Rosstat

In comparison with most countries, both developed and emerging economies, Russia's overall state support to the economy was rather modest at less than 5% of the GDP. But revenues to the budget dropped by 12% yoy on the back of the lower oil prices and weaker economy. As oil output and oil exports dropped by 11% and 16% yoy, respectively, oil & gas revenues in the Russian budget dropped by 42% yoy. According to preliminary estimates of 2020 federal budget execution, the Finance Ministry expects to collect 18.7 tlnR in revenue while spending 22.9 tlnR (+26% yoy), which implies a budget deficit of 4.2 tlnR or 4.0% of 2020E GDP (vs a budget surplus of 3.0 tlnR in 2019 or 2.7% of 2019 GDP).

Russia's current account surplus narrowed by 50% to 32.5 bln\$ in 2020, from 64.8 bln\$ in 2019. The decline is mostly due to the decline in export revenues (-6% yoy to \$418bn) battered by weak external demand, low global energy prices and constrained domestic oil output (-11% yoy), with energy still accounting for about two thirds of Russian exports. Russian spending on imports of goods & services in 3Q20 was still nearly 25% less than a year ago. Goods imports, however, edged towards recovery, and were in September 2020 already close to the September 2019 level. Services imports in 3Q20 remained down by more than half from a year earlier. Russian spending on travel abroad (more than one-third of services imports in 2019) was still down by 90% yoy and imports of other services were down by nearly 25%. Net capital outflow reached 44 bln\$ in 10M20.

Investment and household spending remained subdued in 2020.

According to World Bank, FDI in Russia collapse by 96% yoy in 2020 to 1.1 bln\$ while globally FDI dropped by 42% to 859 bln\$ (-69% to 229 bln\$ in developed economies and -12% to 616 bln\$ in emerging economies). According to Rosstat, fixed capital investment decreased by 13% over 9M20 to 78.8 bln\$.

As a consequence of the Covid-19 crisis, 2.9 mln people (4% of total workforce) lost their jobs in Russia in 2Q20, of which 1.1 mln people (1.5% of total workforce) in SMEs. In 3Q20, the number of people employed fell to 70.2 mln (-1.9 mln yoy). The largest contraction was seen in wholesale & retail trade (-0.9 mln), construction activity (-0.3 mln) and transportation (-0.2 mln). The positive side is that, in these sectors the labour force is relatively easy to recover. Unemployment stood at 6.1% in November 2020 vs 4.6% at the end of 2019.

In addition, wages have remained underpinned in the public sector by the Covid fiscal stimulus measures, whereas the recovery in the private sector wages is muted. On VTB numbers, in October public wages

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were up +10.3% yoy, while private sector wages added +2.0% yoy, some 2.5% below current inflation. The average nominal wage increased (in rouble terms) by 6.4% yoy to R 49,274 (€ 540) per month in Nov 2020 vs R 46,549 (€ 660) per month in October 2019.

Household savings increased by 5.6 tlnR yoy as of September: +3.3 tlnR yoy in the form of bank deposits and +2.3 tlnR in the form of cash. That reflects both an increase in retail lending and the rise of the savings rate. At the same time, bank lending conditions have remained soft.

After an estimated 5.0% decline of the real disposable income in 2020 (4.3% yoy contraction in 9M20), we assume real disposable income growth to be modest in 2021 (est. 2.0% yoy) because following a year of stronger expenditure, the government plan to cut budget expenditure by 5% yoy with an aim to set the budget breakeven at \$66 /bbl in 2021.

The question entering 2021 is whether the Russian government will shift from achieving financial stability (at the expense of a weak growth) towards stimulating economic growth ahead of the September 2021 Duma elections. We assume that some part of the federal budget, and particularly the National Wealth Fund, will be affected to the National Projects, which mainly consists of an uptick in infrastructure spending with some expectations of a potential multiplier effect. 45% of the contemplated \$400bn budget is intended to be spent infrastructure programs, mostly roads, that shall bring Russia's infrastructure level up to that of Malaysia by 2024. So, the stimulus is likely to be investment-led rather than consumer-led and may add no more than 0.1-0.3% of annual GDP growth in 2020-24.

Russian politics

In 2020 Russia turned a bit more Asian with its new amendments to the Constitution that allow Putin to remain in power virtually for life in a similar manner to the one Nazarbayev and Xi Jinping have used to consolidate their grip on their respective countries. Dissatisfaction remains palpable over the worsening living conditions, but not to the point that people would go the streets, particularly in those pandemic times. An exception was the mass demonstrations that took place this summer in the Khabarovsk regions, where people took to the streets to protest the arrest of their local governor. Otherwise, the Covid crisis was handled quite skillfully, at least from a communication point of view, under the efficient management of Moscow's experienced mayor Sobyenin. Following a short period of lockdown in April and May, the Russian authorities decided to impose only light restrictions to people and businesses in the following months, and up to this day stores and restaurants have been working as usual until 23.00 every day. Indeed, they decided to let people work and make for a living, which has proved quite a popular decision.

In 2021, we may see people taking the streets again on some occasions. On 23 January, a few thousand people across the country protested Navalny's arrest and Putin's corruption. Parliamentary elections on 19 Sep 2021 may give them another occasion, but generally speaking people in Russia are more prone to endure than to protest, and the Russian authorities have a good track record of handling protests and managing virtually all possible risks of escalation.

On the international scene, Russia remains under sanctions from the US and the European Union. In 2020, tensions between Russia and the West did not subside. More alleged Russian cyber-attacks on companies and government agencies around the world, Russia's support to Belarusian dictator Lukashenko following last summer's rigged election, the poisoning of Navalny were enough irritants to keep the US and their European allies in alert and determined to craft appropriate responses. Last December, the US Department of Commerce put 45 Russian and 58 Chinese companies on its Military End User List. The US

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government has determined that these entities represent an unacceptable risk of use in or diversion to a 'military end use' or 'military end user' in China, Russia, or Venezuela.

Following Joe Biden's election, much of the Obama-era Russia foreign policy team is back, led by Secretary of State Anthony Blinken. The neo-conservatives under Trump and the neo-liberals aligned with Biden have almost identical positions on Russia, whose expansion they believe needs to be challenged. Russia hawk Victoria Nuland will serve as US assistant secretary of state for political affairs. During congressional hearings in 2019, Nuland called for intensified sanctions against Russia, prompting the Kremlin to include her in its blacklist of those forbidden to enter the country. Andrea Kendall-Taylor, director of the Transatlantic Security Program of the Center for New American Security, will serve as the Russia director in the US National Security Council. She previously served in the Office of the Director of National Intelligence and the CIA. Kendall-Taylor has indicated her Russia policy will be based on the principle of targeting Russian President Putin, but reconciling with the Russian public. She said: *"The U.S. should better position itself to improve relations with Moscow after the departure of Putin and to work on reducing the risk of a strengthened alliance between Russia and China"*. Our interpretation is that total economic pressure should not be applied, such as excluding Russia from the SWIFT international payment system for example. Sanctions shall rather be focused on Putin's entourage of oligarchs and siloviki.

Currently, domestic problems in the US, including those linked to Covid-19, require urgent attention, while on the international arena, relationships with China and the EU are probably more important than putting pressure on Moscow. This does not mean that Russia will slip off the agenda, but our view is that it will not be at the top of the list in 2021. In other words, we believe that it is highly unlikely that Russia-US relations will improve, and we regard maintenance of the current status quo as the most probable scenario.

Russian stocks

In 2020 the MSCI Russia lost 17.2% (MSCI Russia Net Return -12.9%) and the RTS 10.5%, to compare with MSCI EM +15.5% and MSCI World + 14.1%.

Despite the pandemic and volatile markets in 1H20, the second half of 2020 saw a rebound and growing investor interest in IPOs. In line with the global recovery, the Russian market added more than 50% from its March low (IMOEX) and several successful public offerings took place, raising close to 1.9 bln\$, and two of particularly large scale – Ozon (1.2 bln\$) and Sovkomflot (550 mln\$). Ozon (e-commerce) opened 41% higher than its IPO price on the NASDAQ and Sovkomflot (shipping) sold 17.2% of its capital on the MICEX (82.8% remaining property of the Russian state).

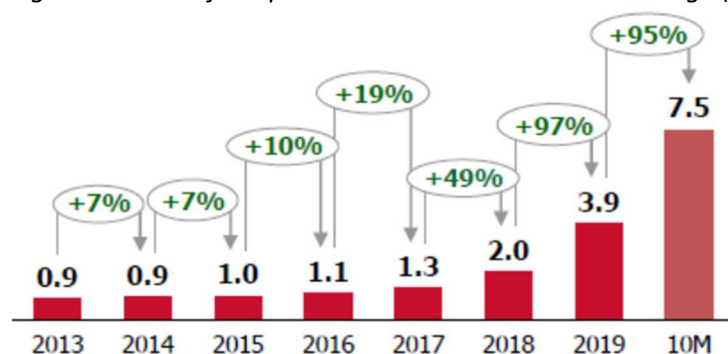
Following Tinkoff at the end of 2019, Globaltrans and Mail.ru, which were all trading on the London Stock Exchange, started listing on the Moscow Exchange.

Total trading volume across markets on the Moscow Exchange rose by 19% in 2020 to reach an all-time high of 947 tlnR (12.7 tln\$). Part of such explosive growth was driven by the equity market, which skyrocketed 92% to 24 tlnR.

With interest rates on the downslope, Russian household savings continued to migrate from bank deposits into securities market. Some 4.7 mln new retail investors came to the market, which is more than three times higher than the year before (Fig.9). The number of Russians running brokerage accounts jumped 4 times in the past two years, accounting for 8.5 mln people at the end of 2020 or 6% of the Russian population.

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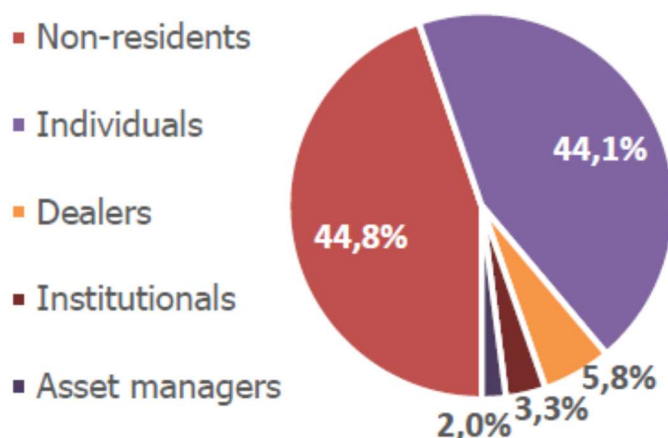
Fig.9 - Number of unique retail clients at Moscow Exchange (in mln)



Source: Moscow Exchange

Individual investors now represent 44% of the volumes traded on the Moscow Exchange (Fig.10). In 2019 and 2020, local retail inflows helped to absorb international investor outflows. We trust they are a new factor of market volatility reduction.

Fig.10 - Investors on the Moscow Exchange, by category



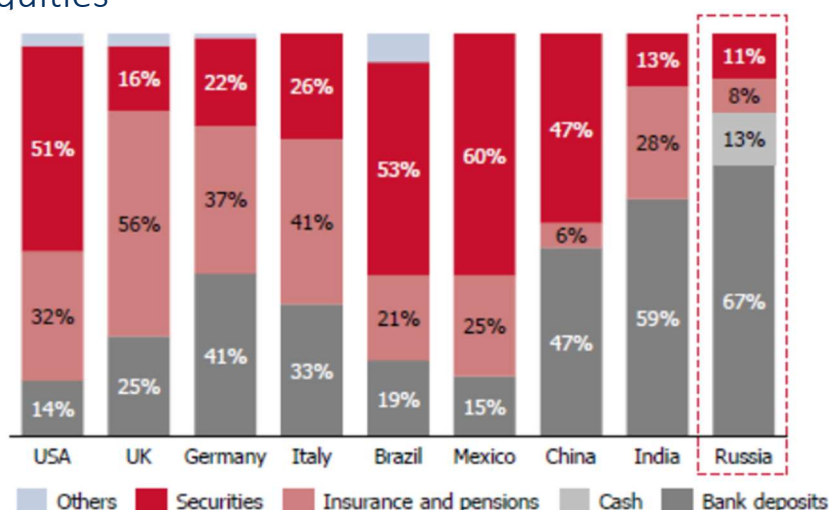
Source: Moscow Exchange

The Central Bank of Russia disclosed in December that Russians have some 4.7 tlnR (c60 bln\$) of direct investments in financial assets, excluding money kept in mutual funds and other institutionalized investment. This amount represents around 15% of personal deposits in Russian banks and was up 45% in 2019.

According to polls around 17% of the population plans to participate in direct investments in the markets in the coming years. But as Russians still hold majority (80%) of savings in banks and cash, there is a huge potential to see more savings swapped from cash and bank deposits into the stock market.

Fig.11 – Distribution of savings in Russia vs RoW

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Source: World Bank, Allianz, CBR, Moscow Exchange

Dividend paradise

Russian equities still offer the highest dividend yields across large EM and DM exchanges, despite falling 2020 earnings. The average dividend yield for companies included in the RTS Index is around 7%, while there are about 20 liquid names that offer robust 9-10% dividend yields. The key dividend-paying sectors are utilities, which yield 8-12%, and metals & mining, where almost every company offers an 8-9% yield with a quarterly payout period. In contrast, the oil & gas sector, which was among the dividend leaders in the past few years, will cut dividends on 2020E earnings. This does not apply, though, to Surgutneftegas preferred shares, traditionally a top dividend instrument in times of rouble depreciation (14% DY expected on 2020E earnings).

We believe that an average dividend yield in excess of 7% will also continue to drag carry trade flows from foreign investors confronted with zero or negative yields at home.

Outlook for 2021

Global

Following last year's sharp contraction (-3.5% as per the IMF's last update), which triggered quick and aggressive fiscal and monetary response, we expect in 2021 the global economy to show its strongest growth over the past 20 years. According to the IMF, global growth is set to rise by 5.5% in 2021 and 4.2% in 2022. Nevertheless, before recovery comes later in the year, we will be facing a few headwinds, with a mutated virus, extended and stricter lockdowns and problems with the supply and distribution of the vaccine. Shall we assume in our base case scenario that together with warmer weather, governments will ease the lockdown restrictions in early spring and that the rollout of the vaccine will gain momentum, we should see a significant pick-up in most economies by the second quarter. Supported by ongoing fiscal and monetary stimulus, our view that the global economy stages a strong synchronized recovery in the second half of the year remains intact.

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Inflation in the goods and labour markets is to remain subdued, reflecting an aggregate supply and aggregate demand gap that does not close until 2022, meaning excess capacity and relatively high unemployment rates keep a lid on inflation.

While debt and budget deficits rise (the IIF estimated that global debt will amount to 365% of GDP by the end of 2021, compared with 320% at the end of 2019), central banks are set to absorb a large part of debt issuance and, with long-term inflation expectations remaining steady, we assume no major increase in government bond yields (the consensus looks for the US 10-year Treasury yield to rise slowly to 1.3% by the end of 2021).

America's rising 'twin deficits' also point to a softer US dollar. We assume the EUR:USD to trade in a 1.20-1.30 range. A weaker dollar in a global recovery encourages international investors to rotate away from safe-haven dollar-denominated assets into emerging economies and markets, where valuations are attractive compared to developed markets. A more cooperative approach to global trade (particularly in the new US administration) and big stimulus infrastructure investment is all very supportive for the commodities complex.

In the US, with undivided Democratic Party control of the White House and both chambers of the US Congress now confirmed, the incoming administration of Joe Biden will have free rein to pursue unconstrained stimulus spending. But with the balance of power in the Senate tight, tax hikes will be off the table for at least the next two years. The IMF now assumes 5.1% growth of the US GDP in 2021.

In Europe, it seems like the German locomotive will emerge strong from the crisis. German industry has remained almost unharmed by the November lockdown and posted its seventh month of growth in a row. German industry seems to be benefiting from the strong economic rebound in Asia but also from an ongoing recovery of domestic demand.

The second half of the year will also get a boost from the European Recovery Fund with public investment shifting into higher gear, while exports will benefit from a synchronized worldwide recovery, though the strong euro is likely to temper this tailwind. That is why we have now downgraded our GDP growth forecast to 3.0% this year, followed by 3.5% in 2022, given the weak start to the year. That means that it will take until the summer of 2023 for the eurozone to regain its pre-crisis activity level. The new IMF forecast for Euro area's GDP growth is 4.2% in 2021.

China's latest set of data confirmed a solid pace of economic recovery in the country. Industrial production grew 7% yoy in November, up from 6.9% yoy in October. Retail sales growth accelerated from 4.3% yoy to 5.0%. The IMF foresees Chinese GDP growth of 8.1% in 2021.

Last, geopolitical risks are not off the table. From the perspective of the Russian market, it is important to monitor the evolution of the relationship between Iran and the US under the new presidential administration. Would the US lift their sanctions, 1.5-2.0 mln bbl of additional crude oil supply could hit the market and send prices down, but given the recent stance of the Iranian government, it looks unlikely Biden would lift the sanctions anytime soon.

Russia

Russia did well in 2020 posting a GDP contraction of 3.1% yoy. The advantage of running a modest contraction has, however, a flipside: it sets modest potential for catchup growth and we expect a relatively

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modest 3.0% yoy GDP recovery (3.0% projected by the IMF, under the assumption of a 3.6% yoy GDP contraction this year) in 2021.

One of the reasons to stay cautious about Russia's economic growth in 2021 is the government's plan to tighten budget policy. Following a year of stronger expenditure, the budget draft contemplates cutting nominal expenditure by 5% yoy or 1.1 tlnR and introducing new taxes – a 15% tax on annual incomes above 5 mlnR and a tax on metal production - with an aim to set the budget breakeven at \$66 /bbl in 2021 vs \$85 /bbl in 2020 (and \$49 /bbl in 2018-19).

By contrast, the CBR governor has indicated a number of times that monetary policy would remain loose in 2021 (rates shall not exceed 5-6%) and the CBR forecasts inflation to remain at 3.5-4.0%.

We believe that by the end of 2021 the spread of coronavirus is to become limited and controlled thanks to the mass vaccination program. In addition, in January and throughout 2021, some OPEC+ restrictions on oil extraction are to be lifted. Therefore, we believe that the 2021 GDP recovery will be underpinned by the bounce back in services, crude oil extraction, petroleum products manufacturing and transportation (sectors which have yet to recover from their current low levels).

After an estimated 5.0% decline of the real disposable income in 2020 (MinEco forecast of 3.0% but 9M20 contraction was 4.3% yoy), we assume real disposable income growth to be modest in 2021 (c2.0% yoy). Therefore, consumer demand shall remain muted, which means that inflation will likely fluctuate around the CBR target (3.5-4.0%) and move down towards 3.5% by the end of 2021. This pattern leaves some room for a further rate cut by the CBR, but we estimate the magnitude of the easing at a maximum of 25-50 bps.

Investment will be supported by the National Projects, with money flowing into infrastructure, but also demography, healthcare, education, ecology, science, culture and the digital economy.

The Russian rouble has a strong appreciation potential in 2021 because of expectations of a weaker USD, of the high debt / low rates in western economies, of the strong balance sheet of Russia's economy, and of Russia's strong trade balance. But sanctions risk on one hand, and the government's overall unwillingness to let the rouble appreciate shall limit this potential. This month, the CBR has already announced it stopped selling currency, while the Ministry of Finance could start forex purchases would the rouble be boosted by the high level of oil prices. Moreover, when borders reopen, Russians will resume international travel after saving around 30 bln\$ in 2020. Therefore, assuming that oil prices will remain in a \$50-60 /bbl (Brent) range, we believe the rouble will stabilize around 70 USD:RUB in 2021.

Russian stock market

In 2021, following the successful IPOs of Ozon and Sovcomflot, we expect a number of new Russian companies to hit the market in the healthcare (EMC, Medsi), retail (Fix Price, Vkusvil), car sharing (Delimobil), online cinema, and other sectors.

Geopolitical factors will continue to bring volatility to the Russian market, but they shall not affect the investment case in a fundamental way, and Russian stocks have a strong potential of rerating vs their emerging peers after last year's underperformance, as has shown the performance of the Russian equity market since the beginning of November.

Russia Equities

We believe that Russian stocks are among the best carry trade plays in the current environment. With their superior capacity to pay dividends (thanks to their solid balance sheets, low costs in an undervalued currency, low funding costs and inflation) and to resume earnings growth when positive external factors recover in 2021 (higher commodity prices), Russian stock shall reduce the 50% price discount to their emerging peers.

We see 30% upside for Russian stock prices in 2021E based on corporate earnings growth, dividend yield compression and carry trade flows.