HYPOTHESIS RESEARCH

Outlook

Economic Research

Macro

Russian-focus ETFs

Eurobond opportunities for 2020

- **The Russian Eurobond market in 2019 followed the trend set by the central banks' easing policy.** The switch to easing mode by monetary authorities, including the US Federal Reserve, in more than 30 countries resulted in fixed income instruments rising 6-15%. The decreasing recession risks and pick-up in international trade in 4Q19, with an expected rebound in manufacturing activity to follow, have suspended the likelihood of a further reduction of the US Fed funds rate, which is now expected to remain at 1.50-1.75%. However, the central banks in other countries, including Russia, continue to adjust their rates. The Russian Central Bank may cut the key rate by at least 0.5% to 5.75% by year-end 2020, following lower-than-expected inflation of 3% in 2019. Russian CDS spreads reached their historical low, indicating decreasing Russian country risk. Russian GDP growth is estimated by the IMF at 1.1% for 2019, while the oil price and exports flows may provide a positive environment for resources companies once Chinese coronavirus concerns are eliminated. The current estimates for Russian GDP growth include 1.9% for 2020 and 2.0% for 2021 by the IMF, and 1.7% for 2020 and 3.0% for 2021 by the government. The new Russian technocratic government, which is expected to focus on social politics, digitalisation and other growth stimuli, may achieve a higher rate in the current steady macro environment.

- **While the general trend is to underweight global fixed income, Russian Eurobonds can offer an attractive Emerging Markets fixed income option.** The trade agreement signed between the US and China, and the approaching US Presidential elections give rise to cautious expectations for slow but steady economic development during 2020. After being strong last year, the performance of the stock market is likely to be more modest this year, as analysts and investors attribute relatively low upsides to the US stocks. The forecast slow-down of GDP growth in the US and China is reducing the investors' appetite for those markets, and the search for undervalued second-tier securities is coming to the fore. Defensive assets were winners last year, but a move from defensive to more risky assets, including those in Emerging Markets, is expected in 2020. Given the global and Russian macro outlook, there is a sill positive environment in 2020 for the performance of Russian securities, in particular longer-duration corporate and sovereign Eurobonds, as well as RUB fixed income instruments benefiting from the key rate cut expected during the year.

- **ITI Funds Russia-focused Eurobond ETF showed 15% price performance in 2019.** The ETF includes sovereign, quasi-sovereign and corporate bonds with an average duration of 5.6 years and a yield of 2.9%. The ETF provides an attractive yield/duration compared to the Russian sovereign, while benefiting from securities with a minimum rating of BBB-. The ETF has quarterly revisions and may include up to 25 securities, and is traded in USD on the LSE, Moscow Exchange, Irish Stock Exchange, and AIX.

Report date:	**28 January 2020**
Ticker	RUSB
Market Price, USD	28.05
NAV	28.14
Exchanges	LSE, MOEX, ISE, AEX

Description:
ITI Funds Russia-focused USD Eurobond UCITS ETF was launched in February 2018 to provide low-cost access to the Russian Eurobond universe via a USD-denominated instrument. RUSB benefits from listing on Moscow Exchange, LSE, AIX and ISE, and from Euroclear settlement. The ETF base includes up to 25 Russia-focused Eurobonds nominated in USD.

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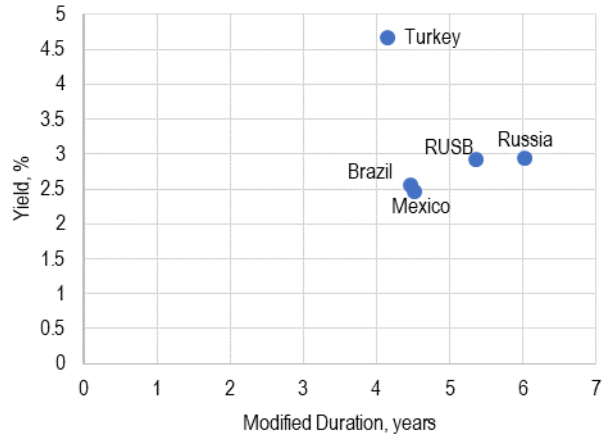
ITI Funds is a research client of Hypothesis Research.

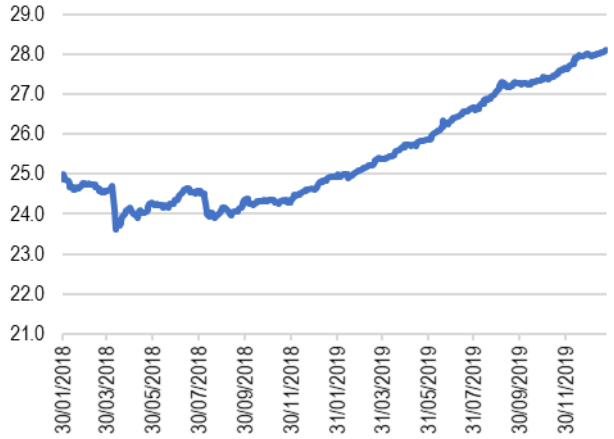
Marina Alekseenkova
Research analyst
+44 (0) 78527 00371
ma@hypothesisresearch.co.uk

Figure 1. Sovereign yield/duration vs ITI RUSB ETF



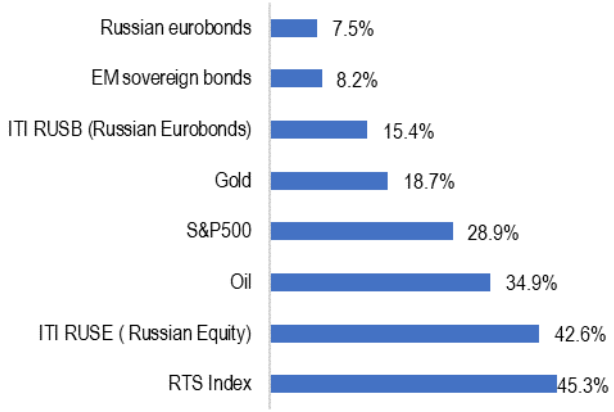
Source: Thomson Reuters, ITI Funds

Figure 2. ITI FD UCITS ETF SICAV RUSSIA NAV (LSE: RUSB), USD



Source: Thomson Reuters

Figure 3. Asset performance in 2019, %



Source: Thomson Reuters, ITI Funds

Figure 4. EM FI benchmark - LYXOR ETF IBOXX $ Liquid Emerging Markets Sovereign, USD

Source: Thomson Reuters

Topics of the year

In 2019, political and economic uncertainty was generated by the US-China trade war, recession risks, non-deal Brexit risks and the general election in the UK, and the geopolitical situation in the Middle East. Despite this rather volatile environment, the S&P500 gained 29%, while Russian stocks rose 43% and Eurobonds (RUSB) were up 15% in US dollar terms.

Easing by the US Federal Reserve and other central banks supported markets. Russian CDS spreads fell to historical lows, also reflecting diminishing sanctions risks and stable domestic macro with a historically low inflation level of 3% for 2019, down from 4.3% in 2018.

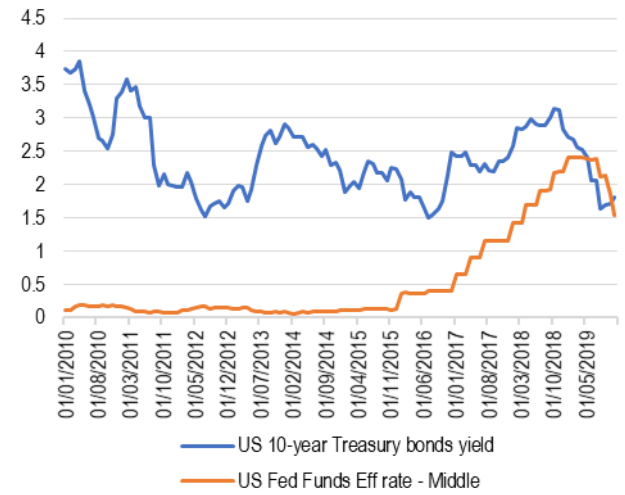
Russian Eurobonds are influenced equally by national and US monetary politics, reflecting Fed rate expectations and the Russia specific risk.

The topics for 2020 include: the US-China trade agenda with a possible new round of trade negotiations; oil price dynamics, which is affected by expectation of lower growth in China due to coronavirus risk; RUB/USD exchange rate movements; Russia's GDP growth and inflation rates; and Russian domestic and international politics.

The US–China Phase 1 trade deal reduces the uncertainty for investors as manufacturing activity and trade flow will now pick up. The trade war brought global growth in 2019 down from 2017-2018 levels. According to the White House economic adviser Larry Kudlow, the US-China agreement will add 0.5 percentage point to US GDP growth in 2020 and 2021.

However, the Phase 1 deal does not permanently remove the risk of further tensions. This year will see the start of Phase 2 negotiations, with several deals expected to be negotiated between the US and China. Given the timeframe, the US presidential elections may disrupt negotiations and bring some other topics to the table. The Phase 2 trade deal will likely be segmented into multiple rounds with more tariffs rolled back, once the agreement is achieved.

Figure 5. Fed Funds rate and US 10-Year Treasury bonds yield

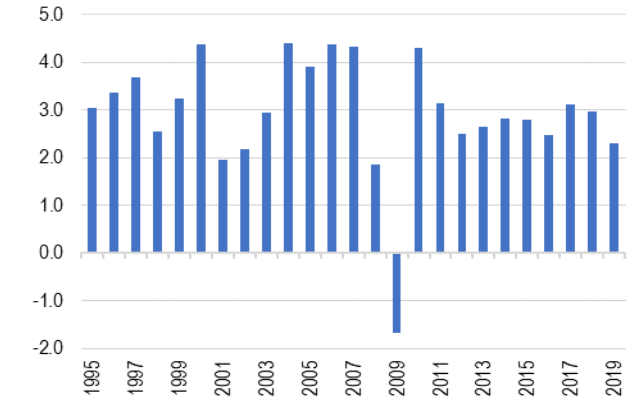


Source: Thomson Reuters

Figure 6. Government of Russia Snr CDS Premium Mid 5Y $

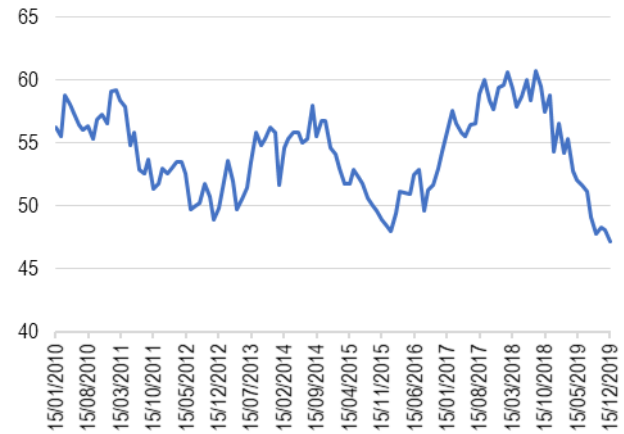
Source: Thomson Reuters

Figure 7. Global GDP, %



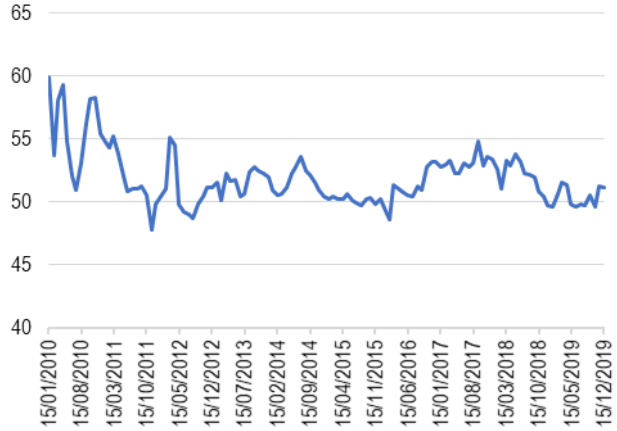
Source: IMF, United Nations

Figure 8. US ISM PMI (MFG Survey) - remains low in 2H19, *expected to pick up in 2020 following the business confidence increase*



Source: Thomson Reuters

Figure 9. Chinese NBS PMI Manufacturing – new order index – *recovery was seen in the last two months of 2019*



Source: Thomson Reuters

PMIs in the US and China are expected to pick up following the US-China deal. The US Conference Board forecasts an acceleration of residential investments and consumer spending in the US.

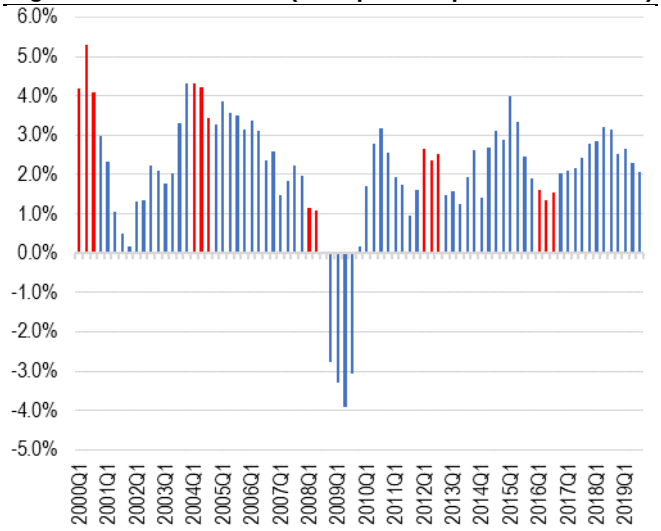
The US Presidential elections create volatility due to the differences between the Republicans and Democrats on taxation and regulation, in addition to the impeachment procedure. The cautious approach to the S&P performance assumes 10-15% YoY for the S&P500 in 2020 following 29% growth in 2019.

Figure 10. The Conference Board projections for the U.S.

	2018	2019	2020
Real GDP	2.9%	2.3%	2.1%
Real consumer spending	3.0%	2.7%	2.8%
Residential Investment	-1.5%	-1.6%	4.6%
Real Capital Spending	6.4%	2.3%	1.0%
Exports	3.0%	-0.1%	0.1%

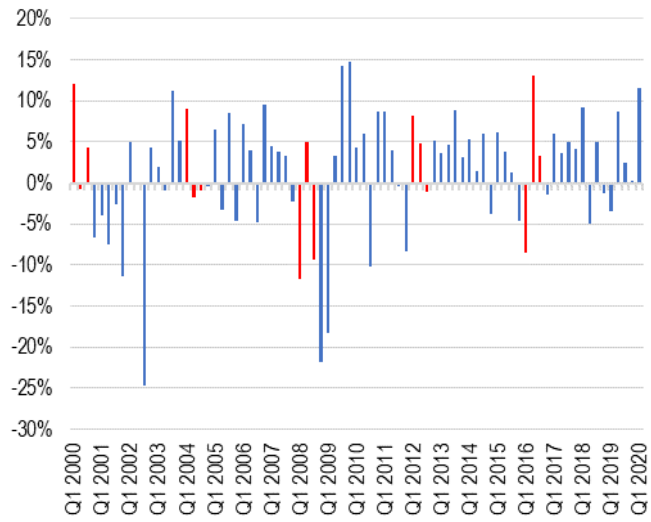
Source: The Conference Board

Figure 11. The U.S. GDP (red=quarters prior to elections)



Source: U.S. Bureau of Economic Analysis, Hypothesis Research

Figure 12. S&P yield, % (red=quarters prior to elections)

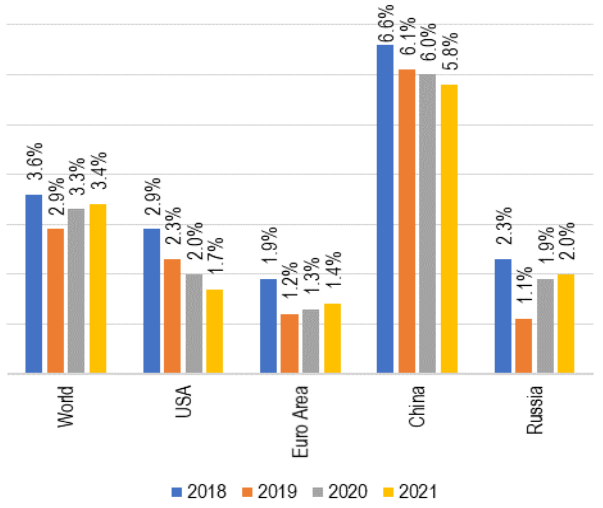


Source: Thomson Reuters, Hypothesis Research

The IMF's projections for US GDP, meanwhile, show a slow-down, to 2.0% in 2020 and to 1.7% in 2021. The IMF also expects the deceleration of growth in China to bring the GDP growth rate down to 6.0% in 2020 and to 5.8% in 2021. Economic monitoring during 2020 will show whether the expected boost to business investment and pick-up in housing have occurred.

Given the emphasis on the US economy, investors will pay attention to the US Fed funds rate, which is currently expected to remain at 1.50-1.75% in 2020. The long-run forecast, beyond 2023, is for 2.0-3.3% for now. However, long-term scenario is yet to be confirmed with the economic trends. The Fed remaining on hold is the main scenario on which the other central banks will base their actions during the year.

Figure 13. IMF GDP forecast – Jan'20

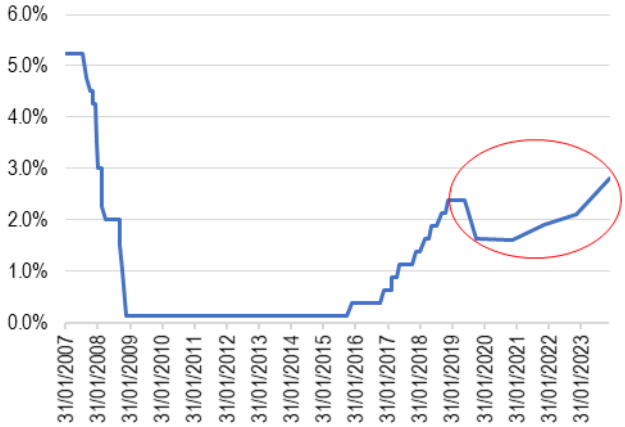


Source: IMF

Once a reduction of the Fed rate looks unlikely, the outlook for non-US bonds is also more certain, including Russian bonds.

Coronavirus concerns affected the global market performance in January 2020 as China growth rate this year may be under pressure. Some experts believe the virus is not as dangerous as the 2002-03 SARS that killed c800 people, or MERS which killed more than 700 people since 2012. Measures were taken to cease the virus; however, market will likely wait until the number of confirmed cases to go down, offering a buying opportunity.

Figure 14. U.S. Fed rate, actual and projection



Source: Thomson Reuters

Russia under technocratic government: to drive the growth, to keep rates low

The projections for 2020 are for relative stability, with the Brent crude oil price staying in its current range of $58-67/bbl, if the geopolitical risks are not realised and China to recover from virus-related issues soon. The slowdown in oil demand due to lower growth in the US and China is expected to be offset by the OPEC+ deal that is now in place, restricting production by the Middle East suppliers and thus resulting in destocking and flattish oil price dynamics. If the oil price stabilised following coronavirus concerns correction, the Russian ruble exchange rate is expected to remain at 62-68 RUB/USD, with a possible level of 68 RUB/USD by the end 2020.

The appointment of the new technocratic government in Russia may imply some potential changes in economic policy. However, the main course of the government will likely remain the same: focus on national projects and social spending to stimulate consumer spending and long-term growth, supporting the low-income population. The new government is politically neutral and will focus on the digitalisation of management and social politics to generate GDP growth. It is unlikely that forecasts for Russian GDP will be reduced from 1.5%-1.7% in 2020 and 1.7-2.0% in 2021 as social spending will likely be supportive for growth.

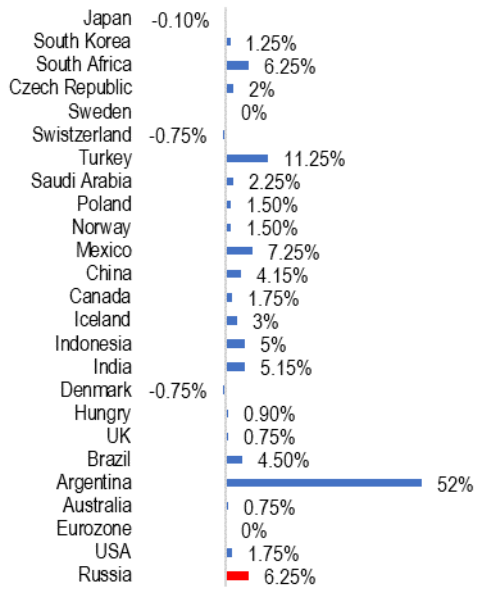
Figure 15. Crude Brent oil price, FOB, $/bbl

Source: Thomson Reuters

Figure 16. RUB/USD exchange rate

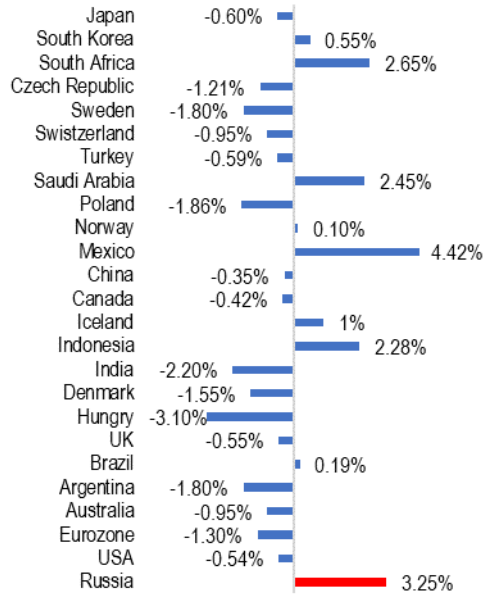
Source: Thomson Reuters

Figure 17. Nominal rates by country



Source: Thomson Reuters

Figure 18. Real rates by country



Source: Thomson Reuters

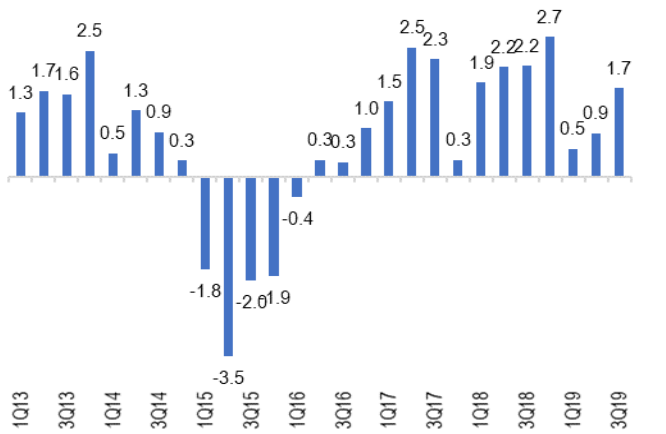
The inflation expectations remain rather low. The inflation rate was 3.0% in 2019 and is estimated at 3-4% in 2020-2021. The Russian Central Bank maintains the target inflation at 4%.

The Russian Central Bank is likely to reduce the key rate during the year, following the inflation correction down to the historical low of 3% in 2019 (Dec/Dec 2019). The base case is that the year-end target key rate will be 5.75%, based on the assumption of 2.5-3.5% inflation in 2020.

However, the changes in the Russian government, with the appointment as First Deputy Prime Minister of Andrey Belousov, who has been a supporter of more active government stimulation of the economy, may indicate a faster decrease in the key rate to 5.0% by the end of the year.

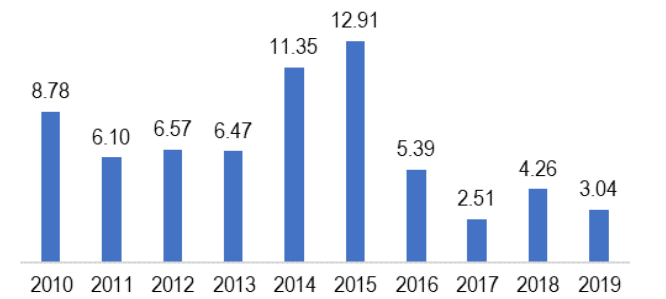
There is a scenario, depending on how fast the social expenses are growing, that inflation may accelerate by the end of the year, affecting the key rate dynamics. Meanwhile, Russia remains one of the few countries with positive real interest rates.

Figure 19. Russian GDP, % quarterly



Source: gks.ru

Figure 20. Russian inflation dynamics, % Dec/Dec

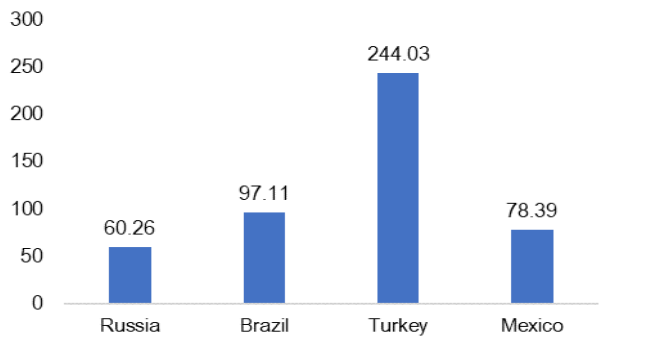


Source: gks.ru

Russian fixed income performed strongly during 2019, driven by the US Fed rate reduction in October and the falling CDS spreads, and supported by a strong oil price, a stable exchange rate and easing of the Russian Central Bank's monetary policy.

Russian 5-year sovereign CDS demonstrate the relatively low risks of the Russian market compared to the other emerging markets of Mexico, Brazil and Turkey.

Figure 21. Russian 5-year CDS vs peers

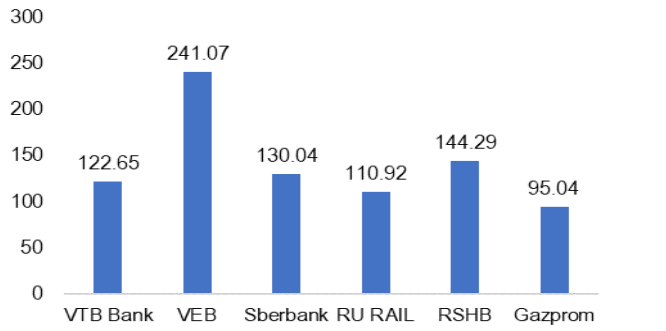


Source: Thomson Reuters

Russian corporate sector spreads are comparable with EM sovereign spreads, indicating the high quality and low risks associated with top quasi-sovereign issuers.

The EM Eurobond market provided a 12-15% yield to investors in 2019, one of the best results since 2012. The Eurobond segment with investment grade (IG) securities was ahead of high-yield (HY) securities. The spread of IG securities dropped to lowest level since 2007. Longer duration securities from the IG segment may still be interesting once the Fed rate expectations are flat.

Figure 22. Russian corporate 5Y CDS spreads



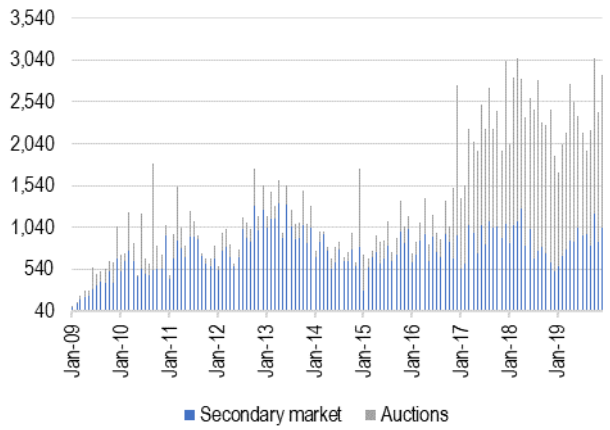
Source: Thomson Reuters

The participation of foreign investors represented 32% of the Russian fixed income market in October-November 2019. A stable exchange rate and high real interest rates over the last several years have attracted institutional holders. The fixed income market more than doubled in size in 2017-2018 compared to 2014-2016, reflecting a recovery after the sanctions imposed in 2014.

The performance of 2019 demonstrates that sanctions risk has diminished, although there is still a low probability of sanctions removal.

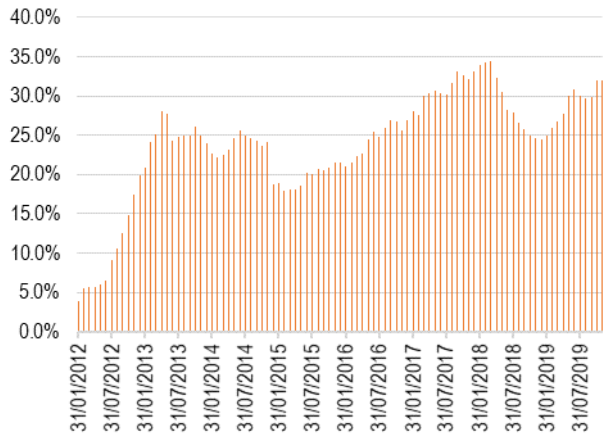
Russian rates and spreads still provide an opportunity in the local market due to the potential reduction in the central bank rate, and in the Eurobond market where high-quality sovereign securities are still available at a relatively good rate.

Figure 23. Bond market trading volume, RUB bn



Source: Moscow Exchange

Figure 24. Russian non-residents' OFZ Holdings



Source: Thomson Reuters

ITI Funds Russia-focused USD Eurobond ETF

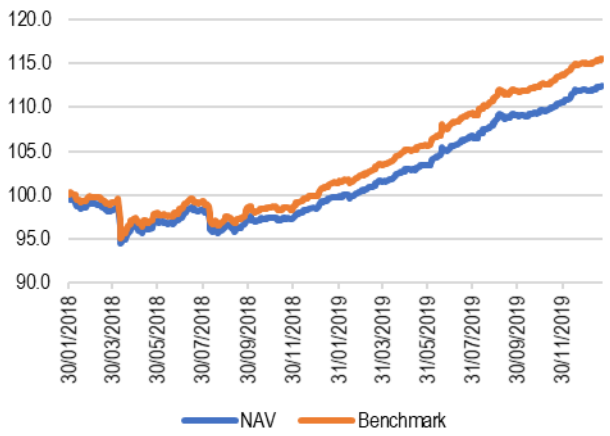
Number of holdings	**14**
Duration, years	5.37
Average rating	BBB-
Lowest rating	BBB-
Average coupon	5.64%
Yield to maturity	2.92%
Total issues outstanding amount, $	22700142978
RUSB performance since 3/01/2019	13.42%
Index Performance since 3/01/2019	14.88%

Ticker	**RUSB**
RIC	RUSB.L
Domicile	Luxemburg
Underlying index	ITIEURBD Index (ITIEURBD)
Listings	LSE, MOEX, ISE, AIX
ISIN	LU1283649825
Base currency	USD

Figure 25. Top-10 holding of ITI Funds Russia-focused USD Eurobond ETF

Security	ISIN	Currency	Weight 09/01/2020	S&P	Moody's
GAZPRU 7.288 08/16/37	XS0316524130	USD	8.61%	BBB-	Baa2
VEBBNK 6.8 11/22/25	XS0559915961	USD	8.51%	BBB-	
RUSSIA 5 7/8 09/16/43	XS0971721963	USD	8.10%	BBB-	Baa3
RUSSIA 5 5/8 04/04/42	XS0767473852	USD	7.86%	BBB-	Baa3
SIBNEF 6 11/27/23	XS0997544860	USD	6.80%	BBB-	Baa2
VEBBNK 5.942 11/21/23	XS0993162683	USD	6.77%	BBB-	
GMKNRM 6 5/8 10/14/22	XS1298447019	USD	6.72%	BBB-	Baa2
RUSSIA 4 7/8 09/16/23	XS0971721450	USD	6.64%	BBB-	Baa3
GAZPRU 6.51 03/07/22	XS0290580595	USD	6.61%	BBB-	Baa2
SBERRU 6 1/8 02/07/22	XS0743596040	USD	6.51%	BBB	Baa3

Figure 26. Relative performance of ITI Russia-focused Eurobond ETF and the benchmark (30/01/2018=100)

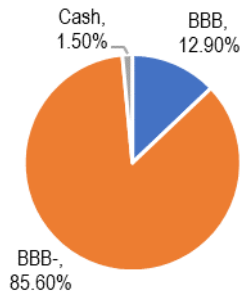


Source: Thomson Reuters

Figure 27. LYXOR ETF IBOXX $ LIQUID EMRG.MKT.SOVEREIGN USD

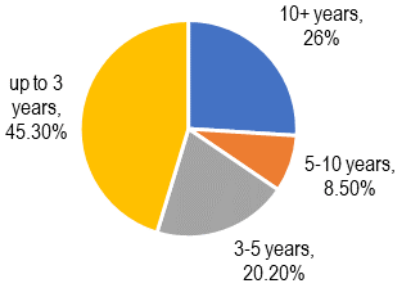
Source: Thomson Reuters

Figure 28. Holding breakdown by rating



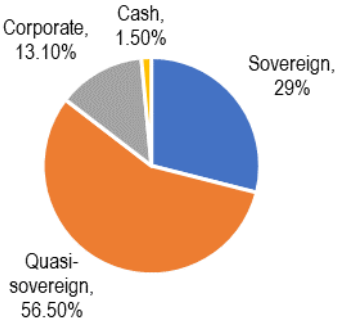
Source: ITI Funds

Figure 29. Holding breakdown by maturity



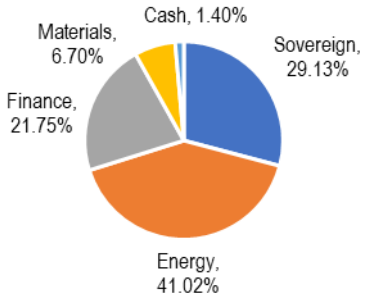
Source: ITI Funds

Figure 30. Holdings breakdown by Issuer type, %



Source: ITI Funds

Figure 31. Holdings breakdown by sector



Source: ITI Funds

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