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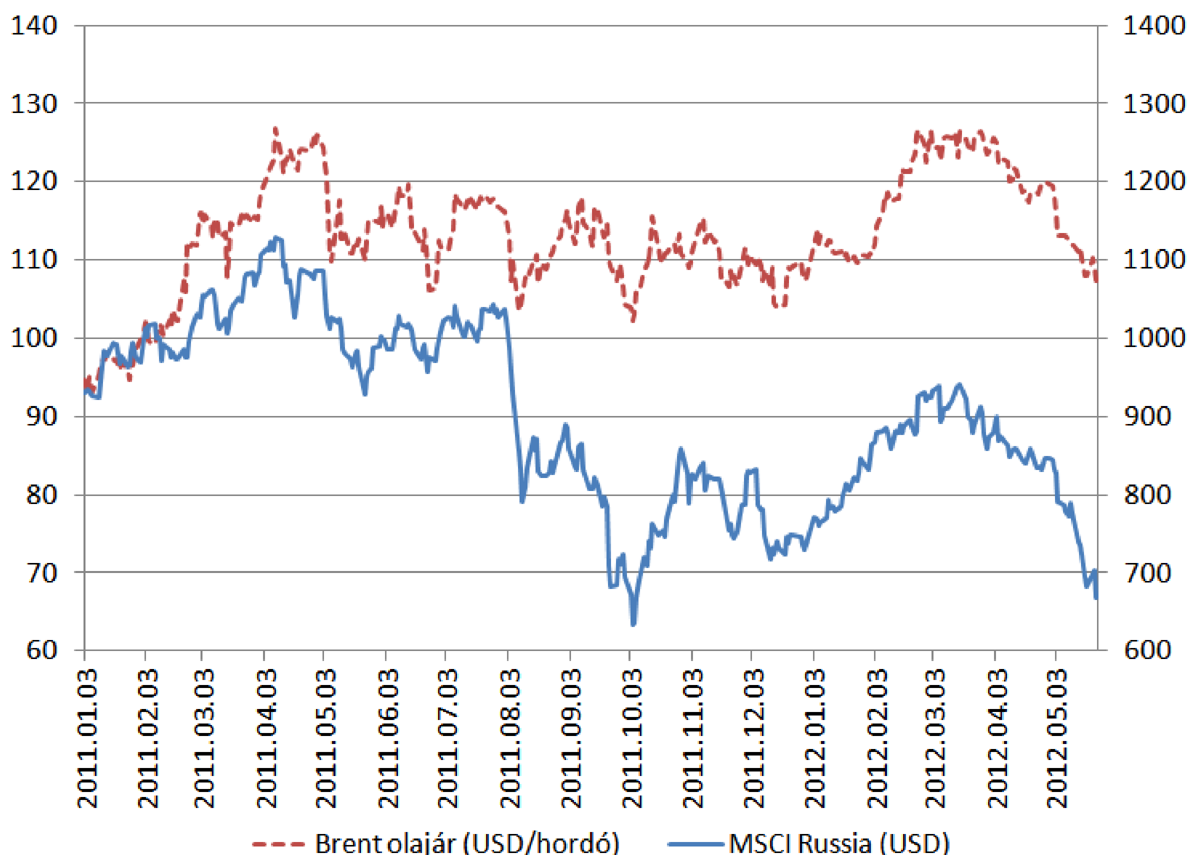
Expert opinion – Gábor Szabó

Oil price correction, Russian stock market plummets to all-time low

Following the outstanding performance of the first quarter, April and May were marked by a slump in the Russian stock market, in what was essentially a repeat of last year's pattern. Naturally, it takes more than seasonality to generate impacts on this scale – alongside the worsening European and Asian growth outlook, the primary factor is the coincidence of conflicts that impact oil prices. While in the first months of last year the "Arab Spring" and the Libyan civil war sent the oil price spiralling upwards, in the first quarter of this year the same role was fulfilled by the growing tensions in Iran.

MSCI Russia index and Brent crude price: high correlation accompanied by a widening differential



Source: Bloomberg, Aegon Fund Management

The oil price correction of the past few weeks come as less of a surprise: the fact that the Brent oil price was still over USD 125 in March meant that, over and above the full costs – also including the expected return – of the most expensive producer, a further USD 35-40 risk premium was being added to the price of crude oil. The oil price correction was caused by the erosion of this virtually unprecedented risk premium, a process that was supported by the weaker economic outlook and a softening of communication related to the Iranian nuclear program. The first signs of the latter development emerged in the course of the negotiations held in mid-April in Istanbul, followed in the

past few days by the progress made with the International Atomic Energy Agency regarding inspections of Iranian nuclear facilities.

With the more restrained business activity prospects and the easing of tensions with Iran, the oil price is undergoing a correction and the Russian market is falling with it – on the surface, therefore, nothing unusual is happening. In the short term there is no doubt that the shifts in oil prices are moving the prices on the Russian stock market, with a high correlation of almost 0.9; in the medium term, however, the more important factor is not the daily movements but the oil price level.
Based on our historic pricing models projected onto the oil price, the major Russian oil companies and the Russian market did not price Brent at over USD 85-90 even during the March peak, which reflects the prudent expectations of an easing in the Iranian tensions over time. The oil price has since undergone a correction, but in the meantime the Russian index has plummeted by 30%. This means that the Russian stock market is valued at close to an all-time low, with a forward-looking P/E ratio of below 5, and this, both relative to the oil price and on the basis of forward-looking multiples, currently represents a 30-55% underpricing in historical terms.

MSCI Russia 12-month forward-looking P/E

Source: Bloomberg, Aegon Fund Management

All this is happening during a period in which the traditionally relatively high Russian political and market risks are decreasing: following the March presidential election Putin strengthened his position as expected, and his key people received the most important positions in the new government formed last week. Corporate transparency, in the meantime, is improving: this year Gazprom doubled its dividend payment, while the switch from Russian to international accounting rules in 2013 will make the operations of Surgutneftegas more transparent. Based on all these factors, the Russian market is unjustifiably trading at close to all-time low prices; in our estimate the current prices would be justified if the oil price were to plunge to USD 70-75 and remain there for a sustained period.

The question, naturally, is how oil prices will develop in future. Without the Iranian risk premium we assume a USD 90 equilibrium oil price, which could rise gradually to almost USD 100 on the back of the annual 5-6% average oilfield decline rate, the challenges of stock replenishment and the resulting cost inflation. The latter could be mitigated by the continued spread of North America's unconventional hydrocarbon extraction methods; however, the oil demand of the emerging markets appears healthy despite the Chinese slowdown, and therefore – after a possible further pricing out of the risk premiums – we do not expect to see a weak oil macro environment for any sustained length of time. As a result of all these factors, despite the more restrained global growth outlook, we see the current depressed Russian share prices as a buying opportunity with an attractive risk to return ratio in the medium term.

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