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Would Russia Risk its Golden Goose?

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Gazprom facility on the Moscow River.

It is the job of investment managers to generate conviction through analysis and interpretation. As an investment opportunity, Russia may be looked back upon as one of the most obvious value traps in the past 20 years, a market dripping with political risk and declining toward the kind of pariah status held by Venezuela and Iran.

I just don't believe it.

I think the economic interests of various players actually coincide in such a way to overwhelm Putin's maniacal dreams. Here's a BIG disclaimer: such bets don't always work. While commentators enjoy describing the globalization of the past 30 years, we didn't invent it; we rediscovered it. Global trade as a percentage of GDP didn't regain its pre-WWI level until the 1970s. Europe prior to WWI was so highly integrated that no one thought war was possible. Same can be said to a lesser extent for 1930's Europe. Those didn't work out so well for the optimists of economics over politics.

There are a lot of positives I hear cited that don't hold a lot of water. Yes, Russia has vast foreign currency reserves (5th highest in the world at about $450 billion). And that makes sense. It has had a balance of payments surplus on the order of $150 to $200 billion annually due to its extensive exports of gas and oil. But such big numbers can evaporate quickly in times of crisis. Last year saw capital outflows of $63 billion. The current estimate for the *first quarter* of this year is $63.7 billion. At this rate the piggy bank doesn't look quite so stuffed.

Russia's failure to adequately diversify its economy beyond defense and energy has left it largely bereft of infrastructure and, more importantly, a broader range of industries from which to generate economic growth. And so we get to the real kernel here: if Russia's balance of payments is so dependent on the energy sector, can it afford to risk its golden goose? Russia spends a fortune on a social safety net to offset the lack of economic opportunity in Russia. This is expensive. Less than ten years ago, an oil price of $30 to $40 per barrel was sufficient to balance the national budget. Today, the estimate is something closer to $115 per barrel. Losing the revenue that its biggest customers (Western Europe) pay for oil and gas would disrupt that social contract. Further, the cost of supporting its expanding empire, including Crimea but potentially with other portions of Eastern Ukraine (which are also poorer than Russia as a whole), would exacerbate Russia's ability to keep the masses satisfied. While the social contract between the government and the citizenry in Russia has never been strong, the history of uprisings against the government is.

So where does that leave Russia?

It needs Europe. But Europe also needs it. For Western Europe, the starting point is pretty good. After a mild winter, natural gas reserves are high and the demand for them during the temperate spring and summer is modest. But come winter, the need for Russian gas will be undeniable. Unlike other forms of fuel that are more easily transported, getting substitutes for gas over the short-term (i.e., several years) is almost impossible. The minimal sanctions employed thus far and the surprisingly conciliatory tack Angela Merkel is taking are indicative of this reality for Western Europe.

With prices roughly at five times current earnings, investors are discounting a tremendous amount of bad news in Russian stocks. Those who are avoiding the market may actually be the ones who get burned.

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