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MACROCOSM

Russia Recovers, Emerging Markets Re-Emerge

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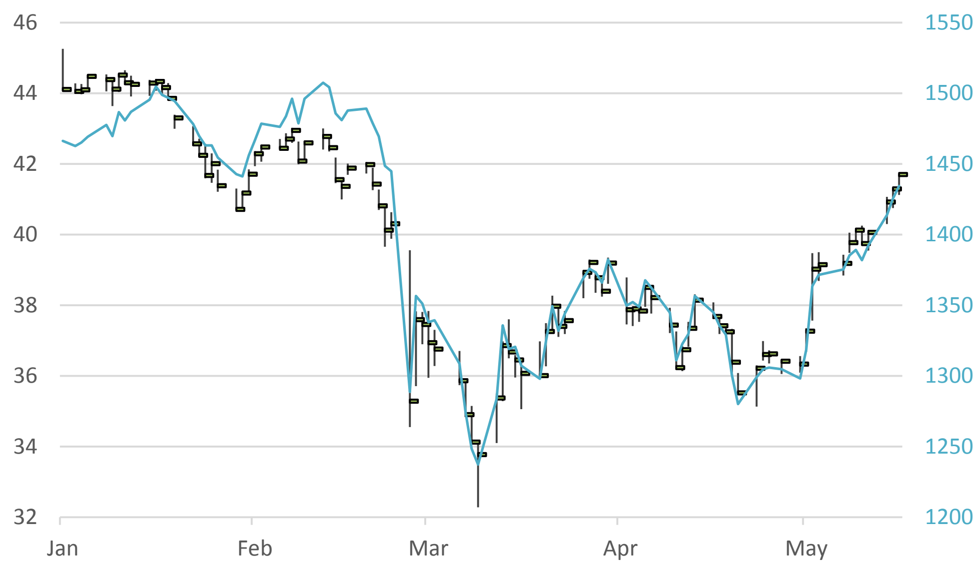
Donald Luskin

The dramatic rebound across emerging markets sends a strong global growth signal.

The Russian equity market and the ruble have recovered from the crash they experienced at the onset of the Ukraine crisis. It's even better in USD terms, because the ruble has recovered even more substantially (please see the chart below). On a local currency basis, the MICEX Index is up 21.3% from its March lows. In USD, it is up 29.0%.

— MICEX Index in USD — In local currency



Source: Bloomberg, TrendMacro calculations

- A couple days before the very bottom we called for buying Russian stocks and the ruble (see "Crimea Doesn't Pay" March 11, 2014), when the MICEX Index's equity risk premium suddenly expanded to rival China's as the most equity-friendly in the world (see "Crimea Doesn't Pay" March 11, 2014). We were willing to bet that Russia's stock market collapse would be self-braking, putting limits on the Putin's military ambitions (see "Crimea River" March 4, 2014). And we bet that Europe would not be willing to pay the economic cost of massive sanctions against Russia for the sake of a failed state (see "Why Putin is Smarter than Stalin…" March 26, 2014, and "No Pain, No Ukraine" April 15, 2014).

Update to strategic view

EMERGING MARKETS STOCKS, US STOCKS: With the Russian stock market now more than completely recovered after its crash at the onset of the Ukraine crisis, we think it no longer represents a special speculative opportunity. Emerging markets overall have recovered brilliantly from their first quarter swoon, some of the supposedly most "fragile" making new all-time highs. While they remain as a class the world's most attractive equity risk premia, their performance is a signal that global growth is alive and well, contradicting supposedly contrary signals coming from US equity sector rotation.

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- We have never expected a great outcome for Ukraine as a nation -- it's a failed state now caught in the mercantilist crossfire between the ambitions of Russia and the European Union (see "Client Conference Call: Former US Ambassador to Ukraine Steven Pifer" May 2, 2014). Instead we have expected a political equilibrium between Russia and Europe in which a crippled Ukraine is made into a buffer-state -- which is where the situation is heading.
- This outcome is fully reflected in Russian equities now, so we no longer see a special speculative case for continuing to hold them.

On a related note, we see Russia's recovery as part of a larger counterpoint to the focus prevalent among US equity investors on the sharp underperformance by growthier sectors (see "Growth: Over Valued and Under Attack" April 9, 2014) and 10-year yields sharply lower since year-end (see "The Yellen Rule is Taylor Minus Two" May 19, 2014). It's not just that some of the risk has come out of the Ukraine situation. It's that at the same time, emerging markets across the board -- which can be thought of as the growth sector of the global economy -- have strongly pulled out of their first quarter swoon.

- Most equity markets of emerging nations show double-digit gains from their year-to-date lows, when we argued that -- as a broadly defined heterogeneous asset class -- they were a true value proposition, no longer a value trap (again, see "Crimea River").
- Two of the so-called "Fragile Five" -- India and South Africa -- and supposed perennial basket-case Argentina are now at all-time highs in local currency terms (the latter two, very nearly so in USD too, despite weak currencies).
- Still, by and large -- with the exception of India -- the emerging markets continue to offer the world's most attractive equity risk premia.
- With continued pessimism about China's growth and financial fragility, and continued talk that Fed tapering will deprive the emerging markets of cheap funding, this performance is all the more extraordinary, and all the more encouraging that what might have been signs of slowing global growth reflected in US equity sectors are a false signal.

Bottom line

With the Russian stock market now more than completely recovered after its crash at the onset of the Ukraine crisis, we think it no longer represents a special speculative opportunity. Emerging markets overall have recovered brilliantly from their first quarter swoon, some of the supposedly most "fragile" making new all-time highs. While they remain as a class the world's most attractive equity risk premia, their performance is a signal that global growth is alive and well, contradicting supposedly contrary signals coming from US equity sector rotation.

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