Market & Investment Insights

Russia: too cheap to sell, too risky to buy

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- The Russian stock market is cheap, with one of the lowest price/earnings ratios in the world.
- Russia's conflict with Ukraine over the eastern region poses significant risks for investors.
- The risks posed by the conflict in eastern Ukraine and foreign sanctions make buying Russian stocks too risky for now.
- Those who already own Russian stocks should hold on, as they won't find a cheaper market to invest in.

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Amid a swirling international debate over the fighting in eastern Ukraine and the imposition of economic sanctions, Russian stocks have weathered some significant ups and downs. When fighting broke out in the region in February, the Russian stock market slumped to its lowest since 2009. Since then, however, Russian stocks have rebounded somewhat, as the fighting appears to be mostly contained and not likely to be the precursor to a much larger military conflict.

For investors, Russia's support for rebel fighters in the eastern Ukraine presents something of a dilemma: sell before international economic sanctions hit Russia's economy, or use the ultra-cheap valuations as an attractive entry point into one of the BRIC economies.

From our perspective, the best course of action is probably to do neither. Yes, Russian stocks are cheap. The benchmark Micex index currently sells at about 5.9-times earnings, making Russia one of the few countries with a single-digit price/earnings ratio according to data from ThomsonReuters. (China and Bulgaria are the only others). For those who already own Russian stocks, they are probably too cheap to sell right now.

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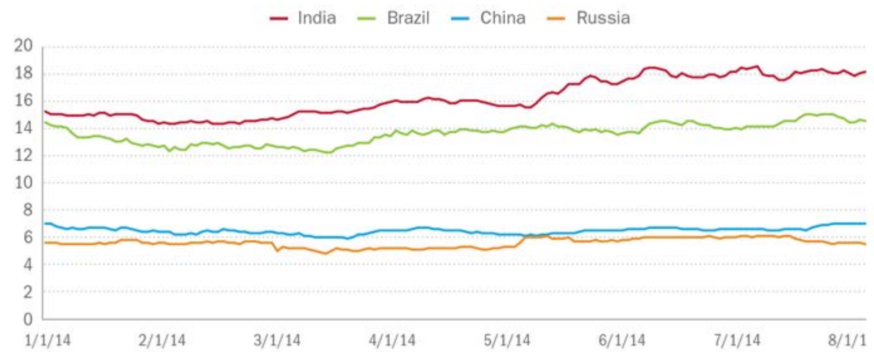
Price/Earnings Ratio for Russia and Other BRIC Countries, January–August 2014



Source: Haver Analytics

At the same time, the shifting political landscape and the threat of tightening economic sanctions makes Russia too much of a risk for new investment. Russia's economy has been losing steam lately, with growth slowing to 1.3% in 2013 from 3.4% in 2012, as a lack of economic reforms weigh down both business and consumer confidence. Also, Russia's heavy reliance on oil for growth has become something of a liability as oil prices have stagnated. Because the outcome of the conflict in eastern Ukraine is impossible to predict, the World Bank has developed two scenarios for the 2014-2015 period. If the conflict is short-lived and contained, growth will probably slow to 1.1% in 2014 and pick up slightly in 2015 to 1.3%. If the conflict gets larger, Russia's economy will probably contract by 1.8% in 2014.

In either case, Russia will have to implement economic reforms if it is to raise consumer and investor confidence, according to the World Bank. These include moves to attract private investment and to improve the quality of regulatory and market institutions. The government's need to manage the conflict with Ukraine, however, makes it less likely new reforms will be enacted soon.

Overall, the situation in Russia is not conducive to taking a strong position right now. Those who think the Russian stock market's low valuation is attractive may find the market trading at an even lower valuation in the months ahead. And those who want to get out won't find anywhere cheaper to get back in.

Please note investments in foreign securities are subject to special risks, including currency fluctuation and political and economic instability.