Russia Shoots A BRIC

This is a business obsessed with signs and indicators. Some are free for the taking, such as selling a retailer after they open a store on Fifth Avenue or selling any firm that buys the naming rights to a sports stadium. Another good one is any investment idea worthy of an acronym will turn into a bubble and will burst accordingly.

The problem with all investment bubbles, of course, is you should ride each and every one beyond the point of reason, and you should never, ever try to pick the top or bottom. Markets move further and faster than we ever think possible – consider the course of crude oil prices over the past sixteen months – and campaigning on the side of rampant ignorance is the way to go. Investors made serious money in the dotcom bubble and more recently in the commodity bubble; the trick is getting out after the turn and not worrying about selling the absolute top.

Take the BRIC fantasy, please. This combined both an investing bubble and another one of those telltale signs Zeus is warming up in the bullpen and soon will be ready to come in hurling thunderbolts, a catchy acronym. The only commonality between Brazil, Russia, India and China was their inclusion in this quartet, but why let that stop you? The total return on the Dow Jones BRIC 50 index between January 2006 and May 2008 was more than 150%; too bad the total return since has been -61%.

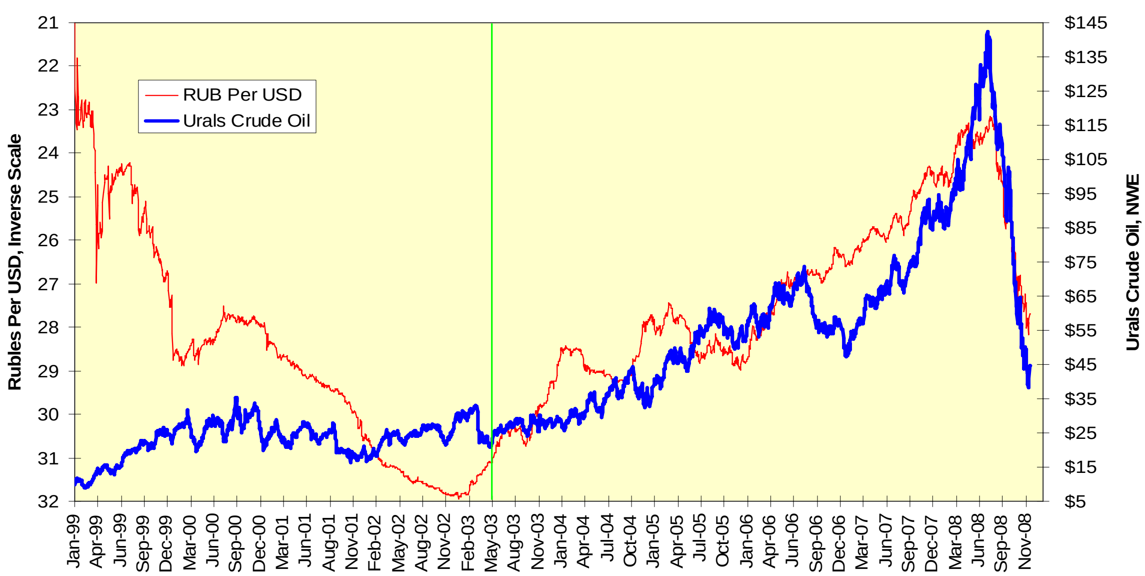
From Russia With Love

As is so often the case with things Russian, we have a troika with which to deal, the Russian stock market, the ruble and the source of so much of the country's export wealth, crude oil. We also have a complicating factor, Russia's economic intimacy with the Eurozone to its west. While much of the country's exports are priced in dollars, much of the country's imports come not from dollar-bloc countries but rather from euro-bloc countries.

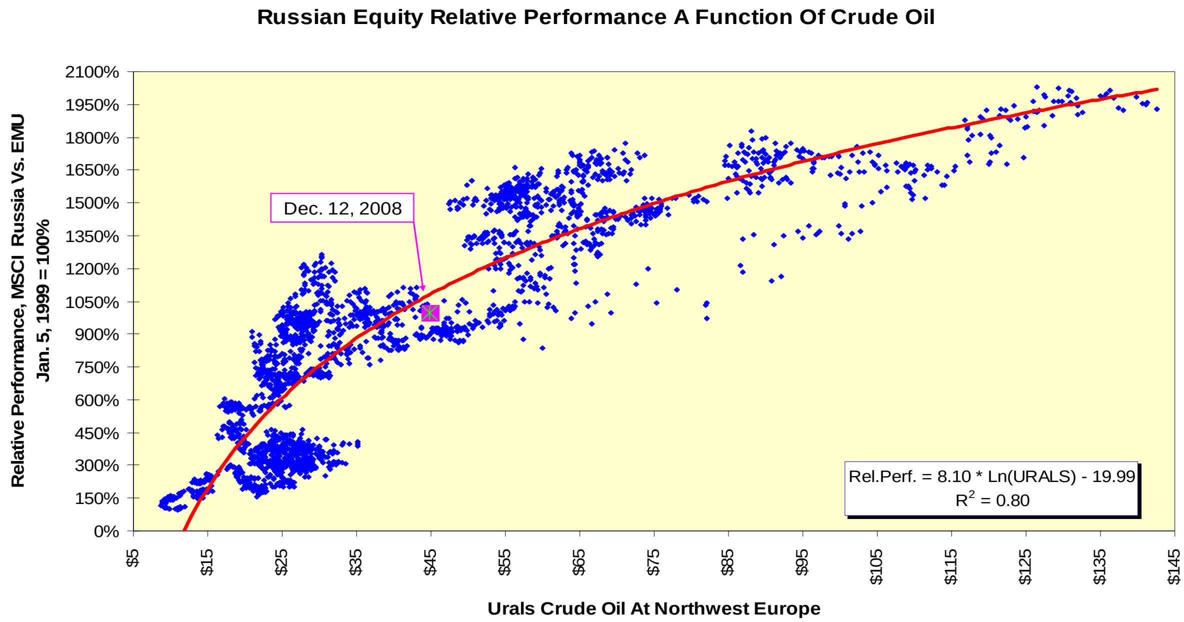
We have to shift back and forth in discussing the ruble between the ruble-dollar rate and the ruble-euro rate. A very strong argument can be made the latter is the more important of the two exchange rates, but we will not delve into that here.

What we can say with great certainty is the ruble-dollar rate started to match the price of Russia's benchmark Urals Blend crude oil exported to the refining centers of northwest Europe after the Federal Reserve's first declaration of war on deflation in May 2003, marked with a green line in the chart; they since have declared war on inflation at least once and on deflation a second time, but that is a topic for another day.

The Ruble/Dollar Rate And Crude Oil



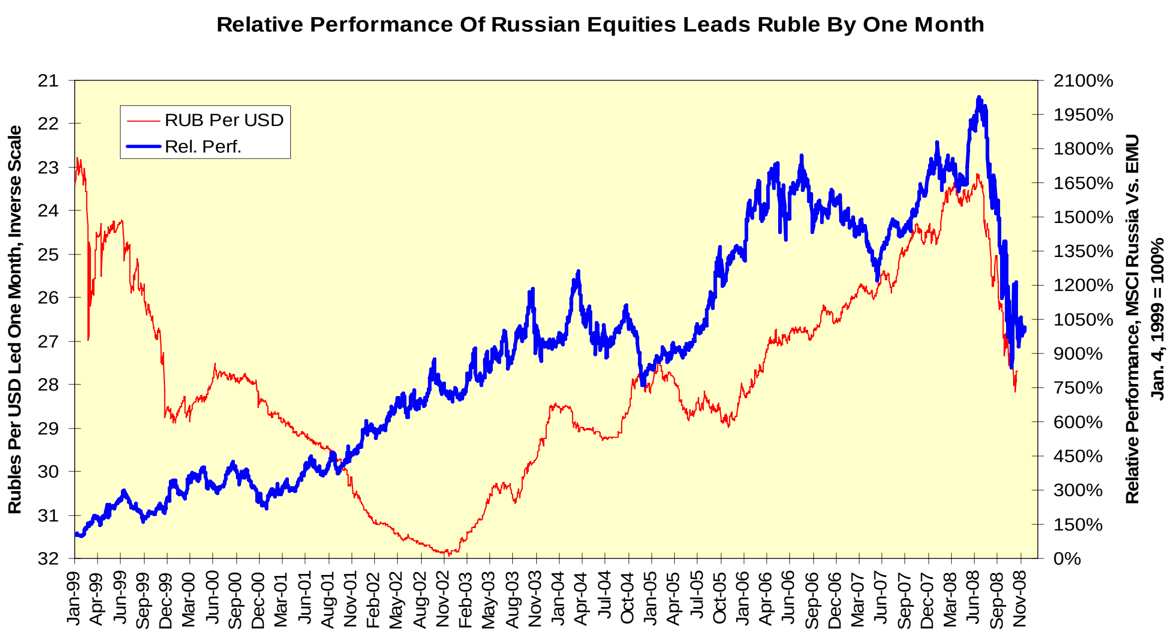
What about the connection between this crude oil's price and the relative performance between the MSCI Russia and Eurozone indices measured in U.S. dollars? That turns out to be a logarithmic one; as the price of crude oil rose in 1999 and 2000, the relative performance of Russian equities really accelerated; by the time crude oil hit its bubble phase, the relationship turned more linear. The current data point is at an interesting juncture; it indicates any further downside in crude oil prices will be met with a relative collapse of Russian stocks relative to their Eurozone counterparts. The opposite is true as well; a rebound in crude oil prices should lead to Russian stocks outperforming Eurozone stocks.



The Currency Connection

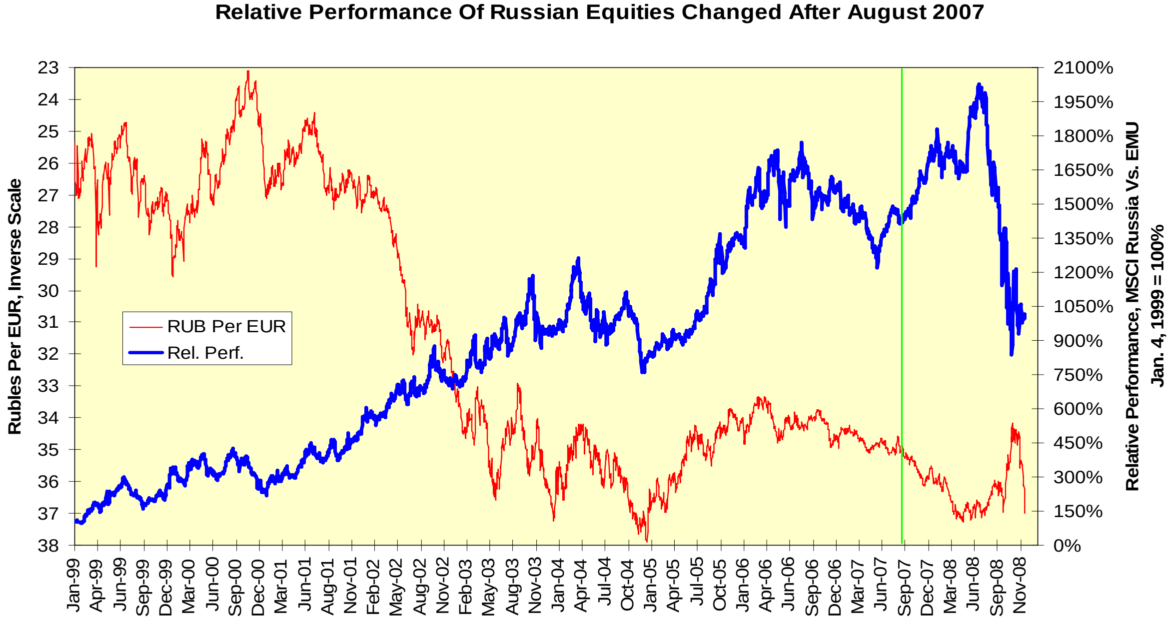
Now let's take a look at the relative performance of Russian markets as a function of the ruble's exchange rate against both the dollar and the euro. As the dollar-euro rate has been quite active since the inception of the common currency almost ten years ago, we should expect to see different pictures, and we do.

In the case of the dollar rate, we see a one-month leading relationship between relative equity performance and the exchange rate. That relationship started out very loose and has become tighter and tighter with time; it depicts a classic case of flows chasing performance. As Russian stocks surged with higher oil prices and the BRIC bubble, dollar-denominated investors became increasingly willing to swap their dollars for rubles to buy Russian stocks. Once the bubble burst this past summer, those same investors had no problem reversing the trade; they sold Russian stocks and the ruble and repurchased their dollars.



The picture vis-à-vis the euro is different, and has gone through several phases. The one operative since the Federal Reserve began addressing the credit crunch in August 2007, marked with a green line on the chart, has been a muddled combination related to both the commodity boom and bust and to the Russian equity boom and bust.

Please note how Russian stocks initially outperformed European ones while commodities surged and the ruble weakened against the euro. Then the relationship shifted to Russian outperformance while commodities fell and the ruble strengthened, and then, finally, into the present trading range in a combination of commodity and ruble weakness.



A chart like this should be instructive to analysts who confine their indicators to a short period of time and to single-variable models. The world can be a very messy place, and those who want simple answers are likely to pay for them with poor results.

What, then, should an American investor do, if anything, about Russian equities? The answer is very simple. If you think the global economic downturn is about to end, that crude oil prices are about to rebound, that risk aversion is a thing of the past, that Russian respect for private property and contract law, now at levels Hank Paulson could admire, is about to increase, then by all means put a 2006 calendar back on your desk and start buying Russian ETFs such as the Market Vectors Russia ETF.

Otherwise, simply stay away from Russia. Bubbles, once burst, do not re-inflate for a long time.