THE RUSSIAN STOCK MARKET IN 2015: RETURNS, LIQUIDITY AND THE DRIVERS OF CHANGE

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In 2015, faced with declining oil prices, the weakening ruble and the outflow of funds of foreign portfolio investors, the Russian stock market found itself in a slump; in fact, this situation has started eight years ago, during the 2008 crisis. This negative trend was augmented by the continuing decline of the share market's liquidity in the Moscow Exchange. This was in part a reflection of the general downward trend in the investment attractiveness of the stock markets in the BRICS countries, but more specifically – the upshot of the troubles experienced by Russia's economy due to the low development level of domestic institutional investors. The conservative attitude towards investment in Russian shares displayed by foreign portfolio investors for a period of more than two years already is indicative of their doubts with regard to the prospects of economic growth in Russia. In view of such conditions, the economic growth and recovery in the Russian stock market can rely only on the domestic savings system.

Rates of return in the share market in the post-crisis period

The year 2015 saw a continuation of the longest slump in the history of Russia's stock market, which had started in May 2008. In 1997–1998, after the RTS Index had dropped by 91.3%, and the MICEX Index – by 73.0% from their pre-crisis highs over a period that lasted slightly more than a year, they both managed to recover their former quotes in 58 and 8 months respectively (*Table 1*). Now, after having plummeted over 6–8 months starting from June 2008, both these stock indices have never recovered: the MICEX Index over the period of 85 months, and the RTS Index – 83 months.

Table 1

THE FINANCIAL CRISES OF 1997/98 AND 2008/09 IN RUSSIA AND THE SUBSEQUENT MARKET RECOVERIES (AS OF 31 DECEMBER 2015)

	1997/98 crisis	2008/09 crisis
1. Decline from peak		
1.1. Depth, %		
RTS Index	-91.3	-78.2
MICEX Index	-73.0	-68.2
1.2. Length, months		
RTS Index	14	8
MICEX Index	13	6
2. Recovery, months		
RTS Index	58	83
MICEX Index	8	85

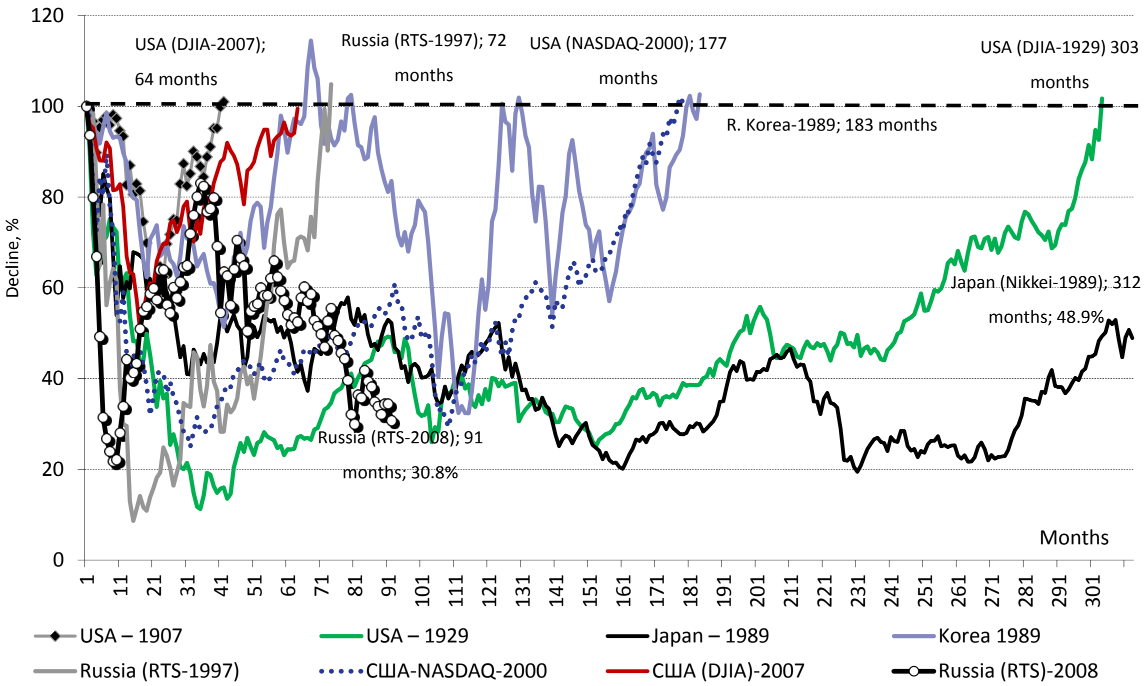
Source: authors' calculations based on data released by the Moscow Exchange.

The length of slump in the Russian share market has already exceeded that of the short-run cyclical crises in the capital market (US major market indices in 1907 and in 2007–2008; in Mexico in 1994; in Indonesia, Brazil and Russia from 1997 onwards, etc.). By now, the trajectory of changes in the RTS stock index has become W-shaped, which is typical of countries where financial crises are caused by structural disproportions in the national economy, as exemplified by South Korea from 1989 of the US market for shares in hi-tech innovation companies from 1999 (*Fig. 1*). The recovery after such a crisis usually takes a longer period of time.

As of 31 December 2015, RTS Index, having climbed to 30.8% of its pre-crisis peak of May 2008, is now set to reach a new low. In January 2009 it had dropped to 21.8% of its 2008 record high. The current slump in the market for shares issued by Russian companies has continued for 91 months in a row, while after its collapse in 1997, the RTS Index managed to recover within 72 months.

The two most notorious medium-run crises with W-shaped trajectories – that of shares in South Korean companies and of NASDAQ in USA, with their onsets in 1989 and 2000 respectively, lasted for 183 and 177 months respectively. In other words, their durations are approximately twice as long as the duration of the current slump in the Russian share market. The longest crisis cycles in the history of stock markets are the slump in the US stock market triggered by the Great Depression of 1929–1933 and that in the market for Japanese shares from 1989 onwards. The recovery of the stock index Dow Jones Industrial Average (DJA) after the Great Depression took 303 months. In 2015, that record was broken by the Japanese index NIKKEI-225, which as of December 2015 had been unable to recover its initial quote for 312 onths in a row, amounting to only 48.9% of its monthly record high of 1989.

The slowness of the Russian stock market's recovery reflects not only the specific issues faced by Russia's national economy and finance, but also the challenges that are common for most of the BRICS countries. Prior to the 2008 crisis global economy's accelerated growth had been sustained in part by cer-



Source: authors' calculations based on data released by the Moscow Exchange and www.finance.yahoo.com.

Fig. 1. The Depth and Length of Long-term Financial Crises around the World, as of 31 December 2015 (peak = 100%)

tain irrational factors like excessive lending that boosted consumer demand and the housing market in many developed countries or active government support of exports to the detriment of domestic demand in the rapidly growing Asian economies. At the same time, governments were increasing their interference in the investment sphere and the production and supply of energy resources in the developing countries, thus imposing constraints on the market investment mechanism. Coupled with the objective factors in the development of the global economy and the increasingly prominent role of the developing countries, in the 2000s all this gave rise to the phenomenon known as 'global saving glut'[1], when the domestic savings generated in the developed countries transformed into investment in the developing economies. Net foreign capital inflow in the BRICS countries triggered growth in their domestic markets for shares and bonds.

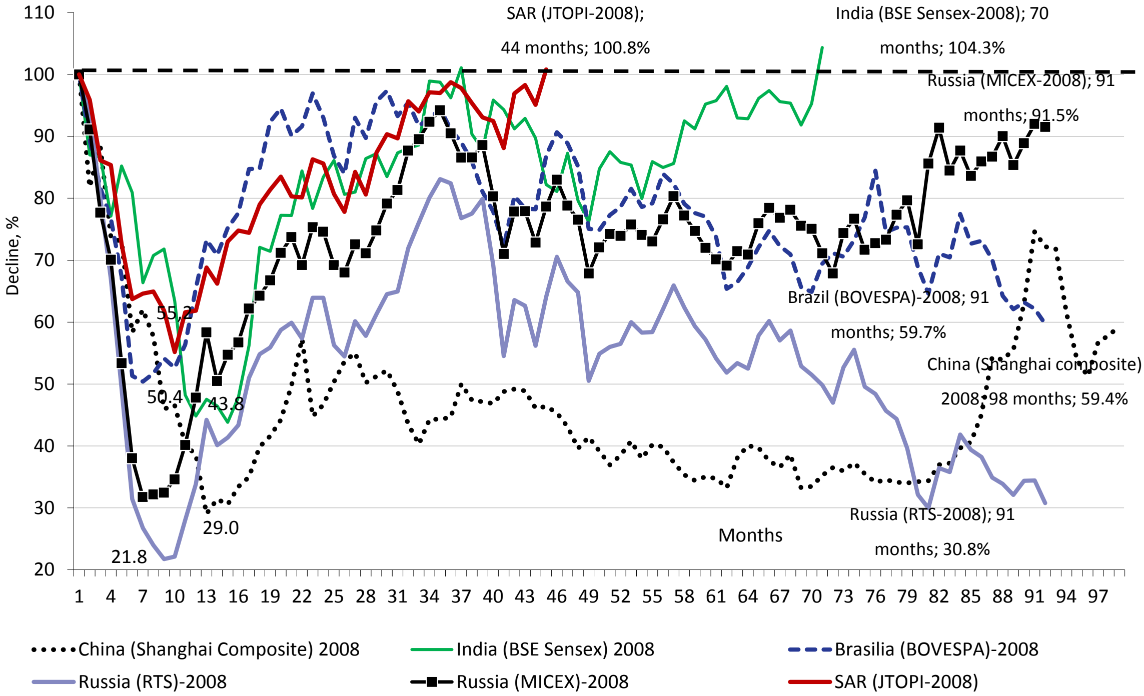
The 2008 crisis and the efforts to control its consequences resulted in a transformation of that phenomenon. The USA and the other developed countries launched the reindustrialization process, introduced a tougher regulation of risks associated with lending and the provision of funding for mortgage loans. China and other Asian countries experienced problems caused by the slower growth of their exports and understood the necessity to reorient their economies to domestic demand. The 'shale revolution' (primarily in the USA), alongside the slowdown in global economic growth resulted in overproduction in the countries that were the principal producers of natural gas and oil, plummeting prices for energy resources, and rising competition for shares in the market for oil and gas. As a result, the BRICS countries were faced with the need for reorientation of their domestic economic growth models, foreign capital outflow, declining returns and increasing volatility of domestic stock markets. Thus, for example, the UNCTAD over the next few years expects an outflow of investment from the developing and transition economies towards the developed countries[2].

As of the end of 2015, the Brazilian stock index Bovespa over the previous 91 months since May 2008 had gained only 59.7% of its pre-crisis peak quote; the Zhenjiang Composite Stock Exchange Index (China) over the previous 98 months had gained 59.4% (*Fig. 2*). Russia's RTS index that reflects the behavior of the value of shares denominated in foreign currency over 91 months had fallen lowest among all of the BRICS member states – to 30.8% of its pre-crisis peak value. Over the same period, the ruble-denominated MICEX index, due to the plummeting ruble-to-USD exchange rate in 2014–2015, gained 91.5% of its record high of May 2008. Among the BRICS countries, the easiest post-crisis recovery was demonstrated by the share markets in India and SAR. The indices of the Johannesburg Stock Exchange (JTOPI) and the Indian Stock Market (BSE Sensex) regained their pre-crisis quotes over 44 and 70 months respectively.

In 2015, by comparison with the other countries, Russia's stock market displayed moderate results (*Fig. 3*). The RTS Index, which describes the value of shares in Russian companies denominated in USD, declined by 4.3%, while the MICEX Index, thanks to the decline by 29.6% of the

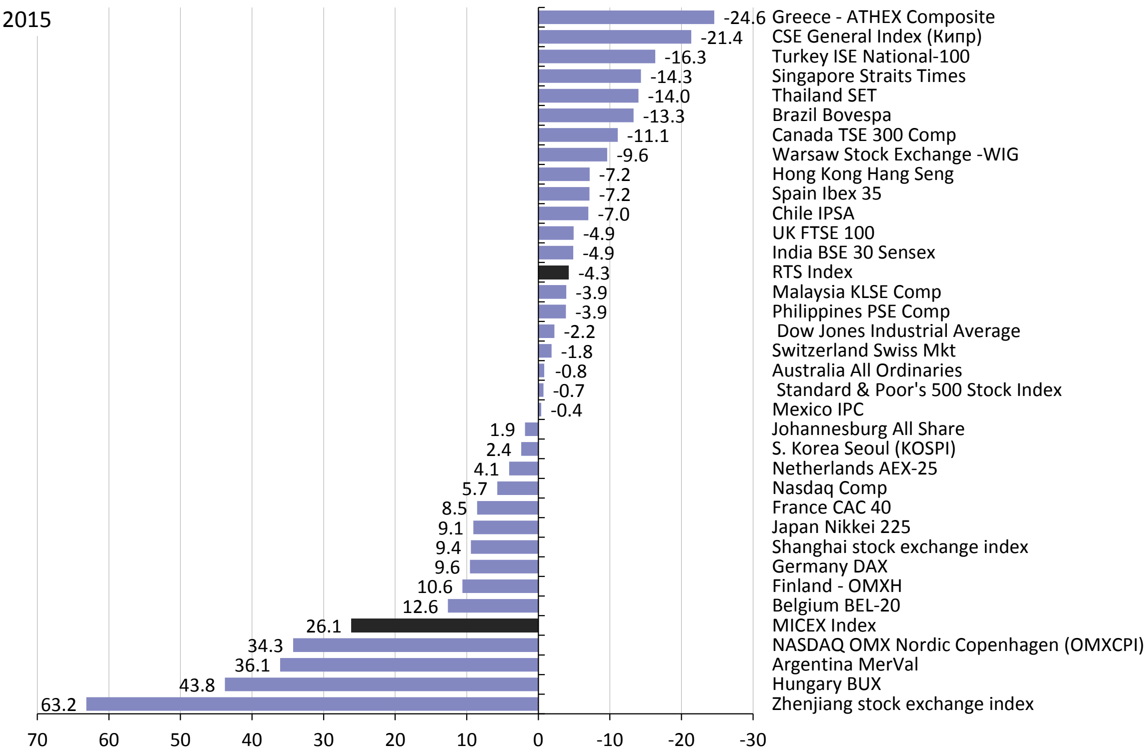
1 The Global Saving Glut and the U.S. Current Account Deficit. Remarks by Governor Ben S. Bernanke At the Homer Jones Lecture, St. Louis, Missouri. April 14, 2005: http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm

2 World Investment Report 2014: Investing in the SDGs: An Action Plan UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD), 2014.



Source: authors' calculations based on data released by The Wall Street Journal and Thomson Reuters Eikon.

Fig. 2. Depth and Length of the Current Financial Crisis in the BRICS Countries as of 31 December 2015 (peak = 100%)



Source: authors' calculations based on data released by The Wall Street Journal.

Fig. 3. Rates of Return of the Stock Indices on the World's Biggest Exchanges in 2015, % per Annum

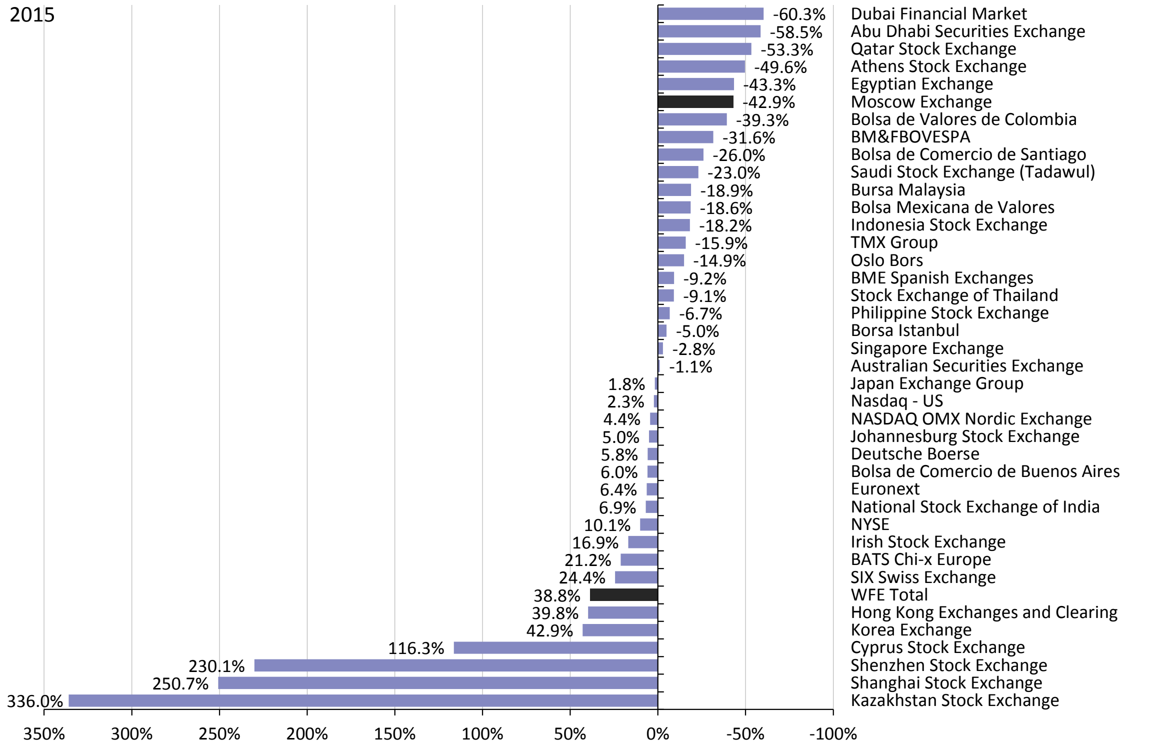
ruble-to-USD exchange rate, rose to 26.1%. The leaders in growth were the following stock indices: Argentina's MerVal, Hungary's BUX, and China's Zhenjiang Composite Stock Exchange Index, which gained in the course of that year 36.1%, 43.8% and 63.2% respectively. The worst results were demonstrated by Turkey's ISE National-100, Cyprus's CSE General Index and Greece's ATHEX Composite, which over that year lost 16.3%, 21.4% and 24.6% respectively.

Liquidity Trends in the Share Market

In 2015, world exchanges were demonstrating some serious changes in liquidity in the markets for shares, measured as the volume of market (or auction) transactions in corresponding securities (*Fig. 4*). This index is important in that it not only reflects the market activity of domestic and foreign investors, but also predetermines the pricing of shares traded on the exchanges. Over the year, for all the exchanges reporting their data to the World Federation of Exchanges, the average growth in the volume of market transactions amounted to 38.8%. However, while many exchanges, and first of all those in the countries relying on their exports of energy resources, experienced a marked reduction in the volume of market transactions, in some other exchanges (predominantly in the countries across the Asian region) the value of such transactions surged. The Moscow Exchange was one of the six securities market operators where the plunge in the value of market transactions in shares was the deepest – by more than 40% in dollar terms. In 2015, the value of market transactions shrank in the Dubai Financial Market by 60.3%, at the Abu-Dhabi Securities Exchange – by 58.5%, at the Qatar Stock Exchange – by 53.3%, at the Athens Stock Exchange – by 49.6%, at the Egyptian Exchange – by 43.3%, and at the Moscow Exchange – by 42.9%. This means that in the situation of a long-run decline of the prices and demand for oil, the domestic and foreign investors operating in these exchanges have significantly reduced both their purchases and sales of shares issued by national companies.

The six exchanges displaying the fastest growth in the volume of market transactions in shares (by 40% or more) are the Hong Kong Stock Exchange, the South Korea Stock Exchange, the Cyprus Stock Exchange, the Zhenjiang Stock Exchange, the Shanghai Stock Exchange and the Kazakhstan Stock Exchange. The last thee exchange are noteworthy in this connection. The increased volume of exchange transactions (by 2.3 times at the Zhenjiang Stock Exchange and by 2.5 times at the Shanghai Stock Exchange) had largely to do not only with liberalization in the currency market and the access to the domestic market for shares granted to foreign investors, but also the high volatility of the Chinese market, which displayed rapid growth over the first half year, followed by a significant downfall over the second half year. In 2015, the highest growth rate in the market for transactions in shares – by 3.4 times – was demonstrated by the Kazakhstan Stock Exchange (KASE). This can be explained in part by the low initial rates, but the other relevant factors were the introduction of new listing rules designed to encourage the participation in trading of foreign brokers and the launch of the People's IPO program.

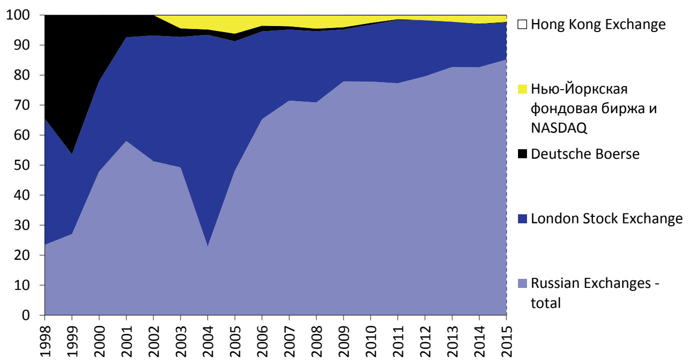
In 2015, in terms of its overall trade in shares, including all modes, the Moscow Exchange managed to retain its role of a major organizer of trading in equity financial instruments (shares and depository notes) of



Source: authors' calculations based on data released by The Wall Street Journal and the World Federation of Exchanges.

Fig. 4. Rates of Return of World Stock Indices and the Volume of Market Transactions in Shares (Anonymous Market) at Exchanges in 2015, % per Annum

Russian issuers (*Fig. 5*). The share of the Moscow Exchange in these transactions increased from 82.6% in 2014 to 85.2% in 2015. The relative shares of the London Exchange, the Hong Kong Exchange, Deutsche Boerse and the two biggest US exchanges shrank. If we look only at the volume of market transactions in shares, the relative share of the Moscow Exchange in the total volume of trade in equity financial instruments of Russian issuers would appear to be somewhat more modest, but nevertheless it increased from 45.4% in 2014 to 48.9% in 2015. However, in this case the increased share of the Moscow Exchange in the trade in equity financial instruments – even given the significant shrinkage of the volume of trade in shares in absolute terms is indicative of the diminishing interest of the global investors operating in foreign exchanges in the depositary receipts issued by Russian companies, rather than of any positive shifts in the ongoing competition between the exchanges.



Source: authors' calculations based on data released by Russian and foreign exchanges.

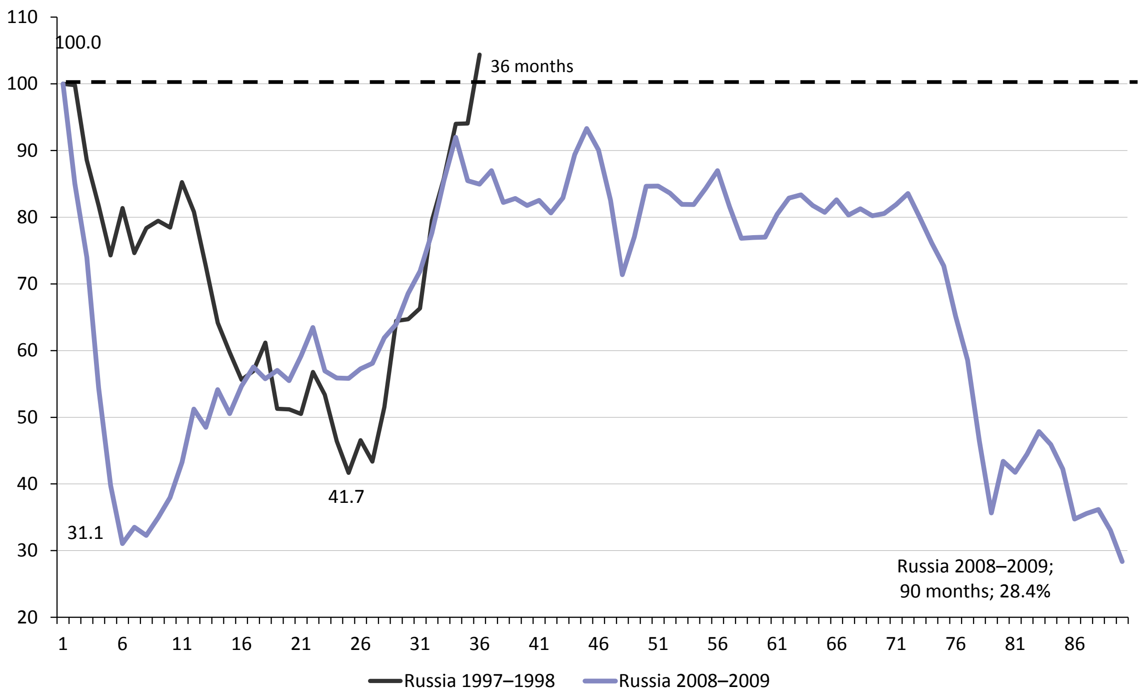
Fig. 5. The Relative Shares of Exchanges in the Volume of Trade in Shares Issued by Russian Joint-Stock Companies in 1998–2015

Factors Determining the Market's Behavior

Among the macroeconomic factors, the strongest influence on the behavior of the Russian market for shares is exerted by oil prices and the exchange rate of the ruble against major foreign currencies. It is these two factors that have been responsible for the differences in the market recovery rates after the 1997–1998 crisis and the protracted recession after the 2008 crisis.

The decline of oil prices in 1997–1998 was relatively short-run: over just two years, oil prices gradually fell to 41.7% of their pre-crisis peak, and then over a period of approximately one year climbed to their previous level (*Fig. 6*). The entire cycle of decline and recovery lasted 36 months and was described by a V-shaped curve. The curve describing the behavior of oil prices from July 2008 was shaped differently. At first, for 8 months in a row, oil prices dropped to 31.1% of their pre-crisis peak, but thereafter, over a period of two years, they began to rise following a V-shaped curve, which resembles the dynamics of the previous crisis. However, stopping short of their complete recovery point, oil prices resumed their long-run downward slide. As a result, as of 31 December 2015, 90 months after the onset of their decline, they hit a new record low at 28.4% of their pre-crisis peak, and the curve describing their movement became W-shaped, where the second bottom point had not yet been reached. All this predetermined the long-run character of the slump-like movement of the RTS Index (denominated in USD similarly to oil prices), which after the 91-month period since May 2008 has been following a W-shaped curve, which tested in 2015 its second bottom at the level of 30.8% of its pre-crisis peak.

Another factor, which has a stronger influence on the difference in the movement of the RTS's indices, where stock quotes are denominated in USD, and the MICEX's indices are calculated on the basis of the ruble-denomi-



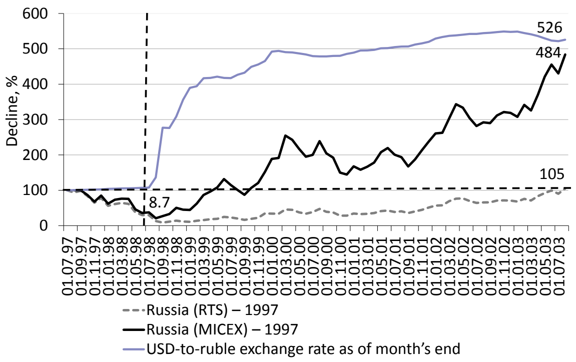
Source: authors' calculations based on data released by IFS IMF.

Fig. 6. The Downfall and Recovery of the Price of Brent Crude During Financial Crises in Russia (Peak Price =100%), As of December 2015

nated quotes of the same issuers, is the behavior of the ruble's exchange rate against major world currencies. As shown in *Table 1,* over the period 1997–1998 the ruble-denominated MICEX index hit the bottom of its trajectory within 13 months, and then recovered within only 8 months, that is, the entire cycle took only 21 months (*Fig. 7a*). The RTS Index denominated in US dollars declined together with the MICEX Index for 14 months, but then its recovery period lasted 58 months. Thus, the downfall-recovery cycle of the RTS Index was 72 months. This significant difference between the periods of recovery of these two indexes can be explained by the instantaneous 4-fold depreciation of the ruble from August 1998 onwards. It is thanks to this factor that the recovery of the MICEX Index took only 8 months.

After the 2008 crisis, the upward movement of the MICEX Index was for a long time as slow as that of the RTS Index. From May 2008 onwards, over a period of 7–8 months, the ruble lost 50% in value due to its controlled devaluation (*Fig. 7b*). However thereafter, with a varying degree of success, the ruble's exchange rate against major foreign currencies remained relatively stable until September 2014. In this case, both the MICEX Index and the RTS Index were almost synchronous in their movement: during the short-run acute phase of the crisis from May 2008 they declined to 31.8 and 21.8% of their pre-crisis peaks respectively. Then, during the period of a relatively stable exchange rate of the ruble against major world currencies, being pushed by the fluctuations of oil prices, the MICEX Index and the RTS Index first climbed to 94.2% and 83.1% respectively of their pre-crisis peak values, and later resumed their downward movement. From October 2014, against the backdrop of an accelerated decline of oil prices, the Bank of Russia decided to abstain from any intervention in the foreign exchange market. So the ruble's exchange rate plummeted, amounting as of the end of 2015 to 307.0% of its value as of May 2008. The ruble's weakening, which accelerated from October 2014, pushed the movement of the MICEX Index and the RTS Index onto two different trajectories. In 2015, the MICEX Index due to the 3-fold depreciation of the ruble regained 91.3% of its record high of May 2008, while the RTS Index declined towards its new historic low, to 30.8% of its pre-crisis peak.

Beside oil prices, an important factor influencing the cyclical behavior of the RTS Index is the changing outflow and inflow of funds supplied by foreign portfolio investors, which is described by data released by Emerging



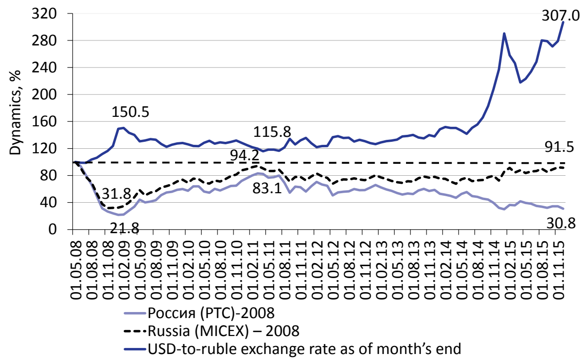


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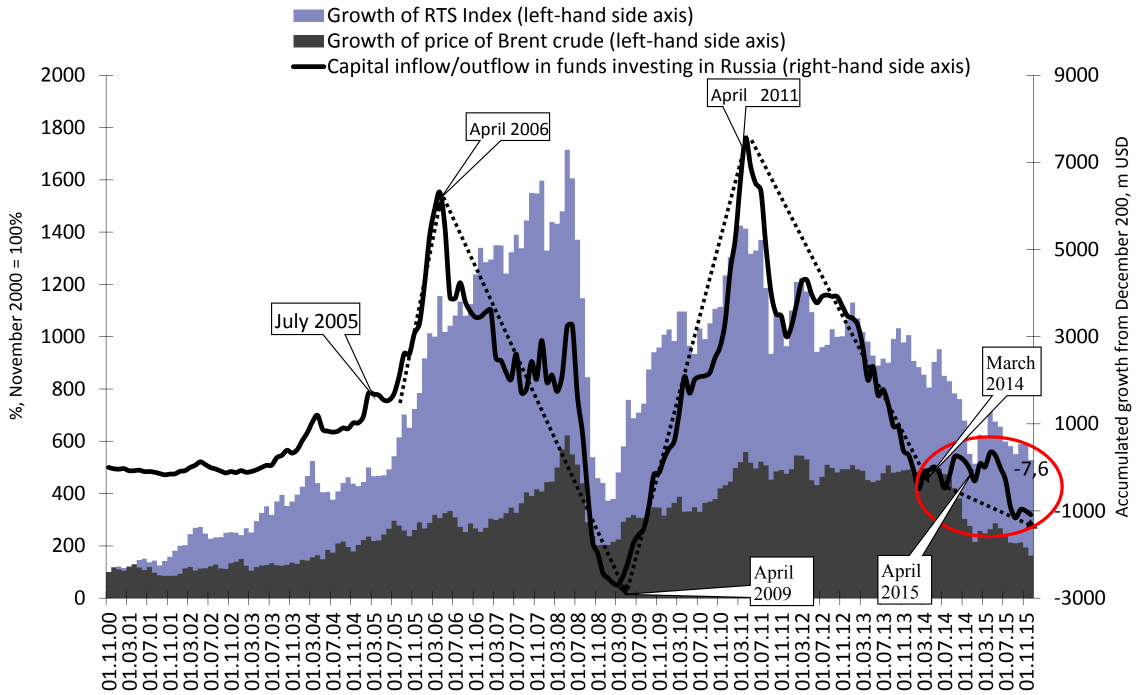
Fig. 7. The Movement of the USD-to-Ruble Exchange Rate, the RTS Index, and the MICEX Index During the 1997–1998 Crisis and After 2008 (Peak Price = 100%), As of 31 December 2015



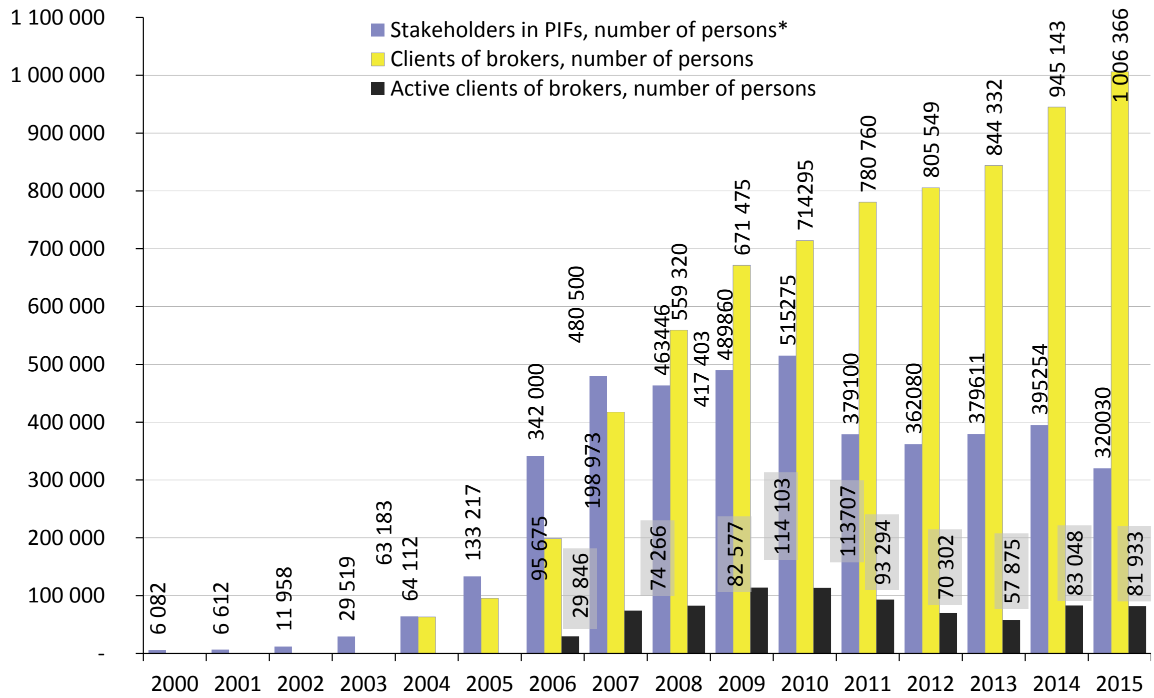
Source: authors' calculations based on data released by IFS IMF, the Moscow Exchange and EPFR.

Fig. 8. Growth of the RTS Index and the Price of Brent Crude, Capital Inflow (Outflow) to/from the Funds Investing in Russia, Calculated by the Accrued Total Method, from November 2000 through December 2015

Portfolio Fund Research (EPFR). The graph depicting the changes in accumulated money flows from the foreign funds specializing in investment in Russia (Russia-EMEA-Equity), which is shown in *Fig. 8*, indicates that major fluctuations in the behavior of foreign investors occurred in May 2006, 2009, 2011, April–May 2014, and May 2015. Thus, from November 2000 through April 2006, these funds received $ 6.3bn from investors; from May 2006 through April 2009, $ 9.0bn was withdrawn from the funds; from May 2009 through April, the funds received $ 10.3bn; from May 2011 through April 2014, $ 7.7bn was withdrawn; from May 2014 through April 2015, $ 0.5bn was received from investors; and finally, from May 2015 through December 2015, private investors once again withdrew their money from the funds to the value of $1.0bn.

So far, Russia's domestic market for shares has not relied on the mass-scale potential of private investors. The number of individual investors (the clients of brokers on the Moscow Exchange) increased from 945.1 thousand in 2014 to 1,006.4 thousand in 2015, or by 6.5% (*Fig. 9*). However, the number of active clients – that is, those who completed at least one transaction per month on the Moscow Exchange, in 2015 declined from 83.0 thousand to 81.9 thousand, or by 1.3%. Although in the second half year of 2015 there was an inflow of some new capital from the clients of open-ended and interval pension investment funds, the number of clients of these pension investment funds (PIF), according to data released by the Expert-RA rating agency, shrank from 395.2 thousand in 2014 to 320.0 thousand as of the end of the 9-month period, or by 19.0%.

In 2015, the most noteworthy event in the sphere of private saving was the launch of individual investment accounts (IIA). According to data released by the Moscow Exchange as of the end of January 2016, brokers had opened



** The data released by Expert PA for 2015 are as of 1 October 2015.*

Source: authors' calculations based on data released by the Moscow Exchange, the National League of Asset Managers, and the Expert RA rating agency.

Fig. 9. The Number of Market Retail Clients of Asset Managers and Brokers

72,153 IIA, and also several thousands of accounts, according to our estimations, were opened by asset managers.

* * *

Thus, in 2015, in response to the steady decline in oil prices, the weakening ruble and the withdrawal of capital by foreign portfolio investors, the Russian share market found itself in the state of a slump, which had begun, in effect, 8 years earlier – at the onset of the 2008 crisis. This trend was coupled with the continuing loss of liquidity in the share market on the Moscow Exchange. In part, this was the upshot of the general trend in the BRICS countries, whose stock markets had been steadily losing their investment attractiveness. However, a more prominent role was played by the troubles experienced by the Russian economy, given the low development level of its domestic institutional investors. In contrast to the 1997–1998 crisis, the current phase of the financial crisis is not cyclical but structural in nature. That is why it is already noticeably longer than the previous financial crisis. The period of conservative attitude towards investment in Russian shares displayed by foreign portfolio investors, which has lasted for more than two years already, is manifest of their doubts concerning the prospects of economic growth in Russia. In view of such conditions, any hopes of economic growth and recovery in the Russian stock market can rely only on the domestic savings system. In 2015, in spite of the high volatility of the domestic financial market, the first positive results of the measures designed to boost the role of domestic investors began to be felt: more than 70 thousand citizens opened new individual investment accounts; a capital inflow in investment funds for retail investors became visible; the process of consolidation is continuing in private pension funds. The new financial market development strategy, which is being elaborated by the Bank of Russia, must make use of these new positive phenomena, so that Russian institutional and private investors could become the principal participants of Russia's domestic financial market.