

Onward, Comrades! 5 Priorities for a Resurgent Russia

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One hundred years after the Russian Revolution, the tsars and the USSR may be gone, but Russia itself is alive and well. With the US becoming more isolationist, Russia has a chance to revise its standing with the US and EU – but this time, as an equal.

Key takeaways

- President Putin sees the USSR's collapse as one of the world's greatest disasters, and he is using his country's proud national identity to re-establish its prominence not militarily, but economically
- Five priorities for the new Russia: turning around its economy, transforming its energy sector, flexing its geopolitical muscle, dealing with its demographic issues and locking down its leadership
- With reduced legal protections for international investors, many Russian assets will stay cheap, but Russia and many CEE nations offer sovereign debt with attractive yields

As Russia commemorates the 100th anniversary of the Russian Revolution, a major geopolitical event that shaped much of the 20th century, it is easy to imagine its citizens taking stock of what went right and what went wrong since the 1917 uprising. From our perspective, we see at least three enduring legacies from the past 100 years:

- *The failure of communism.* After the tsars were overthrown, Russia pursued a path to communism that was ideologically appealing yet economically unsustainable. Even China, long ruled by its Communist Party, seems to have found its capitalist heart.
- *Major military-industrial successes.* Russia's World War II defeat of Nazi Germany in the Ukraine came at a horrific cost and is still generally under-appreciated by the West. After the

war, the Union of Soviet Socialist Republics' technological feats in the space and nuclear races still rank among the 20th century's defining scientific achievements.

- *The systemic misallocation of resources.* As the Cold War raged, Russia kept its huge energy sector going to feed its defence efforts at the expense of its other markets and industries. Unable to keep up with the United States' 1980s-era "Star Wars" spending, the USSR eventually collapsed.

Russia on the rebound

Yet even though the Soviet Union rose and fell during the past 100 years, Russia itself is alive and well today. President Vladimir Putin – who has described the USSR's collapse as one of the world's greatest disasters – is using his country's sense of history and proud national identity to re-establish its prominence not militarily, but economically. Russia retains a great deal of influence over the "Stans" of Eurasia and other neighbouring countries, and it can still exercise its might even though it has been weakened by sanctions. With the US becoming more isolationist under US President Donald Trump, and with China's influence rising in the East, Russia sees an opportunity to revise its standing with both the US and the EU – but this time, as an equal.

Five priorities for the new Russia

So how will Russia celebrate its centenary with Mr Putin at the helm, and what will its new goals be? Here are five issues worth watching:

1 Turning around the economy

Many European countries – especially Italy, France and Germany – are keen to normalize trading relationships with Russia. Sufficient rapprochement would particularly benefit the economies of Central and Eastern Europe, which remain troubled by migration issues and the European Union's austerity measures.

Although Russia's economy is overly reliant on commodities, rising oil and gas prices could be an accelerating story in 2017. If additional government revenue slows Russia's two-year recession, consumer confidence and investment could rise as interest rates fall and the rouble strengthens. But without help from oil prices, Russia's economy should remain relatively dull, and weaker oil prices could create trouble in the coastal and interior regions. This is because Russia's economy is highly regionalized, with more than one-fifth of its wealth generated in and around Moscow. The central government may face regional resentments as

it makes a tough choice between implementing additional austerity measures and reducing military spending.

2 Transforming the energy sector

Allianz Global Investors has been constructive on energy prices for some time, given the global factors of constrained supply and rising demand. If prices climb, Russia should see not only more government revenue but also more investment, as efficiencies developed in the US shale industry are put to work in Siberia's vast energy fields; the Bazhenov Shale alone is the size of the US! Still, Mr Putin will take pains to make sure the new Russia avoids the fate of the Soviet Union, so we expect him to move away from energy and revitalize the formerly strong industrial, space and technology centres that once competed with the US. Much of this can be accelerated with eager investment from Italian, French and German companies that have long-established ties to Russia.

3 Flexing its geopolitical muscle

The West is still struggling to recognize how badly Russia wants to be a major player on the global stage. For its part, the US and Russia are fast becoming "frenemies": Mr Putin has celebrated Mr Trump's presidential victory, and Mr Trump has expressed his admiration for the Russian leader. At the same time, there is growing scrutiny of pre-election contacts between their administrations and Russia's election-hacking efforts, and Russia still must navigate sanctions placed on its intelligence agencies on the eve of Barack Obama's exit from office. With its vast size, Russia can be engaged in many world theatres, though Crimea and Ukraine are its highest priority. If Mr Trump were to ease sanctions there, further rapprochement could be possible.

Syria, on the other hand, is of little strategic value to Russia; it merely offered an opportunity for a little muscle-flexing as the US prevaricated. While it is unclear how this conflict will be resolved, particularly with ISIS in the mix, the Middle East is another story. The battle for Mosul in Iraq rages on, and the regional Sunni vs Shia struggle could last another 25 years – with long-term repercussions for Eurasia as the conflict resonates across Islamic regions from central Africa to China.

Mr Putin may also forge closer ties with China, potentially to the detriment of the US. Both Russia and China face growing threats from radical Islam, and Russia should find it easy to support China's "One Belt, One Road" initiative, which aligns with its own economic prosperity. Elsewhere in the region, Mr Putin is trying to clear up historical legacy issues in Asia, including its disputes with Japan over Pacific islands.

4 Dealing with demographics

Russia will face a dramatic demographic crisis in its next 100 years. The consequences of a rapidly ageing society, low fertility rate and low life-expectancy rate are palpable. Change will require more than mere legislation, yet change is essential to the future health, prosperity and credibility of the nation. Russia's government is facing intense pressure to fix these social issues – pressure that would re-intensify if the price of oil were to fall again.

5 Locking down leadership

Russia has always prospered under strong leaders, but it isn't entirely unclear in which direction the Kremlin is headed. In late 2017 or early 2018, Russia will hold its first presidential elections in five years. Mr Putin has spent much of his time in office extending his rule, using sleight of hand from allies, but he now seems uneasy of his own political security; he has been removing any potential opposition to his authority and appointing not just loyalists, but people with no political identity or heft. These "political purges" – permitted under the pretence of fighting corruption – seem similar to what President Xi Jinping has been doing in China

ahead of his reappointment in late 2017. Will Mr Putin continue with his reign or will Russians wish to rejuvenate the presidency? This question will remain critical over the next few months.

Revolutionary reflections

One hundred years after the February revolution, Russia remains as Churchill once described it: "a riddle, wrapped in a mystery, inside an enigma". In the short term, there are questions about Mr Putin's strategy: Is he sincerely looking for a reliable, strong global partner in Mr Trump, or is he reckoning for a distracted US and a destabilized Europe to provide him with room to pursue his own agenda? Either way, Russia has serious domestic problems – including financial inequality, mass immigration and high unemployment – that echo the environment that gave rise to populism in the West. So while there may not be a new revolution during the centenary of the last uprising, unless Russia begins to re-define its future and its purpose for the post-Putin world, there may well be one on the horizon.

Key considerations for investors

- Many Russian assets are cheap and are set to remain so, since legal protections are not truly afforded to international investors.
- However, a lowering of trade and political tensions would offer European companies significant new market opportunities.
- Sovereign-debt issues from Russia and many CEE nations offer attractive yields in US dollar and local currency terms, and their underlying economies have potential to achieve the living standards of their EU cousins.
- With Eastern Europe thawing, European investors again have access to an interesting emerging market that offers growth potential at a time when de-globalization and trade frictions are causing sluggishness elsewhere.

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