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2018 World Cup in Russia

Investing in emerging markets
Special edition

Authors
Jérôme Audran
Michael Bolliger
Tilmann Kolb
Jorge Mariscal
Quentin Pilloud

Editor in Chief
Tilmann Kolb

Editors
Russell Comer

Project management
Corinne Fedier

Design and publishing
Michael Galliker
Werner Kuonen
Margrit Oppliger

Communication
Fabian Gmuender
Irene Milisenna

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Christine Novakovic
Head Europe, Middle East & Africa
UBS Global Wealth Management

Dear reader,

Every four years, the world displays great emotion as the beautiful game captivates audiences around the globe for an entire month. Russia will host this year's football World Cup, where, on 14 June a whistle at Luznhiki Stadium in Moscow will mark the start of the tournament. Visitors will have far more to marvel at than just the world's top footballers – Russia has a rich history, diverse culture, and majestic landscapes.

Unfortunately, Russia has been in focus in recent months not only because of the upcoming festivities, but also due to its deteriorating relations with the West. This includes the introduction of additional sanctions by the US, which has weighed on Russian assets.

But the upcoming tournament may serve to showcase the country and its people, over and above political differences. A laid-back and friendly atmosphere during the World Cup, cheering together in a stadium or at a public viewing, and celebrating the victors while respecting the vanquished offer ample opportunity to get to know other cultures. We experience this face of the Russian nation daily through our interactions with our Russian clients.

For all of football's passion, getting carried away by emotion is not a sound formula when investing, though. In this report, our Chief Investment Office combines its excitement for the game with a (recommended) cool-headed approach to investing. It takes a closer look at the economic impact of the tournament on the host country, some of the challenges Russia faces, and where it sees opportunities for global investors to seek exposure to Russian assets. And as is customary by now, the CIO also takes a shot at predicting the winner of the tournament.

I hope that you find this paper not only fun and enjoyable to read, but also valuable for your investment decisions.

The most exciting event of the year

With just a few weeks left until the opening game, it's time again to start talking about what many consider the most exciting event of the year: The World Cup.

This time, the tournament will take place in Russia. The opening game is scheduled for 14 June in the Luzhniki Stadium in Moscow. Russia's Sbornaya will meet the Falcons from Saudi Arabia. Looking at their rankings, this might not be the highest standing pairing of the tournament. We are absolutely sure, however, that the game will be followed with great excitement across the globe and that both teams will play with passion and grit for the first victory.

And the winner is…
As always, the tournament is an opportunity to tweak some of the modeling techniques we use in our daily work to the art of predicting the outcome of the competition. We are humble enough not to outright claim that Germany will win the tournament again, but our simulations indicate there is no other team with higher odds to lift the trophy than the defending champion. The list of likely contenders for the title is long, however. Besides Brazil and Spain, it includes England, France, and Argentina. And with Belgium, we even see a moderate possibility that a team might succeed which has not won the competition before. We could even see Brazil face its nemesis from 2014, Germany. While we hope that the best team wins, we also hope that the outcome is less devastating than last time, when our colleagues in São Paulo were depressed for several weeks afterwards.

Emerging hosts
After South Africa and Brazil, Russia will be the third emerging nation to host the tournament. If we add Qatar to the list, the host in 2022, the question can be asked whether great soccer nations such as Germany, France, England, Italy, or Spain have become tired of hosting the tournament, less appealing as hosts, or, whether they simply have run out of money to treat themselves to the luxury of such a costly endeavor.

The reality is probably more complex, but it likely includes the above arguments.

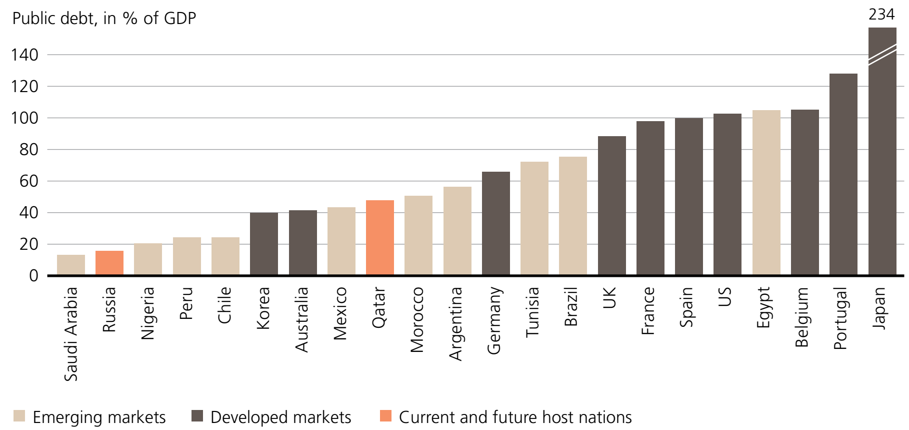
With 28 UNESCO World Heritage Sites, amazing natural diversity, and a rich cultural heritage, Russia has a lot to offer tourists. Yet, it attracts fewer visitors than smaller countries such as Malaysia, Turkey, or Mexico, not to mention tourist powerhouses such as France, Italy or Spain. Moreover, the benefit from investments in infrastructure should be higher in Russia than in many European countries. The estimated spending of USD 12 billion, a bit less than 1% of GDP, might have a higher investment return in Russia than in Spain, Italy, or France. Still, we doubt that it will boost Russian GDP significantly in the longer term.

Moreover, Russia can afford its role as a host with ease. Looking at public finances in the most football-savvy nations on each continent (Fig. 1), it shouldn't be too big a surprise that several developed nations might shy away from the extra spending involved in becoming a host nation. Instead, countries like Saudi Arabia, Nigeria, or Peru seem to have a lot more fiscal leeway to host upcoming tournaments.

Not without international controversies
That said, Russia's role as a host nation has resulted in significant controversy.

Fig. 1

Can your country's public finances afford the luxury of being a host?



Source: Fitch, UBS, as of April 2018

For a start, the naming of Russia and Qatar as host nations for 2018 and 2022 respectively, triggered several investigations, and ended in a wide-ranging crackdown on corruption in the sport. Although several senior officials have been banned from football, many feel that the tournament is still tinged with controversy. And then there is Russia's involvement in Syria, the accusation of meddling in foreign nations' democratic elections, international sanctions against the country, and the conflict in Crimea. Tension between Russia and the West has been rising for a while, and it is going to be difficult to de-escalate the situation in our view. We hope, though, that the the countries will use the tournament as an opportunity to build bridges. This would evoke the ancient Greek tradition of pausing all warfare during the Olympic games.

We structured this report as follows: We first present some interesting facts and figures about Russia, a country that has a lot more to offer than many think. Next, we look at the takeaways from successful soccer teams for investors in section 3. In section 4, we share some more thoughts on why it is mainly emerging countries that seem to be willing and able to act as host nation, and whether it really pays off for Russia to play host to such a major sporting tournament. Section 5 takes a look at the chances of each team progressing through the tournament. In a tribute to the Italian team, we re-run our simulations as if it were the Italians who emerged as winners from dramatic showdown in the qualification round. Last, we share some insights on the investment landscape in Russia, focusing on economic trends and developments, and on the investment opportunities and risks the country offers investors. Given the heightened uncertainty regarding sanctions, we currently advise a neutral allocation to Russian equities and the ruble, while we see opportunities to take selective exposure in Russian credit.

Themis Themistocleous
Head of European
Investment Office

Michael Bolliger
Head Asset Allocation
Emerging Markets

Some surprising facts about Russia

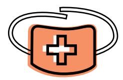
Quentin Pilloud, Junior Associate

Russia is by far the largest country by area on earth. Yet, when it comes to tourism, it is not a popular destination – just 24.6 million people visited the country in 2016, less than much smaller nations such as Malaysia (26.8 million), Turkey (25.4 million) and Mexico (32.1 million). Even though the climate in large parts of the country may not favor tourism, the country offers a great deal to the traveler: 28 UNESCO World Heritage Sites, an amazing natural diversity that ranges from beaches in the south to arctic northern regions, as well as a rich cultural heritage that includes world-famous museums, historical churches and buildings, and excellent art collections and exhibitions.

правда

If someone sneezes while saying something, it means he or she is telling the truth. In this case people say “правда” (or “pravda,” i.e. truth).

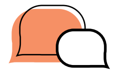
90 years



Alla Illyinichna Levushkina is the world's oldest surgeon. She is 90 and still performing hundreds of operations a year. She has no plans of retiring.

Planet Pluto

Russia has a surface area of 17 million square kilometers, which is almost the size of the dwarf planet Pluto (estimated at 17.6m km^2 by NASA's New Horizon Program).



100 languages

Russia is home to at least 150 ethnic groups and 100 minority languages.

Shops, Bars…

Most shops, restaurants and bars in Russia are open on Saturdays and Sundays.

Russians say…

…that if your right hand itches, you'll soon be on the receiving end of money. It sometimes means you're going to greet someone. If your left hand itches, you're going to give someone money.

11 time zones

Russia has 11 different time zones, more than any other country. However, the football games will only take place in four time zones, spanning from Kaliningrad in the Eastern European Time Zone (UTC +2) to Yekaterinburg (Yekaterinburg Time, UTC +5).

1-3-5-7…

If you present flowers to a Russian, ensure that there is an uneven number of them in the bouquet. Even numbers of flowers are only given at funerals.

1918

Russian women received the right to vote in 1918, two years earlier than in the US and much earlier than in Switzerland (1971).

70 cats

The Hermitage Museum in St. Petersburg is home to around 70 cats. Cats have been working for the Hermitage as mousers since the 18th century on the then-empress’ orders.

5642 meter

Mount Elbrus is the highest mountain in Europe. It is situated in the Caucasus mountains in Southern Russia.

Russian Federation

Population: 144 million (United Nation Estimates 2015)
Day of Russia: 12 June
Major cities: Moscow, St. Petersburg, Novosibirsk, Yekaterinburg, Nizhny Novgorod, Samara, Omsk, Kazan, Chelyabinsk, Rostov-on-Don, and Ufa

50%

Almost half of Russia is covered by forests, this being the largest forest area on the planet, and 70% larger than that in Brazil.

–67.7 °C

The roughly 500 residents of Oymyakon occupy the coldest inhabited place on the planet, where the temperature dropped to –67.7°C at its nadir in 1933.

9289 km

Trans-Siberian Railway between Moscow and Vladivostok is the longest railway line in the world with trains running on a daily schedule.

22%

Lake Baikal is the largest fresh-water lake by volume in the world. It contains 22% of the world’s fresh surface water, and is also the deepest lake on earth.

29%

Russia’s citizens hold a high number of master’s degrees. According to the OECD, 29% of the population aged 25–64 has one, or achieved a comparable level of education.

Cheers

As a rule, every portion of alcohol in Russia is accompanied by a clink of glasses and a toast. It is considered an omen of bad luck to make a toast with an empty glass.

iStock

What investors can learn from successful football teams

Agility. Balance. Calm. Three attributes that complement teamwork and can transform a successful team into a future champion. And also attributes that offer important lessons for investors to learn from successful football teams.

Michael Bolliger,
Head Emerging Market Asset Allocation
Jorge Mariscal,
Chief Investment Officer Emerging Markets

Agility
Agile teams can adjust their play to different opponents. Playing against a team with a very defensive lineup requires different tactics than against a free-flowing attacking team. Teams need the ability to swiftly adapt to sudden, unexpected changes during the game: An injury, a red card, or conceding an early goal can force teams to adjust their tactics quickly.

Investors face similar challenges. The last 10 years have seen an unprecedented change in monetary policy tools and frameworks. The desire to stimulate growth and to fight deflationary forces has resulted in many policy inventions. Investors first had to adapt to the powerful force of quantitative easing programs. Equity markets reached new highs, bond yields new lows. Those who adjusted swiftly made bigger gains. Today, after almost a decade of policy support from the world's major central banks, the pendulum has started to swing in the other direction. The US Federal Reserve has been hiking its policy rate for a while, and the European Central Bank will likely end its quantitative easing program this year. This is occurring amid rising volatility and highly correlated financial assets. Investors should consider alternative assets and be more nimble in adjusting their allocation.

Balance
Balance is another important attribute. A successful team needs top players in all positions. Keeper, defenders, mid-fielders, strikers, and a strong back up of reserve players on the side-lines. A few exceptional players can decide a game single-handedly. But the road to the final is long, and even the best players might be marked out of the game or could simply have an off day.

When it comes to investments, holding a diversified portfolio of assets is incredibly important. Global business cycle dynamics as much as idiosyncratic events can trigger losses. We build our portfolios seeking to optimize the benefits of diversification. Pairing traditional and non-traditional assets, risky stocks and defensive bonds, and allocating across regions is crucial in making portfolios profitable in good times and to preserving gains during downturns.

Calm
And finally calm. Even the most experienced teams risk discarding their game plan when time is running out. And the coolest forward might miss a simple shot or a penalty under pressure. The teams who can control their nerves and stick to their tactics for the entire 90 minutes (or longer) have a greater chance of success.

Investment decisions are similar. The recent flare-up of geopolitical tensions in the Near East. The rising threat of a global trade war. Concerns about a sell-off in global bond markets. Being able to distinguish between deteriorating fundamentals and softer growth on the one hand, and the daily noise on the other, is crucial. The former is a reason to re-allocate a portfolio, the latter an opportunity to take profit on a hedge or to double-down on an existing position. In both situations, though, staying calm pays off. And having a proven investment process at hand and the ability to stay focused on the investment objectives can deliver a big difference for an investor's long-term ability to optimize returns.

Moscow Skyline / iStock

More than goals and feelings?

Shared enthusiasm for the sport, collective cheering at public viewings, a country welcoming hundreds of thousands of fans from around the world – a World Cup offers broad entertainment value. But is this all just fleeting emotion? Given the considerable costs (estimated at USD 12bn, or roughly 0.7% of Russia's 2017 nominal GDP), we look at the factors that can make the tournament a success, from an economic perspective.

Tilmann Kolb, analyst

Beyond intangible gains on reputation and prestige, the tourism sector is an obvious beneficiary. A common classification of the benefits includes the increased visibility of a destination due to the coverage the host country receives before and during the tournament, an influx of tourists who spend during the event, and the development and upgrade of tourism infrastructure from which the host reaps long-term benefit.

According to World Tourism Organization data, Russia drew 4.0% of international tourist arrivals in Europe and USD 8bn in accompanying receipts in 2016. This ranks it far behind tourist powerhouses such as France, Italy or Turkey, but puts it on par with Greece and Austria with respect to visitor arrivals. Compared to other emerging markets such as Brazil and South Africa, it hosted twice the number of tourists in 2016. Cultural destinations such as St. Petersburg and Moscow, as well as Black Sea resorts such as Sochi have already secured their place on a globetrotter's map. Still, some of the less well known venues may draw gains from public media coverage due to the tournament and increase their name recognition.

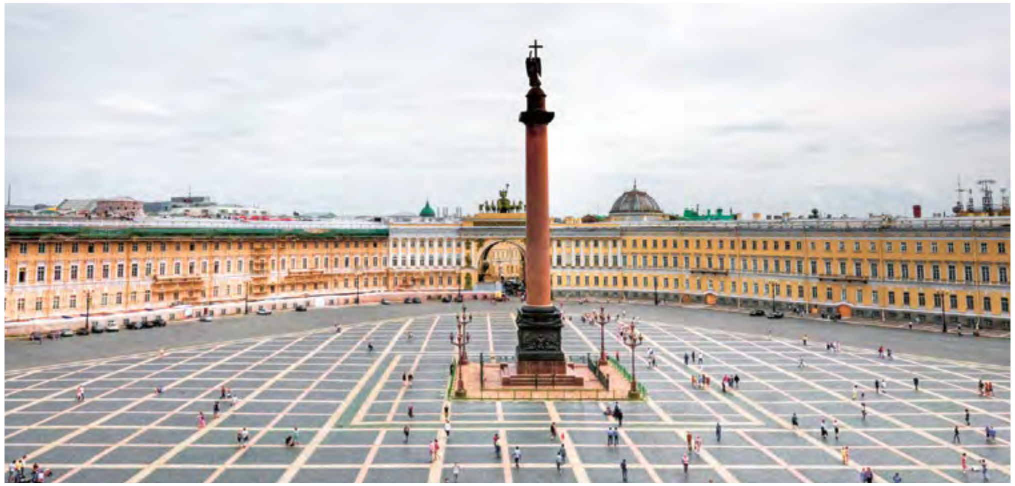
Based on applications for tickets, around half of total demand is coming from non-domestic fans. Assuming an allocation of tickets similar to the show of interest and approximately 3.2m tickets overall, Russia should welcome 1.6m international tourists throughout the tournament period. This amounts to ca. 6.5% of tourist arrivals in 2016, a ratio that can hardly be marked as an exceptional boom in tourism (for comparison: international arrivals picked up by 5.6% from 2014 to 2015). Also, prior experience from similar events has shown that such an event can lead to displacements of regular tourism – the excitement for football is not shared by everyone alike.

Of course, domestic tourism plays a role as well. According to the World Travel & Tourism Council, domestic visitors spent around three times more for business and leisure trips than foreigners in 2016. Preparations for the event that at the same time render domestic destinations more attractive to residents would benefit the economy, as spending on tourism boosts domestic consumption and remains within the country.

Naturally, investments and upgrades around the event are targeted toward a smooth deployment of the event, including construction and refurbishment of stadiums, ensuring availability of accommodation, and transport links to the different venues. For a lasting impact, investments should have a productive life that outlasts the festivities. In the case of Russia, the world football governing council's evaluation of the Russian bid already attested the existence of dedicated local transport to stadiums, as well as the connections between main cities. A significant improvement of so far underdeveloped regions and cities with respect to logistics is therefore not among the benefits for Russia. Still, upgrades to transport links, for example of airports, may have a longer lasting impact, even though the funds invested in aviation infrastructure in recent years have not always seemed to be specifically for Russia's role as a host.

The direct effect of the tournament is felt more with regards to the construction of stadiums, most of which have been built only recently. The value of new stadiums however depends on their ability to continuously draw

St. Petersburg / iStock



Kaliningrad / Gettyimages

crowds in future. The example of the Arena da Amazônia in Brazil, one of the stadiums of the previous event, tells a cautionary tale. Built at a cost of several hundred million USD, local teams can hardly fill the 40,000+ seats, and it now mostly serves for small scale events, including weddings, according to media reports. Given the considerable costs of building and maintaining new stadiums, the question also arises if there aren't better uses for public funds. While it is notoriously difficult to assess these opportunity costs, we present several areas for improvement – and in need of funds – in our "Investing in Russia" section of this report.

The winner of the tournament will be known on 15 July. But a final assessment of the economic benefits for Russia will only be known some years later. We doubt that the tournament will boost the Russian economy in a significant way, given the very event-specific related, one-time spending for construction and tourism receipts. A longer lasting effect could be hoped for by raising Russia's brand value with a welcoming, peaceful, and fun sporting event. Unfortunately, years of efforts and funds can be lost in a heartbeat when it comes to reputation, as recent geopolitical tensions show.

And the winner is…

Germany, Brazil, or Spain. The likelihood of one of these three teams winning is 60%, according to our calculations. What do they have in common? A number of factors which tend to be reliable indicators of how well a team will be doing during the tournament.

Michael Bolliger
Head Emerging Market Asset Allocation

First, they are the top three teams according to the so called Elo rating. The Elo rating is an objective measure of team strength. It also looks at how well a team has played in the past, but unlike other ratings, victories versus stronger teams will improve the rating by more than wins versus weaker opponents. Similarly, more important matches count more than friendly games. It is one of the most important indicators to explain the likelihood of success at the World Cup.

Second, they look back to a successful qualification. Germany won each match, Spain didn’t lose, and Brazil lost only its first game against Chile back in October 2015.

Third, they successfully participated in previous tournaments. They all have won the tournament before. Since 1930, they’ve won 10 out of 20 competitions and they rank above most others when we count the number of previous participations. Brazil is the only nation that has participated in every single tournament since 1930, and also holds the record as a five-time champion.

Controlling for these factors, plus the advantage of the home nation in the case of Russia, we calibrate a statistical model using the results from the previous five tournaments. With this model, we estimate the most likely outcome of the upcoming matches. In this context, also in football a common disclaimer applies: Past performance is no guarantee of future results.

Many roads lead to Moscow
For each team, several ways lead to the Luzhniki Stadium in Moscow, the venue where the final will take place on 15 July. The first two teams from each group qualify for the next round. Hence, depending on who will be first and second in each group, the pairings in the round of 16 and beyond can look completely different. Although our model predicts the outcome of a given game, it still leaves room for error. And some matches are very close calls; the likelihood for the stronger team to win can be only a bit higher than 50%.

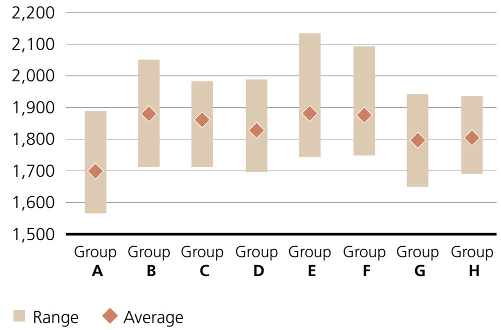
Fig. 2 shows the average Elo rating for each group and the dispersion between the best and the weakest teams. Group A, with Uruguay, Russia, Egypt, and Saudi Arabia, has the lowest average rating, and a high dispersion. Uruguay is set to secure the top spot in this group, and Russia is the main candidate for second place, in part thanks to its status as the host nation. Similarly, our model suggests Germany and Brazil are likely to triumph in Groups F and E, respectively, as their opponents do not appear to be a match for those two champions. On the other hand, the teams in Group H, Colombia, Japan, Poland, and Senegal, are all ranked fairly close and although our model predicts Colombia should win, followed by Poland, our ability to predict the outcome of Group H is lower than in any other group. Similarly, Groups C and D have strong leaders, France and Argentina, respectively, and two to three teams which are fairly close together.

To account for the many different roads to the final, we conduct what statisticians call a Monte Carlo simulation. What might sound fancy to some readers is in practice quite simple: Instead of mapping out all the different constellations, we draw a large number of random variables and use these to bring in a random component to our calculations and to simulate the championship. A better team is still more likely to win than its lower-ranked opponent, but this is sport, and upsets DO happen. After we’ve repeated this again and again, we end up with the results of 10,000 virtual tournaments. We then simply count how many times each team won, made it to the semis, or was already eliminated in the group stage. Table 1 lists the results from this exercise for all 32 participating teams.

Fig. 2

A mixed bag

Average Elo ranking of each group, and range between the team with the highest and lowest ratings



Source: World Football Elo Ratings, UBS, April 2018

Table 1

And the winner is…

Simulated likelihood of each team to advance through the tournament (in %)

	Winner	Runner-Up	Semi-Finalist	Quarter-Finalist	Winner Group Stage	Second Group Stage
Germany	**24.0**	**36.7**	**51.3**	**66.7**	**68.6**	**22.0**
Brazil	**19.8**	**31.9**	**44.1**	**60.5**	**66.8**	**23.1**
Spain	**16.1**	**28.0**	**50.5**	**68.5**	**60.6**	**26.5**
England	8.5	18.7	31.4	66.2	53.7	33.6
France	7.3	16.1	35.1	59.5	60.1	24.6
Belgium	5.3	11.6	23.8	56.9	38.3	43.7
Argentina	4.9	11.3	26.9	51.8	54.7	26.4
Portugal	3.1	8.0	21.8	39.8	25.2	38.2
Uruguay	1.8	5.5	15.8	32.0	42.5	34.3
Switzerland	1.8	5.0	11.5	22.9	19.7	39.6
Mexico	1.8	5.3	10.9	22.5	17.2	36.6
Italy	1.6	4.4	10.1	19.4	15.3	31.0
Russia	1.6	4.6	14.4	30.5	41.4	33.6
Poland	0.9	2.9	7.1	24.7	35.4	28.7
Colombia	0.5	1.8	5.0	20.0	28.2	27.9
Sweden	0.4	1.4	3.8	9.9	8.8	23.7
Iran	0.4	1.7	5.6	14.2	9.4	21.4
Nigeria	0.3	1.3	4.8	15.9	16.3	25.5
Peru	0.3	1.2	5.3	16.8	14.4	27.2
Serbia	0.2	1.0	2.8	7.7	8.7	22.8
Senegal	0.2	0.9	2.7	12.6	19.9	22.8
Iceland	0.2	0.7	3.7	13.6	13.8	23.5
Croatia	0.2	0.9	4.4	15.0	15.2	24.7
South Korea	0.2	0.6	1.9	6.0	5.4	17.7
Denmark	0.1	0.9	4.3	15.5	14.2	26.0
Australia	0.1	0.5	3.3	12.0	11.3	22.2
Morocco	0.1	0.3	2.2	6.8	4.9	13.9
Japan	0.1	0.4	1.6	9.8	16.6	20.6
Egypt	0.0	0.2	1.5	5.1	9.5	17.3
Tunisia	0.0	0.3	1.1	8.0	6.0	15.9
Costa Rica	0.0	0.2	0.9	3.9	4.7	14.5
Saudi Arabia	0.0	0.1	0.6	3.2	6.7	14.8
Panama	0.0	0.0	0.2	2.0	1.9	6.8

Source: UBS

Investing and football

Germany, Brazil, and Spain most likely to win…

According to our simulations, Germany, Brazil, and Spain have the highest likelihood to win the tournament. Germany and Brazil are set for an easy start, while Spain will have to hit the ground running if they are to beat Portugal, the current European champions, in their opening game. Spain will have to hit the ground running to beat Portugal, the current European champion, in its opening game. From there, the going will get tougher for Spain and Brazil, who will possibly face Argentina and England, respectively, in the quarterfinals. Both are former champions. Germany, however, might face Belgium, another strong, young, and talented team, but De Rode Duivels (the Red Devils) have so far not shown their best form in big tournaments.

…but watch England, France, Belgium, and Argentina for surprises

Our simulations indicate that England, France, Belgium and Argentina still have a realistic chance of lifting the trophy. Argentina's fate will strongly depend on the form of their star players in our view, which is an element of uncertainty and hard to capture with our quantitative model. France should

How we've applied the insights from our investment process to the prediction of football matches

We've applied the insights and tools from our daily work as investment strategists to predict the likelihood of each team doing in the tournament. Below, we share the key insights.

1. Be systematic. Not all of our predictions will be right. Some games are hard to call and others will simply end with a big surprise. But applying our framework to previous tournaments indicates that our model has a high degree of accuracy. We face a similar situation with our investment recommendations: Not all our calls are accurate. But by following a systematic investment process, we aim to maximize the number of correct calls and their magnitude.
2. Separate the wheat from the chaff. We've tested several different indicators before selecting a few variables that have worked best in the past. Investors have to deal with an overwhelming flow of new information each day. Distinguishing between the daily noise and important trends is crucial to avoid costly and needless portfolio reallocations.
3. Set aside your emotions. By relying on a quantitative framework, we effectively put our emotions to one side. Although we prefer some teams over others, we strictly followed the predictions of the model. Quantitative signals also play an important role in our investment process. This assures that the qualitative aspects are not influenced by emotions or other behavioral traps.

Investing and football

be able to advance to the semi-final, but after the possible elimination of Portugal, they might face Brazil, another top team. Similar to Belgium, England has a balanced team, but their way to the semi-final leads through Brazil.

It is almost a given that the new champion will come from either Europe or Latin America. The likelihood of a champion from Asia, Africa, the Middle East, or North America is almost nil. From those regions, Nigeria has one of the highest likelihoods to advance to the second round, but it will be difficult for the Super Eagles to push past France in their likely encounter in the round of 16.

What can we expect from Russia?
Host nations tend to do well. Six out of the previous 20 champions lifted the trophy on home soil, while two more hosts made it to the finals, and five more to the semis. However, this correlation weakened as the tournament started to be hosted outside of the traditional footballing heartlands of Europe and Latin America, although in 2002, South Korea (semi-finalist) and Japan (round of eight) did a lot better than their quality scores suggested, while in 2010, South Africa became the first host to fail to reach the round of 16.

Russia is unlikely to share this fate: It will start the tournament in Group A, by far the weakest group in terms of its average Elo rating (Fig. 2). That said, while the game versus Egypt looks like a sure victory, those who follow the English or European club championships should be aware of Egypt's star forward and one of the most successful strikers of the current generation. The Russians are certainly very well advised to keep a close eye on him. However, in the round of 16, the team will most likely face either Spain or Portugal. Both teams are likely too strong for the Sbornaya to advance to the next round. Our model suggests that the likelihood of Russia lifting the trophy on 15 July is less than 2%.

A tribute to Italy
There are many teams which will be missed in Russia, but none more so than Italy. The Italians have won the championship four times and made it to the final another two times. Since 1930, they've only missed two other tournaments, the first not because they didn't qualify, but because the team decided not to undertake the long journey to Uruguay.

Given the international focus on Italy's absence after the Swedes defeated Gli Azzurri in a dramatic showdown in late 2017, we simulate another competition, including Italy instead of Sweden. In its current form, Italy is roughly at par with Mexico. Hence, even if Italy managed to end the group-stage competition in second place behind Germany, Brazil would likely await them in the round of 16. And that, we fear, would be the end of the road for the Azzurri. We hope to see Italy four years from now. The tournament doesn't seem quite the same without them.

Five matches to watch
We conclude this section with a selection of games that we believe will be exciting to watch. We've screened the known encounters in the group stage for possible nail-biters and tidbits, and added a few less well-known teams to our selection. The five games listed in Table 2 might be worth watching, independent of your team affiliation.

Table 2

Five games to watch

Game	Where and when (local time)	Why?	What our model predicts
Russia vs. Saudi Arabia	14 June, 18:00, Luzhniki Stadium	Because it's the opener. And it will set you in the right mood for the coming four weeks.	Russia to win with likelihood of 78%
Portugal vs. Spain	15 June, 21:00, Fisht Stadium	Two great rivals and surely not a game to miss.	Spain to win with a likelihood of 68%
Argentina vs. Croatia	21 June, 21:00, Nizhny Novgorod Stadium	With Argentina, you are always guaranteed a great show. And Croatia is of course a fine competitor.	Argentina to win with a likelihood of 74%
Saudi Arabia vs. Egypt	25 June, 17:00, Volgograd Arena	The two lowest rated teams, yes, but likely the last chance to see one of the world's greatest current strikers in action.	Egypt to win with a likelihood of 54%
England vs. Belgium	28 June, 20:00, Kaliningrad Stadium	Two of the most talented teams, who haven't lived up to the expectations yet.	England to win with a likelihood of 57%

Source: UBS

Moscow, Financial center / Gettyimages

Investing in Russia: Reforms key to improving growth potential

The Russian economy went through a transition in recent years amid international sanctions and large swings in the price of oil. Amid prudent economic policies, cyclical growth has picked up, public and external finances are improving, and Russia's composite rating is now back to investment grade. The next challenge for the Russian authorities will be to transform the cyclical story into a structural one to lift the country's growth potential, which is too low for the country's stage of development. Monitoring tensions with the West is crucial to predicting future developments in this area, especially those around conflicts in Ukraine and Syria, and Russia's alleged interference in other countries' politics. Given the heightened uncertainty regarding sanctions, we currently advise a neutral allocation to Russian equities and the ruble, while we see opportunities to take selective exposure in Russian credit.

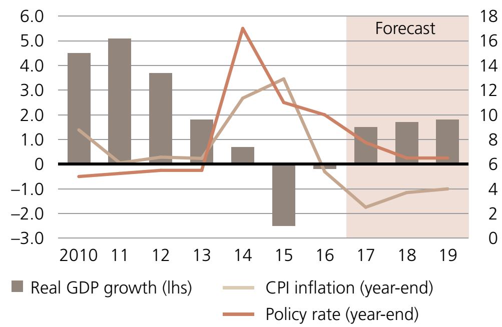
Jérôme Audran, analyst
Michael Bolliger, Head Emerging Market Asset Allocation
Tilmann Kolb, analyst

Higher cyclical growth
Growth in Russia is showing improvement. After two years of contraction, the economy grew by 1.5% in 2017, and we expect the pace of expansion to accelerate to almost 2% this year and next (Fig. 3). Private consumption and to a lesser degree fixed capital investment, are likely to be the main growth drivers. Full employment, combined with a sharp acceleration in real wages and a loosening of fiscal policies, support our view that domestic consumption should pick up. Mean-

Fig. 3

Russian economy endured a turbulent period

Real GDP growth and inflation (in% y/y), and policy rate (in %)



Source: UBS, as of 5 May, 2018

while, inflation declined sharply, with recent readings well below the target rate of 4%, which allowed the central bank to cut its policy rate cautiously.

Prudent economic policy choices
Orthodox economic policy decisions have supported economic stability in recent years. Continued progress in strengthening the economic policy framework, underpinned by a more flexible exchange rate, a strong commitment to inflation-targeting, and a prudent fiscal policy have allowed the Russian economy to adjust to the lower oil price environment and international sanctions. The swift bail out of three large private-sector banks by the central bank prevented contagion and has limited the risk of a systemic banking crisis.

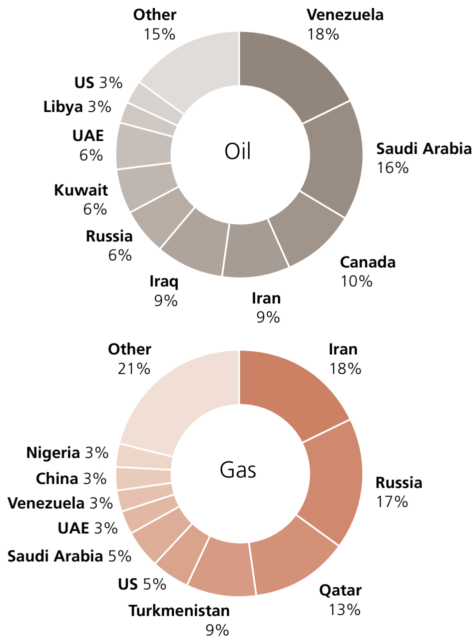
Back to investment grade
In light of these developments, Russia returned to investment grade in February, only three years after the country's downgrade to non-investment grade. The sovereign now exhibits solid public finances, with a close-to-balanced budget and one of the world's lowest levels of indebtedness (public debt is just 14% of GDP). Russia is an external creditor, holds almost USD 500bn of international reserves and runs a persistent current account surplus. Russia's break-even fiscal oil price is at USD 55–60/bbl, which is below our longer-term projection of the oil price.

Huge, unexploited economic potential…
Russia's economic potential is huge, given the country's population of 144 million, high levels of education and skills, and its large resource endowment, with the world's largest land mass and some of the largest hydrocarbon reserves (Fig. 4). But the long-term growth potential is constrained by structural impediments; estimated at 1.5% by the IMF, this

Fig. 4

Russia's hydrocarbon reserves are impressive

Proven oil and gas reserves, in % of total (as of 2016)



Source: BP Statistical Review of World Energy, UBS, as of May 2018

Investing and football

level of potential growth is too low for the nation's stage of development. Tackling these issues is therefore crucial to improving living standards sustainably.

…but structural impediments need to be addressed
In recent years, Russia has made progress in improving its business environment. It now ranks 35th out of 190 countries in the World Bank's Ease of Doing Business Survey (62nd out of 189 countries in 2015). That said, areas such as property rights protection, contract enforcement, governance and transparency, and judicial independence offer room for improvement. Besides, burdensome regulations, the domination of state-owned enterprises (Fig. 5), and a long list of strategic sectors requiring prior approval for foreign investment prevent higher FDI inflows. Other structural constraints include reliance on hydrocarbons, the state of the infrastructure, and subdued productivity, which require higher investment, better education systems and measures to stimulate innovation and labor market efficiency. The aging population also poses challenges for Russia's labor supply, health and pension system. As discussed in a previous section, from a purely economic perspective, we don't expect the funds spent on hosting the World Cup to directly boost growth in the medium- to longer-term, making their use suboptimal in our view.

Fig. 5

Public sector plays important role in Russian economy

Share of public sector in % of GDP

Source: Federal Antimonopoly Service of the Russian Federation, UBS, as of 27 April 2017

Putin's rule extended to 2024
On 18 March, Vladimir Putin secured a comfortable victory in the presidential election, with almost 77% of the votes and a participation rate of 67.5%. Putin's win was widely expected, even more so since his main opponent, Alexei Navalny, had been barred from running. His re-election extends his term in office to 2024.

Putin's convincing win will likely ensure policy continuity, but it may come at the cost of reform stagnation. Current positive developments may continue in terms of fiscal discipline, spending efficiency, the business climate, and adjustments to the tax system, which should be enough for more rating upgrades in the absence of oil price shocks or a further escalation of sanctions. However, we think such developments will not suffice to improve the country's growth potential markedly.

President Putin publicly discussed an ambitious project of increasing the per capita income by 50% by the mid-2020s, implying a 5% average growth for the next decade. Such a transition would require major reforms, in our view. Some measures like pension reform seem likely, which could be enough to surprise the market positively given low expectations. However, in light of Putin's strong popularity, the recovering economy, and the lack of credible political opposition, we do not see strong incentives to embark on an ambitious reform program or create a more open political system. Wide-ranging privatization programs, a large reduction in military spending, or a strengthening of Russia's rule of law seem rather unlikely at this point.

The trilogy of sanctions, geopolitics, and oil

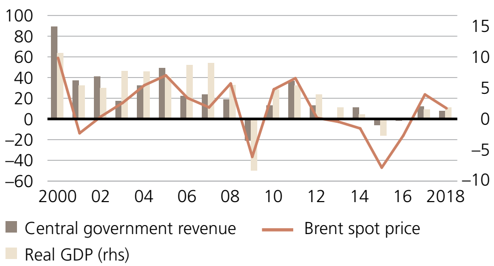
On the external front, international sanctions, geopolitics and the oil price will remain key drivers for Russian assets. Sanctions have in fact had some positive economic side effects such as external deleveraging and import substitution in agriculture. But they weigh on capital flows and technology transfers, and increase the cost of doing business, which may eventually lower productivity growth and exacerbate structural challenges. Monitoring tensions with the West is crucial to predicting future developments in this area, especially those around conflicts in Ukraine and Syria, and Russia's alleged interference in other countries' politics.

Russia's degree of dependence on hydrocarbons is another factor. We see the country's tremendous natural wealth as a solid economic, fiscal, and geopolitical asset. However, with 40% of government revenue and 55% of exports coming from oil and gas, exposure to volatile energy prices induces macro instability (Fig. 6). Reforms to monetary and fiscal policy, in particular the new fiscal rule allows Russia to run countercyclical demand policies in a way that it was unable to do previously. That lowers its sensitivity to oil prices and may reduce risk premiums, in our view. That said, economic diversification through private sector development is the best way to cut dependence on hydrocarbons exports in the long term, in our view.

Fig. 6

Russia's energy dependence brings volatility

% y/y change in average Brent oil prices and central government revenue, real GDP growth (in %)



Source: IIF, UBS, as of May 2018

Investment opportunities

Russian assets outperformed EM peers over the past two years due to recovering energy prices, rising growth, and orthodox economic policies. However, Russian assets sold off markedly following new US sanctions introduced in early April. Sound growth, stable-to-higher commodity prices, and potentially higher fiscal spending should support company earnings in the months ahead. This should support equities. However, the new sanctions have raised business uncertainty, which may weigh on sentiment toward Russia and investment activity, hence capping the upside. In the longer term, performance of Russian assets will first and foremost depend on the implementation of structural reforms in lieu of a prolonged bull market in energy prices.

Equities: Supported by growth, but heightened uncertainty

The large exposure to the energy sector is one of the main reasons for the low valuation of Russian stocks, which trade at a discount to EM peers of almost 50% (12-month trailing price-earnings ratio). However, the weight of energy names in the MSCI Russia has declined substantially since 2002, to the benefit of financials and materials (Fig. 7). Another distinctive characteristic of the index is its high dividend yield of 4.4%. Over a six-month investment horizon, we currently rate Russian equities as "neutral." The economic recovery should translate into low double-digit corporate earnings growth, and the recent sell-off offers a better entry point. However, the risk-reward has deteriorated significantly given the heightened uncertainty regarding sanctions. Meanwhile, structural bottlenecks may cap medium-term upside, and addressing some of the main structural issues is essential to unlock further upside, we think.

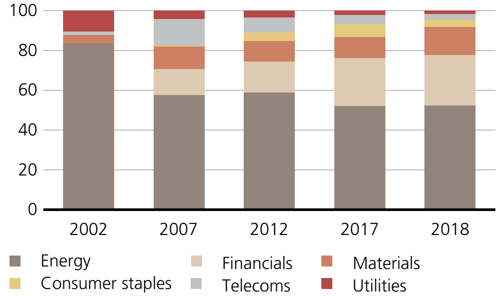
Credit: Back to investment grade

Credit fundamentals have been improving in recent quarters, a trend which we think has further to go. This reflects progress in strengthening the economic policy framework, which has improved macroeconomic stability and, together with robust external and fiscal balance sheets, has increased the economy's resilience to shocks. This should pave

Fig. 7

Weight of the energy sector in MSCI Russia has been declining

Sector composition of MSCI Russia, in %



Source: Bloomberg, UBS as of May 2018

the way for further credit rating upgrades, in our view, unless oil prices drop below USD 55–60/bbl sustainably or additional sanctions are introduced, against Russian sovereign debt, for instance. New US sanctions marked an escalation, in our view, and are credit negative for Russian credits overall. However, the broad-based sell-off offered opportunities to buy sound credits at cheap prices. As a result, we turned overweight on Russia in our EM credit strategy on 17 April. We refer investors to our Model Portfolio for more detailed information on our current positioning.

Currency: Easing tensions, external surplus, and high interest rates should support the ruble

The latest US sanctions against Russia weigh on the ruble outlook, and the risk of further setbacks lingers. Fundamentally, domestic conditions, including benign growth-inflation dynamics and the current account surplus, the interest rate carry and oil prices support the currency. We forecast the ruble to strengthen in the next 12 months, but think risks of renewed weakness are currently too high for recommending a tactical position in the ruble.

Moscow, Zhivopisny bridge / unsplash, Alexander Smagin

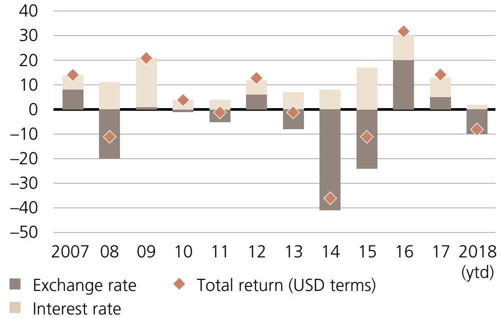
Investing and football

The extent of the new sanctions introduced considerable uncertainty in the ruble's outlook, as the threat of further sanctions weighs on investor sentiment, and Russian policymakers see the flexible exchange rate as a shock-absorber for potential adverse developments. We therefore don't expect meaningful measures to counteract ruble depreciation, unless a disorderly sell-off takes place. Also, the central bank (CBR) restarted FX purchases on behalf of the Ministry of Finance after a short pause, and these are still weighing on the ruble. Meanwhile, the CBR took a pause from rate-cutting at its April meeting and left the policy rate unchanged at 7.25%. We think the CBR will likely keep a cautious stance due to recent developments, even though inflation remains well below its 4% target. High nominal and real interest rates compared to emerging market peers, an economy in better shape than some quarters ago, higher oil prices, and our expectation of a softer US dollar should help the ruble regain ground, other factors remaining equal.

Fig. 8

Ruble from a total return perspective

Annual total return in USD terms, including exchange rate and interest rate return (in %)



Source: Bloomberg, UBS, as of 4 May 2018

Want to learn more about UBS CIO views on Russian assets?

Please refer to our "Investing in Russia" monthly publications.

Investing in emerging markets I Special edition

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