For Investors, Can Kazakhstan's Ambitious Frontier Market Dreams Pay Off?

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Astana, the capital city of Kazakhstan, has been building up over the last decade. Now that China's Silk Road has put a spotlight on the country, Astana aspires to become the Dubai of Central Asia.

It is one of the best and more reliable of the frontier markets. It stands to benefit, or so it hopes, from China's Belt and Road Initiative, the massive Beijing sponsored infrastructure investment mega project. But weak oil prices beginning in 2014 resulted in a currency collapse that pulled the rug out from under Kazakhstan's economy. Yet, next year KZ is expected to make a comeback. And how low can Kazkahstan go? For the bond funds that continue to pump money into this $231 billion economy, their bond yields are going down while U.S. and other developed market bond yields are going up.

There are two stories in Kazakhstan for investors. The bond market is great. The physical economy, not as great. Looked at from afar, believers see room for improvement, and a government seemingly willing to move in the right direction.

“This year KZ has been pretty amazing. Commodity prices are going up, and Kazakhstan assets just follow along,” says Arent Thijsen, a portfolio manager from Brauwtulp Wealth Management in Rotterdam. “Some of the reforms that they are doing makes them a tough competitor to Russia for attracting business.”

Whether that’s measurable or not remains to be seen. Kazakhstan today is resource rich, and resource dependent. Yet, it is making more of a visible effort to diversify its economy. The same cannot be said about Russia.

The Kazakhstan currency, the tenge, went free-float in August 2015 and, exacerbated by the drop in oil prices, sent the exchange rate from 120 to the dollar in November 2013 to 336 three years later. It’s strengthened from a weak point of around 386 to the dollar in January of this year. That kind of currency devaluation has hurt business sentiment on the ground, judging by consensus interviews with local businessmen.

The National Bank of Kazakhstan lowered interest rates last month, following two hefty 200 basis point rate cuts in May and July of this year. The moves bring the policy rate to 12.5%. Another 300 basis points cut is expected next year. Cheaper credit’s good, but that is not enough to pull the economy out from the oil market doldrums.

Kazakhstan’s Central Bank used the period of rising oil prices to their advantage. They added $4.6 billion to gross international reserves since January. So with Brent now trading close to $52, the tenge is finally seen holding steady. The big devaluations are done. That kind of stabilization should allow a return to growth in 2017 after flat-lining GDP this year. Given that Kazakhstan’s oil output has been declining since 2013, this October’s re-launch of the giant Kashagan oil field holds the key to fast and easy economic growth. This is still an oil and commodities economy after all, not much different than Russia. UBS forecast 1.5% GDP growth for 2017, with chances of KZ beating their estimate — if oil cooperates. It will definitely beat Russia growth.

“There are some bright patches now in Kazakhstan data,” says Anna Zadornova, a UBS economist in London.

Industrial production rose a mild 0.1% annually in September, which contrasted August’s record drop of 7.5%. Due to September’s improvement, the decline in industrial production ceased and the overall trend is moving in the right direction. The annual average variation in industrial production rose from minus 2.7% in August to minus 2.3% in September.

Kazakhstan is led by the 76 year old Nursultan Nazarbayev, the country's founding president. The country is a unique mix of Asian and Russian. It's politically neutral, pursuing a "multi-vector" foreign policy and being on friendly terms with Moscow, Beijing, Washington and Brussels

It's a member of the fledgling Eurasian Economic Union, which was the brain child of Nazarbayev back in the 1990s. But its latest claim to fame on the external front is the Chinese proposed One Belt One Road initiative.

If there is one country with the location, demographics, and the chops in Central Asia to participate successfully in this endeavor, it's Kazakhstan. The question everyone investing in KZ asks is, what happens when the post-Nazarbayev transition happens?

"There are surely problems with Kazakhstan, and a lot of it has to do with the clan system, which makes it difficult to implement change." says David Herne, an American hedge fund manager running the Specialized Research & Investment Group in Moscow, "but I think that one of the best things about Kazakhstan is its generation of young and excited people, some of whom left to study abroad and are coming back to change the country," The government has a tri-lingual education system and a mandatory 12 year education system. The median age is 30.3 years old.

Compared to its neighbors, Kazakhstan is loaded. It's GDP per capita is close to $14,000, on par with Russia and greater than Brazil's and every other 'Stan nation.

Every emerging market fund manager knows the Kazakh bonds have outperformed U.S. Treasuries. The stock market there is up 144% in local currency terms, over the last 12 months, despite currency weakness. But how does Kazakhstan actually become more than a gamble for fixed income fund managers in London and New York, and something more enticing to long term foreign capital when it comes to FDI?

The Organization for Economic Cooperation and Development said earlier this year that the country was "well-placed" to catch up with OECD income levels by 2050. The country is in the process of reforming its economy to become an OECD member, which gives those foreign corporates a better sense of how KZ plays ball both in terms of its rule of law, and corporate governance.

Can KZ Bootstrap Itself?

It sure wants to.

The strategic goal is to grow beyond commodities – despite many decades-worth of uranium, metals, oil and gas supplies that they can monetize and pay its bills. Over the years, Kazakhstan has positioned itself as a bellwether of post-Soviet reliability. In the headlines, Kazakhstan is relatively drama free. It holds the Expo 2017 global business and investing forum in the capital city of Astana next year, a city that is being built as a sort of mini-Dubai in central Asia. The Expo will morph into Astana International Financial Center, which has adopted the British law. It could become a regional financial hub for Silk Road investing, if all goes according to plan.

Last year, Nazarbayev came up with the government's so-called 100 Steps to Reforms program which seeks to capitalize on the 'Nurly Zhol' infrastructure stimulus plan from 2014. It's using state money and private sector money to build the usual: roads, rail, ports and telecom like fiber optic cables.

"Look, the economic crisis definitely affected us all at least since 2008," admits Adilzhan Kaliyev, an entrepreneur and director of Agrostan. "On the bright side, as imported goods become too expensive, and there is a room for local production to replace it. We used to import a lot of frozen meat from Argentina. Now it's more lucrative to produce it locally. It's one of the reasons I got into this industry last year. And for many basic products it's the same case. So I think that with the right approach, transition from a resource based to production base economy could happen naturally."

The government has been spending money from its National Wealth Fund to stimulate local production. Most of it is going to transportation, energy, industrial and social infrastructure, and to small and medium businesses.

In a 44-page report by Deloitte industries looking for white knights include oil and gas, mining, chemical, and nuclear energy. Deloitte also said that the policies in place now are geared towards a Chinese-style focus on the local market, such as machine engineering, pharmaceuticals, and real estate.

For exporters, agriculture, light industry and sectors like information technology, biotechnology, space exploration, and alternative energy look the most attractive, based on Deloitte's view.

Over the last three years, the government has taken steps to mimic Singapore and to some extent, even the Chinese with their special economic zones. These have become like FDI magnets in emerging and frontier market economies worldwide over the last decade.

Astana-New City special economic zone is one of 10 industry specific or export-driven tax zones that give companies 10 year exemptions, including no corporate income tax and VAT exemptions for goods and services. Outside of those zones, the effective corporate tax rate is 24%, according to Deloitte, with VATs of 12% on domestic goods and imports only.

Despite the mixed economic news coming out of KZ over the last few years, the wheels have not fallen off.

The share of the population living in poverty fell from 47% in 2001 to about 3% in 2013, as measured by the national poverty line. Based on World Bank figures, as measured by the purchasing power parity (PPP), poverty in Kazakhstan fell from 41% in 2001 to 4% in 2009.

“We are long-standing investors in Kazakhstan,” says Jan Dehn, head of research of the Ashmore Group in London. “As for the political risk in the economy, Nazarbayav will stay until he can’t stay anymore,” he says, tongue-in-cheek. “I am not basing my views on the country on tail risk from the government.”

The future for Kazakhstan is in the Singapore-style low tax zones, economic diversification, and reforms along the lines of what OECD member states expect. The new leadership, whenever that time comes, should stay on the current track, pushing transparency and good governance forward. In such a case, Kazakhstan will remain a serious market player not only for global bond lords that love it, but Chinese, Russia, European and American investors who set up shop there as well.