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IN CONTEXT
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Russia in Review: 2013

Either a neutral or a wasted year. 2013 was a very mixed year for investors and businesses in Russia. The frequent flow of disappointing news was almost counterbalanced with positives to create a neutral effect. One may conclude that 2013 was something of a wasted year although the surprisingly active December does offer a case for optimism that 2014 may bring greater activity and positive actions. As the month and year ended the headlines have been dominated by the tragedies in the city of Volgograd. We can but hope that these are isolated incidents.

Headline macro numbers declined. From a business point of view the biggest concern of 2013 was the deteriorating macro indicators. The headline numbers were unquestionably poor but some of the ingredients are actually very good. By the end of the year economists have almost split into two camps; those who believe that Russia is now irreversibly headed for a long period of low growth which will soon start to impact earnings and the business climate; and those who believe that all talk of gloom and doom is tabloid sensationalism and that the economy is actually in good shape.

Negative trends. What we can say for certain is that, on the negative side, headline growth is too low; debt service costs too high; confidence too low; capital flight too high; investment spending too low; and the cost of running a business in Russia is too high…and rising.

Some positive trends. On the other hand, the sovereign balance sheet is one of the best in the world; the oil price outlook should again keep budget pressure low in 2014; small and medium sized businesses are growing faster than the big state enterprises; there is almost full employment;, the country is very stable; some regions of Russia have very strong local economies; the middle class segment is still expanding; population decline has been arrested; and steady reform progress, albeit slow, is visible.

A relatively dull year in politics. After a hectic 2012 politics provided only brief episodes of distraction in 2013. Nothing much changed. President Putin is still dominant. But, here also commentators have opposing views that either Putin's power is slipping or, that he will be president until 2024. Russia has rotated out of the chairmanship of the G20 but assumes the presidency of the G8. The leader's summit will be held in Sochi in early June.

2013 was a good year for:

- **Central Bank**. It won the battle against those pushing for stimulus measures and rate cuts. It maintained fiscal and monetary stability. The Central Bank also finally accelerated the process of closing down bad banks. A total of 29 licences have been cut since mid-year.
- **Demographics**. Russia recorded the first natural population increase, i.e. births exceeded mortality, since 1991
- **Workers.** Unemployment is 5.5% nationally which means there is almost full employment in cities. Average real wage growth was 5.5% over the first eleven months and double that in the public sector. The minimum wage rose again from January 1st.
- **R.D.I.F.** The Russia Direct Investment Fund attracted some substantial investment flows, the biggest of which was $5 bln from Abu Dhabi.
- **Business**. Russia moved up 20 places in the World Bank's Ease of Doing Business Survey, to 92nd. There is still a long way to go but the jump shows that the government's commitment is real.

2013 was a bad year for:

- **Debtors.** Central Bank and Finance Ministry money market operations kept liquidity tight and lending rates far too high and access to new debt difficult.
- **Minorities**. Rosneft snubbed minorities in TNK, eventually forced into making a low offer, and Surgutneftegaz refused to clarify the Treasury shares position.
- **Economy.** At the start of the year the economy was expected to grow by 3.5% and not far off that of the previous year. It looks set to actually grow by 1.3-1.4%. Reduced consumer spending and a decline in investment both weighed on the headline numbers.
- **Tax Avoidance**. The government has introduced legislation which will penalize companies who transfer earnings off-shore so as to avoid paying Russian taxes.

Ruble/Debt. The ruble lost 10.4% against the basket of US Dollars (-8.0%) and Euros (-12.4%). The yield on Russia sovereign '28 rose from 3.83% to 5.65% over the twelve months.

2013 was a neutral year for:

- **President Putin.** His approval rating ended the year at 65% according to the Levada center polls. That is exactly where it started the year.
- **Oil Price.** The price of crude remained in a tight range all year with Brent ending at $110.8 p/bbl, or 0.3% lower than at the end of 2012. That meant that the Federal Budget stayed close to breakeven for the year.
- **SME's.** It was a mixed year for small and medium sized businesses. The sector is estimated to have grown faster than the economy overall while the May amnesty and the World Bank survey improvement should help improve conditions for entrepreneurs. But costs, across a number of areas, has increased in real terms.
- **Bureaucrats.** Legislation passed in 2013 now prohibits state officials from owning foreign bank accounts and other liquid assets (shares). But salaries increased by well above the national average and few bureaucrats have been implicated in anti-corruption campaigns.
- **Equities**. MICEX finished the year up 1.9% and the RDXUSD (DRs) lost 1.1%through 2013. Technology shares, especially the two new listings in that sector last year, rose strongly while the metals sector names fell heavily.

2013 - Summary

Equity indices were becalmed. The MICEX Index gained 1.9% for the year while the RDXUSD and RTS Indices respectively lost 1.1% and 5.6% due mainly to the currency impact. That compared with a loss of 5.0% for the MSCI Emerging Markets Index, a gain of 24.0% for the MSCI World Index and 29.6% for the S&P 500. Within the emerging market asset class the MSCI Frontier Market Index was best with a gain of 27.8% for the year (full table later in this note).

EM funds lost $12.2 bln in 2013. Investors switched a total of $12.2 bln from all emerging market funds with most of this money going to US equity focused funds. The outflow from EM was a record.

Tech shares were best while extractive industries were worst. The best performing Russian stock was QIWI which rose 229% from its May IPO listing price, followed by another new listing, Luxoft which finished the year up 118%. The top five performers were all in the IT/Media sector and all US listed. The metals sector dominated at the other end of the table with gold producer Petropavlovsk losing 80% for the year (full table at end of this note). The price of gold bullion fell 28% and silver lost 36% in 2013.

Agriculture prices fell. It was a bad year for agriculture producers with the price of sugar off 16%, wheat fell 22% and corn lost 40%.

Ruble traded lower. The ruble lost 10.4% against the basket as the Central Bank widened the band several times. Against the US dollar the ruble fell 8.0% and against the Euro the 12 month loss was 12.8%

US Fed concerns pulled all debt prices lower. On the debt market the yield on the Sovereign Eurobonds maturing in 2028 rose from 3.83%at the start of the year to 5.65% while for debt maturing in 2030 the yield rose from 2.55% to 4.13%. The US 10Year Treasury yield rose from 1.77% to 2.99% over the twelve months as investors reacted to the start of the Fed tapering programme.

Euroclear got local debt market access. On the domestic ruble debt market, Euroclear and Clearstream finally gained settlement access and the percentage of foreign investors holding domestic debt rose to circa 25%. The yield on the 10yr OFZ finished the year at 7.67% while the 15yr OFZ closed with a yield of 8.04%.

The oil price traded in a tight range. The price of Brent remained in a tight range close to $110 p/bbl for a third straight year. Brent ended the year at $110.8 p/bbl, off less than 0.5% for the twelve months. Supply disruptions in Libya, Nigeria, Iraq and Sudan balanced the rising production in the US as oil demand rose by an average of 1.3 million barrels per day last year.

President Putin's approval rating held quite steady all year. According to the Levada Centre's poll Putin's approval rating was unchanged at 65% in December 2013, i.e. similar to December 2012. His low score was 61% in November. But the number of people who say they are satisfied with his performance and that of the government has fallen to 39%, from 44% in the summer (see trend tables later in this note).

PM's rating suffered. Prime Minister Medvedev is no longer the 2nd most trusted politician. He lost that traditionally held position to Defence Minister Shoigu from early summer.

Navalny has been side-lined for now. The September regional and Mayor elections produced no surprises. Alexei Navalny fared well in the Moscow poll but has since been swamped with various law enforcement agency investigations. Putin surprised he opposition with greater engagement and dialogue for the first time ever.

Demographics improve for first time since 1991. According to President Putin, during his address to the Federal Assembly, the country recorded natural demographic growth over the first ten months of 2013. This was the first time the birth rate exceeded mortality since 1991.

The economy was the main talking point in 2013. Having started the year expecting growth of 3.5%, economists are now looking for a final growth number closer to 1.3%. The forecast number was trimmed back several times during the year as retail sales growth slowed and investment spending turned negative. Surveys showed that confidence in the future slipped lower all year amongst consumers and small business owners (table of macro data later in this note).

Central Bank refused to cut rates. The new head of the Central Bank, Elvira Nabiullina) took over in late June and has resolutely stuck with an inflation and fiscal/monetary stability priority. As a result the Central Bank did not cut rates, as had been expected, because inflation remained above the 6% threshold. Instead it adopted a new benchmark rate, the Key Rate (5.5%) as a replacement for the previous benchmark, the Refinancing Rate (8.25%). The end year 1 month MosPrime rate was 7.05%.

Central Bank has become more aggressive in cutting bad banks. The Central Bank also strengthened its position as regulator and, since the appointment of the new Chairman, has shown considerable bite. Since Nabiullina's appointment in June the Central Bank has withdrawn twenty-nine banking licences. Cutting the number of licences – there are close to 900 currently – especially from the approximate 400 so-called pocket banks, has been an ambition of the Central Bank and Finance Ministry for years. Now that the Deposit Insurance scheme is in place, and working, the pace of cutting licences has picked up.

Capital flight remained high as the Current Account shrank. Capital Flight remained high throughout the year and is expected to have exceeded the $57 bln recorded in 2012. For the first three quarters the total was $48 bln. The total since 2008 is now in excess of $400 bln or 20% of GDP. Of course the majority of this is not so-called suitcase cash but part of normal trade and debt management. But 20-25% is estimated to be from individuals exporting cash and buying assets abroad. The 4th quarter Current Account surplus fell to only $629 million, pulling the full year surplus to less than $30 bln ($25 bln of this in Qtr 1). That is the lowest surplus since 1998.

Good year for R.D.I.F. It was a good year for the Russia Direct Investment Fund. It considerably boosted co-investment commitments for infrastructure and industrial diversification projects with several sovereign wealth funds. The largest commitment was from the Abu Dhabi government ($5 bln) while the most recent were from he Italian and South Korean national investment funds.

It was another poor year for new equity issuance. A total of $7.9 bln was raised via five IPOs ($3.2 bln) and four SPOs ($4.7 bln). That is better than the $3.7 bln raised in 2012 but a long way from the record IPO/SPO year of 2007 when $33 bln was raised. When strategic stake sales, i.e. from controlling shareholders, are added the total raised last year increased to $9 bln, down from the almost $10 bln total raised in both 2012 and 2011.

State privatization sales were negligible. The biggest disappointment of the year was the almost non-existent privatization programme (the VTB sale was an SPO from the company). The only public listing was the $1.3 bln Alrosa listing of which approximately $650 mln went to the Federal budget. The previously ambitious privatization programme was scaled back considerably in the spring as a result of what PM Medvedev called "lobbying by vested interests in government agencies"

World Bank business ranking move was a success. Some progress was made with the reform agenda last year.

Notably Russia moved up 20 places in the World Bank's Ease of Doing Business Survey, to 92nd) and actions against corruption continue to grow.

Fight against corruption stepped up. Russia failed to make any progress in Transparency International's Corruption Perception Index. But three significant actions took place in 2013; the government signed off on the "economic crimes" amnesty (often used in asset grabs); public officials re now prohibited from having foreign bank accounts or shares and must disclose other assets; the former Defence Minister was charged in an ongoing corruption case. More actions against corruption have taken place since the summer of 2012 than ever before.

Poor corporate governance standards remain a risk issue. Corporate Governance standards remain patchy at best. The top headlines in 2013 were taken by two egregious actions, i.e. Rosneft's treatment of the minorities in TNK and Surgutneftegaz's lack of disclosure concerning the Treasury shares. Balanced against that was the mandatory adoption of IFRS reporting standards and an increase in dividend payouts.

Ukraine and Khodorkovsky dominated December news. December was the most active news month. Ukraine and Russia finally announced a closer engagement and Russia amnestied several high profile prisoners and others awaiting trial. President Putin surprised the Federal Assembly by accepting for the first time that the country's economic problems are "home-grown" rather than imported and that the solution must also come from within. No question, however, that the biggest news item was the release of the ex-Yukos chief Mikhail Khodorkovsky (more on this in the Op-Ed I contributed to the Moscow Times last week which is produced at the end of this note)

Russia finally started producing oil in the Arctic. But, as the Greenpeace protestors left Russia oil started to flow from under the Russian Arctic for the first time. Gazprom announced that it is now producing a modest 12,000 barrels per day from the platform on the Prirazlomnoye field. The plan is to increase daily output to 120,000 by the end of this decade.

Gazprom lost LNG export monopoly. December was a mixed month for Gazprom. The positive news as the Arctic oil flow (above) while, on December 2nd, the president signed an order which breaks Gazprom's LNG monopoly. This will allow Novatek to export LNG when its Yamal project comes on stream. Over the past few days there is news that China and Russia have intensified talks to try and conclude a decade long negotiation over the supply of pipeline gas. At issue is the price and part of that has been China's claim that Gazprom's pipeline build cost is far too high. Despite the emergence of LNG, China wants the energy security which comes with a direct pipeline. Russia wants export diversification. Both sides have been here before but Putin has recently been in the mood to tidy his pending tray and bring old issues to a conclusion.

Both Russia and the EU lodged WTO complaints. Finally, as the year ended Russia lodged a complaint against the EU to the WTO. The complaint alleges that the EU is illegally imposing unfair import tariffs against Russian steel and chemicals. The EU defence is that Russian industry benefits from cheap energy. Earlier this year several EU countries and japan launched a formal complaint against Russia because of the recycling levy imposed on vehicle imports.

Economy: Standing still but tilting backwards

A safety first approach across most developing economies. Despite the flurry of activity in, and concerning, Russia through December, 2013 was otherwise disappointing for investors and businesses in Russia. Partly that was because, globally, investors remained focused on the recovery in the US and other developed markets and steadily switched funds out of developing economies in favour of the former. For many policy makers across the emerging market world it was a case of "wait and see" rather than take risks.

It is now clear that the problems are domestic rather than external. In 2013 it became very clear that the cause of the poor economic performance in Russia was because of domestic policy failures and actions rather than external contagion. The one positive we can take from last year's poor economic performance is that President Putin finally ended years of blaming contagion from the rest of the world for Russia's sluggish performance and, in his annual address to the Federal Assembly in early December, he pointed the finger of blame firmly inwards (see Moscow Times Op-Ed below)

Confidence fell as policy makers waited. In the international arena the major event, apart from the "budget-positive" stable oil price, which had an impact on Russia was the "will they, won't they" US Fed tapering plan. The initial indication came in May and immediately led to the start of a steady outflow of investor money from emerging markets and the start of a summer of volatility in EM currency markets. The uncertainty caused by the Fed Chairman's May comment also contributed to the Russian government's decision to postpone any actions which might have caused domestic fiscal or monetary uncertainty. Stability was again emphasised as the order of the day. Food sales recorded growth of 2.6% last year (versus +3.6% in 2012) while non-food sales increased +4.9% (v +8.6% in 2012).

The headline numbers for the economy were disappointing. GDP growth is more likely to have ended the year close to +1.3% instead of the +3.5% expected at the start of the year; investment spending will be negative for the year; retail sales grew at less than half the growth recorded in 2012.

There were some positives. Set against that the positives include a near balanced federal budget (the final result should be less than 0.5% deficit to GDP); growth in the small to medium sized sector is estimated to be above 10%; the country has almost full employment in the major cities; real wages and disposable income are rising which can sustain a positive retail spend.

Inflation rose into the year-end. The Central Bank failed in the battle to pull inflation below 6%. Having almost reached that target in early autumn price growth accelerated in the autumn so that the final number is expected to be close to 6.5% YoY CPI. Inflation in the services sector was +7.9% over the first eleven months of the year, +7.5% in the food sector and +4.5% in non-food. The government tightly controlled utility prices all year.

Central Bank battled to contain the ruble weakness. The Central Bank was forced to widen the ruble currency basket several times last year and was much more active, i.e. compared to 2012, in its interventions. Despite that the ruble fell 10.4% against the basket over the 12 months. Against the resurgent Euro the ruble dell 12.8% and against the US Dollar the loss was 8%. That was actually a much better performance than many of the other emerging economy currencies, especially in countries with a current account deficit.

Some obvious problems. Amongst the biggest issues facing the economy currently;

• Wages are rising in real terms which, despite the near full employment, means that cost competitiveness is poor and deteriorating.

• The cost of borrowing is too high, especially for consumers and small/medium sized businesses. That is because the central Bank is soaking ruble liquidity as it battles to keep the ruble from depreciating.

• Investment needs to be rising rather than showing a decline.

• Inflation, although still expected to fall in 2014, has been rising over the past few months. Actual "real world" inflation in cities such as Moscow is considerably higher than the official rate of 6.5%.

• Confidence amongst consumers and business managers is too low.

Key Macro Data Points for November & YTD, YoY Change

Data Point	1-11 mths, YoY	November, YoY
Budget deficit, % of GDP	1.0%	-1.0%
Industrial Production, % Chge	-0.1%	-1.0%
Capital Investment, % Chge	-0.8%	0.2%
Construction spend, % Chge		-0.3%
Apriculture Output, % Chge	6.8%	-18.3%
Cargo volumes, % Chge		-0.8%
Inflation CPI, % Chge	6.5%	6.5%
PPI, % Chge	1.6%	1.6%
Central Bank Key rate	5.5%	5.5%
RUB-USD		33.178
RUB-EUR		45.162
Retail Sales, % Chge	3.9%	4.5%
Vehicle Sales, units		231,982
Vehicle Sales, % Chge	-6%	-4%
Real Wages, % Chge	5.5%	4.8%
Average Monthly Wages (US$)	$912	$912
Real Disposable Income, % Chge	3.6%	1.5%
Unemployment rate	5.4%	5.4%

Source: Federal Statistics Service

Politics: A dull year

Only one election date in 2013. There were some notable developments in politics in 2013 but the net conclusion is that very little actually changed. The only election date last year was September 8th when all mayor and regional elections took place. As expected Sergei Sobyanin won the Moscow Mayor election in the first round and there were no surprises of importance in any other election. Moving from being an appointed mayor to a first round elected mayor enhances Sobyanin's political standing, albeit so far his support base is Moscow centred rather than national (see table below).

Alexey Navalny. Navalny featured extensively in the media ahead of his trial (for alleged fraud) in the Kirov region and ahead of the Moscow mayor election. He came second in the Moscow election but since then has had a very low profile. The sentence handed down in the Kirov trial has been suspended but he currently faces additional criminal allegations. The opinion polls show that his approval rating has improved nationally since the summer but he is a long way from being a credible national politician.

Putin met with 2nd tier opposition leaders. The one notable event over the past few months was the meeting between president Putin and leaders of the non-parliamentary opposition. This was the first ever time for Putin to meet with opposition leaders outside those parties represented in the Duma. According to the Kremlin's press office the reason for the meeting was because the parties comprise the next echelon, after parliamentary parties, in terms of political potential, and the president wanted to discuss issues which he planned to raise in his address to the Federal Assembly (December 12th). Participants included Mikhail Prokhorov (Civil Platform party – he has since resigned in favour of his sister), Vladimir Ryzhkov (RPR-Parnas) and Sergei Mitrokhin (Yabloko).

Putin's approval rating holds steady. Most observers follow the Levada Centre's surveys of public opinion. Set up by the highly respected Yuri Levada (now deceased) the polling methodology has been consistent and an accurate predictor of actual election results over the years. The table below shows the trend in the approval ratings for both President Putin and Prime Minister Medvedev over the past two years. In the case of the president his December 2013 approval rating was exactly the same as that of twelve months earlier. PM Medvedev's approval rating fell from 57% to 51% over the same period.

President is also the most trusted politician. A separate poll, asking who is the most popular politician in Russia, published by the All-Russia Public opinion research centre (VTsIOM) reported that President Putin achieved a rating of 44% in December compared to 54% twelve months earlier. But, the director-general of VTsIOM was quick to clarify that this poll is heavily influenced by elections and he explained the high Dec 2012 rating as a result of the March election. The VTsIOM election is closer in structure to the Levada monthly poll which asks people "which politician they trust most". Putin has a 36% rating in this poll, up from 34% in December 2012.

Approval Ratings for President and Prime Minister

	Jan '12	July '12	Oct '12	Nov '12	Dec '12	Mar '13	May '13	Oct '13	Nov '13	Dec '13
Vladimir Putin										
Approve	64%	67%	67%	63%	65%	63%	64%	64%	61%	65%
Disapprove	34%	32%	32%	36%	34%	36%	35%	35%	37%	34%
Dmitri Medvedev										
Approve	57%	59%	61%	54%	57%	54%	54%	51%	46%	51%
Disapprove	41%	39%	38%	45%	42%	45%	46%	49%	53%	47%

Source: Levada Center

Prime Minister's position slipped. As President Putin's approval and trust rating held steady/improved through 2013, that of the prime minister weakened. He is now no longer the 2nd most trusted politician in Russia. Defence Minister Shoigu has held that spot since the summer. There has been a lot of media speculation about the Prime Minister's future in government and it has been clear for some time that certain groups at the top of government would like to see significant cabinet changes.

People are becoming less satisfied. But as people continue to show support for the President there is evidence of declining satisfaction with the work of government and the results achieved thus far. Levada Center released a survey in December which showed that;

• 39% of people approve of the government's actions down from 44% in the summer)

• 33% approve of the Duma's performance (from 40% in July) while 65% disapprove (up from 59% since July)

When asked if President Putin was following a clear course of action;

• 7% said "definitely"

• 37% said "on the whole" yes

• 36% said that he has a "general idea"

• 20% had no idea or refused to answer

When then asked what they thought the president's key strategy is;

• 24% said "to stay in power"

• 21% said he wants to "maintain national stability"

• 16% said "to improve the quality of Russia life"

• 16% said that there is "no strategy"

• 23% had no idea or refused to answer

G20. Russia held the rotating Chairmanship of the G20 through 2013 and hosted the leader's summit in St Petersburg in early September. It had been hoped that the "year of the G20" might act as a spur for greater reforms in Russia but, mostly because of the still uncertain global backdrop, relatively little was achieved. Or, at least not visibly so.

Amnesty. 2013 ended with an amnesty for approximately 20,000 prisoners to mark the 20th anniversary of the adoption of Russia's constitution. The Kremlin used the opportunity to rid itself of several controversial cases, such as the Greenpeace activists, in the hope that these will not intrude ahead of, or during, the Sochi Olympics.

Khodorkovsky. The most controversial event at the end of the year was the presidential pardon for former Yukos chief, Mikhail Khodorkovsky. I have written about this in the Op-Ed reproduced at the end of this note. The only point to add is the fact that his release was not part of the amnesty programme and it came even as it was disclosed that law enforcement agencies have been working on a third case against him.

Trusted Politicians

		Jan '12	Mar '12	Sept '12	Dec '12	Mar '13	Oct '13	Nov '13	Dec '13
Putin	President	41%	44%	36%	34%	35%	33%	32%	36%
Medvedev	Prime Minister	28%	28%	23%	19%	17%	14%	11%	14%
Shoigu	Defense Minister	11%	9%	10%	14%	18%	17%	19%	19%
Zyuganov	Leader Communist Party	12%	14%	8%	8%	9%	10%	8%	9%
Zhirinovsky	Leader LDPR	12%	9%	8%	8%	9%	8%	9%	8%
Prokhorov	Businessman-Independent politician	4%	8%	5%	4%	6%	5%	5%	5%
Patriarch Kirill	Head of Church	7%	5%	6%	3%	3%	3%	2%	4%
Matveinko	Leader of the Federation Council	5%	4%	4%	4%	4%	3%	3%	3%
Lavrov	Foreign Minister				4%	5%	5%	5%	6%
Sobyanin	Moscow Mayor				5%	2%	6%	4%	5%
Mironov	Founder member of A Just Russia	8%	6%	4%	3%	4%	4%	3%	3%
None of the above		17%	15%	22%	20%	20%	22%	25%	20%
No opinion		5%	4%	10%	9%	6%	6%	6%	7%

Source: Levada Center

Stock Market: Russian tech sector shares led the way

A poor year for all EM Indices. Overall it was a disappointing year for Russian equity indices, as it was for most indices in the emerging markets asset class. MICEX managed to scramble just above the break even line with a full year gain of 1.9%. The dollar denominated indices, the RTS and RDXUSD, both lost due to the negative impact of the weaker ruble.

EM Indices used trade at a premium but are now at a discount. The main theme within global markets this year was the shift in investor liquidity from emerging markets to developed markets, mainly to the US market. A total of $12.2 bln was transferred over the course of the year and that both weighed down on the MSCI EM Index (-5%) while helping boost the S&P 500 Index (+29.6%). Since the start of the recovery in the US economy the MSCI EM Index has under-performed developed market indices by over 30%. What that means is that while historically the MSCI EM Index has traded at up to a 20% premium in terms of price-earnings ratio, as 2013 closed the EM rating was trading at an approximate 10% discount.

The uncertain earnings outlook is the key. The issues are the outlook for liquidity flows, i.e. as the US Fed starts to taper the QE programmes, and the outlook for earnings on the back of economic growth forecasts. The specific concern which has hung over all EM assets in 2013, is that the reversal of investor liquidity and structural problems within emerging economies, e.g. current account deficits and high debt service costs, may substantially reduce previously high growth trends. This is the key issue to be resolved in early 2014 and will be the major factor in determining whether there is another relatively poor year for emerging market assets relative to developed market assets.

EM Indices, Commodities and Currencies in 2013*

	Index/Price*	2013 full year
RTS Index	1,442.2	-5.6%
MICEX Index	1,503.4	1.9%
RDX USD Index	1,712.9	-1.1%
Kazakhstan KASE	918.0	-5.3%
Ukraine UX	910.0	-4.3%
Turkey ISE	67,810.7	-14.9%
Shanghai Composite	2,116.0	-6.7%
India BSE	21,140.5	8.0%
Brazil Bovespa	51,507.2	-15.5%
MSCI EM Index	1,002.8	-5.0%
MSCI World Index	1,659.7	24.0%
S&P 500	1,848.4	29.6%
MSCI EMEA	328.4	-8.0%
MSCI Latin America	3,200.8	-15.7%
MSCI Asia	446.2	18.1%
MSCI Frontier Markets	594.5	27.8%
Copper, $ p/lb	$339.65	-7.0%
Brent, Fwd, $ p/bbl	$110.80	-0.3%
Gold, $ p/oz	$1,205.90	-28.0%
Rub/US$	32.855p.	-8.0%
US$/Eur	$1.377	-4.3%

Bond Yields	Jan 1 '13	End December*
UST - 10 Yr Yield	1.77%	2.99%
Russia - Eurobond '28	3.83%	5.65%
Russia - Eurobond '30	2.55%	4.13%
OFZ - 10y		7.67%

Source: Bloomberg

* prices at close December 31st - US$ except where indicated

Big divergence between the best and worst Russian names. But, while the Russian indices tracked close to the breakeven line, there was considerable divergence of performance between the industry sectors. The table below shows the performance of the Russian stocks which trade as DRs in international markets.

Technology sector shares stormed ahead. The best performing theme was that of technology and media with two of last year's new listings, QIWI and Luxoft both recording price gains in excess of 100% from their debut listing price. The top five best performers are all listed in New York. IT services and internet usage are amongst the fastest growth areas in the economy and, so far, are unaffected by the slowdown elsewhere. The best share outside of tech-media was again Magnit. Magnit has been consistently one of the best performing Russian names over the past few years as it continues to match, or exceed, investor expectations for growth and margins.

Metals propped the bottom of the table. The other end of the table is dominated by gold and industrial metal producers. The price of gold bullion fell by 28% in 2013 and silver collapsed 36%. Petropavlovsk earnings took a big hit on those price falls. Industrial metal prices fell as China/ Asia demand slipped against a backdrop of excess supply. Changes to the LME warehouse management, which has led RusAl to launch a legal case against the LME in December, also undermined sentiment. Several companies, notably Mechel, ran into debt service and gearing problems as earnings and cash flows suffered.

Russian DRs Leaders & Laggards 2013*

	Price*	2013*		Price*	2013*
	$ p/s	%		$ p/s	%
Out-Performed RTS Index			**Under-Performed RTS Index**		
QIWI*	56.00	229.4%	X5 Retail Group	16.77	-6.1%
Luxoft*	37.00	117.6%	Ukrnafta (Eur)	59.00	-7.5%
Yandex	43.15	100.3%	Novorossiisk Seaport	6.25	-8.8%
EPAM	34.94	93.0%	MD Medical	11.30	-9.4%
CTC Media	13.99	79.8%	Gazprom	8.55	-9.6%
Magnit	66.20	64.0%	Norilsk Nickel	16.62	-9.8%
Sistema	32.12	59.0%	TCS Group*	15.70	-10.3%
Megafon	33.50	40.8%	Tatneft	38.22	-12.3%
Chelyabinsk Zinc	3.45	30.2%	KazMunaiGas	15.70	-12.8%
Mail.Ru	44.60	29.3%	VTB	3.00	-13.4%
Eurasia Drilling	45.00	26.1%	Rosneft	7.62	-14.5%
AFI Development	0.72	25.2%	Novolipetsk	16.89	-16.6%
Raven Russia Plc (GBP)	0.80	25.2%	Severstal	9.88	-18.8%
Halyk Bank	10.25	25.0%	Ferrexpo (GBP)	191.00	-20.8%
Vimpelcom	12.94	23.4%	TMK	11.79	-23.0%
Moscow Exchange (Rub)*	64.75	17.7%	RusHydro	1.73	-25.3%
MTS	21.63	16.0%	Phos Agro	9.79	-28.1%
Novatek	136.90	14.3%	Uralkali	26.60	-30.4%
MHP	17.05	8.6%	Magnitogorsk	3.00	-31.4%
Nomos Bank	14.50	7.0%	IRC (HK$)	0.78	-33.3%
KazkomertsBank	1.80	5.9%	Transcontainer	9.00	-36.8%
PIK Group	2.32	5.5%	Highland Gold Plc (GBP)	58.50	-39.4%
Avangard	11.75	3.7%	Hydraulic Machines	2.50	-40.8%
Cherkizovo Group	12.30	3.0%	Pharmstandard	9.92	-40.9%
Sberbank	12.58	2.3%	Polymetal (GBP)	575.00	-51.1%
O'Key Group	11.90	1.7%	RusAl (HK$)	2.30	-53.1%
LSR Group	4.19	0.5%	Federal Grid	1.35	-55.0%
Integra	16.85	0.3%	Evraz Plc (GBP)	111.90	-56.8%
Alrosa*	35.00	0.0%	Mechel	2.56	-63.1%
Ros Agro	6.45	-0.7%	RusPetro Plc (GBP)	27.50	-65.2%
Global Ports	13.98	-0.9%	Kazakhmys (GBP)	218.60	-71.9%
Surgutneftegaz	8.64	-1.8%	Petropavlovsk Plc (GBP)	72.75	-79.8%
GazpromNeft	22.60	-2.5%			
Etalon Group	5.30	-2.8%			
Polyus Gold Intl (GBP)	198.75	-2.9%			
GlobalTrans	15.90	-3.7%			
LUKoil	62.45	-5.6%			

* prices at close December 31st - US$ except where indicated
** performance is from IPO listing price

Equity Issuance: Better than 2012 but still struggling

Big ambitions – slow delivery. Low volume compared to the queue of issues waiting 2013 was a better year than 2012 for new equity issuance, but still very modest when compared to the total volume of equity issuance which needs to be placed both by the state and by the private sector. It is estimated that approximately $25 bln worth of placings from the private sector are waiting for the right market conditions to list while the value of state's long-term privatization programme is estimated at close to $100 bln.

IPOs/SPOs raised $7.9 bln versus $3.7 bln in 2012. Five IPOs raised $3.2 bln, while four SPOs raised $4.7 bln. That compares with four IPOs in 2012 ($2.5 bln) and two SPOs ($1.2 bln). In addition, four strategic shareholder sales took place, raising $1.1bln (table below). That brought the total (IPOs, SPOs, and strategic stake sales) raised in 2013 to just under $10 bln. That almost equates to the $9.9 bln raised in both 2012 and 2011.

Note: Strategic shareholder sales are those where a core shareholder sells equity to the market rather than to another strategic shareholder. Hence the sale of Mikhail Prokhorov's equity in Polyus Gold is excluded as is Suleyman Kerimov's equity in Uralkali.

State privatization programme was sharply reduced. The biggest disappointment was the almost non-appearance of any privatization issues. The $3.3 bln raised from the sale of VTB equity was an issue from the company to boost its balance sheet. The state did not sell any equity nor did the Federal Budget receive any cash. The only public listing was the state's participation in the Alrosa IPO in October. The issue raised $1.3 bln in total and the proceeds were split almost equally between the Federal budget and the Yakutia regional budget.

State bureaucrats are in no hurry to sell equity.

The previously ambitious privatization programme, which aimed at raising approximately $15 bln annually for the federal Budget was scaled back considerably last spring as a result of what PM Medvedev called "lobbying by vested interests in government agencies"

Note: Other state asset sales did take place on a private (non-listing) basis but we do not as yet know the value of these transactions.

One issue was pulled. Only one issue was formally launched but then pulled in 2013. This was Sibanthracite, which is a producer if high grade anthracite. It attempted a London listing in July targeting between $160 mln and $220 mln but pulled the issue due to low demand. Owners appear to have learned the lesson to conduct greater pre-marketing to find out investor appetite and to determine a viable valuation range.

New Equity Issuance: IPOs. SPOs and Stratgeic Stake Sales* in 2012 & 2013

	Total raised	Month		Total raised	Month
2012 IPOs			2013 IPOs		
RusPetro	$265	January	Moscow Exchange	$498	February
MD Medical	$408	October	QIWI	$213	May
Megafon	$1,830	November	Luxoft	$80	June
Multisistema	$3	December	Alrosa	$1,300	October
			TCS group	$1,087	October
Total IPOs	**$2,506**		**Total IPOs**	**$3,178**	
SPOs			SPOs		
GlobalTrans	$520	July	PhosAgro	$467	April
			VTB	$3,300	May
Polyus Gold**	$636	Q3	PIK Group	$330	June
			NMOS	$600	October
Total SPOs	**$1,156**		**Total SPOs**	**$4,697**	
Strategic Shareholder sales Sales			Strategic Shareholder sales Sales		
Mail.ru	$122	March	Yandex	$607	March
Highland Gold	$130	April	Eurasia Drilling	$122	September
Sberbank	$5,200	September	QIWI	$288	October
M.Video	$146	September	Luxoft	$95	November
Mail.ru	$408	September			
GlobalTrans	$200	October			
Total Strategic S/H sales	**$6,206**		**Total Strategic S/H sales**	**$1,111**	
Total Equity Issuance for 2012	**$9,868**		**Total Equity Issuance for 2013**	**$8,986**	

Source: Macro-Advisory estimates

****** equity sales excludes sales from one strategic shareholder to another strategic shareholder***
****** sale of 7.5% of Treasury shares to CIC/VTB***

One issue was pulled. Only one issue was formally launched but then pulled in 2013. This was Sibanthracite, which is a producer of high grade anthracite. It attempted a London listing in July targeting between $160 mln and $220 mln but pulled the issue due to low demand. Owners appear to have learned the lesson to conduct greater pre-marketing to find out investor appetite and to determine a viable valuation range.

Six out of nine issues made money. The table below shows the performance of the nine IPOs/SPOs completed in 2013. Six beat the index performance (+1.9% for MICEX and -1.1% for the RDXUSD), with the two IT/Tech company issues, QIWI and Luxoft, gaining by more than 100% each. Alrosa managed to claw back over the last few days of December to close the year exactly at the issue price. Two issues, Phosagro and TCS group lost money for investors.

Price Performance of 2013 IPO/SPOs				
Issue	**IPO/SPO**	**Price - Dec 31st**	**Issue Price**	**Gain/Loss**
QIWI	IPO - May	56.00	17.00	229%
Luxoft	IPO - June	37.00	17.00	118%
PIK Group	SPO - June	2.32	1.90	22%
VTB	SPO - May	0.05	0.04	21%
Moscow Exchange	IPO - February	64.75	55.00	18%
NMOS	SPO - October	960.00	875.00	10%
Alrosa	IPO - October	35.00	35.00	0%
TCS group	IPO - October	15.70	17.50	-10%
PhosAgro	SPO - April	9.79	14.00	-30%
Source: Macro-Advisory, Bloomberg				

Companies which have publicly indicated that they are targeting an IPO/SPO in 2014 include:

Obuv Rossii
Shoe manufacturer
Metro
Cash & Carry business
Lenta
Food retailer
Rostelecom
Fixed line telecoms
Aeroflot
Airline
Bashneft
Oil producer – targeting a London listing
IGSS
Seismic Exploration business
Detsky Mir
Children's Toys retailer – maybe 2014 or 2015
Rosnano
Technology developer…part of privatization programme

History of Russian IPOs & SPOs*		
Year	**No of Issues**	**Total raised, $ mln**
1996	1	$111
1997		
1998		
1999	1	$52
2000	1	$323
2001		
2002	2	$220
2003	1	$14
2004	5	$620
2005	12	$4,926
2006	13	$17,654
2007	29	$32,869
2008	4	$1,985
2009	9	$1,690
2010	16	$6,617
2011	12	$6,138
2012	6	$3,662
2013	9	$7,875
Source: Macro-Advisory Ltd		
* excludes sales from Strategic Shareholders		
where money raised did not go to the company		

Moscow Times Op-Ed: Khodorkovsky Pardon Bodes Well for Economy

24 December 2013

A great deal has been written recently about the early release from prison of former Yukos CEO Mikhail Khodorkovsky. Many commentators have concluded that the timing of his release was linked to the upcoming Sochi Olympics, now less than 50 days away, and that the move was possibly an effort to deflect media attention away from the Ukraine situation. Undoubtedly, there is some element of truth in both of these assumptions. But let us also place this news in the broader context of President Vladimir Putin's recent comments about the country's poor economic performance and the now urgent need for accelerated efforts to boost confidence and investment flows. Finally drawing a line under what has been one of the most egregious incidents in Russia's modern history can also be viewed much more positively — or perhaps hopefully — as part of that new reform focus.

The year 2013 was terrible in terms of economic growth. From 3.4 percent in 2012 and early expectations of a repeat performance this year, the economy is much more likely to report growth of only 1.3 percent. In global terms, that is still a good number, but it is certainly a long way from the 4 to 5 percent growth promised by Putin when he was re-elected in 2012. A second consecutive year of poor growth will create a sense of stagnation and a more negative backdrop coming into the next election cycle.

The good news is that the president is finally starting to pay attention. In his mid-December address to the Federal Assembly, there was a very important shift in his rhetoric about the economy. The president's diagnosis of the reasons for poor growth and his view of what needs to be done about it also changed markedly in that address. This is not a case of "we have heard this all before," as Putin has previously been very consistent with the view that Russia's economic problems are a consequence of global contagion and, therefore, the domestic policy priority should be to maintain fiscal and monetary stability while waiting for the rest of the world to sort itself out.

This change in attitude meant that the debate about the need for stimulus that was so prevalent in the spring this year was totally abandoned in favor of another "battening down of the hatches" immediately after U.S. Federal Reserve Chairman Ben Bernanke's tapering comments in May led to a sharp rise in currency volatility in emerging markets. Moving to Russia, stimulus and cutting rates was then deemed too dangerous. But while the decision led to greater ruble stability, the pace of growth in such areas as retail spending and capital investment continued to slide. These have been the two biggest factors behind the poor performance of the economy this past year.

In his mid-December address, however, Putin acknowledged that the slump had actually been caused by domestic policy failures. Still, even though the urgency is now better acknowledged, it is not expected that the debate over what specific policy changes to make will gain momentum until the spring. For the next two months, one policy priority will eclipse all others: delivering a controversy-free and efficiently managed Winter Olympics.

By then the sense of urgency will very likely have increased. The first quarter indicators are expected to be bad, especially on a yearly comparison with what was a strong first quarter this year. And that is a good thing. Russia has a bad habit of ignoring forewarnings of impending crises, taking remedial action only when already suffering the consequences of the problem. One only has to recall the persistent warnings of former Finance Minister Alexei Kudrin about the probability of a growth collapse. It is also very encouraging to see that he has been brought back into a formal economic advisory role as a member of the presidium of the presidential Economic Council.

Realizing the goal of returning growth back toward the 3 percent level in 2014, i.e. as an interim step toward the main goal of sustaining annualized growth at 4 to 5 percent, will require fiscal and monetary policy changes and faster progress with the reform agenda. With that in mind, investors' wish list for 2014 includes some clear actions from the government, including;

• greater efficiency in budget spending to shift resources toward growth boosting projects and away from non-productive areas such as defense spending

• the start of cuts to the Central Bank's benchmark interest rate and a big cut in the commercial bank's average lending rate to small businesses

➢an increase in infrastructure spending

➢greater determination to meet OECD conditions, which means improving investors' perception of Russia's risk and its business environment

➢an improvement in corporate governance, especially in the state sector

The battle for lower interest rates will certainly be one of the tough issues. The Central Bank is opposed to any cuts in its benchmark rate so long as inflation is even close to 6 percent. Inflation has again been recently rising and is expected to end the year close to 6.5 percent. Putin's economic adviser recently demanded a rate cut as part of a growth stimulus package.

That looks like it will be a key battle in the spring.

Ultimately it is recognized by all sides that the economy needs a new growth driver based on higher investment spending, and the only way to generate that is to create the conditions which lead to higher inward investment flows and lower capital flight. Although the decision to grant a presidential pardon to Khodorkovsky drew a line under one of the most nefarious episodes in Russia's modern history, on its own, this surprise move is not a magic wand and will not lead to a boost in capital flows. Since Khodorkovsky's incarceration, the Yukos case as a poster child of Russia's business risk has been edged out by the Sergei Magnitsky case.

Today, investors are much more focused on what is actually being done to reduce the incidence of corruption, to improve the rule of law and to reduce bureaucratic hurdles. Progress remains slow. Despite the dismissive comments of Kremlin critics, however, there has been measurable progress in 2013. The number of former officials dismissed and now under formal investigation for corruption has increased. Russia moved up 20 places in the World Bank's Ease of Doing Business survey as the number of bureaucratic procedures and business costs are cut.
Of course, much more needs to be done across all areas of the reform program. One of the biggest obstacles in the past has been the intransigence of bureaucrats. Prime Minister Dmitry Medvedev directly blamed vested interest groups within the state bureaucracy for the big cut in the state's privatization program last spring. It must be said that attitudes among this powerful group will not be changed with a presidential signature.

That said, Khodorkovsky's release, along with the president's acknowledgement of the root cause of the current slowdown, plus his change of stance on the urgency for policy and spending reforms, at least offer greater optimism that 2014 will be the transition year we have been hoping for. The old model is broken. It needs to be replaced.

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