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Country Atlas/Index Atlas

Russia
Countries/Indexes/Funds/ Strategy

April 2017

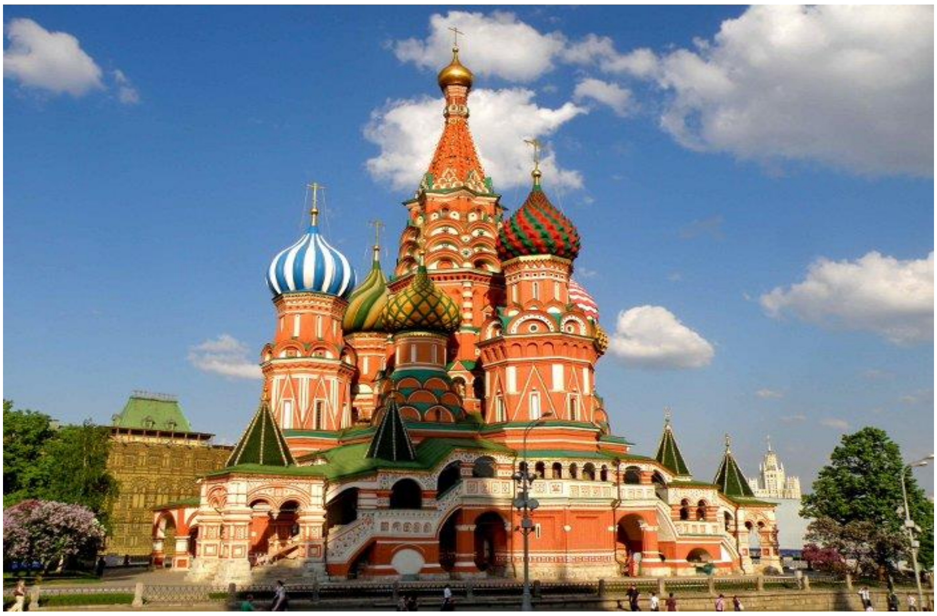
Russia News – Politics

(This column contains headlines and links to relevant recent Russia related news)

- Donald Trump and the **Russia** connections: From **president's** ...
- Former adviser to three GOP **presidents** questions Trump's ...
- Deutsche Bank examined Donald Trump's account for **Russia** links
- **Russia** denies targeting French **presidential** contender
- **Russian** Deputy **Prime Minister** to Hold Talks on New Anti-Terror Law
- Japanese **Prime Minister** Shinzo Abe says Donald Trump ...
- Why did the **Russian** deputy **prime minister** abruptly cancel a visit to ...
- **Russian** law decriminalising domestic violence slammed by **Prime** ...
- **Russia** deputy **Prime Minister** Vitaly Mutko says doping coaches ...
- **Russian prime minister**: Obama's mistakes 'will be remembered by ...
- Principal Conditions for **Russian Economic Growth** Greatly

2017 Russia in Spotlight and Which Benchmark Is Good? – RTS.

- **Russia has been a problem child of global emerging markets ever since 2008 crisis. Investor perception worsened following 2011 political unrest, 2014 geo political problems and the oil price collapse.**
- **Nevertheless in 2016 Russia was the second best performing market globally - following Brazil up 70%. Can it repeat the success in 2017?**
- **International investors are increasingly exposed to Russia via ETFs yet most of the ETF money is tracking either MSCI Russia universe or a RSX Russia universe. While probably the only proper benchmark which is most widely associated with Russia is RTS index, but there are no large ETFs linked to RTS universe.**
- **Having looked at Russian macro, we think that recovery is unavoidable and will be driven either by restocking, an oil price bounce or major structural shifts i.e. productivity increases or fall of inflation and Reagan style credit expansion.**



Increases

- **Russian Economy** May Grow 2% in 2017 Amid Highest Business ...
- UPDATE 2-**Russian economy** may be over the worst, returning to ...
- Structural constraints weigh down **Russia's economic growth** ...
- OPEC Revises **Russian** 2017 GDP **Growth** Forecast Up by 0.1% to 1 ...
- Why the **Russian economic** crisis is far from over

- The Munich Security Conference Focuses on Russia and Reflects ...
- Ambassadors of Austria, Italy, South Africa to attend Russian ...
- BP's Path To Improvement Looks Intact
- US-Russia relationship may be top question at Davos
- The Russian Economy Boasts Winning Combination in 2017
- China announces strategic plans for Russia and USA
- US small-caps and emerging markets look ripe for **growth**
- **Russia Investment** Bet Turning Out A Winner
- Headed by Billionaires and a Banker, Trump's Econ Team Takes ...

- Labor minister says **Russia's population** grows naturally by 80000 in ...
- Death throes of Russia's iconic countryside
- Why the Russian economic crisis is far from over
- Almost all **Russia's population growth** caused by migration
- Russian scientists offer drug addicts hope for a new life
- Trump's Russia Reset Will Survive Flynn's Ouster
- When will Russia finally break its 'resource curse'?
- New stadiums won't hide Russia's poverty wound

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- Laying Foundations for **Growth**: The Future of Vietnamese ...
- China's Foreign Trade in 2016: Identifying Trends and Opportunities
- China in 2017 Increasing Trade Alliances With Eurasia

- Russia lost $26 billion on oil and gas exports
- 1. Why Is Russia Buying US Dollars?
- Why Is Russia Suddenly Buying Billions of US Dollars?
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- Here's Another Way Russia Is Getting a Boost From Donald Trump's ...
- Russia may place $3 bln in Eurobonds in spring: finance minister
- Exclusive: Russia could rebuild fiscal reserves at $55 oil price

- Belarus Files Lawsuit Against Russia Over Oil Delivery Cut - President
- Cries of Violating the Logan Act Are Frequent
- **Russia's debt** collectors turn violent as recession leaves 11.5m in debt
- Ukraine halts $3bn **Russia debt** repayment
- In **Russia, debt** collectors may

Russia Drivers

RTS Index long time history

Source: ML, Bloomberg

Trump

New US president election result was a black swan event that happened quite unexpectedly. Many thought that the winning candidate will be a negative driver for the emerging markets. But the US markets took the election results quite positively, and the rest of the markets – followed. Subsequent announcement of 1 trln$ infrastructure spending plan has provided more fuel for the markets that has partially offset negative pressure of falling bond prices and expectations of rising interest rates.

Russian markets reacted quite positively to Trump election on expectations of possibility of future sanctions removal. But the allegations that Russia has somehow interfered into elections results as well as escalation in Eastern Ukraine cast shadow over the possibility of falling sanctions. Few have voiced concern that sanctions are probably forever. Yet there are indications that sanctions might be removed if the appropriate compromise is reached.

sexually assault you or burn your ...
- American In Charge Of Ukraine's Finances Thinks **Russia Debt** Deal ...
- **Russia's debt** downgraded to junk by Moody's
- 'Where Is This Country Going?' Debt Crisis Tugs At Russian ...
- Trump Campaign Aides Had Repeated Contacts With Russian ...
- **Putin** Says Accusations in Trump Dossier Are 'Clearly Fake'
- Trump, Asked Again About **Putin**, Suggests US Isn't 'So Innocent'
- Russia Deploys Missile, Violating Treaty and Challenging Trump
- **Putin** Critic, Who Said He Was Poisoned in 2015, Falls Into Coma
- Multiple Russia-China Ministerial Meetings Planned For This Year
- Russia pursuing sanctions-busting strategy: expert
- Russian **premier**, Slovenian president express hope for Ukraine ...
- **Dmitri Medvedev**, le **Premier** ministre russe attendu en Isral
- Military hardware fetches Russia $15b
- Russian president Vladimir Putin fights on for World Cup 2018 in ...
- David Beckham fighting to deliver last-minute heroics for England ...
- Prime Minister David Cameron and Prince William will both be in ...
- Can space bring two old frenemies Japan and Russia closer together?
- Four Russian airlines apply to fly between Russia and Egypt: Moscow
- Google boss Eric Schmidt may snub David Cameron over ...
- Why Hong Kong investors may find Russia newly attractive
- Russians jump Sharm queues: Britons in anger over 'priority ...
- Li Keqiang Attends Closing Ceremony of the China-Russia Youth ...
- After 72 Die, Putin Tightens Limits on Consumer Products High in ...

Sanctions

Factors supporting the removal of sanctions - the positive effect of falling sanctions on Ukraine, EU and the US businesses and economies. While Russian bargaining for sanctions removal, given limited choices, leads to global negatives - escalation in Ukraine, Syria and rearming. While prolonged sanctions are unlikely to have any dynamic effect on Russian internal politics but their removal could possibly ring fence Ukraine from Russia creeping deeper into a sister neighbor. There are hopes that sanctions will be removed by the end of first half of 2018 when the dust from Russian election settles while international elites will have a clearer view of their options with Russia.

Macro Drivers

Russia economic growth is slowly getting closer to positive numbers. Industrial production has been in a growing mode since summer of 2016. The real wages are growing while retail sales decline headline numbers are less and less negative, but the recovery looks fragile and is unlikely to be V-shaped.

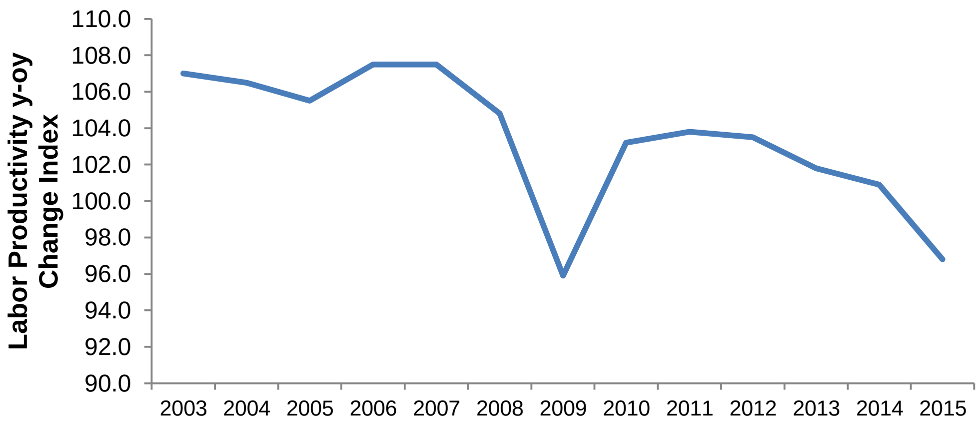
Unlike in 1998 when Russia had lavish excess of unutilized capacity and unlike in 2008 when destocking and quick bounce in oil price provided support for Russian economy, the current crisis has a much fewer options for policy to maneuver.

Sanctions and devaluation provided some protectionist advantage to the economy, but they were quite short lived as capacity utilization rates are quite at post-Soviet maximums while scarcity of capital and high risk would not allow any sizeable expansion.

Oil prices have also been unsupportive and are now seen in a very long sideways trend.

Policy makers mentioned several remedies for economic reversal citing possible increases in infrastructure improvement programs, expansion of local credit as well increases in productivity. In each of the later 3 areas expansion may occur from a very low base and could be quite helpful in improving the economy.

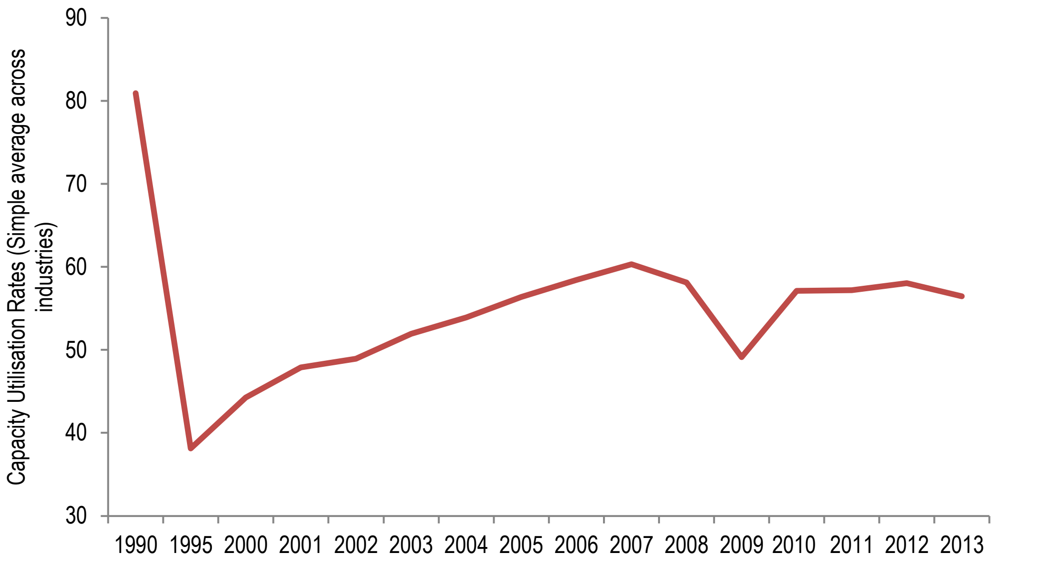
Russian Labour Productivity Index Change % y-o-y (simple average across industries calculated by ML)



Source: Goskomstat gks.ru

- 175 states sign landmark Paris deal on climate change
- Li Keqiang and Prime Minister Dmitry Medvedev of Russia Co-chair ...
- Weekend diplomacy: PM Narendra Modi meets Russia's **Deputy** PM ...
- Russia unveils Fedor the 'cyber cosmonaut' that Putin hopes will ...
- Has Russia's **deputy** PM shot himself in the leg? Vladimir Putin's ...
- India, Russia review bilateral ties ahead of President Putin's visit
- Russia to 'conquer the moon' and station a squad of cosmonauts in ...
- **Deputy** Prime Minister to Attend Korea-Russia Economic Science ...
- Li Keqiang Attends Opening Ceremony of 9th Summer Davos Forum ...
- Li Keqiang Meets with Prime Minister Chimediin Saikhanbileg of ...
- UAE imports 80% of its food needs: Al Mansouri
- India Russia to cooperate in the field of **Disaster** Management
- India joins hands with Russia for **disaster** management
- Russian plane crash: remains of victims arrive in Saint Petersburg
- India for enhanced global partnership in **disaster** management
- Armenia's Minister meets Russian **Minister of Communications** and ...
- First 2017 Confederations Cup 'FAN ID' passports issued in Moscow
- Russia to Sell Computer Processors to Iran
- Erjavec opens talks in Russia
- Pahor visiting Russia as part of mini tour
- Political Violence Becoming Commonplace in Russia -Rights Leader
- Academics Protest Closure of European University at St. Petersburg
- Profile: **Vladimir Medinsky**,

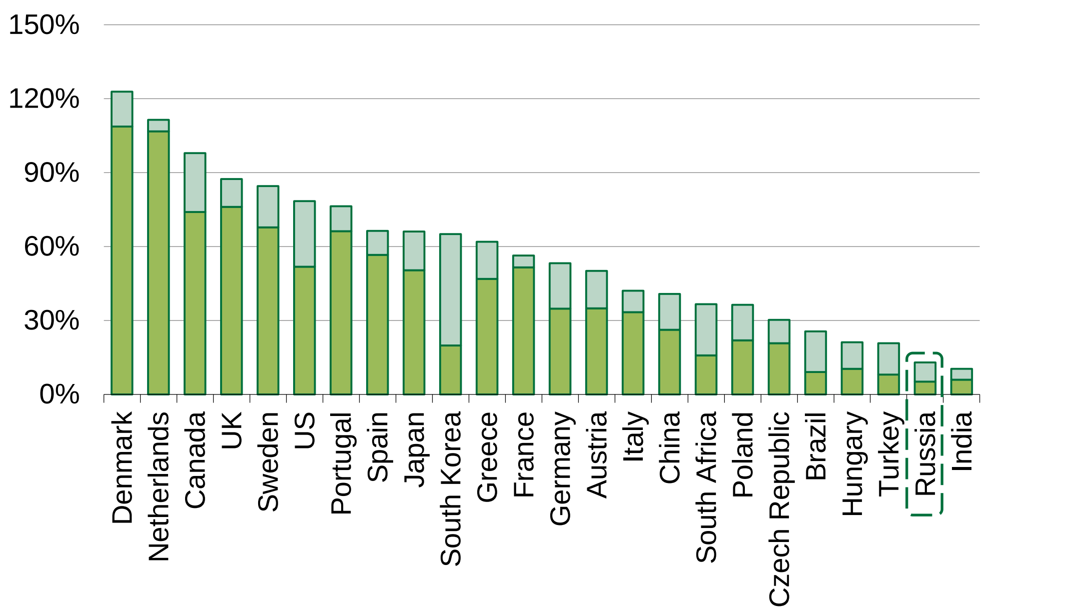
Capacity Utilization Rates In Russia (simple average across industries calculated by ML)



Source: Goskomstat gks.ru

Despite many Russians fairly leveraged

Russia remains strikingly underleveraged



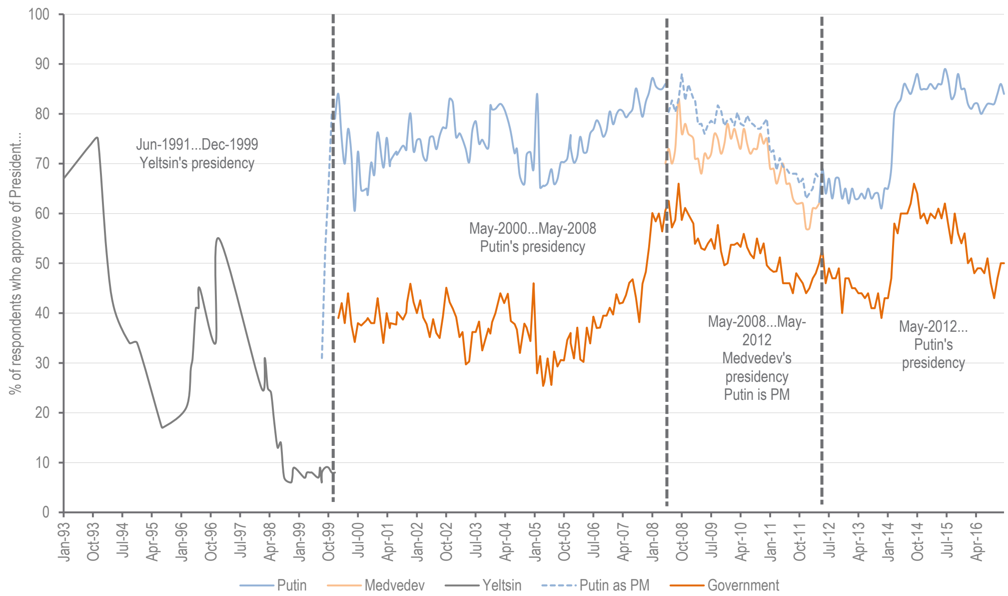
Source: Sberbank CIB, Euromonitor

Election

While many view the upcoming 2018 election as a non-event with pretty predictable outcome, the election years are generally profitable for investors who go long before the vote and sell after. (Most of this report has been written before the March 26 2017 anti-corruption protests. Please refer to our "Russia Sneakers Revolution – In Search of New Balance" for that discussion)

There are different views on when exactly to enter the trade expecting the repeat of 2011 but there is a large chance that unlike in 2011 the internal political quarrel could exacerbate the positives for investors, which is why they are unlikely to delay their orders until December 2017 to wait to see if the opposition in Russia is alive. While if even if it turns out that the opposition is completely crushed – which probably is not the case – markets are likely to face the repeat of 2007 and 2011 mini rally.

Popularity of Government and the President



Source: Levada Center

Russia's Controversial New **Culture** ...

- Entire staff of Moscow's Museum of Cinema resigns in protest ...
- HM the King, Russian President hold talks
- Russian asserts full support for Egypt in combating terrorism in Sinai ...
- Revealed: How Vladimir Putin's **defense minister** has secretly built a ...
- Russia's Zakharova Viciously Mocks UK's Boris Johnson for 'Shame ...
- The economic toll of the new age of terrorism - Daily News Egypt
- Iran Urges United, Immediate, Decisive Action against Terrorism
- In a Late-Night Move, Russia Arrests a Top **Economic** Official in a ...
- Putin's Kremlin Wracked by Corruption Charges
- Sergey Aleksashenko: Russian **Economy** Still Hasn't Reached Bottom
- Vladimir Putin says Russia 'won't start an arms race' at annual press ...
- Vladimir Putin names Maxim Oreshkin Russia's new **economy minister**
- Russia, Saudi Arabia sign joint statement to stabilize oil market
- Turkish Stream Deal Could Be Signed Monday - Rusisan **Energy Min**
- Iran to import 500MW electricity from Russia
- Russia - global oil output could be frozen at November level
- AP Analysis: Will oil producers' cut have lasting impact?
- Russia's Banking Crisis
- Obama and Allies Created Arab Spring and Refugee Crisis
- Wang Yi Holds Talks with **Foreign Minister Sergey Viktorovich** ...
- **Ministry of Foreign Affairs** Holds Event Presenting Guangxi Zhuang ...

- **Ministry of Foreign Affairs** Holds Briefing for Chinese and Foreign ...
- Russian FM in His Own Words: **Sergei Lavrov's** Top Ten Quotes
- Russia slump forecast to end; rapid recovery unlikely
- UAE Foreign **Minister** calls for closer **trade** ties with Russia
- BRICS summit: India banking on **trade** ties with Beijing, Kremlin to ...
- Russian **Trade Minister** Offers Indian Firms to Join High-Tech Projects
- Comprehensive deliberations at BRICS **Trade** Ministers meet
- Political Violence Becoming Commonplace in Russia -Rights Leader
- Academics Protest Closure of European University at St. Petersburg
- The pitchforks are coming
- US to Russia: We won't seek death penalty for Edward Snowden
- Russia Blacklists George Soros Foundations for 'Endangering ...
- Clans are marching
- Special Report: Russia Amends IP Law In Advance Of WTO Accession
- **Labor minister** says Russia's population grows naturally by 80000 in ...
- Putin pays tribute to Turkey's founding leader Atatrk in Ankara
- Chechen Leader Has His Ministers On The Ropes
- Senior citizens enjoy Russian government's growing care
- Russian government approved, only quarter of ministers stay
- Wallabies hurt by talent exodus
- Vladimir Putin visits Derbent, Dagestan, Russia exhibition
- Context, Conflict and Historical Consciousness: Pondering the ...
- Defiant Putin signs treaty making Crimea part of Russia
- Flights to Egypt to resume before year's end: Russian **transport** ...

Is Shift to Fundamentalism possible?

As widely noted -it is probably the shape of the Volga river that defines complexity of Russia. Volga river spans some of Russia's north, then flows east and then turns south to steppes. After Volgograd it passes "ITIL" Russia's pre-Christian capital and ends up in Caspian sea. On the other side of the sea is Iran, where in 1979 student appraisal in a fairly westernized country yielded clerical political leadership. Many commentators highlighted that the power was simply granted to clerics, because in chaos following the student appraisal, clergy was the only organized semi-political force with credibility.

Is fundamentalism just Caspian influence? All other countries bordering Caspian have strong fundamentalist influences – including Azerbaijan, Turkmenistan and Kazakhstan.

There are fragrances in Russian social and political life that smell like fundamentalist influences are on the rise.

On one hand they are reflections of global vectors noted by some scholars, who highlight global rise in fundamentalism as a function of various variables: reaction to consumerism, fall in civil education levels, rise in nationalism and etc.

This year Russia reflects on 1917 events when Russia lost the Tzar and gained Patriarch. The last Russian Tzar Nicholas II was a long opponent of nominating anybody for Patriarch role other then himself. But long he lived, and Russia's got the clerical leadership dissolved by Peter the Great.

Clergy was then purged by Bolsheviks. Though the recently deceased Patriarch Alexey, compared the Bolshevik period to Ecclesiastes' time of stone scattering, while the times following Yeltsin revolution to times to stone gathering.

Now the stone gathering has gathered some speed Russian Orthodox Church, which is , despite many positive examples, best known in the west for the monk Gregory Rasputin and his lavish lifestyle, became very well organised quasi-political force in Russia, influencing policy making on every occasion (formally church is separated from the state in Russia by law).

In fact Patriarch Kirill alongside Tikhon Shevkunov (who is frequently cited as Putin's personal confessor), Archbishop Illarion (who is more famous in London but his profile in in Russia is fairly low) as well as deacon and theologian Andrey Kuraev frequently cited as the modern Orthodox Russia ideologists.

The rise in spirituality is quite strong in Russia; the laws are being passed by the Duma that grant immunity to clergy and protect them from pretty much any public criticism.

It is not yet clear how it all will evolve, and any consequences on Russian political life, but the trends are set and some trends rise concern that a substantial shift to political fundamentalism could be possible.

On the other hand Russia is not uniformly orthodox. One of Putin's favorites Alexey Shoigu - Russian defense minister is Buddhist and is a from Buddhist region of Russia. Putin supports Chechen leadership – which are also devoted neophyte Muslims and is quite widely supported by them in reciprocity. While media sometimes reports that Putin courts

- Russian delegation to inspect Egypt's airports, consider resuming ...
- Russian Official Say Metrojet Broke up in Mid Air over Egypt
- **Security Council** accepts the Salmon Challenge
- Congratulations, President Putin! Everything Is Going According to ...
- Dangers of the Cuba Russia **Security** Agreement
- Obama's Secret Letter to Tehran: Is the War against Iran On Hold ...
- Can a China-Russia Axis Bankrupt the US?
- Putin's **Central** Banker Is On a Tear
- Putin's right-hand woman
- Putin's **Central** Banker **Nabiullina** Recites Verlaine as Regulator
- **US** Acting Deputy Secretary of State to Meet With Russian ...
- Put country before party
- Russian **Ambassador** Blames **US** For Spiraling Tensions With Moscow
- In 2015, Secretary of State hopeful said he's 'probably not qualified ...
- Beijing must adapt to unusual **US**-Russia ties
- Who Can Lead The **UN**?
- Security Council backs former Portuguese PM for **UN** chief
- Russia Holds War Games, Ukraine Troops Go On Alert, US Calls For ...
- Kerry Says Russia Violating **UN** Cease-Fire But May Soon Comply
- Ukraine Seeks To Blunt Russia's **UN** Veto Power

GDP

- **Russia** Nears End of Recession as **GDP** Shrinks Less Than Forecast
- **Russia's GDP** down 0.6% in 2016

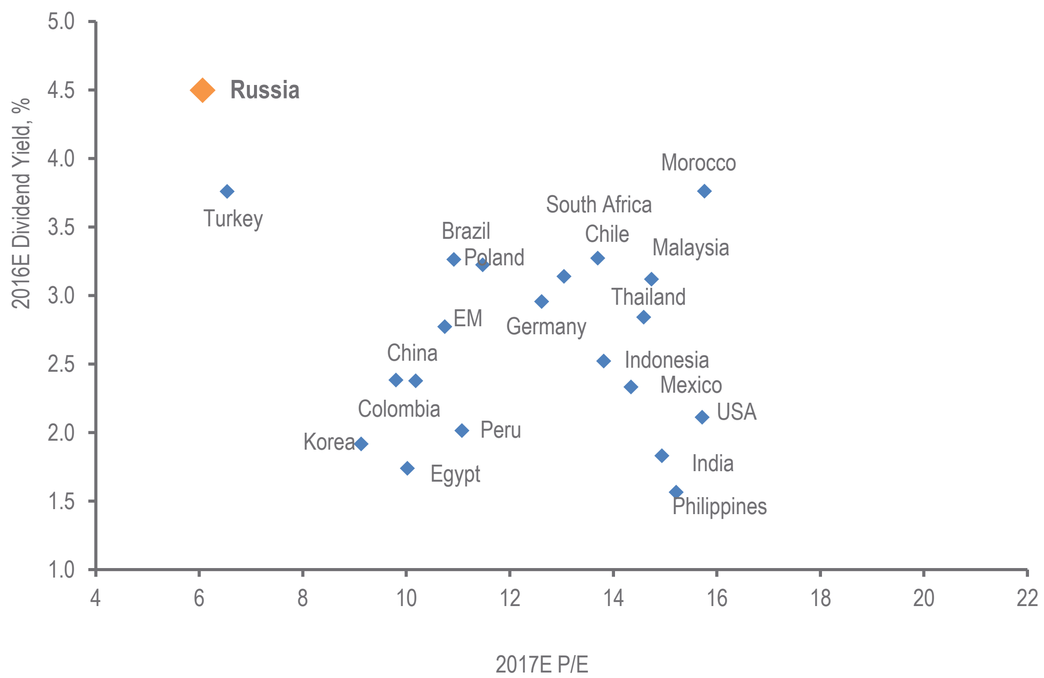
Muslim girlfriend. At the same time Vladimir Putin is very well greeted by influential Russian Jewish community, and keeps the relations close.

This looks like a balancing act, that Putin is performing very well and he probably gains additional credit for that, which also highlights that the balancing is possible while he is still there on top of Russia's political life.

Valuation

At current levels Russian valuations are cheap in historical perspective. Russia trades on 2017 expected PE of slightly higher than 6x and the dividend yield of 4.7% expected for 2017. Russia did trade on lower PE multiple of 3x in the end of 2008 when the oil price briefly ticked below 30$bbl however that was before the dividend reform for the SOEs and the dividend yield had not been higher that 2.5%. Comparing to December of 2011 which was also before the newer dividend policies of 25% payout for SOEs, Russia traded on F 2012 PE of 5x while the dividend yield was 3%. Russia still trades at very favorable PE and yield combination that has not deteriorated materially compared to the beginning of 2016 levels and after almost 70% run in prices. Low PE and high dividends is Russia new normal which will continue to attract investors into Russian stocks especially after the sovereign yields contraction. Russia maintains circa 40% discount to GEMs on forward PE basis while its payout ratio is 10% below GEMs average of 35% and has further room to improve.

Cross Country Valuation PE vs. Dividend Yield

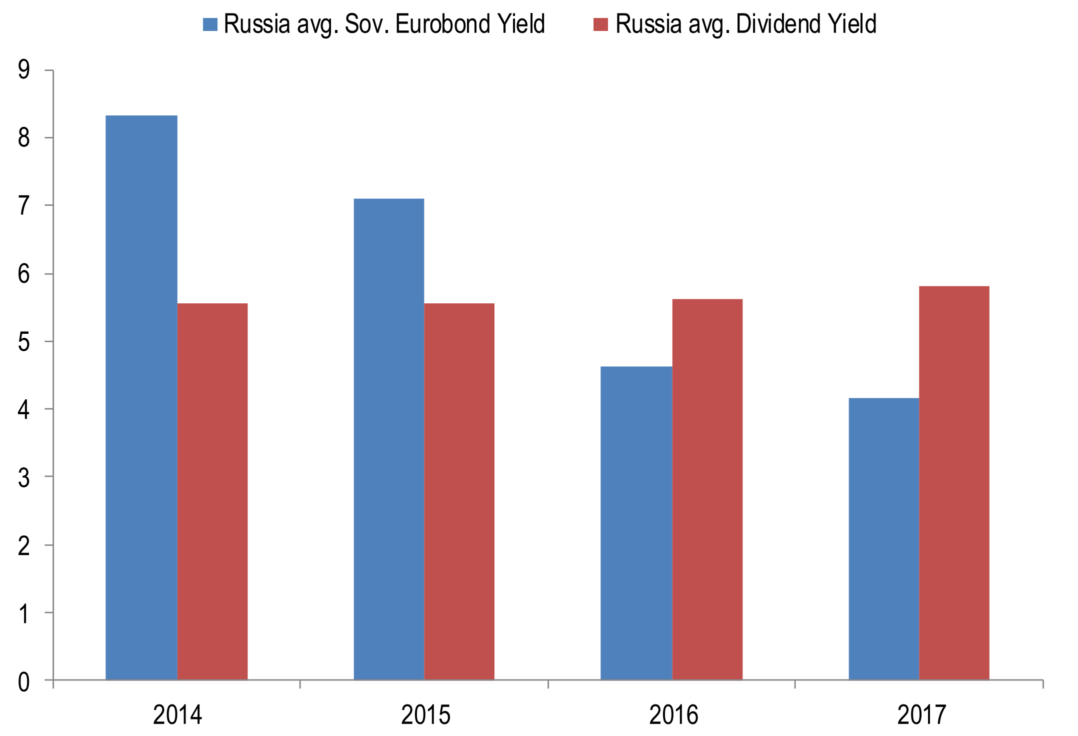


Source: Bloomberg, MidLincoln Research

Russian Eurobond prices are quite average for the emerging markets, while Russian local bonds are expected to gain from possible CBR cuts and lower inflation figures.

- [OPEC Revises **Russian** 2017 **GDP** Growth Forecast Up by 0.1% to 1 ...]
- [Central Bank says **Russia's** **GDP** positive in fourth quarter of 2016]
- [China to dominate global economy by 2050, US to fall behind India ...]
- [**Russia's** Shuvalov says 2017 **GDP** could rise 2 pct - reports]

Russia Sovereign Yield vs. Eurobond Yield



Source: ML, Bloomberg

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Public Spending

- [Russia lost $26 billion on oil and gas exports](#)
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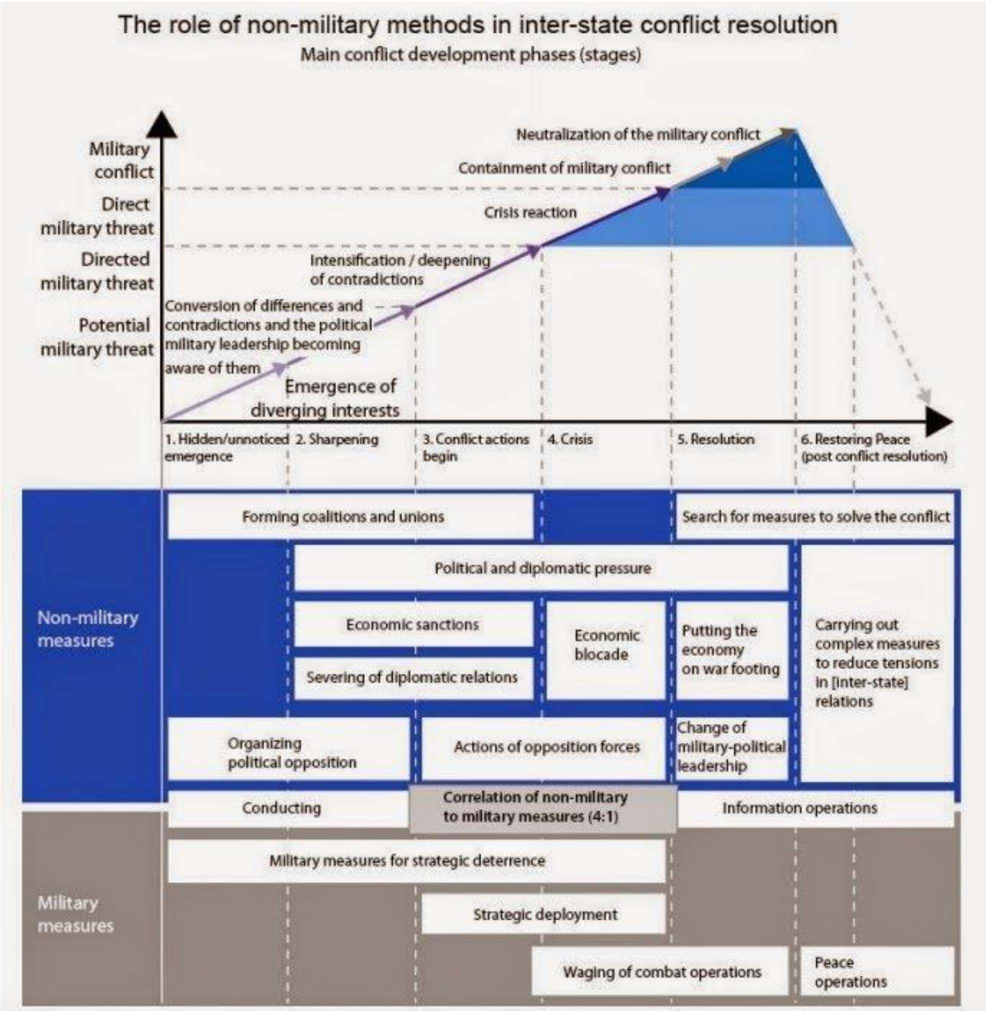
Ukraine

The later stages of conflict in Ukraine could be seen as Ukrainian reaction to Russian attempts to look for measures to solve the conflict.

Gerasimov Chart



Source: warontherocks.com

According to this chart - called in the media (by the name of Russian Chief of Staff) http://warontherocks.com/2016/03/russian-hybrid-warfare-and-other-dark-arts/ conflict in Eastern Ukraine may be in the final stages of post conflict resolution.

[Eurobonds in spring: finance minister](#)
- [Exclusive: Russia could rebuild fiscal reserves at $55 oil price](#)

- # Public Debt

- [Belarus Files Lawsuit Against Russia Over Oil Delivery Cut - President](#)
- [Cries of Violating the Logan Act Are Frequent](#)
- [**Russia's debt** collectors turn violent as recession leaves 11.5m in debt](#)
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- [In **Russia, debt** collectors may sexually assault you or burn your ...](#)
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- [**Russia's debt** downgraded to junk by Moody's](#)
- ['Where Is This Country Going?' Debt Crisis Tugs At Russian ...](#)

IPOs

Russian oligarchs and corporates are coming back to the market for large IPOs which is a characteristic of market returning to life. The process will soak some international money that would have otherwise pushed prices for existing stocks higher, but it will also attract new investors and further broaden the market.

Historical Russian IPOs*

Totals of USD mln placed per year and number of deals per year including

Source: Bloomberg, MidLincoln Research

- *Number of deals include withdrawn deals but the total don't*

Ulyukaev

The high profile event such as arrest of the economy minister introduced unwanted intrigue. But can serve as a positive catalyst when dust settles and Ulyukaev is released.

Kudrin

It is a common observation that Kudrin is gaining traction. He is undoubtedly one of the ideologists behind fiscal, structural and monetary responses to the current economic conditions while the rumors of his possible promotion are not ever stopped and have probably become more persistent recently.

Relationship with Japan

Last year the Russia-Japan relationship seen a major upgrade. The peace treaty is on the cards and land dispute could yield a compromise. Russia could gain from improved relationship with Japan. And its attempt to improve soar relationship with eastern neighbors could help Russia in its search for substitutes for regular sources of capital.

CBR

CBR is as usual is in the counter cycle versus the trend in the global monetary policy and is expected to cut some rates as inflation keeps getting weaker. The process is likely to be delayed given the overall cautions stance of the CBR. It is definitely will watch the effects of stronger dollar before moving with further rate cuts.

Fed, China and other external factors

Global markets YTD put on solid performance -- Latam markets are in the lead up almost 9% YTD, overall GEMs are almost as strong too. US market is strong up c.5% up YTD while Europe is a laggard.

Single best market YTD is Kazakhstan. Best markets are also Turkey, Poland, Ukraine and Argentina all above 10%.

Russia unfortunately is the laggard and that's probably unjust, but nevertheless represents investors vote on Russia.

India, China Turkey and South Korea have all been doing well supported by long oil importers trade. China strength is especially a good sign and may be the second key support driver for the markets this year after a US markets strength as a driver. Albeit US case is not hugely convincing and mostly reliant on Trump's infrastructure spending promise.

Every Fed hike this year is likely to serve as a buying opportunity, including the one last month.
Oil price stood still in the first 2 months of the year while started falling in March. We think the key knock out driver for oil was US dollar strength. USD dollar strength is likely to continue for a while and there could be some more negative pressure on oil. Short oils long steels trade is therefore likely to continue.

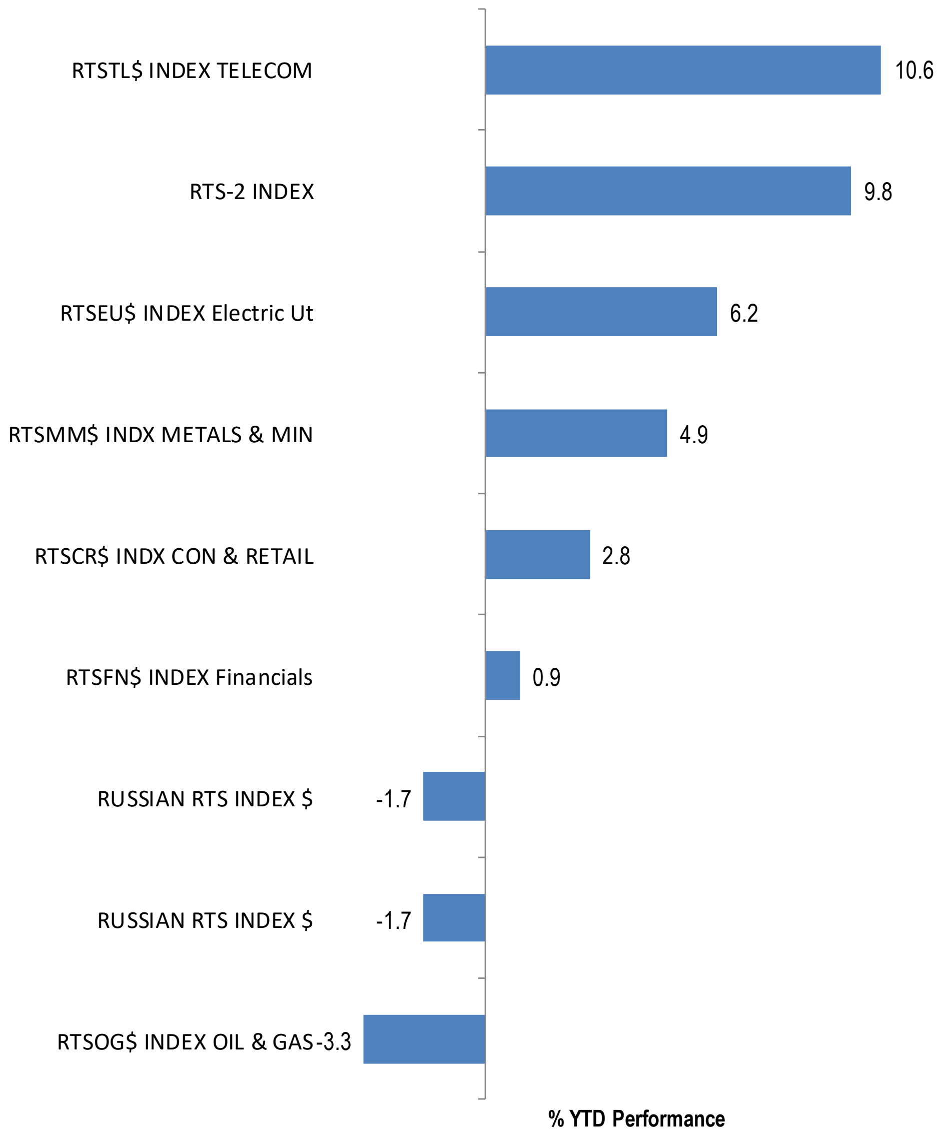
Though there is still quite a lot to go through this year - like Brexit and Turkey possibly getting closer to falling out of NATO, the year's positive tune is likely to continue.

The trade is long dollar, steel and long equities, short oil and bonds. Gold is supposed to be weaker, but it's also strong, probably behaving like equity in the higher inflation backdrop.

Top Best/ Worst Sectors

Telecoms lead YTD while oil and gas sector lags

YTD Sector Performance 2017



Source: Moscow Exchange, Bloomberg

Evolution of Russian Benchmarks and ETFs

Russian equities exchange date back to 1993-1994 when the exchange trading was established in addition to popular and unorganized OTC markets.

At approximate the same time couple of benchmarks have been launched tracking Russia performance. In 1994 the famous ROS index has been launched by Russian market pioneer Dimitri Kryukov of CSFB and then Rencap who launched Verno Capital in 2010 currently the biggest money manager focused on Russia.

At the same time the Skate Inc in co-operation with Moscow Times has launched its MT Index, which for a while has been the key benchmark for Russia all the way until 1998 crisis.

In Jan 1995 MSCI has modified its GEM methodology to include Russia and launched MSCI Russia standard index.

In Sep of 1995 the RTS index has been launched by the RTS trading system. The man behind the index was Sergei Golovanev, former head of indexes at RTS and now one of the executives running Moscow Exchange.

Some of the names in the original RTS Index back than would mean nothing to the investment professionals which launched their careers in 2000.

RTS Index Initial Composition in 1995

Ticker	Company
EESR	UES
IRGZ	Irkutskenergo
KMAZ	Kamaz
KNFT	Komineft
LKOH	Lukoil
MSNG	Mosenergo
NKEL	Norilsk Nickel
HYGS	Noyabrskneftegas
PFGS	Purneftegas
RTKM	Rostelecom
SNGS	Surgutneftegas
TOMG	Tomsckneft
YFGA	Yuganskneftegas

Source: Moscow exchange

Only 8 names out of initial 13 blue chips have remained in the RTS Index since its launch. And only 3 names remained blue chip to date.

In 2000s, Russia investment professional seen launches of various benchmark – the RDX and RTX indexes for offshore Russian GDRs, MSCI Renaissance Index of top liquid Russian stocks, DJ Russia index as well as RSX Russian Market Vectors Index, custom made for Van Eck's Russia ETF.

The indexes as usual had different methodologies and scope and sometimes have been quite technical as Micex 10 Index.

Later on in Russian markets history a few of the ETFs have been started and most of them concentrated on tracking either MSCI Russia or MSCI Renaissance index.

MSCI Renaissance effort was especially memorable as MSCI in co-operation with Renaissance capital finally crafted a proper Russia benchmark with over 70 names while Oleg Jelezko (now Davinci Capital) and Anna Vasilenko (now Moex) launched the ETF on the index. It all ended in tears in 2008 as Russian market collapsed 89%.

Other ETF managers as Van Eck had created custom indexes for their own ETFs, while some followed London IOB RDX Index and some tracked DJ Russia

Almost none of the ETF issuers had decided to follow the key Russian benchmark the RTS Index despite that the benchmark on many accounts won the competition for leadership among other Russian benchmarks and remained the most popular and most frequently mentioned benchmark associated with Russia.

MSCI Russia due to its consistent country methodology had remained popular among institutional investors, who kept tracking and benchmarking the index.

Companies in the MSCI country index are the most exposed to international institutional investors. International investors do not just invest in any stocks on the exchange; they pick up the stocks from the MSCI Index for a particular country.

But following fall of foreign ownership rights in Sberbank and Gazprom the Minimum Market Cap criteria for Russia was so badly skewed upward from roughly 1bn$ to 2$bn which had its negative implications on Russian evolution of markets.

MSCI Russia index is popular among some very large ETFs who track this index including Blackrock IShares and DB.

Even more important that Emerging Markets ETFs linked to MSCI GEM index or MSCI World Index built their Russia positions in accordance with MSCI Russia structure.

The likes of Ishares GEM ETF and Vanguard GEM ETFs are a few examples where Russia portion exceeds 1bn$. While Vanguard AM in 2013 switched to FTSE GEM index breaking up the link to MSCI Russia structure there is still a mass of money with more than 5bn$ allocated to Russia – track MSCI Russia universe as part of Global, GEM, EMEA or CEE strategy.

In the US VanEck's RSX ETF due to its almost monopolistic position in the US markets became a market force in itself. While its index despite its quite obscure structure and lack of transparency is nevertheless important because inclusions/exclusions in the index stimulate large inflows/outflows given the size of the ETF of 1,5bn$.

Comparison of Russia ETFs

Comparison of ETFs on Russian market

Midlincoln

RTS Index ETF is not present within variety of ETFs on Russian market

	Market Vectors Russia ETF	iShares MSCI Russia ADR/GDR UCITS ETF	iShares MSCI Russia Capped ETF	db x-trackers MSCI Russia Capped Index UCITS ETF	HSBC MSCI RUSSIA CAPPED ETF	Lyxor Russia DJ	Source RDX UCITS ETF	Finex RTS ETF	DVC RTS ETF
Issuer	Van Eck Global	iShares	iShares	Deutsche Bank db x-trackers ETFs	HSBC	LYXOR	SOURCE	FinEx	da vinci capital
Benchmark Index	Market Vectors Russia Index	MSCI Russia ADR/GDR Index Net USD	MSCI Russia 25/50 Index	MSCI Russia Capped 25 Index	MSCI Russia Capped Index	DJ Russia Index	RDX Index	Finex Russia Abridged RTS	RTS Index
Replication Type	Physical Replication	Physical Replication	Physical Replication	Physical Replication	Physical Replication	Physical Replication	Physical Replication	Physical Replication	Full Physical Replication
AuM, $m	2528	369	431	169	7733	633	28.34	5.05	NA
Tracking Error	2-4%	1-2.5%	2-4.5%	5-12%	1-4%	2-10%	5-10%	No history	NA
Domiciliation									
Stock Exchange	NYSE	London Stock Exchange	London Stock Exchange		London Stock Exchange		London Stock Exchange	Moscow Exchange	Moscow Exchange
UCITS Compliant	✗	✓	✗	✓	✓	✗	✗	✓	✓
Local/Global	Local	Global	Global	Global	Global	Global	Local	Global	Local
# of Market Makers	NA	NA	NA	5	NA	NA	3	1	NA
Subscription for Market Maker	End of day only	End of day only	End of day only	End of day only	End of day only	End of day only	End of day only	End of day only	Intraday

Source: Nomura, Van Eck Global, SPDR, iShare, Morningstar, and HSBC, Bloomberg, MidLincoln

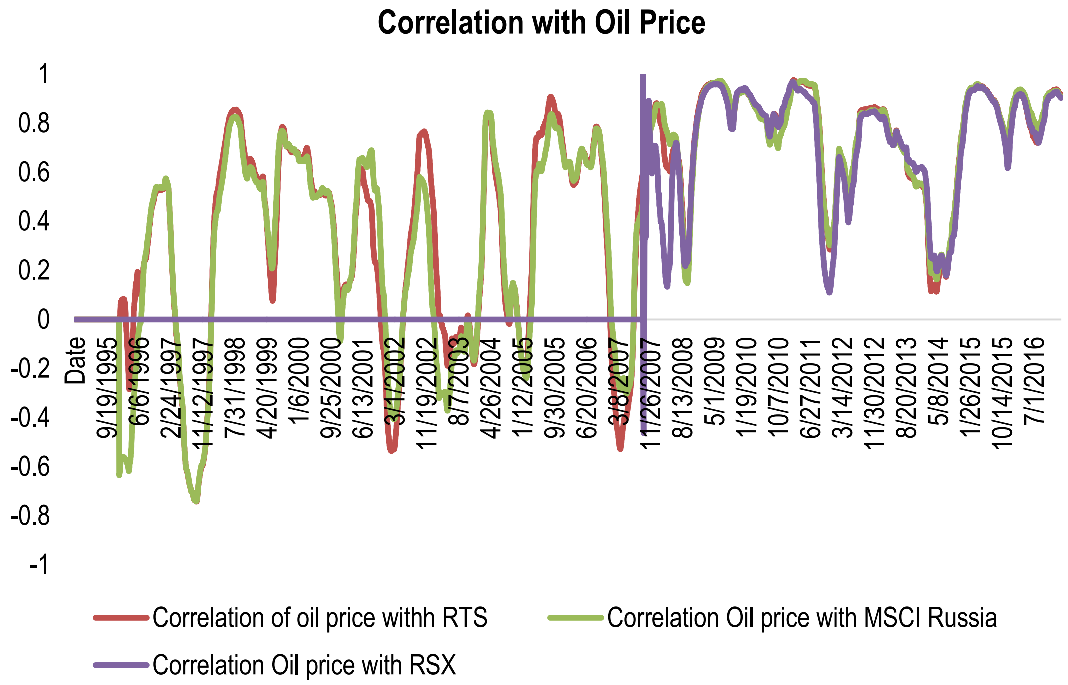
Source: ML

What's the point in having many Russian benchmarks if they are all correlated between each other and to the oil price?

It is very difficult to argue against the statement that the dynamic of the three key benchmarks are very similar and all are very well correlated to the oil price.

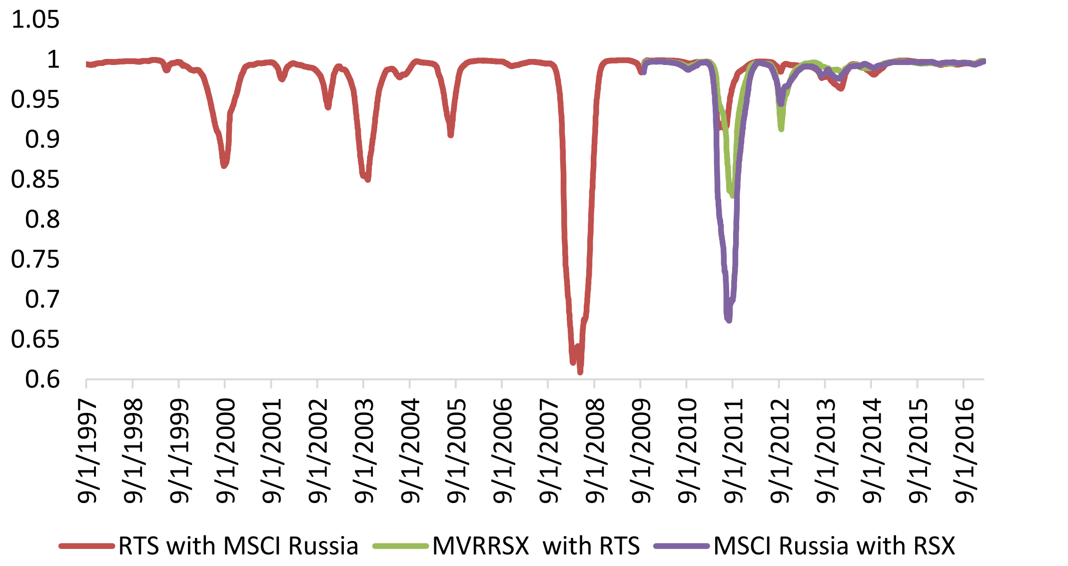
Now what are the differences and similarities between the key 3 Russian benchmarks – RTS Index, MSCI Russia Index and RSX Market Vectors Russia index?

Correlation of RTS, RSX and MSCI Russia with oil price



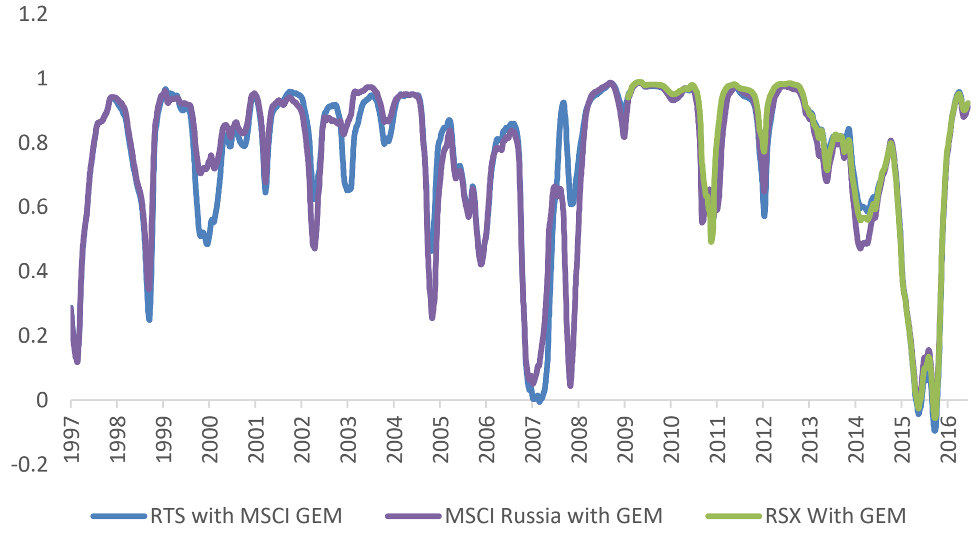
Source: Bloomberg, MidLincoln Research

Correlation of RTS, RSX and MSCI Russian between each other



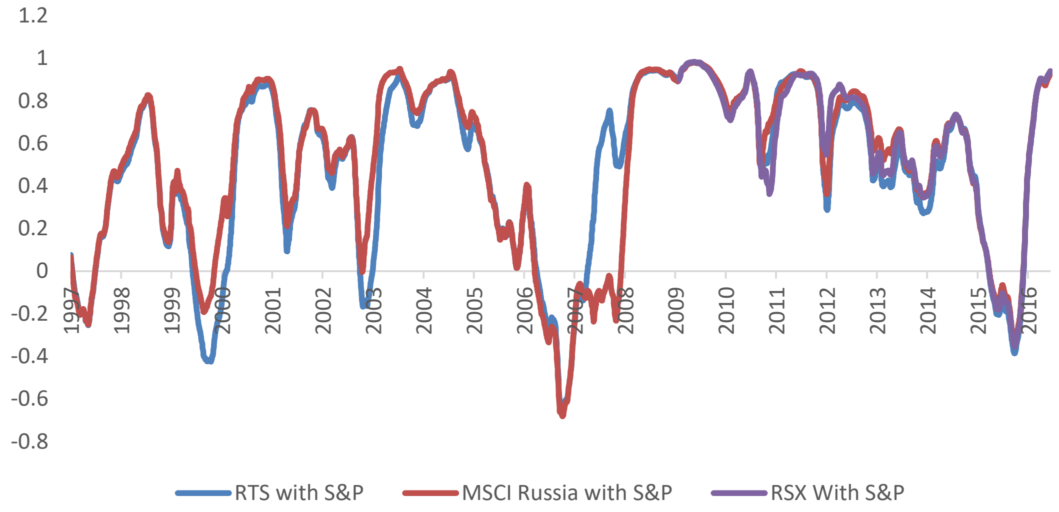
Source: Bloomberg, MidLincoln Research

Correlation Study MSCI Russia, RTS RSX vs GEM



Source: Bloomberg, MidLincoln Research

Correlation Study MSCI Russia, RTS RSX vs SPX



Source: Bloomberg, ML

But there are considerable differences too

Universe of Coverage of the 3 key benchmarks on Russia

RTS Index is the most diversified targeting to have exactly 50 stocks in its index, but both RSX and MSCI Russia indexes are quite modest in terms of number of stocks that they cover. The key reason is the market cap minimum cut off.

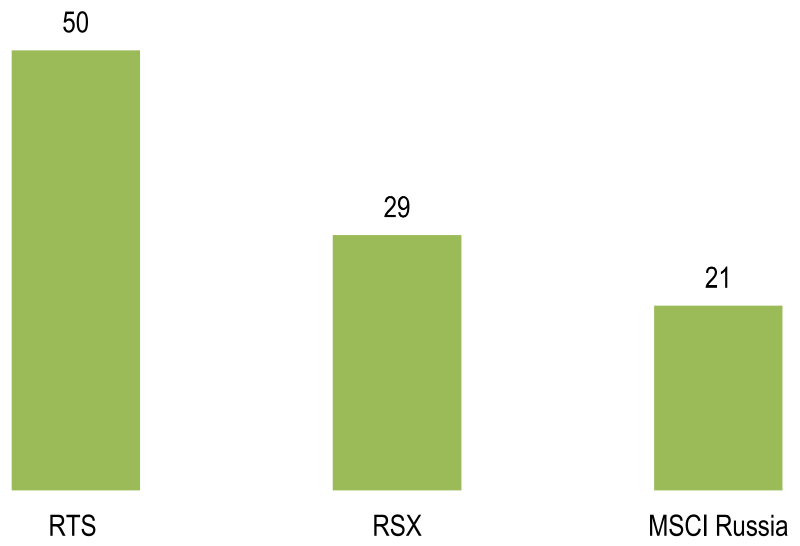
MSCI is a financial information agency that tells which stocks in each country form an investible universe. Investors chose MSCI indexes rather than FTSE or S&P or any other financial index agency product because MSCI was the pioneer in setting up consistent methodology indexes for any country across the globe. They started their indexes right after World War II, just as the need for global diversification was coined by U.S. investors and as globalization started to gain speed.

MSCI detailed methodology rules are complex, but in a nutshell, they are actually quite simple. MSCI picks stocks for each country that fall into 85% of the free float market cap range. Two thirds of the selection, MSCI labels as large cap, and the remainder are the mid cap stock. Together, two sets form the so-called standard universe.

While MSCI uses statistics to define the universe with Russian universe in the absence of foreign ownership limits 3 or 4 stocks make up most of the market cap leaving the rest behind.

It turns out that for Russia, the limits on entry in the country universe are among the toughest. As a consequence, Russia's investible universe is small. The new stocks, not reaching the size required for entry into the MSCI Russia index, become marginalized off index plays for investors, which make it optional for investors to invest in the off index stock market universe.

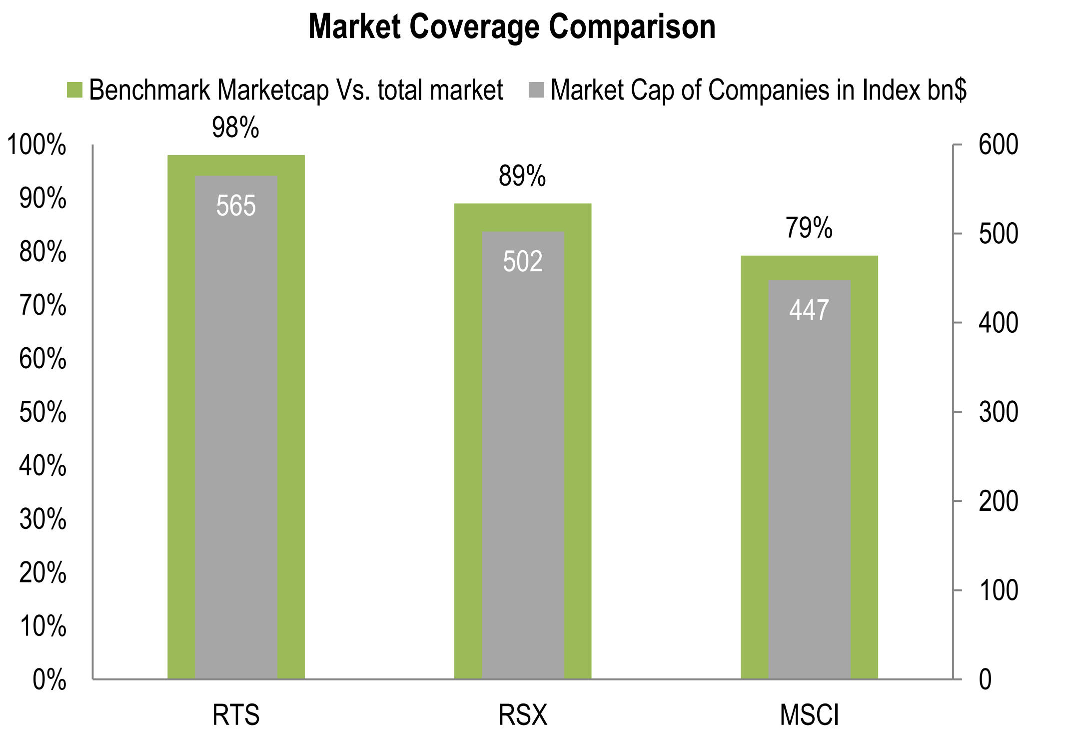
12 Key Indexes compared by number of stocks



Source: ML

MSCI Russia universe shrank to only 21 companies in 2017 (from 26 companies in 2012) which is ironic, given that the major effort was spent by the Russian regulator in 2012 to introduce rules which were supposed to increase the ease of access of international institutional investors to Russia. Russia's 21companies MSCI universe compares poorly to MSCI South Africa 50 companies, MSCI India 73 companies, MSCI Brazil 78 companies, MSCI South Korea 105 companies and MSCI China 143 companies. Russia looks kind of small here.

Market Coverage Study



Source: ML

The smallest company in Russian standard universe defined by MSCI is the Rostelecom with market cap of 3.7bn$. The actuary cut off is slightly lower than that *circa* 2bn$ which is still substantially larger than Turkey's $0.9 billion cut-off, China's $1.7 billion cut-off, Poland's $1.1 billion cut-off, Brazil's $1.9 billion cut-off, India's $1.4 billion cut-off and South Africa's $1.9 billion cut-off.

Final criterion for entry into the universe is the size of free float available to foreigners. If no foreign ownership limits exist in a stock, the criteria for entry is based on free float equal to half the market cap minimum. So, Russian companies must have at least $1 billion or so in free float in order to make it into the MSCI Russia standard index and to reach the widest universe of investors: the international institutional investors.

Valuation

On PE comparison RSX is the cheapest, and RTS and MSCI are similarly priced. RSX however considerably misses on growth and RTS wins in PEG study

Valuation and Growth Study

	PE 2017E	Growth 2017	PEG
MSCI	8.06	21%	38.5
RSX	5.79	11%	51.4
RTS	7.85	21%	36.7

Source: Bloomberg, MidLincoln Research

RTS Index Methodology

The index consist of top 50 liquid Russian stocks traded on Moscow exchange as common shares, shares of international companies or GDRs.

RTS index is calculated real time. All the stocks trade in the same time zone.

The index is free float based but is capped at 15%.

Only stocks that are on the waiting list which is quite transparent can make up an index entry. Similarly for leaving the index.

The new entrants on the waiting lists are announced quarterly and approved by the index board consisting of key market professionals. Rebalancing is done quarterly as well.

Industry Diversification Study

RTS is the most diversified benchmark across various basic industry sectors. It covers 7 sectors out of 10 standard basic sectors. RSX is almost as diversified as RTS covering one sector less, while MSCI is the least diversified with only 5 sectors covered.

Industry and sub-industry diversification also shows RTS leadership.

Index composition by Industry Sectors

	RTS	RSX	MSCI
Basic Materials	13.6%	17.3%	10.6%
Communications	5.6%	15.0%	4.6%
Consumer, Cyclical	1.1%	1.9%	
Consumer, Non-cyclical	6.3%	8.6%	6.8%
Energy	48.3%	38.0%	53.1%
Financial	21.0%	15.6%	22.4%
Industrial	0.5%		
Utilities	3.6%	3.7%	2.4%
Total	100%	100%	100%

Source: Bloomberg, MidLincoln Research

There is a big gap in the number of industries covered between RTS and the remaining benchmarks

Sub-industry diversification shows the same gap between RTS index and other benchmarks in the study.

Industry diversification also shows RTS leadership. There is a big gap in the number of industries covered between RTS and the reaming to benchmarks

	RTS	RSX	MSCI
Airlines	0.81%		
Banks	18.90%	12.85%	20.71%
Capital Markets	1.68%	2.71%	1.73%
Chemicals	1.13%	1.61%	0.82%
Diversified Telecommunication	0.79%	1.13%	0.74%
Electric Utilities	3.30%	3.66%	2.42%
Food & Staples Retailing	6.03%	10.53%	6.82%
Food Products	0.23%		
Household Durables	0.31%		
Independent Power and Renewabl	0.31%		
Internet Software & Services	0.87%	5.80%	
Machinery	0.18%		
Metals & Mining	12.56%	15.67%	9.82%
Oil, Gas & Consumable Fuels	48.29%	37.98%	53.09%
Real Estate Management & Devel	0.16%		
Specialty Retail	0.28%		
Transportation Infrastructure	0.20%		
Wireless Telecommunication Ser	3.97%	8.06%	3.85%
	100.0%	100.0%	100.0%

Source: Bloomberg, MidLincoln Research

From 2000 to the end of 2006, Russian MSCI stock universe increased from just six companies in 2000 to 23 stocks in 2007. In the next 10 years the number of stocks dropped to 21. Nevertheless it added 5 or 6 stocks new stocks.

Unfortunately from the companies that made an IPO on the Russian market in 2010-2012, not a single company has been able to make it into the MSCI Russia index.

While since 2012 only 3 companies Alrosa, Moex and Phosagro of the recent IPOs made it into the MSCI Russia index.

Most investors who bought Rusagro, Rusal, Tinkoff Bank, Yandex, Lenta or Detski Mir stocks maintain them as off-index bets in their MSCI Russia portfolios.

While on the other hand RTS universe increased from 13 initial names to 50. While infrastructure reform and cross listing of Rusal, Yandex, Rusagro, Polyus and Polymetal. Made the stocks eligible for RTS inclusion.

In MSCI Russia before the fall of Gazprom foreign ownership limits, only 3% of Gazprom market cap was counted for MSCI Russia index. This is because foreigners could only buy 3% shares of the company in the form of GDRs. But in 2006, the GDRs and locals were made fully fungible. The size of Gazprom's GDR program increased to the size of all free float in the company, which totaled $90 billion at the time or 38% (c.25bn$ now). As a reaction to the fall in foreign ownership limits for Gazprom, MSCI adjusted the universe for

Russian stocks.

MSCI started counting Gazprom's full free float for Russia's investible universe. Gazprom weight in index went up to 35%. The 85% of Russian free float all of the sudden became mostly filled with Gazprom. The limits for entry on new companies that just IPOed were instantly increased to the levels possible to achieve only by very large IPO deals.

Sub-industry diversification shows the same gap between RTS index and other benchmarks in the study

	RTS	RSX	MSCI
Agricultural Products	0.23%		
Airlines	0.81%		
Aluminum	0.48%		
Computer & Electronics Retail	0.28%		
Construction Machinery & Heavy	0.18%		
Diversified Banks	18.90%	12.85%	20.71%
Diversified Metals & Mining	5.27%	4.94%	5.40%
Electric Utilities	3.30%	3.66%	2.42%
Fertilizers & Agricultural Che	1.13%	1.61%	0.82%
Financial Exchanges & Data	1.68%	2.71%	1.73%
Food Retail	5.88%	8.59%	6.82%
Gold	0.42%		
Homebuilding	0.31%		
Hypermarkets & Super Centers	0.15%	1.93%	
Independent Power Producers &	0.31%		
Integrated Oil & Gas	35.42%	23.40%	38.25%
Integrated Telecommunication S	0.79%	1.13%	0.74%
Internet Software & Services	0.87%	5.80%	
Marine Ports & Services	0.20%		
Oil & Gas Exploration & Produc	9.98%	10.38%	12.00%
Oil & Gas Storage & Transporta	2.90%	4.19%	2.84%
Precious Metals & Minerals	3.12%	6.11%	2.58%
Real Estate Development	0.16%		
Steel	3.27%	4.63%	1.84%
Wireless Telecommunication Ser	3.97%	8.06%	3.85%
	100.0%	100.0%	100.0%

Source: Bloomberg, MidLincoln Research

The monstrous size of Gazprom in the index has affected the Russian universe by hiking the limits of entry for new stocks. As a result, Russian stock universe has stopped growing.

In a sense, the last piece of capital available for Russian companies planning to do the IPO has been shut down, making each IPO deal difficult and exotic.

Foreign names in Benchmarks

0 – not allowed	5 stocks	6 stocks
MSCI	**RSX**	**RTS**
none	Yandex NV	Polymetal International plc, Shares of a foreign issuer
	X5 Retail Group NV	PJSC Polyus, Ordinary shares
	Polymetal International PLC	United Company RUSAL Plc, Shares of a foreign issuer
	Mail.Ru Group Ltd	PIK GROUP, Ordinary shares
	Evraz PLC	ROS AGRO PLC, DR (Issuer The Bank of New York Mellon Corporation)
		Yandex N.V., Shares of a foreign issuer

Source: Bloomberg, MidLincoln Research

In terms of stock capital, — it's well known there is also very little domestic long-term capital for Russian stocks, as there is very little pension money or insurance money in Russian equities.

At the same time, Russians don't want to invest their savings into the stock market as they view that stocks could grow but the growth depends on various factors

So Russian mid-size corporations are facing pressure in a search of capital on every front. Most ironically, they are barred from international capital by the MSCI index criteria.

What's the solution?

One simple solution for most of the key ETFs to switch to tracking RTS index as MSCI universe is unlikely to change while delisting key state champions such as Gazprom or Rosneft or reintroducing FOLs is not the option and is probably quite bad.

Tracking MSCI 10-40 is not particularly a good solution as the number of companies in that benchmark and inclusion rules mimic the standard index.

10-40 Structure Study

	Weight of Issuers of more than 10%	Count of names with more than 10% Weight	Weight of Issuers of more than 5%	Count of names with more than 5% Weight
RTS	41%	3	52%	5
RSX	0%	0	34%	5
MSCI	47%	2	71%	7

Source: Bloomberg, MSCI, MidLincoln Research

It is also unlikely that the state will be willing to restructure its key enterprises into smaller companies. Even if the universe is so skewed towards large caps.
The process is quite contrary- Rosneft absorbs TNK BP and Bashneft and get larger. Similarly Gazprom takes on Sibneft.

While Sberbank size and market share grows as many small banks go bankrupt.

The possibility that investors can persuade MSCI to redefine limits for the Russian market, as Russian stocks are of two types is small given the rigidity of the MSCI Methodology.

The first type of stocks is of companies that are operating Soviet assets that they bought or got from the state through privatization or in some other way. The second type includes stocks of companies that have grown their assets base in the post-Soviet period: e.g. consumer goods companies, telecoms, transportation, and even some oil companies (e.g. Lukoil).

If MSCI acknowledges that the sizes of two classes of companies are not comparable — the first took 70 years to build and the second was just built in the last 15-20 years — the limits might be redefined. Most likely, however, MSCI will create some sort of additional custom index for stocks with non-Soviet assets. It is unlikely that MSCI would change its overall country methodology for Russia.

New ETFs with domestic focus could help especially if they chose to track RTS Index.

Ownership Study

Original RTS composition contained 13 stocks of companies that have been just partially privatized. Ironically most of them are now in the hands of the state in one form or the other. The 5 stocks remained in private hands of Nornickel, Basel, Lukoil and Surgut. The remaining 8 all belong to the state in one form or the other.

RTS Index Initial Composition

Ticker	Company	**Current Owner**
EESR	UES	Federal Grid/Interao
IRGZ	Irkutskenergo	Basel
KMAZ	Kamaz	Rostek
KNFT	Komineft	Lukoil
LKOH	Lukoil	Lukoil
MSNG	Mosenergo	Interao
NKEL	Norilsk Nickel	Nornik
HYGS	Noyabrskneftegas	Gazprom
PFGS	Purneftegas	Rosneft
RTKM	Rostelecom	Rostelecom
SNGS	Surgutneftegas	Surgut
TOMG	Tomsckneft	Rosneft
YFGA	Yuganskneftegas	Rosneft

Source: Moscow Exchange

This is as far as the original composition of the RTS goes. The current composition or the RTS still shows that 51% of the index is the state hands. RSX picked stocks for the index that reduce state ownership to 42% while MSCI has the most state owned stocks in its index composition.

Company Ownership In Index Oligarchs, vs. State vs. Private

	RTS	RSX	MSCI
Oligarch	37%	41%	36%
Private (not Oligarchs)	12%	16%	9%
State	51%	42%	55%

Source: MidLincoln Research

RSX stock picking process yields the composition that has biggest portion of stocks of regulated companies i.e. utilities in index and completely free companies like retailers while MSCI wins in commodity stock picking

Index composition by commodity, regulated or free classification

	RTS	RSX	MSCI
Commodity	60%	51%	61%
Free	33%	40%	33%
Regulated	7%	9%	6%

Source: MidLincoln Research

Breaking down the composition further and combining the 2 ways in which to classify company ownership structure can be decomposed. Show that all three indexes mostly own oligarch companies that are commodities producers followed by the state commodity producing companies.

RSX owns more of the completely free stocks than any of the other indexes.

What is RTS?

	RTS
Oligarch com	33%
State commodity	25%
State & Free	19%
Private & Free	10%
State Regulated	7%
Oligarch & Free	4%
Private Commodity	2%
Private Regulated	0.3%
Oligarch Regulated	0.2%

Source: MidLincoln Research

What is RSX?

	RSX
Oligarch Commodity	29%
State Commodity	21%
State & Free	13%
Private & Free	15%
State Regulated	9%
Oligarch & Free	13%
Private Commodity	2%

Source: MidLincoln Research

What is MSCI?

	MSCI
Oligarch Commodity	32%
state Commodity	28%
state & Free	21%
Private & Free	9%
state Regulated	6%
Oligarch & Free	4%
Private Commodity	1%

Source: MidLincoln Research

Simple Average Valuations of RTS By Ownership

Simple Average Valuations	PE 2017	EV/ EBITDA 2017	2017 EPS Growth	2017 EBITDA Growth	2017 Est P/B	ROE Est 2017	Total Market Cap US mn$
Oligarch	10.11	5.69	7.5%	7.1%	3.28	24%	276,398
Private	11.21	6.43	13.9%	13.3%	2.44	21%	110,744
State	10.16	3.63	6.1%	8.1%	3.47	16%	192,607

Source: MidLincoln Research

Simple Average Valuations of RTS by Type of Business

Simple Average Valuation	PE 2017	EV/EBITDA 2017	2017 EPS Growth	2017 EBITDA Growth	2017 Est P/B	ROE Est 2017	Total Market Cap US mn$
Commodities	10.09	5.68	15%	11%	2.83	27%	276,398
Free	10.60	5.80	22%	9%	5.00	20%	110,744
Regulated	10.98	2.73	-28%	6%	0.48	6%	192,607

IOSCO principles for benchmarks

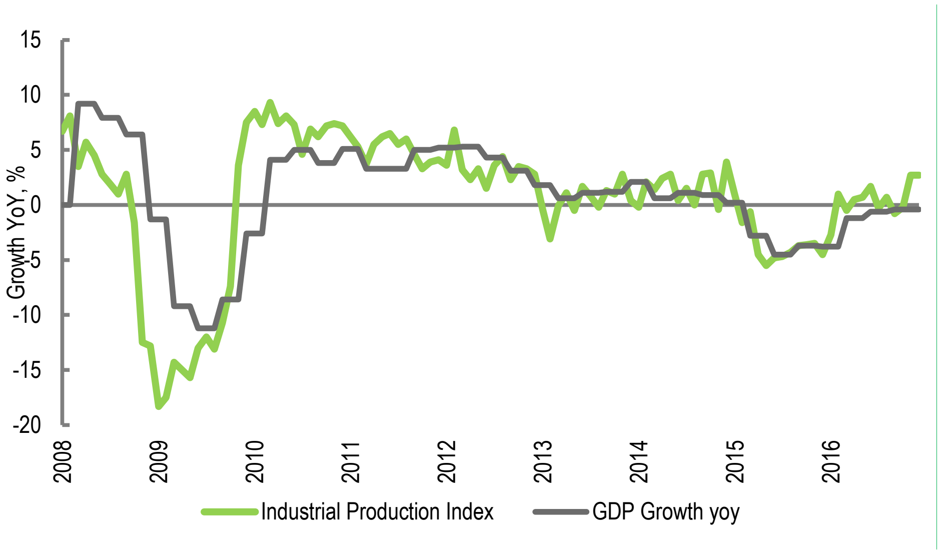
In recent years compliance with IOSCO rules became somewhat important for the benchmark producers. IOSCO is a self-regulated body has defined some common sense principals for financials benchmarks that publishes them since July 2013.

RTS and MSCI especially rely on the IOSCO compliance.

Macro Section

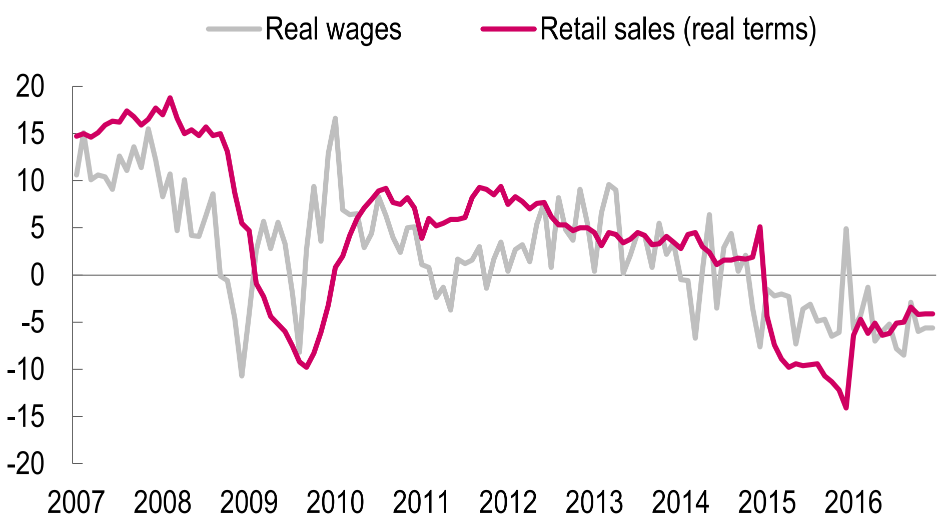
Russia economic growth is slowly getting closer to positive numbers. Industrial production has been in a growing mode since summer of 2016. The real wages are growing while retail sales declines' headline numbers are less and less negative, but the recovery looks fragile and is unlikely to be V-shaped.

GDP and Industrial Production



Source: IMF

Real Wages and Retail Sales

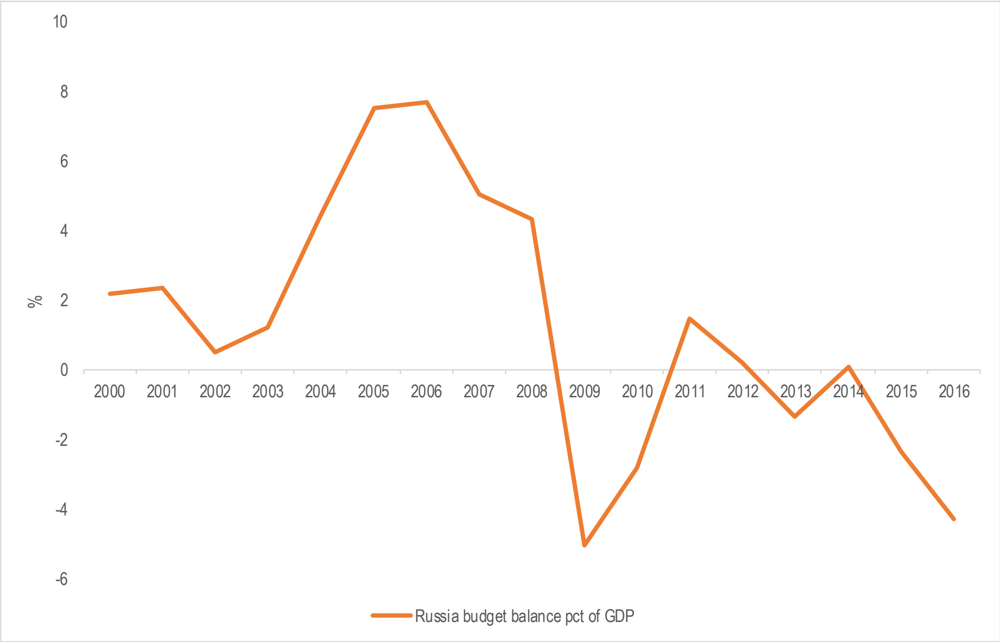


Source: Rosstat

In recent crisis Russia suffered two external shocks – the sudden decline in the oil price; and the US and EU sanctions regime, in particular, the closure of international capital markets. The shocks impacted an economy that was only slowly recovering from the international financial crisis of 2008.

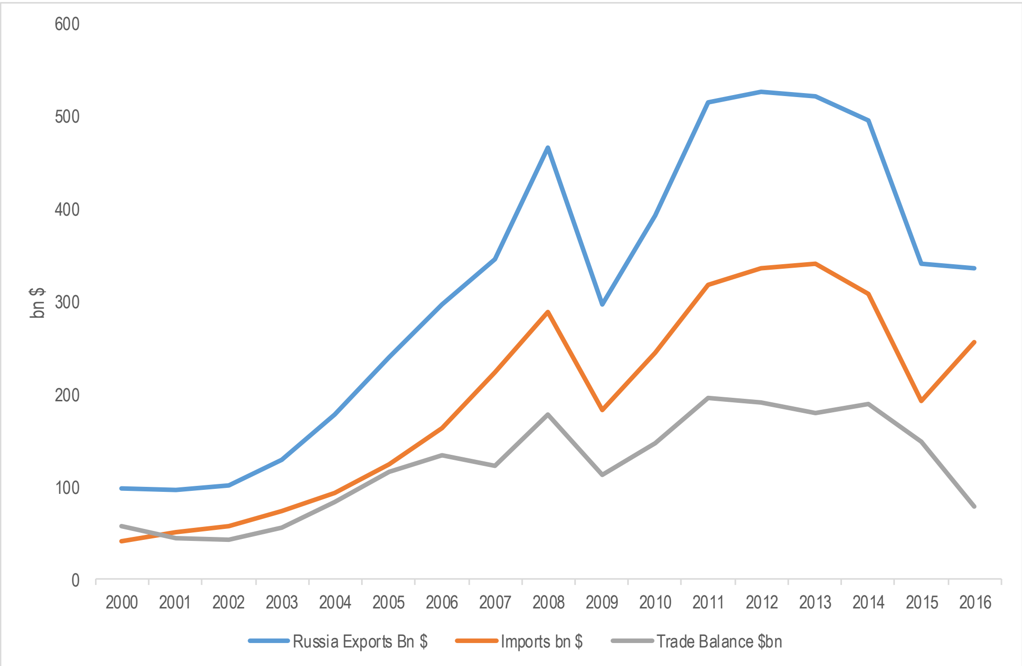
Russian trade balance dipped below 100bn$, fiscal deficit dropped to c. negative 5% levels, state borrowing increased while reserves and stabilization funds started rapid leakage.

Russia's fiscal position.



Source: CBR, Bloomberg

Russia's trade position.

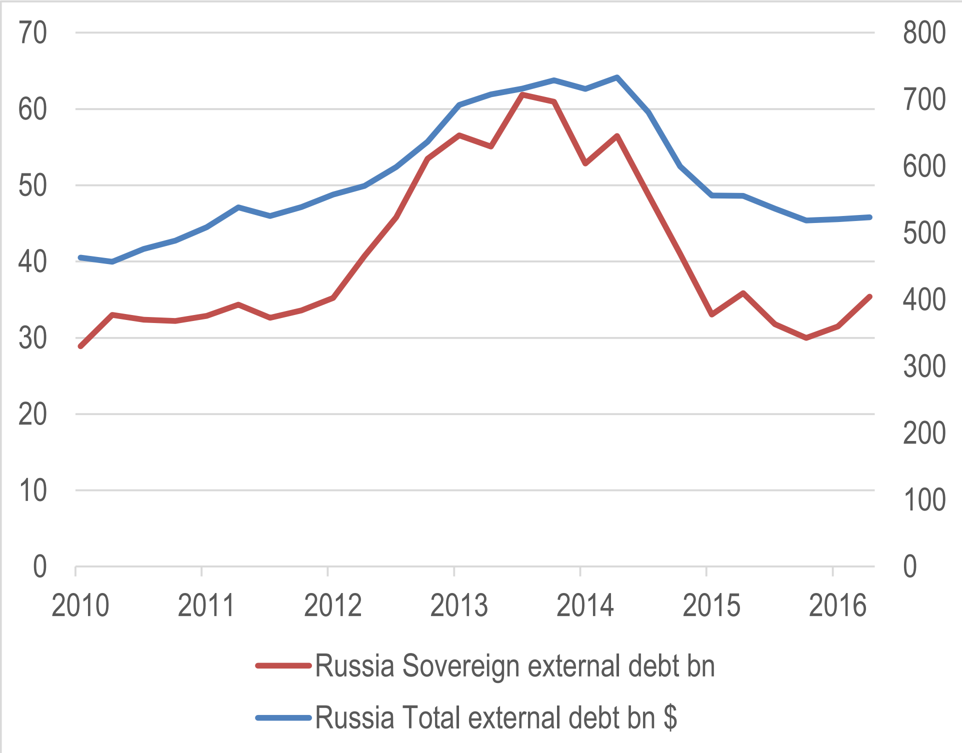


Source: IMF

The economy was tipped into a sharp recession at a politically sensitive time following the first political protests since the 1990s

The policy response combined monetary and fiscal while structural reforms have been procrastinated.

Sovereign and total external debt

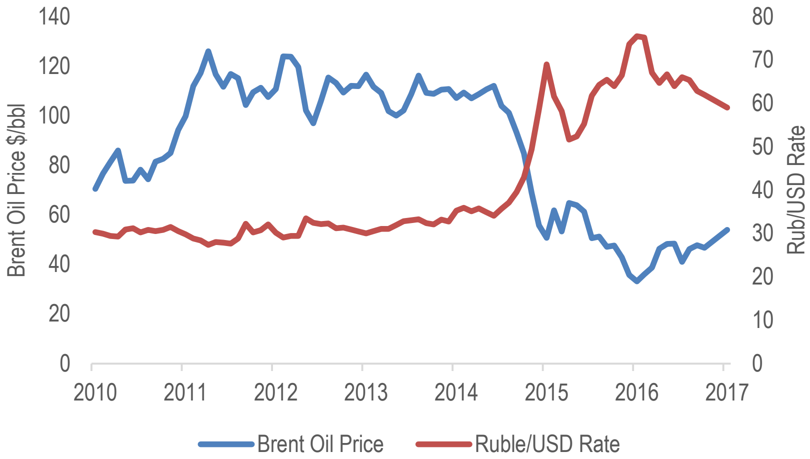


Source: Minister of Finance of Russia

Two key policy steps intact was the decision to keep markets open and get the benefits of floating ruble.

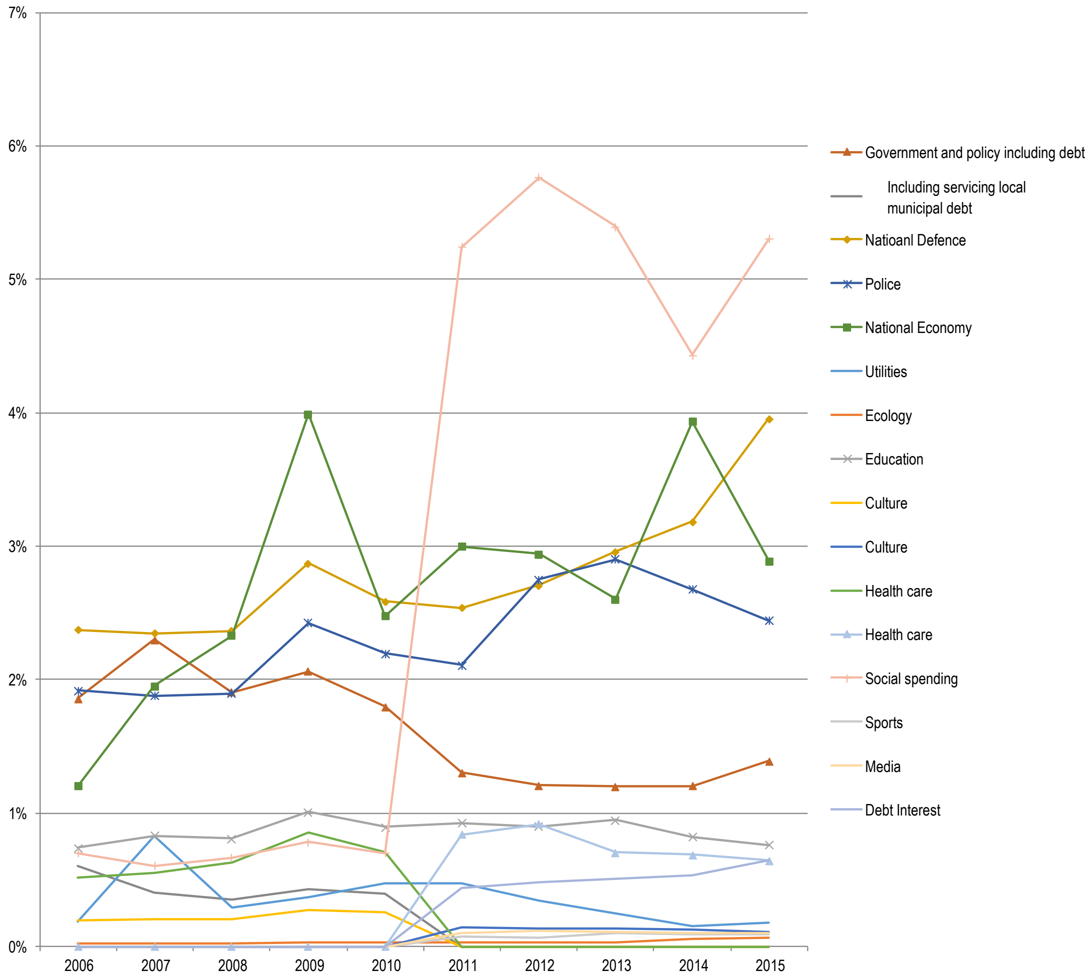
CBR stepped away from supporting the Ruble that was freely traded since 2006, but the FX rate was nevertheless managed. The result was a deep devaluation of the ruble and a one-off spike in inflation.

USD-Ruble exchange rate against Brent oil price, 2010 to 2017



The Ministry of Finance ring-fenced certain budget items

Expenditure items as a % of GDP



Source: Ministry of Finance of Russia

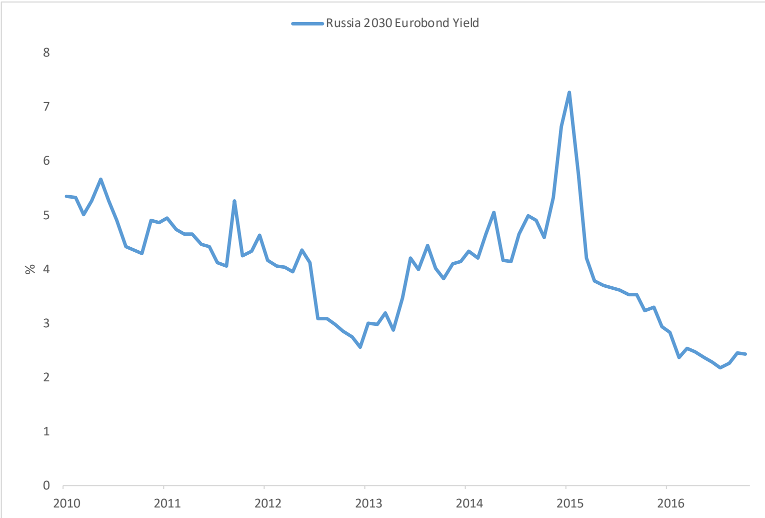
(in particular, defence and social spending) while sharply cutting spending elsewhere (in particular, education, health care and infrastructure).

The decision was made to look for funding opportunities in other geographies.
The ruble and inflation are now back under control and the economy is about to return to

growth.

Credit markets are back at levels seen before Crimea annexation.

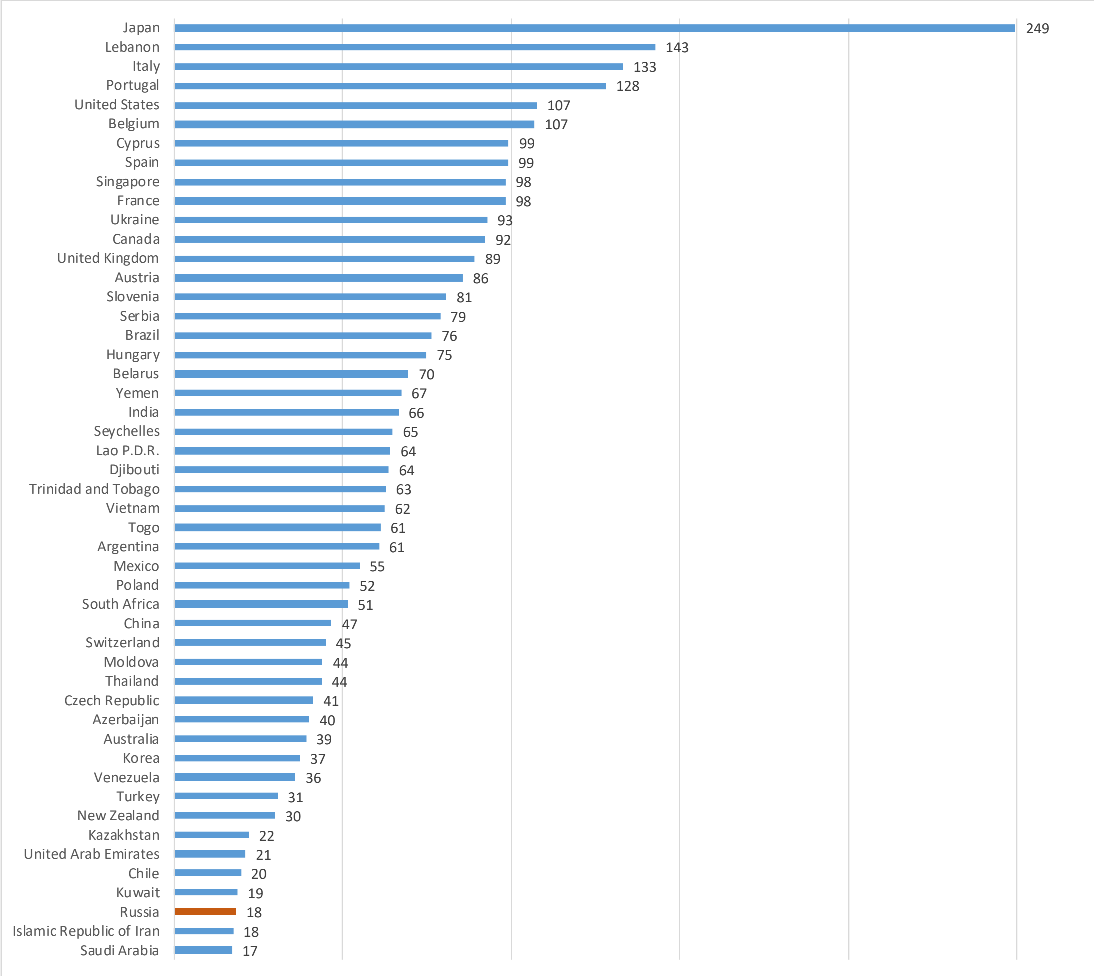
Benchmark Sovereign Eurobond history, 2010 -2016



Source: Bloomberg

The current account is in surplus and the fiscal situation at the federal level is manageable, with debt levels low. Confidence in credit markets has been restored.

Federal debt levels as a percentage of GDP, cross-country comparison, 2016.



Source: IMF

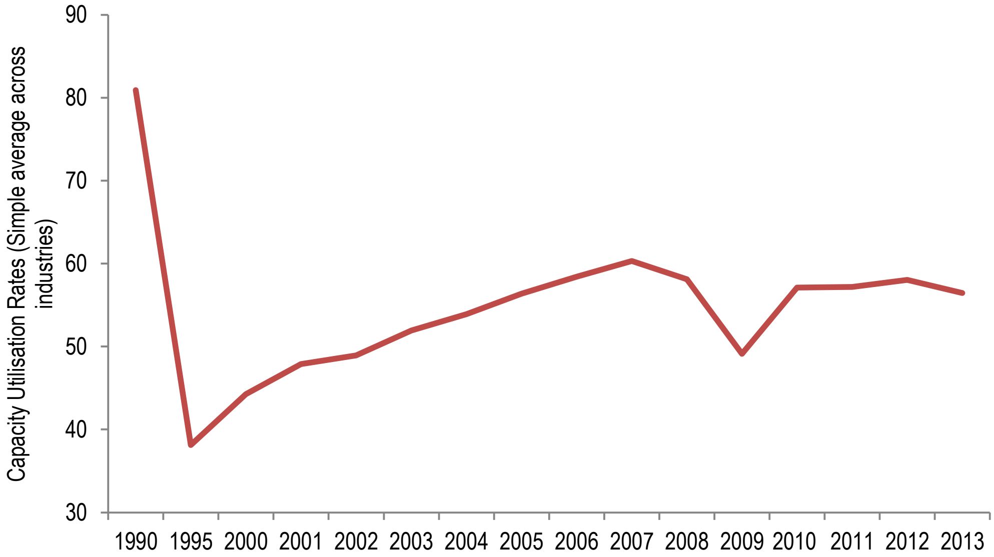
However FX reserves and welfare funds have been depleted while regional budgets are under substantial pressure and Russia's infrastructure continues to decline.

Russia’s National Welfare and Reserve Funds

Source: Ministry of Finance of Russia

Unlike in 1998 when Russia had lavish excess of unutilized capacity and unlike in 2008 when destocking and quick bounce in oil price provided support for Russian economy, the current crisis has a much fewer options for policy to maneuver.

Capacity Utilization Rates In Russia (simple average across industries)



Source: Goskomstat gks.ru

Sanctions and devaluation provided some protectionist advantage to the economy, but they were quite short lived as capacity utilization rates are quite at post-Soviet maximums while scarcity of capital and high risk would not allow any sizeable expansion.

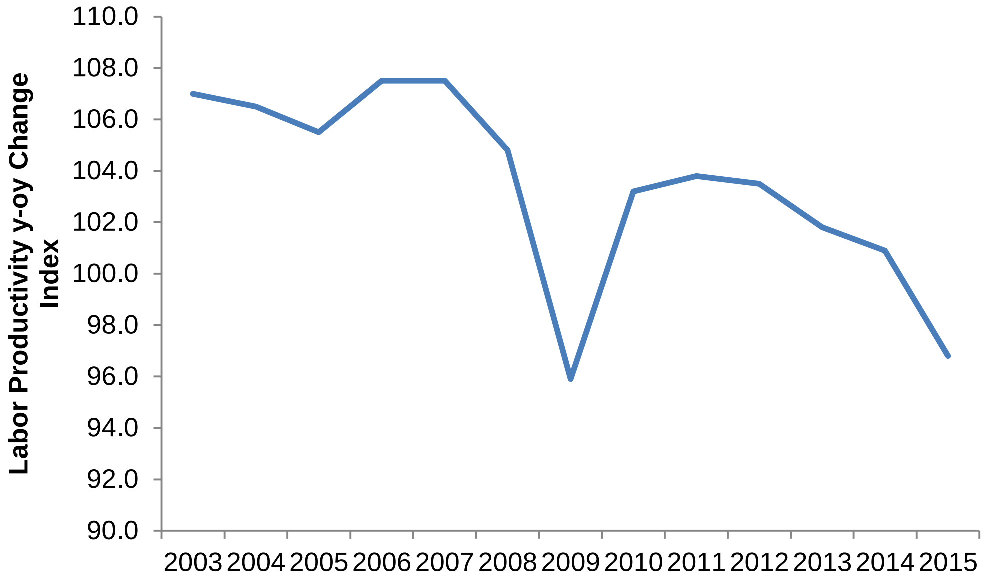
Oil prices have also been unsupportive and are now seen in a very long sideways trend.

Policy makers mentioned several remedies for economic reversal citing possible increases in infrastructure improvement programs, expansion of local credit, increases in productivity as well as restocking as real rates become less positive.

In each of the later 4 areas expansion may occur from a very low base and could be quite helpful in improving the economy

Productivity improvement s is probably the key area where structural change is needed. Most likely the drop in productivity is a result of manual shift economy management. Similarly the recovery is unlikely without easing the manual economy management.

Russian Labor Productivity Index Change % y-o-y

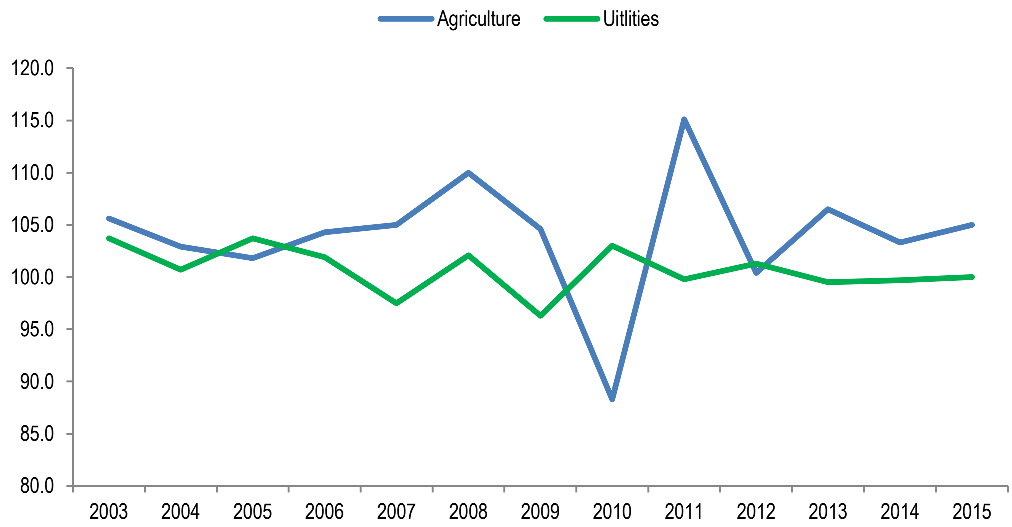


Source: Goskomstat gks.ru

Two sectors – Agriculture and Utilities where productivity was maintained and possibly even increased recently

Ironically these two sectors are the only sectors in Russia which underwent key structural reforms. Putin's land reform of 2001 was one of the first reforms executed by the president then supported by Russian key reformists. While 2008 UES restructuring and accompanying electricity sector reform has helped to maintain the productivity levels in the sector. In addition more recently sanctions have some what helped to improve the productivity in agri sector.

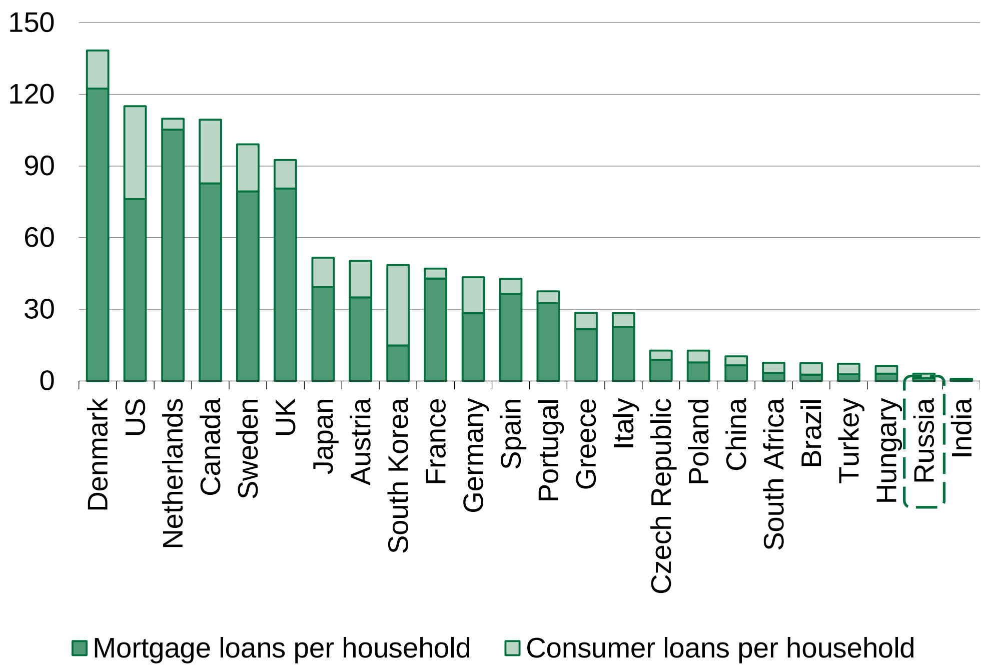
Russian Productivity Index for Agriculture and Utilities



Source: Goskomstat gks.ru

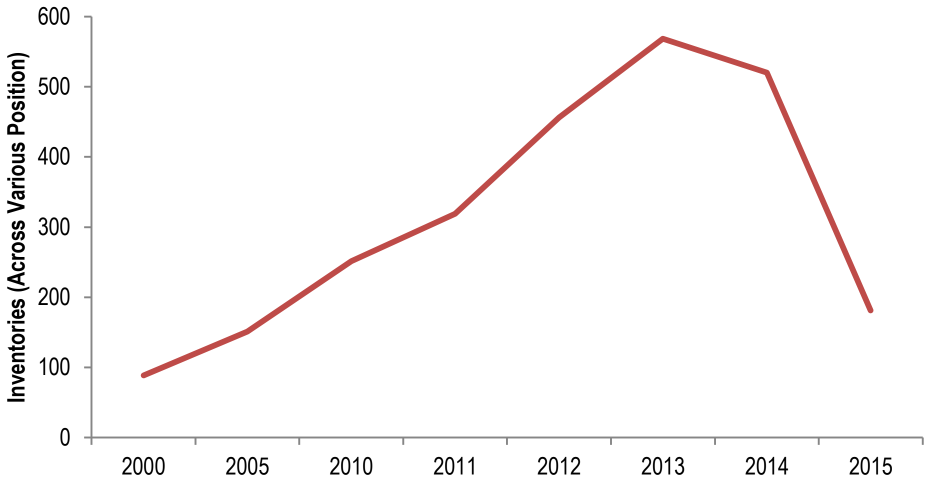
Further credit expansion is a simple option given the low base. Reagan style programs could kick start the growth which is very sensitive to credit expansion and could be helpful for a while but could lead to a bubble.

Russia remains strikingly underleveraged



Source: Sberbank CIB, Euromonitor

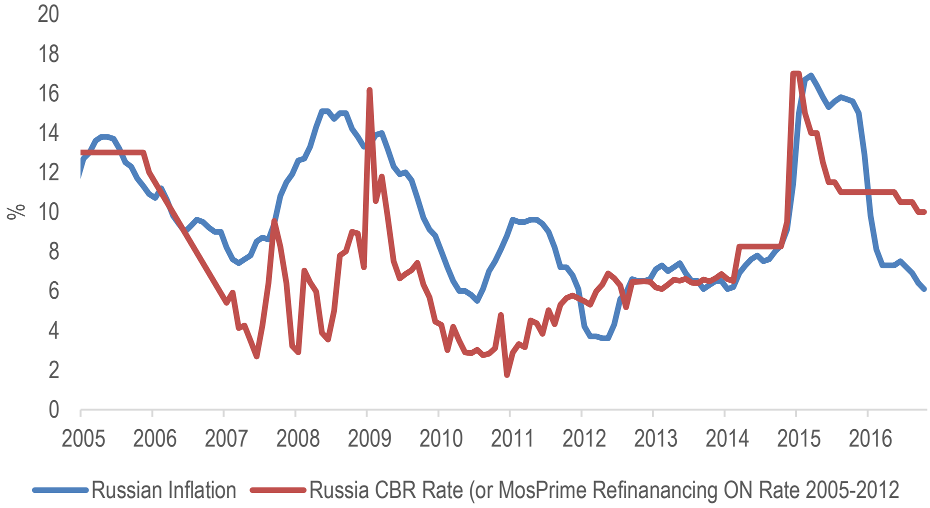
Major destocking was intact as real rates rose. Restocking will be possible when CBR cuts rates further.



Source: Sberbank CIB, Euromonitor

Inflation is supportive for CBR to further cut rates. But the speculative inflows from special situation funds which bet on lower ruble rates and stronger ruble cause CBR to be buying dollars by printing rubles and stimulating inflation.

Inflation vs CBR policy rates, 2010-2016.



Source: CBR

Conclusion

Russian economic growth in 2017 in unavoidable: whereas it will be a result of an oil price bounce, credit expansion, restocking, infrastructure spending or productivity increases. Policy makers if step away from manual management of the economy could reap benefits on increase in productivity. Politics could play positive role in 2017 in the run up to elections given the usual buy before and sell after the election trading habit. There is money to be made in ruble markets as well as in equities. When choosing a benchmark for Russia stick to RTS index. It helps to be diversified while diversification is the only known free lunch.

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