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INVESTMENT NOTE

19 June 2014

Emerging market power politics creates new Best Friends Forever

Russia's falling out with the West is turning an old enemy into a new ally, with potentially profound consequences, says Head of Hermes Emerging Markets, Gary Greenberg.

Investors who don't have daughters with Facebook friends may not be familiar with Best Friends Forever, but in geopolitics, as in teenage girl-politics, allegiances always start out as permanent and then shift dramatically, only to re-establish themselves again under different circumstances.

Putin 'friends' Xi: Russia's assertion of first diplomatic (in Syria) and then military (in Crimea) power has had wide-ranging effects. A renewed enthusiasm for alternative sources of natural gas has been sparked in Western Europe, along with a born-again zeal for Nato. In the US, despite the virtual impossibility of winning a land war with Russia 20 miles from its border, hawks have successfully painted Obama as "weak" on defence, with a resurgence of Tea Party candidates in Republican primary votes. Most interestingly, Russia and China have become best friends again, healing a rift that began in 1956 when the countries' leaders were Khrushchev and Mao.

Unfriending the dollar: Now, 25 years after the fall of the Berlin Wall and 45 years after some serious border incidents, following the American "pivot" to Asia, Russia has announced its own pivot. Russia has agreed a 30-year (or more) gas deal with China, complemented by increased currency, military and diplomatic cooperation. The US dollar is now being bypassed in the Russia/China oil exchange, and not that alone: the China/Japan, China/Australia and China/New Zealand bilateral oil trades all have swap deals allowing alternatives to the greenback. In these cases, it is the renminbi that is the basis of exchange. This is a significant erosion of the petrodollar system that has been in place since the collapse of the Bretton Woods Gold Standard in 1971. It also represents a potential long-term challenge to the dollar as the international reserve currency.

New romances: In the stark light of the US inability or unwillingness to intervene militarily in Syria or the Ukraine, allies are looking to each other for protection. China is becoming ever more belligerent towards its neighbours, ramming Vietnamese fishing vessels, appropriating islands in the South China Sea that most agree belong to the Philippines, and threatening Japanese holdings. This has brought about the second Best Friends Forever romance, between Japan and India, with Japanese prime minister Abe following prime minister Modi on Twitter, Japan underwriting a major railway expansion in India, and extensive cooperation in planning manufacturing for defence. Japan certainly has what India needs (money), and India has what Japan needs (opportunities for investment, such as an enormous infrastructure deficit), but both of them also need support against a powerful and growing China. Modi's inauguration – what the locals are calling his "coronation" – not only included the prime minister of Pakistan, but also the leaders of Bhutan, Nepal, Bangladesh and Sri Lanka. Southeast Asian nations are likely to be the next to feature prominently on his Facebook page.

Cui bono?: Chinese underwriting of more than 30 years of cashflow to Russia provides breathing room for the latter to gradually modernise its economy, expanding the time horizon for numerous investments in energy infrastructure in the Russian Far East, but also for the build-out of India's logistical infrastructure. As railways, highways, ports and defence companies bulk up, second order effects will become evident in banking, manufacturing, and consumption. Beneficiaries of first and second order effects in Russia include Sberbank (financial deepening of the economy), Magnit (the spread of modern food retailing), and Mail.Ru (ecommerce benefiting from a more robust economy). In India, demand for and supply of power will increase, benefitting Power Grid, while modernization will benefit Housing Development Bank. Better logistics and infrastructure will improve India's position as a manufacturing exporter, requiring more commercial vehicles, benefiting Motherson Sumi and Bharat Forge. Implications for trade between emerging markets will be profound, and investors need to be aware of the potential winners and losers at the market and corporate level as these events unfold.

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Notes to Editors:

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