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INVESTMENT NOTE **15 April 2015**

HERMES: BEWARE OF FALSE DAWNS IN RUSSIA

For investors, the Russian market is a little like a Ukrainian ceasefire – calm today does not preclude mayhem tomorrow, says Gary Greenberg, Head of Hermes Emerging Markets and Lead Portfolio Manager.

Russia enjoyed a strong bounce through the first quarter, up 18.6%[1]. There have been a number of catalysts in recent months, such as two American acquisitions: Abbott Labs bought Veropharm and Schlumberger took a controlling stake – subject to approval - in Eurasia Drilling.

A c.20% recovery in the oil price since January, even if erratic, has also helped, as has the Ukraine peace deal agreed in Minsk in February.

This has pushed up last year's worst performers – the Mechel share price is up 117% after falling 73% last year and Hydraulic Machines, down 90% last year, is up 111%.

In late 2014, it was widely assumed Russian companies would experience financial distress, but Hydraulic Machines' $2 billion of external debt, due this quarter, has been domestically refinanced. The government has listed 199 strategically important companies that will get quick access to financing if necessary. Petropavlovsk, a gold miner, does not seem to be on the list, as it is struggling to get financing and is down 62% in the first two months of 2015 after falling 79% last year.

Russia will be in recession this year and probably next, with inflation in double digits and foreign currency reserves declining, though still high. The government forecasts this year's fiscal deficit at 3.7% of GDP, financed in the best case by borrowing and in the worst case by raiding the Reserve Fund - which was $80 billion at last count. Special funding will probably be needed to support the banking and energy sectors, possibly by dipping into the $78 billion National Welfare Fund. Reserves of $385 billion are reportedly depleting at $12 billion a month. With tax rises off the table, policy debates centre on freezing nominal public sector wages, postponing new capital investment and cutting existing projects by half.

Despite a downgrade to "junk" by S&P and Moody's, Russian debt has rallied. The Russia 2030 Eurobond, yielding 7.3% at the end of January, traded at 4.2% at the end of March.

The central bank expects a drop in inflation from an annualised 16.9% in March[2] to 12% by the end of the year - though some international observers expect more like 15% - and so will probably cut rates from 15% towards 11% by year end.

Sentiment may improve if the Minsk deal holds and sanctions are lifted, but Russia will not attract significant investment in the medium term, even if Putin hands back Crimea tomorrow.

Portfolio investors on the whole remain overweight Russia, possibly attracted to the 4.7x 2015 estimated p/e ratio, or because they are unwilling to sell at a loss. Unfortunately, earnings estimates for 2015 are likely to follow the quickly declining estimates of GDP, down as much as -3% to -6%, meaning multiples will rise. However, portfolio investors may choose to value Russian stocks on 2016 "normalised" earnings. How normal 2016 will be remains to be seen.

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[1] Russia return within MSCI Emerging Markets Index – US Dollar
[2] http://www.nytimes.com/2015/04/07/business/international/consumer-price-inflation-reaches-16-9-in-russia.html?_r=0

In the very short run, the market should give back some of its recent gains, as the fast money crowd takes profits and waits for a better opportunity. The rally could then resume if fears of sanctions escalation fade.

The long-term outlook for Russia is cloudy. A change in political leadership or a strong oil price spike would be major catalyst to the upside. Failing this, the upside would have to come from sleight of hand.

The rabbits that need to be pulled out of a hat include dividend increases, share buybacks and mergers and acquisitions. Talk of improvement in corporate governance would also help.

But this would be little more than an illusion: the state can provide the funds required by companies to act in shareholder-friendly ways only for so long, and the seizure of the conglomerate Sistema last year showed that businesses – even those run by oligarchs close to Putin – can become captives of the government almost overnight.

Unlike China and India, Russia is not modernising through structural economic change. Its market may rally sporadically on positive headlines – a higher oil price, a trade deal with a neighbour – but its real economic promise is unlikely to be realised without root and branch political reform.

Until then, we will see only false dawns.

-ENDS-

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Notes to Editors:

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