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RUSSIA

POLITICS WON'T SPOIL THE HIDDEN TREASURE OF THE RUSSIAN MARKET

As a country, Russia is worthy not only of headlines on the front page but also on the investment pages. With increased transparency and structural reforms comes real growth and a better business environment

The arrest of Mikhail Khodorkovsky in autumn last year and the recent dissolution of the cabinet highlight the greatest risk in Russia: its lack of legal and political transparency. This is, however, not unusual in a developing economy.

We therefore class such a case as a typical "event risk" to which even positive markets tend to resort to swift overreaction, normally recovering within a very few days when there are no other negative repercussions. For example, when Mr Khodorkovsky's "right hand man" and head of Menatep Bank, Platon Lebedev, was arrested in July 2003, the markets initially lost 15 per cent, but within three weeks they added 25 per cent to stand ahead of where they had been prior to the incident.

DANGERS

Although we are optimistic, this does not change a fundamental conflict, which must not be overlooked. Recently re-elected President Vladimir Putin stands for stability, but any system that is so singularly focused carries inherent grave dangers.

The fact that the markets have not recovered quite so swiftly since October 2003 to their former highs is also a factor of the enormous increases overall – in euro terms 1200 per cent since 1998 and 60 per cent in the calendar year 2003. When Boris Yeltsin was in power in 1996 and 1997, the index had already experienced a similar boom. However at that time the situation was different. Russia had to meet interest payments in excess of 50 per cent of public spending, the rouble was in a desolate state and the country was suffering under a lack of reform, excessive debt and substantial political instability, causing the exchange to collapse.

REFORMS

Since then the situation has improved radically. With Mr Putin's election as president in 2000, Russia opened up more and more to the West and started extensive market-driven reforms.

Administrative reforms gave powers and accountability to democratically appointed governors in the 89 sub-republics. Although the media often paints quite a different picture, nepotism and corruption have had their roots fundamentally weakened. Tax reforms have produced a simple system that has been widely accepted, thanks mainly to its low taxation rates. Corporation tax stands at 24 per cent and the highest rate of personal income tax is 13 per cent. This has been translated into a rapid increase in honest declaration of tax liabilities.

In addition, the improvement in securities supervision and deregulation of the energy sector, as well as the prospects of banking reforms, are all significant contributions to producing a functioning regulatory system.

The results are already clear in the macro-economic statistics. Real growth in 2003 amounted to 7 per cent

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Dr Andreas Gummich, DWS

1 RUSSIA'S MINERAL RESOURCES

	Share of total reserves	Share of total production	Total sales in US$bn
OIL	6%	10%	575
GAS	30%	22%	246
Iron ore	19%	9%	25
Gold	4%	7%	22
Copper	5%	4%	21
Nickel	10%	21%	8
Gemstones	19%	25%	6
Palladium	33%	46%	4
Diamonds (industrial)	21%	21%	1

Source: Renaissance Capital, Deutsche Bank, 2003

and in 2004 is expected to be between 5 and 7 per cent. Russia has a budget surplus and inflation is falling. With increased currency reserves the country has more possibilities of paying its debt on time.

Both the anticipated worldwide economic recovery as well as the increased demand for raw materials should benefit Russia given its vast raw materials reserves. (See Chart 1.) With 6 per cent of the world's oil reserves and 10 per cent of production, Russia is very much in the focus of the energy sector, especially for expanding economies in Asia where energy consumption is increasing rapidly. From 1985 to 1998, per capita oil consumption in Korea quadrupled and is already at 60 per cent of the US level of approximately 3700 litres per annum. By contrast in 1998, per capita consumption in China stood at only 200 litres per annum. As China's high rates of growth already account for 16 per cent of global growth, demand is going up dramatically.

DEMAND FOR GAS

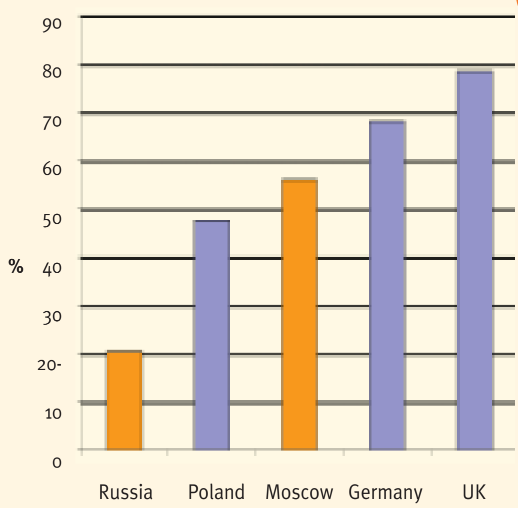
In Europe, and especially in Germany, demand for gas is growing at disproportionately high levels. Total energy consumption worldwide is predicted to increase by 2.1 per cent per year from 1997 to 2010, while gas consumption should rise by 3.4 per cent per annum. Europe is being served more and more by Russia as it controls around one-third of the world's reserves. Indeed, already one in every three cubic metres of gas consumed in Germany originated in Russia. Most probably 90 per cent of future increases will be supplied by the world's largest gas supplier, Gazprom.

So far the wealth of raw materials resources does not appear to have been adequately reflected in prices, even they have already increased substantially. The Russian RTX Index has a market price/earnings ratio of around 10, and comparing equity prices versus oil and gas resources there are almost unbelievable pricing discounts for Russia of as much as 90 per cent and over in comparison to oil stocks in the West. However, to put this into perspective, if oil prices fall internationally the Russian equity market could see considerable price corrections.

MOSCOW STYLE

On the other hand, Russia has a burgeoning middle class which continues to expand around the political and business centre in Moscow. Of the 145m inhabitants of Russia, 9m live in Moscow and 15m live in the Moscow region. A lifestyle similar to other international cities is

Mobile penetration rate: Russia 2



Source: CA IB Intl Markets

developing with more than 56 per cent of Muscovites having mobile telephones in comparison to 68 per cent in Germany and 20 per cent in Russia as a whole. (See Chart 2.) The telecommunications provider MTS is the main beneficiary.

DWS continues to class the Russian equity market as fundamentally positive. Corrections are both healthy and necessary, whether they are of a political or purely market nature.

Dr Andreas Gummich is a director and Eastern European expert in product management at DWS

CORPORATE STATEMENT

DWS Investments is the leading German mutual fund manager with a market share of 25 per cent. Managing assets of €120bn in more than 400 mutual funds, DWS-Group is also one of the leading European mutual fund companies. DWS has received numerous awards by independent experts for its superior performance record. Among these is the prestigious Standard & Poor's Fund Award as best mutual fund company in Austria, France, Germany, Spain and Switzerland

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