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The Maturing of a Market

By James Beadle

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This has been an odd year for investors. The market has ultimately managed healthy gains, and bonds have performed well. But even so, old Russia hands are probably disappointed. After so many years of astounding out-performance, both up and down, 2012 stands out as the year in which the Russian equity market reached adulthood. No more adrenaline rushes as the MICEX turned 20 and promptly entered corporate matrimony with the younger, but more future-oriented, RTS. What will happen next in this exciting epic of economic evolution?

Russia has put its go-go teenage years behind it. Annualized index volatility has slumped to 19 percent, the lowest on record, and 2012 returns will ultimately disappoint many accustomed to fast and easy money. Investors need to accept that a new level of maturity will be required to negotiate the market's challenging third decade of existence. There is good news though. The Russian financial sector is on course to mature into a respectable and productive young adult, efficiently intermediating between investors and companies with a wide range of interests. Despite some impressive developments in 2012, the high and rising equity risk premium tells us that there is plenty more exciting work ahead.

Technically, the RTS and the MICEX finalized their merger in 2011, but the integration took

place only this year, culminating in the upcoming adjustment of the MICEX Index to include the same 50 names as the RTS. At last, Russia will have real volume trading in an index that is investable and reflects more than just the biggest blue chips. The formation of a central depository was an equally important event. But the infrastructure development of greatest importance is surely the subsequent opening of the ruble debt market to international investors. By early 2013, global investors will have easy access to a diverse array of locally traded ruble bonds. This development will bring immediate benefits to corporations, Russia's capital account and the global investor community. It may also rapidly have the knock-on affect of improving corporate governance and regulation. Managers should quickly notice that the best-behaved companies borrow at the best rates.

Elsewhere, the government won accolades for the decision to reinstate budget constraints against fiscal largesse, talked tough on corruption, implemented impressive dividend policies and defined ambitious modernization plans with clear milestones to allow independent monitoring of progress. The Central Bank also rose to the occasion, pursuing the path to inflation-targeting and playing a considerable role in one of the ruble's most stable years to date. The country's top billionaires, too, contributed, with concerted efforts to resolve several long-standing conflicts. Not least, the end of the TNK-BP saga lifts a substantial blight overshadowing the whole equity market, and the signs are good that Norilsk Nickel will pursue a clear and profit-oriented strategy going forward. Let's also not forget that Russia finally joined the World Trade Organization in late August.

If all appears to be well and good, why is the equity risk premium rising, and why is Russia's discount to its peers so high? The answer to both these questions can be found in the difficult transition from communist superpower to modern capitalist state. The government is talking the talk, but next year more than ever it will need to walk the walk.

At the top of the list, countries need a fair, independent judicial system to enjoy low costs of capital and sustainable global capital in flows. What's more, one-party systems always make investors nervous about long-term projects.

But perhaps the most urgent item on the list is the need for a cogent macroeconomic policy. It doesn't only define the path forward, it is also essential for consolidating the progress already achieved. The government has correctly acknowledged that the old economic model is broken. Despite the probability of healthy global growth in 2013, Russia runs the risk of missing the party. Commodities prices are unlikely to rise like they did in the pre-crisis era, and Russia remains a resource-dependent economy. Slower retail sector expansion this year, coupled with soaring household borrowing, should raise concerns. Next year's growth will come from investment or nothing.

It is true that for the time being, the government can provide the capital that the private sector is so nervous about deploying, especially as returns on investment appear to be declining while risk lingers at an elevated level. But this is not a sustainable solution. First, the state sector is already far too large and is struggling to shrink itself. Second, the government is notoriously bad at economically efficient capital allocation. Third, the state simply lacks the funds to keep funding huge projects year after year. Government projects might get the ball rolling, but for Russia to resume healthy growth it is going to need to meet its qualitative development milestones. That will require the bureaucratic elite to do more

than just talk the talk.

Russia's financial market is growing up fast before our eyes. But 2013 will determine whether it becomes an organized and responsible member of the global economic community, or whether at this sensitive young age it becomes easily distracted and runs off the rails. We all have a responsibility to play our part in stewarding it to a successful middle age.

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