STRATEGY

METROPOL INVESTMENT FINANCIAL COMPANY | RUSSIAN EQUITY RESEARCH | **21 JANUARY 2005**

Bloomberg:
GAZP; VIP US; LKOH; NLMK

REASONS TO BE CHEERFUL

Reuters:
GAZP; VIP N; LKOH; NLMK

2005 OUTLOOK

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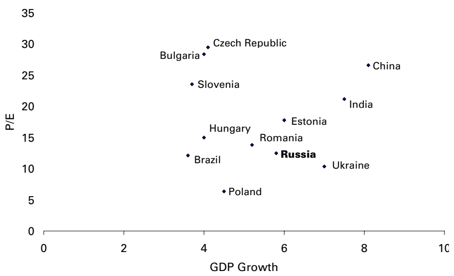
Exhibit 1
Emerging markets market P/E versus expected 2005 growth



Source: Economist Intelligence Unit, market data

Exhibit 2
Emerging markets: average annual GDP growth, 1999-2003

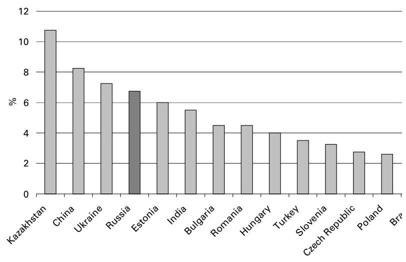


Exhibit 3
Top Buy recommendations

Company	Ticker	Target price
Gazprom	GAZP	$3.80
LUKoil	LKOH	$44.00
VimpelCom	VIP	$49.33
Novolipetsk	NLMK	$1.27

Source: Market data

Professional optimists

Local brokers cannot be pessimistic about their country of operation. Part of our role is to supply reasons to be optimistic about Russia for investors who need them. The main reason to be cheerful is the fact that the Russian market has shrugged off yet another apocalypse, and the macroeconomic picture is not bad, either.

Silver lining to political cloud

The main good news about the YUKOS affair is that we do not expect it to recur. We think the company's shareholders were perceived by the Kremlin as a political threat. We do not see any other traded companies that pose a similar threat. We are optimistic that the Kremlin has learned from the recent events in Ukraine.

Sunny macro outlook

There is real good news on the macro front. GDP should grow at around 5.8% in 2005, and non-oil GDP will grow even faster. The hidden good news of 2004 was a rise in the numbers of small businesses, and in investment. The government will also give a fiscal stimulus through a reduction in the budget surplus.

Consumption boom

Consumption will be a major driver of GDP in 2005, we think. Government spending should benefit households, particularly those with low savings ratios. We recommend the mobile telephone operators as the best exposure to this segment.

Underweight oils

The Russian market is dominated by oil, so getting this right is the key to out performance. We expect a lower oil price and high taxes to continue to weigh on the sector. We like the telecoms sector as a consumer proxy, and we like metals, as a play on high commodity prices, and on Russian investment and construction.

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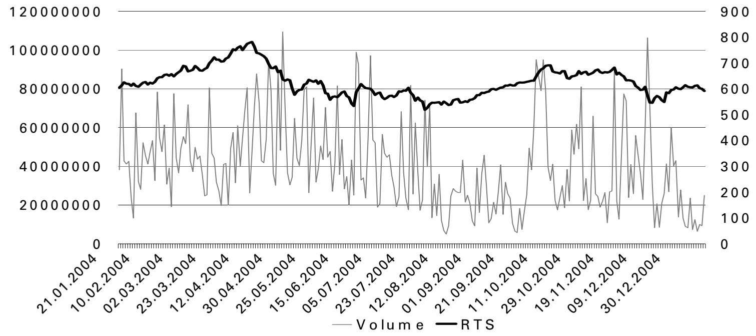
Exhibit 4
RTS Index and volume, 2004-2005



Source: RTS

We think that the average investor has at best a neutral weighting on Russia at the moment. Those who were underweight last year did well relative to other EMEA countries. We would expect the average investor to keep their Russian weighting low, given that there appears to be no news that might make them change their stance.

The big issue is still YUKOS. The dismemberment of this oil company hit investors' morale on a scale similar to the default of 1998. In a way, YUKOS was even worse. At least the default created the foundation for the growth that has taken place since 1999, and the political fallout was probably beneficial as well. The YUKOS affair does not hold out any hope of a similar silver lining, except for the Kremlin elite, who may feel less threatened, but this won't help investors.

We think that Russia has not changed as much as the market might think. Much of the original investment case remains, and the economy, including the non-oil sector, is growing at over 5%. The government is still pursuing structural reform, in spite of the YUKOS affair. A recent survey of the small business sector showed that it is doing well, and genuinely benefiting from the government's initiatives.

For an observer inside Russia, it is surprising to hear the view that government policy has changed in the last two years. What has really changed is that Putin has lost the positive image in the West that he built with his immediate support after 9/11. It is hard to see the Bundestag giving him a standing ovation today as they did in 2001. YUKOS has tarnished Putin's image. The Western press talks about a slide towards dictatorship, because of the lack of due process afforded to the largest company in the index.

We are not happy about the anti-YUKOS pogrom, but our view is that it was a tactical reaction, not a strategic initiative. The Kremlin elite were reacting to a perceived threat to their authority, and so they crushed this threat with all the power of the state. This was not a planned action. The fact that it happened increases the risk that the same tactics could be used on another victim, but it does not automatically mean that there will be such a victim. VimpelCom was able to get a much fairer hearing from the state.

In the meantime, the government does have an economic strategy. It is following a tight fiscal policy, although that is gradually loosening. It is prudently using the gains from the higher oil price. It has begun to make painful structural adjustments, such as pension reform, the abolition of price subsidies, and reform of public housing. Bureaucratic barriers to entrepreneurship are being chipped away. Although Russia has a long way to go, it is generally on the right track. The major disappointment is legal reform, as the YUKOS affair has shown that the judges are not independent.

GDP will carry on growing this year, as will consumer spending. Inflation is higher than in the West, but it is under control. It has been robust, despite the YUKOS affair, and grew at 8% in the first 10 months of 2004. The government's relaxation of its fiscal stance should replace the stimulus of higher commodity prices, and transfer the oil wealth to the consumer sector. The Russian market is trading at a P/E ratio of about 12.0. Only the P/Es of Brazil, Ukraine, and Poland are lower, in our EM universe.

Local brokers have to be optimistic about Russia, or we are out of a job. But the view from inside Russia is a lot better than that from outside. And it won't take much for the perception to change.

Exhibit 5

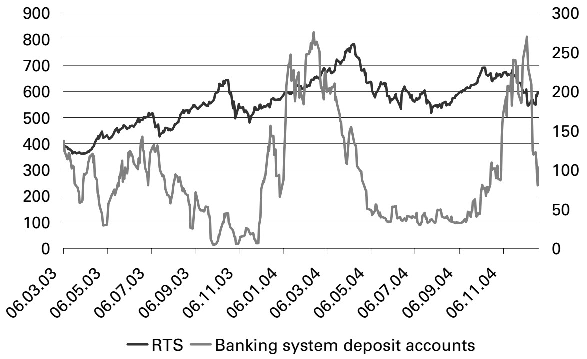
Expected financial results, various Russian companies, 2004-5, $ mn

	Sales			EBITDA			Net income		
	2004E	2005E	% change	2004E	2005E	% change	2004E	2005E	% change
Oil & Gas									
Gazprom ADR	33,079	39,011	18%	13,847	17,310	25%	8,611	11,483	33%
Gazprom OTC	33,079	39,011	18%	13,847	17,310	25%	8,611	11,483	33%
YUKOS	21,109	21,755	3%	6,112	5,025	-18%	4,570	3,713	-19%
Sibneft	10,082	10,632	5%	3,348	3,118	-7%	2,462	2,239	-9%
LUKoil	33,334	34,675	4%	6,097	5,094	-16%	4,143	3,119	-25%
Surgut	13,811	14,105	2%	3,595	2,721	-24%	2,363	1,658	-30%
Tatneft	7,000	6,930	-1%	843	558	-34%	400	216	-46%
Oil sector average			**7%**			**-7%**			**-9%**
Telecoms									
Rostelecom	1,222	1,270	4%	494	496	0%	125	139	11%
Golden Telecom	585	711	22%	177	248	40%	66	122	85%
MGTS	704	837	19%	361	425	18%	138	157	13%
Center Telecom	824	901	9%	208	238	14%	18	17	-5%
North West Telecom	494	529	7%	164	179	9%	49	49	0%
Southern Telecom	613	649	6%	226	249	10%	39	15	-62%
Volga Telecom	727	835	15%	275	346	26%	110	127	15%
Uralsvyazinform	991	1,127	14%	362	431	19%	113	138	22%
Sibir Telecom	725	832	15%	237	299	26%	91	108	19%
Far East Telecom	269	295	10%	72	90	25%	20	22	12%
VimpelCom	2,249	3,161	41%	1,079	1,520	41%	436	574	32%
MTS	4,049	5,603	38%	2,213	3,031	37%	1,078	1,493	39%
Telecom sector average			**17%**			**22%**			**15%**
Metals $ mn									
Norilsk Nickel	6,232	6,087	-2%	2,593	2,692	4%	1,167	1,249	7%
VSMO	544	659	21%	202	251	24%	135	171	27%
UGMK	754	926	23%	161	182	13%	91	98	7%
UfaNickel	73	65	-11%	8	7	-15%	5	4	-28%
ChelZink	158	204	29%	36	46	28%	27	35	29%
Sual	1,000	890	-11%	250	190	-24%	85	70	-18%
Rusal	4,939	5,934	20%	1,629	2,052	26%	1,198	1,534	28%
Metals sector average			**10%**			**8%**			**8%**
Steel									
NTMK	1,618	1,527	-6%	529	687	30%	264	363	38%
Zapsib	2,019	1,974	-2%	723	760	5%	472	488	3%
Mechel	1,301	1,109	-15%	413	309	-25%	262	179	-32%
Severstal	4,839	4,172	-14%	2,034	1,470	-28%	1,316	885	-33%
NLMK	4,072	3,684	-10%	1,943	1,603	-17%	1,307	1,009	-23%
MMK	4,368	3,392	-22%	1,482	1,040	-30%	941	567	-40%
Mechel Steel Group	3,006	2,704	-10%	741	591	-20%	456	333	-27%
Nosta Steel	850	721	-15%	175	180	3%	75	65	-13%
Oskol Steel	700	550	-21%	175	120	-31%	56	45	-20%
MGOK	1,139	1,087	-5%	258	245	-5%	201	189	-6%
Steel sector average			**-12%**			**-12%**			**-15%**
Consumer									
Wimm-Bill-Dann	1,219	1,242	2%	132	166	26%	36	58	61%
Kalina	195	233	19%	33	40	21%	22	26	18%
Consumer sector av′ge			**11%**			**23%**			**40%**
Overall average			6%			5%			3%

Source: Metropol data

Exhibit 6

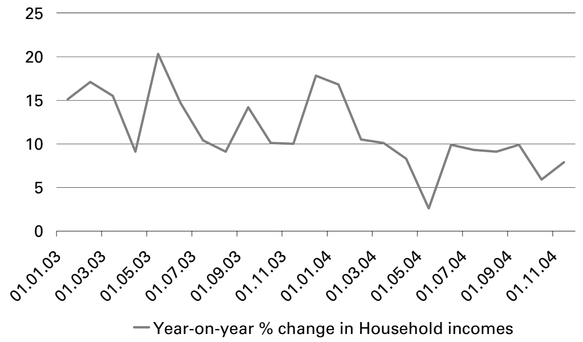
Changes in the RTS, and Rus. bank. system deposits with the CBR, 2003-4



Source: CBR, market data

Exhibit 7

Y-o-y % increase in Rus. household real incomes, 2003-4



Source: Goskomstat

Macroeconomic growth... Russia grew at 6.8% in 2004, and is forecast by the government to grow at 5.8% in 2005. We think that forecast is realistic. This year should see a more 'natural' economic growth, without the boost from the extraordinary oil price growth of 2004. We expect most natural resources to maintain their prices, so that higher prices will not be a major contributor to economic growth. This means that Russia's growth is driven by rising economic activity, not just by an improvement in the terms of trade.

We expect growth to be driven by all components of GDP except the current account. Consumption should continue to grow, because of an increase in household incomes. Investment picked up in the fourth quarter of 2004. The key to growth here is business confidence, as we believe there is no shortage of funds in the economy, given the booming money supply and increasing liquidity in the banking system. Government spending should be an important component of growth in 2004. Government spending is officially forecast to make up 34.9% of GDP in 2005, so the planned reduction in the budget surplus as a percentage of GDP will be significant for GDP growth. Although the current account should stay in a healthy surplus this year, we do not expect it to increase as a percentage of GDP, unless the oil price goes even higher.

...translates into top line growth We forecast that the companies in our stock universe will increase their revenues by an average of 6% in 2004; this allows for expected revenue falls in the steel sector that are likely to result from price falls later in the year. The growth rates that we expect range from 22% for Golden Telecom to a fall of 22% at Magnitogorsk. The oil companies are unlikely to get much help from the oil price, but their growth is driven by higher output, the fruit of increased investment in 2004. We see the main driver of steel revenue as Russian demand. The really big gains, though, should come in the consumer sector.

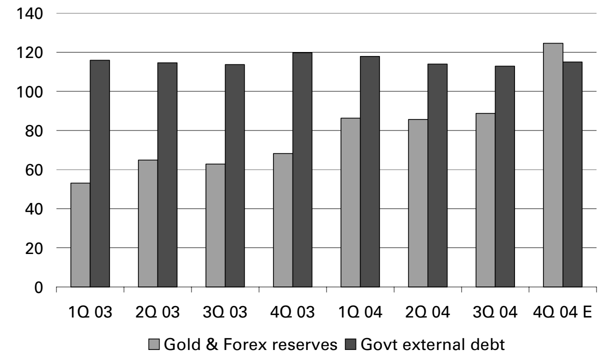
Consumer boom Real household consumption in 3Q04 was 10% higher than in the same period in 2003. Disposable incomes grew by nearly 10%. The two mobile telephone companies' revenues grew by an average of 60% in the year ended 30 September 2004. New foreign car sales rose 80% in 2004. All that money from the higher oil price is trickling into the consumer sector. The government is increasing spending in the social sector, for example on medicine and education, and much of this will go on increasing salaries. Pensions should also rise higher than the rate of inflation. Pensions should also get a boost from the end of price subsidies. Poorer people will no longer pay lower prices for telephone service, electricity and public transport, but will get extra money to spend as they wish. The expected cost of these transfers is RUR 203 bn, or about 2.5% of total consumer spending in 2004.

Fiscal prudence. The Russian government has got into the habit of running budget surpluses, so much so that some economists are calling for a looser policy. That kind of talk has not been heard in the West since the sixties or seventies. True, this prudence is being relaxed, but the government is still running a primary surplus, for the fourth year running. This should give investors some comfort that there will be no Latin American-style crisis any time soon. If the oil price holds up, by the end of the year the government should have considerably reduced its debt, starting with the most expensive items, which should create a virtuous circle.

Abundance of liquidity With all these surpluses, it is not surprising that the banks have plenty of liquidity. Although this money is unlikely to find its way directly to the market, it is available to be lent to corporations. Total lending at the end of November was 36% higher than at the end of January. Most of this gain was generated by household lending (up 86%). Corporate lending was up 34% in total, which included a 20% fall in lending of less than 30 days, implying that companies are generating

Exhibit 8

Russian government debt, and foreign exchange reserves, 2003-4, $ billion



Source: CBR, Ministry of Finance

their own short term funds. Loans of more than three years were up 59%.

Reserves exceed debt As of the end of 2004, Central Bank reserves exceeded the government's external debt, and are well over 50% of total external debt. The government is in negotiations to redeem most of its Paris Club debt, which comes to about $45 bn. This is some of the country's most expensive debt, with interest rates in the 9-13% range, according to the Ministry of Finance, so redeeming it will create a virtuous circle for the government's finances.

The number one fear for the market has been that some other company will suffer the same fate as YUKOS. Investors lost a lot of money in YUKOS, although some got out in time. The market seems now to be taking the view that it is better to get out at the first sign of danger than to live in uncertainty. This would seem to explain the sharp falls in Sibneft's and VimpelCom's prices following news of possible new tax demands. None of this sounds like a reason to be cheerful. Looked at from most sides, it is not. The only silver lining to the YUKOS cloud is that the worst is probably over, as we are confident that no other company will suffer the same fate. It is true that the political threat posed by YUKOS's shareholders was not very public, and mostly came to light only after the fact. This means that there could be other political struggles that could have equally disastrous results, but we do not see any signs of this.

There will continue to be challenges to the owners of the better assets in Russia, especially those that were acquired through privatisation. As a result, the owners of these assets have to be perpetually vigilant, as do shareholders in companies controlled by these owners. So the market is right to be careful about oligarch-related companies such as Sibneft, Norilsk, and VimpelCom, because there are plenty of people who would like to take away these assets from, respectively, Mr Abramovich, Interros, and Alfa. There is a risk that investors could suffer collateral damage in this struggle.

The downside to this type of risk is several degrees of magnitude smaller than that run by YUKOS's shareholders. It was alleged that they reduced the state's freedom to set policy when they lobbied against legislation to increase oil taxation. It is not surprising that this set off the state's self-defence mechanisms. The position of other oligarch groups is less risky, in our opinion. True, they have enemies who have access to various instruments of state power, and who want to use these for their own private ends. However, firstly, there are limits on the extent to which state power can be abused for private ends, while there are no limits on the use of state power in the state's interests. Second, the oligarchs also have access to the instruments of state power, and can wield them in self-defence.

This situation was well demonstrated by the resolution of VimpelCom's 2001 tax demand. This may or may not have been caused by VimpelCom's owners being in conflict over the ownership of 25% of Megafon. The arbitrariness of the Tax Inspectorate is well documented. However, even if it was, then this is a clear case of private interests using the state for their own ends. It is not a case of the state attacking private interests across all fronts, as happened with YUKOS. VimpelCom was able to mobilise its own access to state power, and successfully lobbied the government for fair treatment.

Exhibit 9

"Vladimir Putin's hard line policies finally prove too much for the Russian people. Revelations of widespread corruption on top of the Ukrainian election controversy precipitate a second Russian Revolution and Mr Putin resigns. The economy slumps, the ruble weakens, and the Russian market declines 25%."

Number 7 among "The Ten Surprises of the New Year – 2005", Byron Wien, Morgan Stanley

Source: Morgan Stanley

In 2000, Mr Putin set out an agenda that promised to strengthen the state. The liberal policies of his predecessor meant that the state had abandoned even a minimal role in the economy. At the same time, he promised to make it more effective by increasing control by the courts and civil society. This promise was attractive to investors. Coupled with Putin's clear pro-Western stance after the attack on American in September 2001, that created an image in the West that Russia would become a European style state. Clearly, something has changed between now and then, but we think that this change has more to do with the perception of Putin than with his actual philosophy.

We couldn't ignore the above quote from a recent report by Byron Wien, the US equity strategist at Morgan Stanley. This is partly because Mr Wien is undoubtedly a market guru, and partly because we can imagine that his way of thinking may not be too far from the US investor mainstream. We understand that Mr Wien was writing about future events to which investors might be expected to assign a probability of less than one in three, but which Morgan Stanley thinks are more than 50% likely.

We also understand that, as Mr Wien says, "the Surprises of the New Year are meant to challenge investors to reflect on how the important issues facing the market might work themselves out." So our commentary is not meant to be a refutation, because we don't believe that Mr Wien was making a prediction, but suggesting a scenario. The Russian press, with its usual accuracy, has reported that Morgan Stanley is predicting a revolution in Russia. We are not criticizing this Surprise, but taking it as a launch pad.

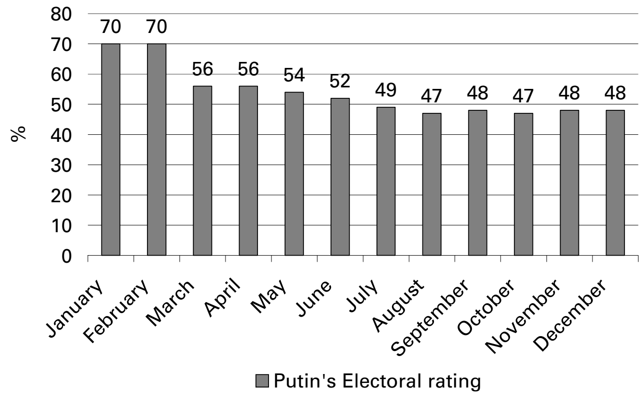
Mr Putin's policies undoubtedly did become more 'hard-line' in 2004. In particular, he took away the people's right to choose their own local governments. The denial of this right was the result of an event, the Beslan Siege, which only partially had its roots in the failure of local government. It seems to us that Putin had for a long time been frustrated with the over-independence of local government, and used the shock of the Beslan tragedy to push through such a harsh measure. Also, the press in Russia quite clearly ceased to be free in 2004. Many will say that this happened a long time before, but press control became a lot more blatant in 2004, as the last independent journalists at the best news channel, NTV, were sacked for permitting controversial issues to be debated evenly. TV news in Russia is much more Soviet than it was a year ago.

However, both of these changes are continuations of a trend that was begun shortly after Mr Putin took office. The Russian people have been calmly accepting similar infringements on its civil rights for four years. We don't think that the recent changes will bring people out into the streets. Polls still show strong support for Mr Putin, and there does not seem to be any strong popular anger at the recent infringements on civil liberties.

Of course, with popular protest stifled and the TV channels under state control, it would be quite hard to hear about any popular opposition if it existed. However, we have recently seen a wave of popular protest against another 2004 policy initiative, the monetization of price subsidies. In the past, pensioners and invalids have enjoyed low prices for public transport and other public services, including medicine. Now they will pay the same price as everyone else, but will receive higher benefits in compensation. This measure was pushed through the Duma in the middle of last year, and was lavishly praised and described on state TV. Now that the pensioners actually have to pay, they are demonstrating in force, across the country. People in Russia are not afraid of popular protest when the issue is a major grievance.

Exhibit 10

Percentage of the population who would vote for President Putin, 2004



Source: Public Opinion Foundation

Nonetheless, one of our reasons to be cheerful is the potential effect of the 'Orange Revolution' in Ukraine. The controversial election in Ukraine was widely discussed on TV, but only from Mr Yanukovich's point of view. Many Russians believe that Mr Yuschenko and his supporters were financed by the Americans, and so support the heavy-handed intervention by Mr Putin and his political advisors.

Liberal consequences of Ukraine Curiously, the Russian people have one good reason to be grateful for Mr Putin's intervention in Ukraine. In order to attract the votes of the many Ukrainians who live in Russia, the government announced that Ukrainians could live in Russia for three months without registration, where previously they had to register after three days. It was then pointed out that Russians who find themselves in a Russian city other than their place of permanent registration have to register within three days, and so the requirement for Russians was extended to three months. This is actually a real extension of Russia's civil liberties, and a step towards the freedom of movement that is promised by Yeltsin's 1993 Constitution.

Ukraine as an example for the Kremlin Our main reason to be cheerful about the events in Ukraine is that we hope that they will remind Mr Putin and his advisors that any government ignores popular opinion at its peril. There are limits to which an autocratic leadership can ignore its people. Russia can muddle along with only partially free elections, and a muzzled press, but the government has to allow some checks and balances, or there will be popular protests. We think Russia has a long way to go to reach that stage, but hopefully the failure of his initiative in Ukraine will serve as a brake on Mr Putin's autocratic tendencies.

We do not expect political protests. There have been plenty of economic protests, and no doubt there will be more. They will get a more sympathetic hearing from the government, we believe. There is already a sign of panic at the pensioners' protests, and a planned 15% increase in pensions has been brought forward by two months. If anything, the government is too sensitive to popular pressure – Mrs Thatcher must be disgusted. There is a huge gulf, however, between this temporary weakness, on the part of a government that can easily afford it, and the resignation of Mr Putin.

Retired Russian leaders are a modern invention Mr Khrushchev was disgraced. Mr Gorbachev was the first leader who was able to leave office, and retain some kind of political role. Mr Yeltsin only resigned after assuring himself that his successor would not persecute him and his supporters. Otherwise, historically, only death has removed Russian leaders from office, and we hope that Mr Putin will be the first Russian leader to cede office following a democratic election to choose his successor. Eventually, no doubt, the Russian government will run into financial problems, Latin American-style, and this could cause the president to leave office, but we are happily a long way from that at the moment.

Black and white view of Russia It's clear that we don't agree that Mr Wien's surprise will happen, but he raises an interesting issue. The fact is, the US public, including its investors, were pleasantly surprised at first by Mr Putin. Perhaps they were too simplistic in interpreting his pro-Western stance after 9/11, but then Russia is only one of many countries that US investors have to think about. Their view seems to be that governments either are democratic and market-oriented, or they are not. The inflow of investment in 2001-3 was driven by a view that Russia was steadily on a course to becoming a nice, non-threatening country like Poland, but in 2004 this image crumbled. Russia is no longer nice, therefore it must be nasty.

Exhibit 11

Which events in what proportion attracted the most attention in 2004?

Terrorist acts	71
War in Iraq	29
Ukraine Presidential elections	21
Monetisation of subsidies	18
Athens Olympics	14
YUKOS	13
Fall of dollar relative to rouble	13
Death of Kadyrov	13
Abolition of holidays on 7 November and 12 December	11
Scandal around Philip Kirkorov (Russian pop star)	11
Russian presidential elections	11
Abolition of governors' elections	10
European football championship	9
US Presidential elections	6

Source: VTsIOM

Image, not reality We are professional optimists on Russia, so we will always have a more positive view on the country than the Western mainstream. We can and will continue to point out the reasons to be cheerful, but if public opinion in the West has sw

ung against the Russian government, it will be hard to change. However, it is possible that some action by Mr Putin or his government would change perceptions in the West. This action would probably have to be Western-oriented. The change in the registration rules, a major improvement in peoples' lives, has passed unnoticed. A shot on Fox News of Mr Putin wearing cowboy boots would have more effect on US public opinion. The point here is that, as far as the market is concerned, the appearance of reform is probably more important than real changes.

Potential changes in 2005 At present it is hard to judge whether there will be any political events that might have a serious effect on Mr Putin's or Russia's image abroad. There will be a summit meeting in February, which could improve things a bit. Apparently Putin and Bush get on quite well on a personal level, but recent rhetoric does not bode well. The US and Russia were unhappy with each other's conduct during the Ukrainian elections. Mr Putin was quite critical of what he perceived as double standards by the West over elections in various countries around the world. He has already showed us at his year-end press conference that he is not prepared to soften his line, so we are not optimistic that his image will improve after the February summit.

There may be real, but less obvious, improvements. There has not been much comment in the West about Mr Putin's new Civic Chamber, which is designed to create a forum for public discussion of legislation and actions by the government. In theory, this is a new arm of government, and a proxy for the work done by non-governmental organizations in the West. Most observers have dismissed it as a rubber-stamping organization that will be staffed by apparatchiks, rather like the old Committee for People's Control in the Soviet Union. If they did start to fight for human rights, however, for the first time there would be an independent mediator between the State and the individual.

Things can't get worse for Khodorkovsky. Mikhail Khodorkovsky is doing his best to set himself up as Russia's leading prisoner of conscience. This will not be an easy task, given his wealth and question marks over the way in which he acquired YUKOS and consolidated some of its subsidiaries. It does not seem likely at the moment that he will succeed, but at this point it's hard to see what the government could do that would make his treatment seem worse. And maybe, just maybe, they might cut a deal, and improve the international image of the Russian justice system.

Exhibit 12

Russian government spending, 2004-5, RUR 000

	2004	Share	2005	Share	% change
State management	76,967,150	3%	92,641,627	3%	20%
Defence	411,472,653	15%	531,139,221	17%	29%
Law and order, state security	310,577,078	12%	398,889,472	13%	28%
Court system	33,250,793	1%	36,768,994	1%	11%
Education	117,791,867	4%	155,337,963	5%	32%
Culture	16,101,176	1%	16,901,155	1%	5%
Health	47,097,830	2%	72,238,982	2%	53%
Social policy	161,193,511	6%	167,360,933	5%	4%
State and municipal debt service	287,570,589	11%	244,150,356	8%	-15%
Financial transfers to other budgets	813,969,816	31%	954,545,242	31%	17%
Transfers to regional budgets	273,776,129	10%	274,616,803	9%	0%
Total spending	2,659,447,000		3,047,929,300		15%

Source: Official data

The Russian government will face the problem in 2005 of generating non-oil growth, since the oil price seems to have peaked. Mr Putin has set the government the task of doubling GDP by 2010. Andrei Illarionov, his main economic adviser, estimates that this requires the economy to grow by 9.1% every year between now and then. For the last two years, it has been growing at about 7%.

At a government meeting in December 2004, German Gref, the Minister of Economic Development and Trade forecast that GDP would grow by 5.8% in 2005, and on average by 6.1% in during 2005-07. His ministry estimates that GDP growth was 6.8% in 2004. He suggested that it could be as low as 4.5% in 2005 if Russian companies do not become more competitive. This work may be done for him, however, by the weaker dollar. Russia has a long term strategic aim of weaning itself off its natural resources, to avoid ending up as nothing more than a primary goods supplier to the Asian economies, which would put it low down the food chain in the international division of labor.

To do this, Russia has to encourage private enterprise, and this is where the after-effects of YUKOS come in. If Russia decides that the state has the upper hand in the state-business trade-off, and therefore that business exists only with the state's permission, this would not be a good environment to create a dynamic sector. And this is precisely the kind of atmosphere that the YUKOS affair has created. Capital flight quadrupled in 2004. Companies are less willing to repatriate funds which might be subsequently confiscated. Rational entrepreneurs are diversifying risk away from Russia, and buying assets outside the country.

Where did growth come from in 2004? Exhibit 11 suggests that the main contributors to GDP in 2004 were higher prices for industrial goods. Industrial output also rose, almost exactly in line with GDP. The other strong performer was exports. These are not encouraging signs, as they suggest that much of Russia's success last year was driven by higher prices for natural resources.

One bright spot was investment growth of 10.5%. This growth increased towards the end of the year, after dipping in September and October. So the YUKOS affair was not the disaster for investment that was forecast. It could be argued that investment should have been much higher, given that the country is awash in liquidity. Still, it shows that the real economy has not suffered that much from a loss of confidence following the dismemberment of YUKOS.

Consumption grows faster than GDP We are starting to see a trickle-down effect, with retail spending outpacing GDP.

The 2005 outlook At the time of writing, it seems to us that oil prices are unlikely to return to their highs of 2004. The US economy looks to be landing softly, it seems that the supply problems caused by hurricanes in the Gulf of Mexico will not recur. There may even be some optimism about supply from Iraq, although this will only become clear after the elections there. We are hopeful that steel prices will be kept strong by demand in China. However, even if Chinese production comes on line, we expect Russian steel companies to find demand in Russia. The continued growth in investment is evidence of this.

Expect fiscal stimulus in 2005 The 2005 budget surplus is currently set at 1.4% of GDP. This is much less contractionary than the surplus of 4.8% of GDP that the government ran in the first ten months of 2004. The government has accepted that fiscal policy was a drag on growth in late 2004. If the looser policy in 2005 does not cause inflation, we would expect more loosening in a new budget, later in the year, other things being equal.

Boost to defence and security spending Prominent among the gainers in the 2005 budget are defence and security spending (Exhibit 11). This is in keeping with Mr Putin's making the war against terrorism the main priority. It should have some positive macroeconomic effects, as much of it will go on higher salaries for officers, and equipment purchases. The Prime Minister, Mr Fradkov said on 22 December that the state military procurement budget would rise by 26.7% in 2005.

Education and health also rise Spending on education and health is planned to rise, by 32% and 53% respectively. These are relatively small components of total spending, so the macroeconomic effect is not likely to be great, but it should win Mr Putin some political points. It is interesting that transfers to the regions are not expected to grow, even though Mr Putin promised that there would be compensation for the loss of political independence.

Stabilisation fund policy. The stabilization fund will be a subject for political debate in 2005. It is created from excess government revenues from oil extraction taxes and from oil export duties, caused by the higher oil price. As of 1 December, 2004, this fund stood at RUR 462 mn (about $16.2 mn, or 3% of 2004 GDP). The Ministry of Finance forecasts that it will reach RUR 520 bn by 1 January, 2005, and RUR 600 bn by 1 February, 2005. The fund is capped at RUR 500 bn, and current policy is that the excess will be spent on topping up the pension fund deficit or on repaying state debt.

Other uses of the surplus It has also been proposed that the fund should be capped at a percentage of GDP rather than a fixed monetary level, which would allow it to grow some more. Alternatively, the government might increase the threshold price of oil above which taxes accrue to the stabilization fund. At present it is set at $20. At $21 it would leave RUR 60 bn available for current spending rather than accumulation in the stabilization fund.

Infrastructure projects It would be a matter of concern for us if the government chose to spend the stabilization fund surplus on major infrastructure projects. Russia has a history of overspending on this type of project, and the money might end up lining the pockets of contractors. This type of interventionist policy could be interpreted by the market as a return to the old planning system, and the money would probably be better left in the stabilization fund. If these infrastructure projects are worth building, there is probably some viable form of private/public partnership, especially given the liquidity in the Russian banking system that is looking for projects.

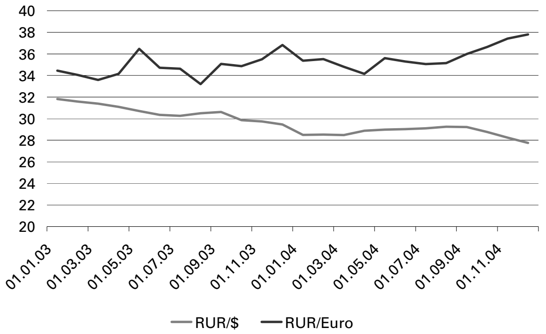
The rouble in 2005 In 2004, the Central Bank of Russia spent a lot of money to stop the rouble rising against the dollar. The bank decided to let the dollar fall in September, with the result that the rate fell from RUR 29.2/$1 at the end of September to RUR 27.8/$1 today. At the same time, the rouble weakened against the euro from RUR 35 in August to RUR 37.9 today. Much of the Russian economy remains dollarized, although imported goods from Europe, which might have been priced in dollars, now tend to be priced in euro. Some restaurants have decided that their dollar prices are now actually euro prices, but without changing the actual numbers.

The rouble's move is caused by factors outside Russia's control The dollar is weakening against all currencies. The main reason for its move against the rouble is more the result of Russian investors moving savings out of dollars into roubles, than of Russia's trade surplus with the United States. The recent weakness against the euro is because most of Russia's exports are dollar-linked, and the dollar has been plummeting against the euro.

The EU is becoming a more important partner for Russia In the first ten months of 2004, trade with the European Union was 45% of total trade. In the same period of 2003, it was 36%. The recent tendency towards European

Exhibit 13

RUR/$ and RUR/Euro rates, 2003-4



Source: Bloomberg

trade is strong – its share was 51% in October 2004. Only a part of this can be explained by the Euro's relative strength. Trade with Europe, measured in dollars, in the first ten months of 2004 was 62% higher than in the same period for the previous year, much more than the 30% or so fall in the dollar/euro rate. Our view is that this was generated by higher disposable household income – most of Russia's consumer goods come from the euro zone. If the dollar slides much more against the euro, this would presumably reduce imports from Europe, which should be good news for domestic producers of consumer goods.

Exhibit 13
Metropol model portfolio

	RTS weight	Current price, $	Portfolio Weight	Price as of 23 Dec. 04, $	Change, %	Target price	Upside to target, %
RTS		**611.74**		**585.83**	**4%**		
Gazprom	n/a	$2.62	15%	$2.61	0%	$3.80	45%
LUKoil	32%	$30.00	35%	$29.00	3%	$44.00	47%
Surgutneftegaz	14%	$0.74	11%	$0.71	4%	$0.83	12%
VimpelCom	n/a	$35.20	7%	$30.65	15%	$49.33	40%
Rostelecom	1%	$1.81	5%	$1.72	5%	$2.58	43%
NLMK	n/a	$1.00	3%	$1.05	-5%	$1.72	72%
Norilsk	9%	$53.00	6%	$65.00	-18%	$73.50	39%
Severstal	1%	$7.65	6%	$7.00	9%	$10.90	42%
Sberbank	8%	$479.00	2%	$479.00	0%	n/a	n/a
RAO UES	3%	$0.27	8%	$0.28	-2%	n/a	n/a
Baltika	n/a	$16.50	1%	$16.80	-2%	n/a	n/a
Kalina	n/a	$16.60	1%	$16.70	-1%	$26.00	57%
Weighted average					2%		37%

Source: Market data, Metropol data

Remain underweight oil. Our stance has not changed – we are still negative on the oil sector, because of fears of increased taxation and nationalization. At some point, prices should fall to reflect this bad news, and to reflect lower oil prices. We still have 55% of the portfolio in oil, but this nevertheless reflects a significant underweight.

Overweight consumer and metals. The good news on the Russian front continues to come from the consumer sector and metals, especially steel. Disposable incomes rose 10% in 2004, and we expect this to continue, especially with the government spending more on social payments.

Since inception in November 2004, our model portfolio has returned -9%, while the RTS has fallen 8.5%. We have underperformed since the last portfolio revision, in late December, because of the poor performance of Norilsk Nickel. We are confident that the stock will recover, though.

Gazprom should get a boost from its expected market liberalization, and from its merger with Rosneft. We think that, as the core of the government's energy policy, this company will not be harshly treated when it lobbies for tariff increases.

LUKoil is our top oil pick. We think that its owners have a good relationship with the current elite, and are safe from YUKOS's fate. The company has a good mix of Russian and offshore assets. Our other oil pick is **Surgutneftegas**, which currently is at a corporate governance discount because of investor unhappiness about its treasury shares. We expect this issue to be resolved.

In telecoms, we like **VimpelCom** and **Rostelecom**. We think VimpelCom has more upside than MTS, especially given that recent announcements have hit its price, despite their having little effect on the company. Rostelecom is better placed than the regional telcos to benefit from GDP growth. We also expect the government to treat it favorably in return for Rostelecom's taking on obligations to service the military and security services.

In the metals sector, our major overweight, we like **Norilsk**, **NLMK** and **Severstal**. Norilsk should benefit from continued high metals prices, and from its diversification away from nickel. We expect NLMK to raise its investor profile this year. Severstal should benefit from record steel prices, and from its proximity to the European market.

Our consumer picks are **Sberbank**, **Baltika**, and **Kalina**. Sberbank should benefit from rising household savings rates and the boom in personal borrowing. Baltika is the cheapest play in the beer sector. Kalina gives exposure to middle class spending on cosmetics.

2005 IPOS

Exhibit 14

IPOs expected in 2005-6

	Estimated market cap ($ bln)	Per-centage sold	Amount sold ($ bn)	Sector	Primary listing
Sistema	10.0	10%	1.00	Telecoms	RTS
SuAL International	2.5	10%	0.25	Metal	LSE
TNK-BP Holding	18.5	7%	1.30	Oil and Gas	RTS
VSMPO-AVISMA	1.8	5%	0.09	Metal	NYSE/Nasdaq
Novatek	2.0	15%	0.30	Oil and Gas	RTS
Megafon	5.0	20%	1.00	Telecoms	NYSE/Nasdaq
RusAl	8.5	15%	1.28	Metal	NYSE/LSE
NLMK	6.2	10%	0.62	Metal	RTS
Evrazholding	3.5	10%	0.35	Metal	NYSE
Total	58.0		6.20		

Source: Metropol data

Exhibit 15

Share of Mcap of IPO companies in total Mcap, vs share in RTSI

	Sector share in RTS index at end 2005 (forecast)	Sector share in current RTS index
Banking	7.69%	5.28%
Consumer	0.59%	0.71%
Energy	6.39%	13.26%
Manufacturing	2.62%	3.72%
Metals	11.11%	12.38%
Oil and Gas	59.69%	55.83%
Telecoms	8.49%	5.17%
Transport	3.41%	2.26%

Source: Company data, MSCI

Exhibit 14 shows the new companies that we expect to come to market this year, their expected market cap, and the markets on which they will trade. We expect a total of around $6.2 bn worth of stock to come to the market. The good news is that this should re-weight the index although oil and gas will maintain its share. The effect of the new companies breaks down as in Exhibit 15:

It is not clear, though, which of these companies will get into the MSCI Russia, and they will probably only be included once they have demonstrated that they are generating sufficient liquidity on the RTS. It seems to be quite hard for MSCI to include a company whose de facto primary listing is a non-Russian exchange. For instance, we think MTS should be part of any Russian benchmark, but it has still not been included.

The valuations given above are our rough estimate, and we have tried to stay on the conservative side. The market is generally quite depressed at the moment, and if it picks up, and the issuers' bankers do a good job, then the prices should be higher.

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