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## EM Strategy Monthly

### *Why the exit from quantitative easing is good news for EM equities*

#### Global themes for portfolio allocation

- ❑ The exit from quantitative easing policies in developed economies will boost investment flows to EM equities as investors rebalance portfolios.
- ❑ Fears of a sharp slowdown in Chinese demand for both hard and food commodities are unwarranted; global commodity prices will continue to rise in the medium and long term.
- ❑ The best local market fixed-income opportunities can be found in Russia.

#### BRIC themes and investment ideas

- ❑ **Brazil** – Uncertainty about official policy on inflation and the Real dominate the outlook. Brazilian equities will remain hostage to this uncertainty until a more coherent policy framework is set out. Stay underweight.
- ❑ **Russia** – Thanks to continuing high energy prices and evidence that the inflation cycle peaked early last month, Russia is in an enviable position. Continue overweight.
- ❑ **India** – The policy outlook is improving but progress is excruciatingly slow. Stay on the sidelines for now.
- ❑ **China** – We move to an overweight recommendation as inflation is on track to peak in the coming months. Continue to play the China story through commodities.

#### Macro and sector spotlight

- ❑ Why Brazil will plant more
- ❑ India: Food inflation to spur agriculture supply chain investment
- ❑ Russia: The Medvedev-Putin competition spells more reformist policies

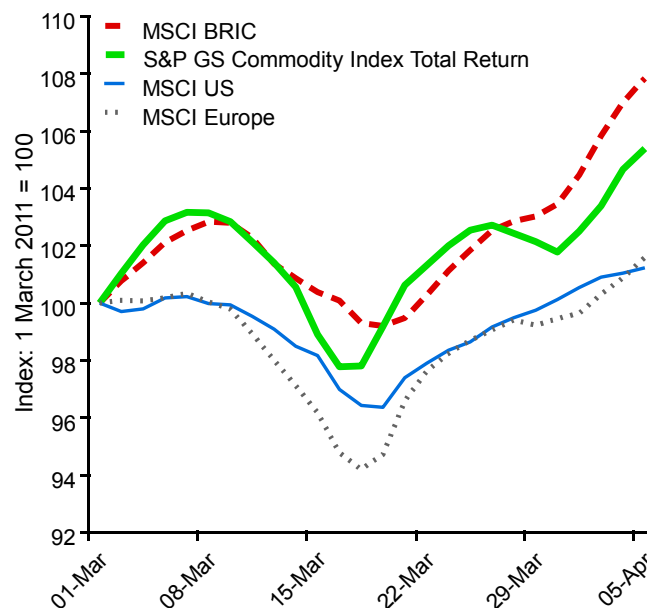
**Our next Strategy Monthly will appear the week of 9 May.**

# Portfolio Strategy

## Overview

After a mid-month dip, EM equities performed strongly in March. This outperformance was mirrored by our commodity price index, which closely tracked the overall BRIC index. By contrast US and European equities lagged significantly.

**Chart 1: MSCI indices and Standard and Poor's GS Commodity Index, 1 March 2011 to date (US\$ terms, three-day moving average)**



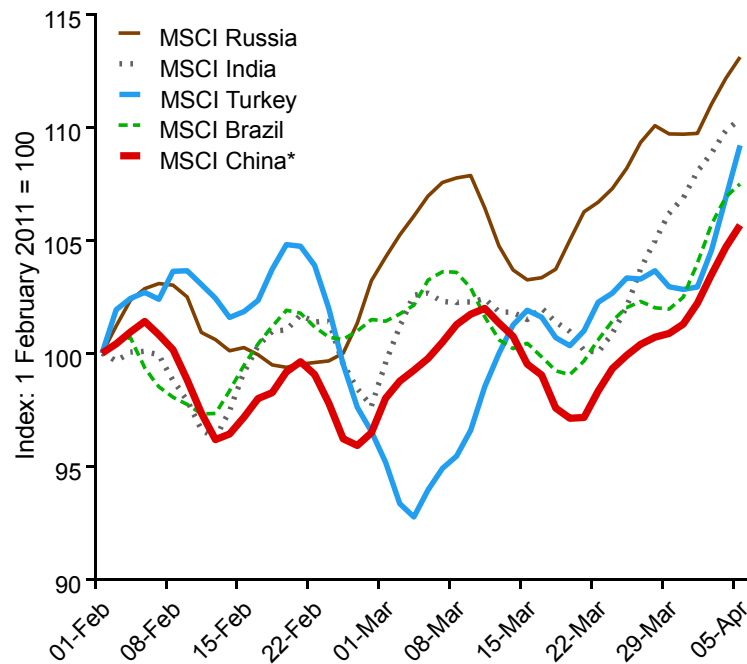
\* The S&P GSCI Total Return index is the measure of commodity returns that is completely comparable to returns from a regular investment in the S&P 500 (with dividend reinvestment) or a government bond.

Source: Bloomberg.

Chart 1 illustrates a sharp rise in BRIC equities despite the fact that energy prices increased during the month – energy is the single largest component of the S&P GS Commodity Index. Chart 2 below shows that all the major EM markets moved up, energy-dependent importers Turkey and India as well as a major energy exporter, Russia. Surprisingly investors showed little concern about the impact of energy prices on equities.

Chart 2 also highlights that all the major EM equity markets moved up very much in lockstep. This suggests that external forces rather than domestic factors were behind these trends. In the absence of current data on fund flows, our tentative thesis is that we are witnessing a significant rebalancing of investor portfolios back into EM equities. Further, we argue that the major reason for such a rebalancing is the expectation of a move away from QE policies on the part of the major developed country central banks. The initial hike in rates by the European Central Bank (ECB) that took place on 7 April and the end of the Fed's QE2 programme in six-eight weeks are indications of this move.

**Chart 2: Stock market performance, 1 February 2011 to date (US\$ terms, three-day moving average)**



\* The MSCI China Index includes China H-, B-, Red Chip and P-Chip shares. The Shanghai A-share Index lagged substantially during 2010.

Source: Bloomberg.

Assuming our thesis is correct, should investors expect EM equity markets to continue to be highly correlated? Our answer is: no.

We believe countries' success in fighting inflation still matters to longer-term performance. On this metric some countries are further ahead than others. So we anticipate a growing divergence of performance among the major EM markets in the next two-three months, though the overall correlation will probably remain higher than last year.

For example, inflation in Russia already appears to have peaked while in China we expect to see a peak in two to three months. This is why we recommend that investors overweight both countries in equity portfolios.

By contrast, we are less sanguine about the near-term prospects for success of anti-inflation efforts in India and Brazil. As we spell out in greater detail below, both countries are still some months away from turning inflation rates back down again. Turkey is an anomaly in this regard. The latest inflation figures hit an all-time low but prospects are that inflation will be rising again as soon as rising oil prices impact domestic prices.

# Global themes for portfolio allocation

## The exit from quantitative easing policies in developed economies will boost investment flows to EM equities

A popular market view is that the exit of the Fed and the ECB from quantitative easing during Q2/11 will threaten the performance of EM equities. The argument is based on two primary judgments (recently highlighted in the *Financial Times*):

- ▣ EM markets have benefited from liquidity created via the carry trade, which artificially stimulated the flow of investment into EM assets. The ending of QE policies will restrict the creation of such liquidity in future.
- ▣ The ending of QE policies reflects much improved economic prospects in developed market (DM) economies. EM economies by contrast are still stuck fighting inflation, so investors will continue to underweight them.

We have a different perspective, one that focuses on rebalancing by investors of their global portfolios.

The fact that DM have outperformed EM equities since Q3/10 suggests to us that the primary effect of QE policies was to boost equity returns in DM, especially in the US. Chairman of the Fed Ben Bernanke's explicit rationale for QE2 was after all to improve asset returns in US markets as the primary channel for improving overall confidence in the economy. In this regard he succeeded well beyond his original expectations. But he also sowed the seeds of future inflation that may come back to haunt the Fed.

The argument about EM economies facing inflation problems is incomplete. Yes, EM countries are suffering from higher inflation but so are DM economies. To us, the difference is that EM policymakers have been fighting their inflation problems for some time now and several countries are beginning to show positive results. By contrast, their counterparts in developed economies are only just beginning to address their emerging inflation problems (ECB) or are still in denial (the Fed).

In our view, the key questions that investors have to answer in response to the ending of QE policies are:

- ▣ Where are the best prospective returns at the margin in my investment portfolio?
- ▣ Where am I over- or underinvested relative to those expected returns?

We think most global investors today are underweight EM equities. Given rising inflation in major EM economies and a liquidity-fuelled equity rally in DM, it made sense to underweight EM last year in favour of DM. Now that EM economies are achieving success in fighting inflation, notably in Russia and China, it makes sense to take profits in DM equities and to begin rebalancing portfolios back into EM equities. Such portfolio rebalancing will increase equity flows to the major EM economies, particularly if they get on top of their inflation problems. The investment theme that is the main driver here is "out of developed markets", not relative valuations of EM equities.

**Fears of a sharp slowdown in Chinese demand for both hard and food commodities are unwarranted; global commodity prices will continue to rise in the medium and long term**

Judging by the volatility in commodity prices every time some high official in China talks about inflation, one might think that commodity markets are poised on a knife edge waiting for news of the next Chinese policy move. The reality is rather more prosaic:

- ▣ Yes, Chinese growth is slowing, but only modestly. We expect strong growth this year of about 9.5 per cent, down from 10.3 per cent in 2010.
- ▣ The authorities are addressing inflation primarily via direct controls on bank lending rather than higher interest rates. The growth of bank lending will slow from over 20 per cent last year to about 16 per cent this year, slightly faster than nominal GDP. So slower growth in lending is already on the cards but it does not amount to a “lending squeeze”.
- ▣ With the change of leadership scheduled for October 2012 along with the promotion of ambitious regional party officials, there is little chance that priority investment projects will be starved of funds. This means that major urban infrastructure investments in transportation and social housing will be assured adequate funding.
- ▣ Major investment initiatives in urban transport and the power grid will require major inputs of steel, copper and aluminium. China’s demand for hard commodities will therefore continue to be strong. This is a theme that major western commodity firms have echoed repeatedly and one that we agree with.
- ▣ Various comments from senior Chinese agricultural officials highlight that higher imports of corn are probable along with curbs on exports of industrial corn products such as high-fructose corn syrup, corn starch and other corn derivatives (which consume about 40 per cent of the country’s total corn production).
- ▣ Policies to boost blue-collar wages some 20-25 per cent (to facilitate the growth of domestic demand) will fuel continued strong growth in high-protein food demand.

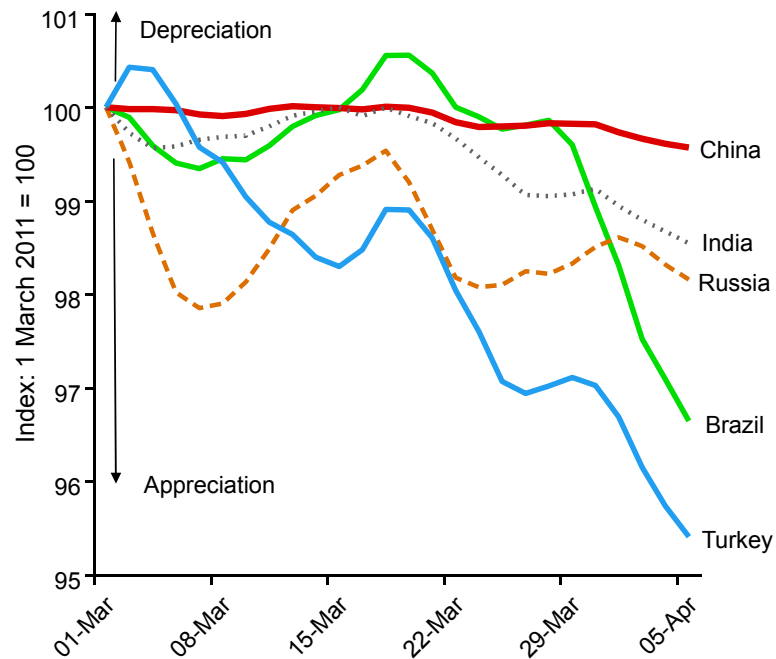
The bottom line is that Chinese demand for commodities will continue to be strong.

**The Russian market offers the most attractive local currency investment opportunities**

Chart 3 below highlights the strong appreciation in major EM currencies over the past month. The moves in the Brazilian Real and the Turkish lira are particularly striking.

To a significant extent these trends reflect dollar weakening; during March the dollar fell 3.7 per cent against the euro. But they also point to renewed large-scale flows of private capital into major EM currencies, both those that are subject to “dirty floating” (such as the Real) and those that float more freely (the Turkish lira).

**Chart 3: Currency performance, 1 March 2011 to date (US\$, three-day moving average)**



Source: Bloomberg.

Our preferred local market at this time is Russia for the simple reason that inflation appears to have peaked (see our detailed comments and qualifications below in the Russia section). China is following Russia with a lag of several months – we expect to see Chinese inflation peak towards the end of Q2/11. But the best way for investors to play this trend in China is via equities, not local rates. We do not expect any change in China’s policy of a slow upward crawl of the yuan. Turkey, Brazil and India all face rising inflationary pressures and are not attractive for local market investment at this time.

# BRIC themes – Investment ideas

## Brazil

Soon after we highlighted Brazil's aggressive anti-inflation efforts in our March monthly, Alexandre Tombini, the Banco Central's (BC) new governor, announced a new strategy for dealing with the country's rising inflation rate. Instead of the traditional dependence on a single policy instrument, the Selic rate, the BC will now add new macroprudential measures to its anti-inflation toolkit.

The implication is that macroprudential measures such as raising banks' reserve requirements and capital ratios will in future substitute for higher interest rates. Tombini also announced that the BC would not attempt to bring inflation down quickly but would target an adjustment period of 18 months in order to reduce inflation from today's 6 per cent-plus level to the 4.5 per cent midpoint of the current inflation targeting band.

The reason for this change was obvious: higher interest rates conflict with the government's goal of weakening the Real, or at least preventing its further appreciation. Instead of the expected 150-200 bps in future interest rate increases, markets now believe that the BC will limit interest rate hikes in favour of other – as yet unspecified – measures.

If Tombini's intention was to dampen speculative pressures on the Real then he failed. Since 10 March when the minutes of the early March monetary policy committee meeting (Copom) were released the Real has appreciated nearly 4 per cent against the dollar. This has added to an uncertain policy outlook: the government and the BC are undoubtedly planning new initiatives to counter upward pressure on the Real and on loan expansion. The markets are unimpressed with what the government has done so far and have been left with a sense that new draconian measures might be coming.

Bloomberg reported on 6 April that a number of Brazilian firms were planning to sell debt abroad in a volume that put offerings on pace to match the record US\$15 billion raised in Q1/11. So far the 6 per cent tax on borrowings brought into the country from abroad covers borrowings with maturities of up to two years, but longer-term borrowings and FDI have been exempted from the tax. While a growing list of measures have been introduced by the government, markets are sceptical that they will deter a further strengthening of the Real.

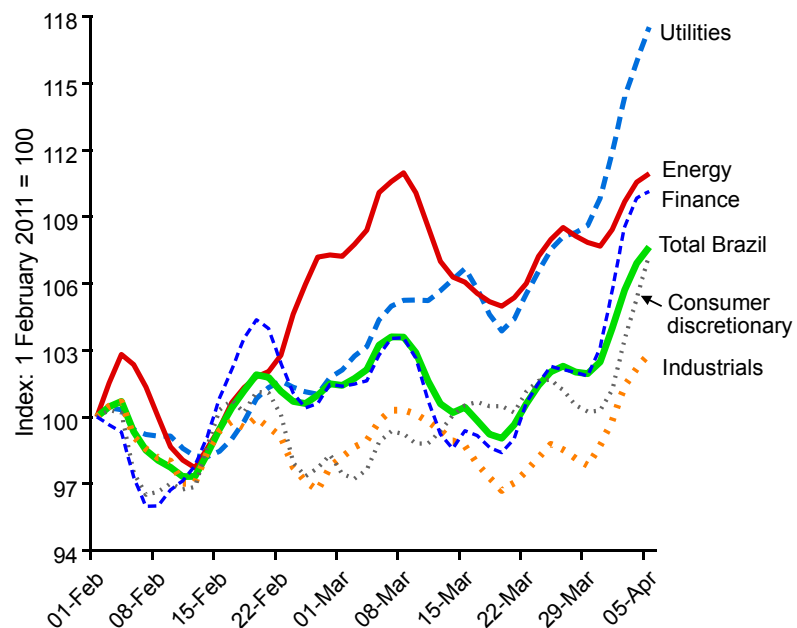
Brazil's efforts to dampen speculative pressures on the Real without adversely affecting new investment from Brazilian firms or FDI are clearly not working. During Q1/11 total net capital inflows totalled US\$35.3 billion compared with US\$24.4 billion in inflows during the previous year. The taxes imposed on non-resident portfolio inflows are being arbitrated by the country's relatively sophisticated financial markets. This raises expectations of either more draconian taxes and restrictions or a capitulation to speculators by freeing the currency to appreciate to even more overvalued levels. Both options would be negative for equities.

What is missing from all these efforts to cap the rise in the currency is a clear picture of how inflation will be brought under control. If further rate hikes are deferred for fear of pushing up the Real to undesirable levels, then we will be left with a mishmash of ad hoc restrictions that will fail to boost confidence in

the outlook for equities. In this environment Brazilian equities face uncertain prospects until a more coherent policy framework can be set out.

The only sectors that stand out as clear winners in this evolving environment are the utilities (whose tariffs are typically inflation-indexed) and energy firms. For now Brazilian equities remain hostage to new government initiatives that will attempt to dampen further appreciation of the Real.

**Chart 4: MSCI Brazil Index, performance by sector, 1 February 2011 to date**



Source: Bloomberg.

### Focus on inflation winners

The sectors best positioned to outperform in the context of the current monetary tightening cycle include:

- ▣ Utilities whose tariffs are inflation-linked
- ▣ Consumer staples
- ▣ Metals and mining
- ▣ Energy (due to higher oil prices)
- ▣ Agricultural exporters.

## Russia

Russia's economy remains in a favourable position thanks to both domestic and external developments. Recent data show that inflation peaked at the beginning of February at 9.6 per cent and is now trending down. We expect the rate to move below 8 per cent before year end. Meanwhile the earthquake in Japan is expected to mean higher global demand for natural gas and LNG, enhancing Russia's strong position as a major gas exporter.

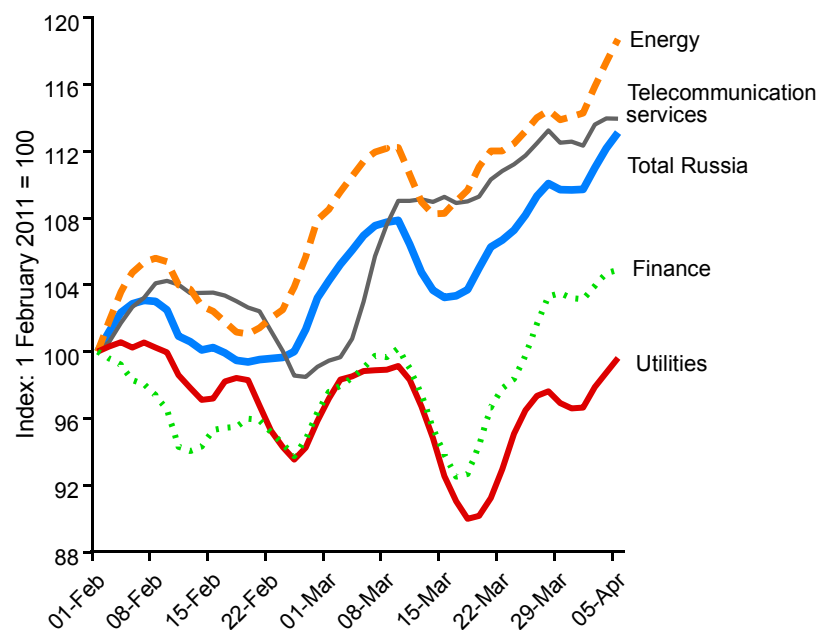
Expectations of an improving inflation performance have attracted foreign capital into the domestic bond market and dampened corporate outflows. Private capital outflows totalled US\$21 billion in Q1/11 but the month-to-month trend was sharply down as only US\$4 billion in outflows were recorded in

March. Sergey Ignatiev, Chairman of the Central Bank of Russia, recently predicted that private capital flows for the rest of the year would be near zero or modestly positive. This turnaround will undoubtedly be beneficial for the ruble in the coming months.

The combination of steady economic growth and falling inflation should keep Russia's equity market in the camp of outperformers for the foreseeable future. The main risk to this scenario would come from a substantial decline in global energy prices, a risk that looks relatively small at this time. If an average crude oil price of US\$100/bbl this year is factored in, Russia's fiscal deficit can be expected to fall below 1 per cent of GDP, a level that will easily be financed without central bank money creation. Although there are concerns that government spending will be ramped up in advance of elections later this year the government's overall fiscal performance should not suffer unduly.

We expect to see several additional sectors join energy as outperformers in the coming two-three months. Our favourites include cyclical industrial stocks and the large state-controlled banks. The banks are well positioned to improve profitability as loan demand recovers this year.

**Chart 5: MSCI Russia Index, performance by sector, 1 February 2011 to date**



Source: Bloomberg.

**Play the natural gas theme**

The energy sector has led the equity market higher over the past two months and further upside could be in store for gas-related plays including Rosneft and Novatek, given the expected rise in demand for gas for power production.

**Overweight cyclical industrial stocks**

The investment case for cyclical stocks is based on the impressive results Russia's manufacturing firms have achieved in labour cost control and productivity gains that we highlighted last month. These should begin to show up in periodic earnings reports as we move into H2/11.

**Overweight the major state-controlled banks**

The major state-controlled banks will likely attract increasing foreign interest as

a way to play the “recovering economy/falling inflation” theme. Prospects for partial privatization of VTB and further sales of Sberbank shares should also draw new investors.

### **Local bonds are overhyped but still attractive**

Every investment bank’s favourite trade is local ruble bonds. The prospect of falling inflation will provide capital gains as interest rates fall later this year. We think the best way to play falling inflation is via the major bank stocks rather than corporate or government bonds. Abundant liquidity in ruble local markets has kept bond rates relatively low for some time, so the decline in bond yields associated with falling inflation will probably be less than one might expect.

## **India**

India’s economic policy environment has fallen into a familiar rut:

- ❑ Inflation has remained stubbornly high at close to 10 per cent; this is higher than government forecasts and higher than India’s major competitors. Periodic small interest rate hikes from the Reserve Bank of India follow without causing surprise and without dispelling market perceptions that the RBI is still behind the curve in tackling inflation. Investors are left with the impression that controlling inflation is a lower priority for the government than a “dash for growth”.
- ❑ Positive noises on fiscal discipline are heard from the Ministry of Finance and piecemeal initiatives on subsidy reduction and tax reform do in fact appear. But actual progress is nonetheless excruciatingly slow.
- ❑ Investor concerns about corruption and corporate governance are acknowledged by senior government officials but without convincing follow-through demonstrating that a far-reaching reform of India’s business environment is a top priority of the governing Congress Party.

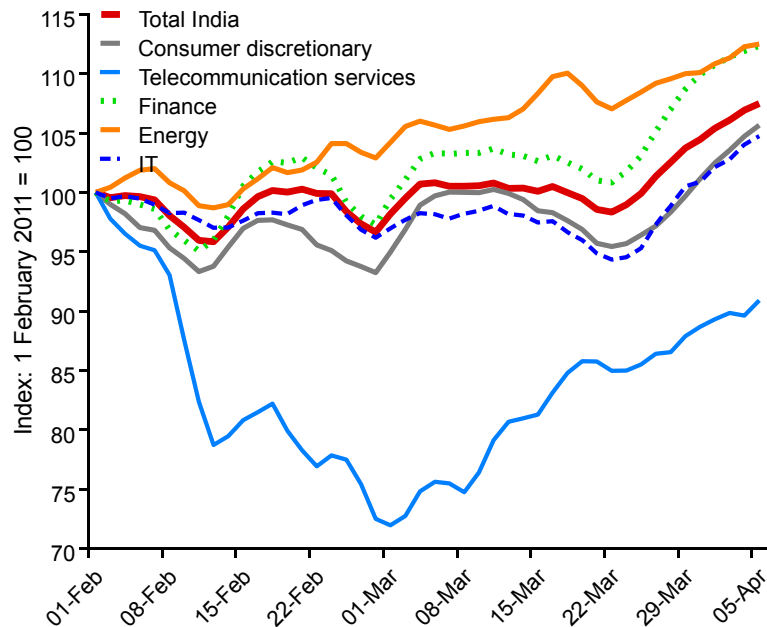
In our view, the primary positives for the Indian market include the resumption of partial privatizations of major state-owned firms and the resumption of a more active agenda on policy reform after the stasis of the past year. The theme of “policy reform through adversity” is perhaps a weak argument in favour of a rebound in equity prices but it does represent movement in the right direction. What matters for investors is consistent, even if slow, progress in implementing some of the most obvious reforms that are needed if India is to realize its undoubted growth potential.

The big question marks on the horizon include the economy’s vulnerability to sustained high commodity prices and the continuing block to growth from insufficient investment in infrastructure, especially in power generation. A related issue is the growing dependence on short-term capital inflows to cover the country’s current account deficit. Although this deficit is still moderate at 2.5-3.0 per cent of GDP, net capital inflows are becoming more short term in nature. The government’s goal of sustaining high growth means that the lack of longer-term capital inflows in the form of FDI and other relatively stable sources of capital to finance this growth creates a major vulnerability for the future.

Last month we moved to a neutral view on Indian equities after having been negative for over six months. We remain neutral despite the sharp rally in the market during the second half of March. We do not think this rebound will be sustained in view of the lack of progress in solving the economy’s inflation problem. Our best-case scenario would see gradual improvement in equity

valuations driven by success in the government's upcoming privatization programme. Much will be riding on these initiatives; a disappointing performance could easily undermine investors' confidence.

**Chart 6: MSCI India Index, performance by sector, 1 February 2011 to date**



Source: Bloomberg.

### Look for opportunities in India's agricultural supply chain

In our **Macro and sector spotlight** below we highlight investment opportunities associated with India's agricultural supply chain. The combination of high food price inflation and structural inefficiencies in the country's agricultural supply chain is attracting new firms into the sector.

## China

Recent interest rate hikes have generated widespread comment in Western media suggesting that China is finally beginning to address its inflation problem and that slower growth is inevitable. The reality is that interest rates are very much a lagging indicator – China's monetary authorities have been limiting loan demand via administrative measures ever since January. We do expect a reduction in this year's growth but only from 10.3 per cent in 2010 to between 9 and 10 per cent.

The key variable for investors to monitor is inflation. In the next two to three months inflation will likely move higher to around 5.5 per cent, due partly to base effects and partly to rising international commodity prices. From this level we expect to see a gradual decline in inflation back into the 4-5 per cent range during the second half of the year.

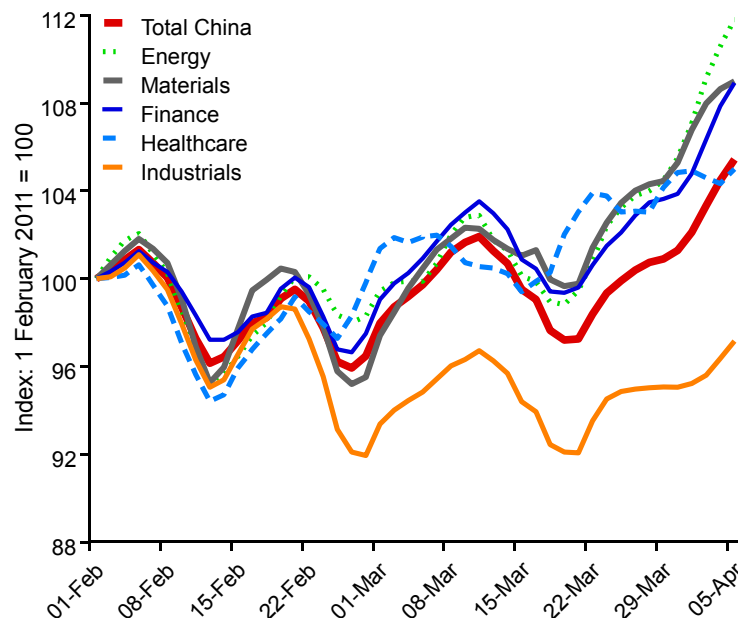
With these prospects we think predictions of a sharp tightening of monetary policy are very wide of the mark. In our view, official policy will be successful in preventing a spike in inflation and we see little appetite among the top policymakers to reduce inflation sharply. Our judgment is that the country's top leadership is relatively relaxed about inflation in the 4-5 per cent range. One reason is that they believe such a level of inflation is normal for an economy

growing at nearly 10 per cent. A second reason is that blue-collar wages will likely rise close to 20 per cent this year, so there is little risk of real personal incomes falling with inflation in this range.

Given this scenario of strong growth and an imminent peaking of the economy's inflation rate, we expect to see Chinese equities begin to outperform other markets from now to the end of 2011. Our sense is that investors have already discounted higher inflation for March and April and have begun to increase allocations to Chinese equities. For this reason we think it now makes sense to move China to an overweight allocation.

During the past month energy, materials and financial shares have led the market higher while consumer and industrial stocks have lagged. Our favourite sectors to outperform over the next two to three months include cyclical industrials, materials and logistics. We are negative on consumer, healthcare and finance shares as they represent crowded trades that offer more limited relative value.

**Chart 7: MSCI China Index, performance by sector, 1 February 2011 to date**



Source: Bloomberg.

**Overweight industrial, material and logistics firms**

We expect the build-out of urban infrastructure to continue full steam ahead even if modestly tighter loan guidelines are not loosened in the coming months. The political imperative to complete major projects before the October 2012 political transition will ensure priority allocation to funding these projects even if cost overruns occur. Industrial stocks have lagged the market recently and should play catch-up in the next two to three months once the market's fear of new monetary tightening efforts is dispelled.

**Continue to play the China story via commodities**

Commodity markets have experienced substantial volatility recently in part because of expectations that Chinese inflation would force a new round of monetary tightening. We think these fears are unwarranted. We do not think a modest reduction in the pace of China's growth will have a major impact on commodity demand and we see inflation turning down after Q2/11. While

seasonal patterns in demand and stockpiling will influence short-term price trends our view of China's growth story makes us bullish on the medium- and longer-term prospects for both hard and food commodities.

- ▣ Property and urban infrastructure investments (especially metro rail) will sustain demand for steel, cement, copper and other hard commodities.
- ▣ The resumption of a major push in power grid investment will generate an estimated US\$364 billion in new spending in the period up to 2015. This will provide major support for domestic demand for copper and aluminium.

We believe Chinese imports of feed grains (especially corn), sugar and edible oils will continue to be strong during 2011.

- ▣ In order to meet rapid increases in domestic food demand we expect the government to let domestic traders increase food imports both to rebuild domestic stocks and to meet current demand.

# Macro and sector spotlight

Below we highlight recent Trusted Sources research that identifies key macro and sectoral themes in BRIC markets. Our sectoral focus this month is on agriculture in Brazil and India. With global demand and domestic production costs now positively aligned, Brazilian farmers are expected to increase output of food commodities. In India the government is responding to the structural causes of high food inflation by reforming the agriculture supply chain, creating opportunities for private firms to bridge the infrastructure gap.

Our macro offering this month focuses on the impact of the increasingly open jockeying for position by Medvedev and Putin on the outlook for reform in Russia. This political competition is boosting reform prospects, particularly for the domestic gas market, as both leaders seek to assert their liberal credentials.

## Why Brazil will plant more

After several difficult years, Brazilian grain and oilseed producers are on target for a profitable harvest in 2010/11. The positive outlook for global food commodities demand, coupled with lower domestic production costs, is creating an environment in which Brazilian farmers are preparing to increase planted area for the 2011/12 crop. The expected increase in Brazilian production of food commodities will come mainly from growth in productivity, however, rather than aggressive expansion into new areas.

- ▣ Expansion of planted area and healthy profit margins will result in stronger demand for fertilizers and pesticides as well as greater use of technologies, benefiting companies like Vale Fertilizantes (FFTL3:BZ), Fertilizantes Heringer (FHER3:BZ), Monsanto (MON:US) and Syngenta (SYT:US).
- ▣ Transport of crops out of the centre-west has been particularly difficult this year but recent investments including the expansion into Rondonopolis by ALL (ALLL3:BZ) should start easing the burden on highways in the 2011/12 harvest.
- ▣ Strong Asian demand and growing domestic sales of grain and oilseeds will benefit companies involved directly in the production of these commodities, such as SLC Agricola (SLCE3:BZ) and BrasilAgro (AGRO3:BZ).
- ▣ BC currency sterilization and government measures to keep the Real from appreciating have contributed to the positive outlook for the agriculture sector; any change in currency policy resulting in appreciation would be negative for producers.

## India: Food inflation to spur agriculture supply chain investment

The government's growing recognition of the structural aspect of high food inflation in India and of inefficiencies in the agriculture supply chain is creating strong momentum for reform. Although Finance Minister Pranab Mukherjee was silent on the issue of allowing FDI in multi-brand food retail in his 28 February budget, the government is seriously considering this reform and taking other measures to spur private investment.

- ▣ Companies already investing in this sector, such as Adani (ADE:IN) and Marico (MRCO:IN), are poised to enjoy first-mover advantages as the government liberalizes its agriculture-related policies.
- ▣ Some steps to open up the food retail sector to foreign investment are

likely in FY12, with the government indicating that serious discussions are under way among high-level officials.

- ▣ In the retail sector, companies that have tie-ups with foreign retailers, such as Bharti Enterprises with Walmart (WMT:US) – and potentially the Future Group with Carrefour (CA:FP) – stand to benefit the most from any reform in FDI retail.
- ▣ Avenues for private investment also exist outside retail, including procurement, storage and distribution, owing to the present low levels of private investment and competition in the agriculture supply chain.

### **Russia: The Medvedev-Putin competition spells more reformist policies**

In the run-up to the legislative elections in 12 Russian regions on 13 March – which confirmed the dominance of United Russia (UR), albeit with some mild erosion of support – both President Dmitry Medvedev and Prime Minister Vladimir Putin stepped up their own electioneering. In consecutive days in early March, national TV networks showed Medvedev casting himself as a great 19th-century liberal tsar and Putin – more down to earth – giving a campaigning address to a regional UR conference. The increasingly open jockeying between the two leaders has somewhat altered our view of this political cycle, which will be the most important domestic driver for Russian asset prices in the coming year.

- ▣ Uncertainty will be removed only when Putin explicitly announces his intentions, and this will not happen until nearer the State Duma election due on 12 December.
- ▣ We reaffirm our prediction that Medvedev will remain president. In a political system where the stability of the ruling establishment is paramount the force of inertia will prevail, barring some shock.
- ▣ The political competition between Medvedev and Putin is focused on reformist credentials. Medvedev has long championed reform; the surprise is that Putin has joined in and is leading the charge for liberalization of the domestic gas market and encouraging large-scale new FDI in the natural resource sectors.
- ▣ Even if Putin does return as president, he will do so as a rebranded reformist, and that outcome could present a strong politically driven buying opportunity.

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