INDEX INSIGHTS

Russell Indexes 2015 Global Commentary

By: Mat Lystra, Senior Research Analyst[1]

APRIL 2015

Key points:

- The Russia-Ukraine crisis moved equity markets in 2014. With economic sanctions from the West, the continued index eligibility of certain Russian stocks was threatened and heavy pressure was placed on the Russian ruble.
- Sharp declines in global oil prices in the second half of 2014 created a potential economic boost to oil-importing countries and increased the potential for fiscal instability in oil-exporting economies.
- The approximately US$3T China A-share market is now partially accessible through three foreign investment programs. Each program comes with a different set of rules, and investors experience each program differently. As a result, the need exists for a customized set of solutions to proxy an investor's exposure to Mainland China equities.

This Russell Indexes Global Commentary expands on global equity themes noted during our country classification research.

In this commentary we review a 2014 that saw instability in Ukraine draw neighboring Russia into a proxy war over Western influence. The economic sanctions that followed have had ripple effects across equity markets, and in a few cases, even among index constituents. Further escalating Russia's economic predicament was the falling price of oil, which negatively impacted the economy of other large oil-exporting countries as well. Although low oil prices were a drag on oil-supplying countries' economies, many other nations' economies were boosted as a result.

We also look at investors' rapidly expanding options for accessing the China A-share market, and how this might ultimately lead to China's inclusion in a global equity index.

The Russia-Ukraine crisis

Ukraine was roiled by political unrest and violence in 2014, in Ukraine's national identity struggle between Russian and Western[2] loyalties. Following Russia's unilateral annexation of Ukraine's Crimean peninsula, and again after the downing of a commercial airliner in Ukrainian airspace, Western countries led by the U.S and European Union (E.U.) enacted a series of economic sanctions against Russia, which are detailed in Table 1 below. Some of these sanctions impacted

[1] The author wishes to thank Layla Hirschfelt and Tom Goodwin for their editorial contributions; and a special thank you to Ben Van and Jackson Peng for their invaluable contributions to this research.

[2] "Western" can be defined as the U.S., U.K. and Eurozone member countries.

constituents of indexes maintained by Russell Indexes and FTSE, now both wholly-owned subsidiaries of the London Stock Exchange Group. Index constituents impacted are shown in Table 1.1.

Sanctions against Russia

The sanctions executed by the West in 2014 targeted the sectors most vital to Russia's economy, including oil and gas, defense and banking sectors (which are partially if not completely state owned) and/or those linked to the crisis. Prohibitions included the financing of new debt, trading in dual-use goods and technologies for defense companies, and supporting oil exploration and production.

Table 1: Sectoral sanctions introduced by the U.S. in the second half of 2014, which were quickly followed by similar measures from the E.U.

OFAC Directive	Sector affected	Prohibition(s)	Date Issued
Directive 1	Financial Services	New debt financing with longer than 30 days' maturity; new equity	7/16/2014
Directive 2	Energy	New debt financing with longer than 90 days' maturity	7/16/2014
Directive 3	Defense	New debt financing with longer than 30 days' maturity	9/12/2014
Directive 4	Energy (oil producers)	Provision of exploration goods, services or technology	9/12/2014

Source: U.S. Office of Foreign Assets Control

Table 1.1: Russell Indexes and FTSE constituents that were impacted by the sanctions

Date of sanction	Company	Impact of the sanction
7/16/2014	VTB Bank OAO	Debt financing and new equity
7/16/2014	AK Transneft OAO	Debt financing
7/29/2014	Rosneft OAO	Debt financing
7/31/2014	Sberbank	Debt financing new equity

Sources: U.S. Office of Foreign Assets Control, E.U. Common Foreign and Security Policy

Actions by Russell Indexes and FTSE

Russell and FTSE responded to these sanctions with a swift but measured approach that allowed the impacted Russian companies to remain in the applicable indexes, while establishing guidance regarding how these constituents would be treated should conditions change or new information become available. Details are available via the links below:

Russell Indexes: https://www.russell.com/documents/indexes/russell-indexes-treatment-of-sanctioned-russian-companies.pdf

FTSE: http://www.ftse.com/products/index-notices/home/getnotice/?id=600061

Russia's financial crisis

As economic sanctions took hold in the latter half of 2014 and global oil prices plunged, the Russian economy dipped into recession. The Russian ruble declined 50% against the U.S. dollar, and the Russian Trading System (RTS) index, denominated in USD, saw an even steeper decline, of 55%, during the same period. On December 15, the Bank of Russia raised the country's key interest rate from 10.5% to 17% in an attempt to slow the ruble's decline, but with little effect.

The collapse of the ruble has made foreign debt repayment significantly more expensive for Russian companies issuing foreign currency–denominated debt. Russian banks currently owe $170 billion in debt[3], and in December 2014, research analysts at Capital Economics predicted that the banks could suffer as much as $22 billion in losses.[4] In addition, in January 2015, Standard & Poor's cut Russia's sovereign debt rating to junk status.[5]

With Russian companies, including banks, restricted from access to Western capital markets, the Bank of Russia has been left as the only means of borrowing dollars or euros to repay foreign debt. This has placed added pressure on Russia's already declining foreign currency reserves, which fell from approximately $510 billion at the start of 2014 to $385 billion by year-end. Through 2015, the country's reserves continued declining at an average pace of $10 billion per month. If this rate of decline were to continue, Russia's currency reserves could become critically low.[6]

The impact of Russia's crisis has not been limited to Russian companies. A distressed Russian economy has hit multinational companies as well, including Apple, Ikea and GM, which have halted or suspended their sales in Russia.

Table 2: Multinational companies impacted by the Russian financial crisis[7]

Company	Consequence of Crisis
Adidas	Shuttered stores and scaled back expansion plans in Russia
BP (which owns a large stake in Rosneft)	86% decrease in Q3 2014 profit, shares down 17% year-to-18 December 2014
Ford	Car sales down 12%, sales slumped 40%; 950 jobs cut in Russia
Siemens	Russian revenues dropped 14% in fiscal 2014 compared to 2013
Volkswagen	Russian car sales fell 20% compared to 2013

Source: CNN Money

Conversely, some companies that receive revenue in dollars and pay expenses in rubles such as oil and gas giant Gazprom, steel producer Severstal and other commodity exporters have benefited from the depreciation of the ruble. Also, many large companies, including Gazprom and OAO TeleSystems, had relatively modest levels of debt prior to the Ukrainian crisis, which made them less vulnerable than companies with heavier debt burdens. Moody's reported that most of the Russian companies it rated have sufficient liquidity to service their debt in 2015.[8]

[3] As of 12/31/2014

[4] Andrianova, A. & Galouchko, K. (2015). Russia credit rating is cut to junk by S&P for the first time in a decade. *Bloomberg*. Accessed on 2/4/2015 at: http://www.bloomberg.com/news/articles/2015-01-26/russia-credit-rating-cut-to-junk-by-s-p-for-first-time-in-decade

[5] Where to watch for signs of stress in Russia's banks. *Capital Economics*. Research report issued 12/17/2014.

[6] Central Bank of Russia: http://www.cbr.ru/eng/hd_base/default.aspx?Prtid=mrrf_m, from January 2014 through March 2015.

[7] Harrison, V. (2014). Russia crisis hurts these brands the most. *CNN Money*. Accessed on 2/1/ 2015 at: http://money.cnn.com/2014/12/18/news/companies/russia-economy-brands-losers/

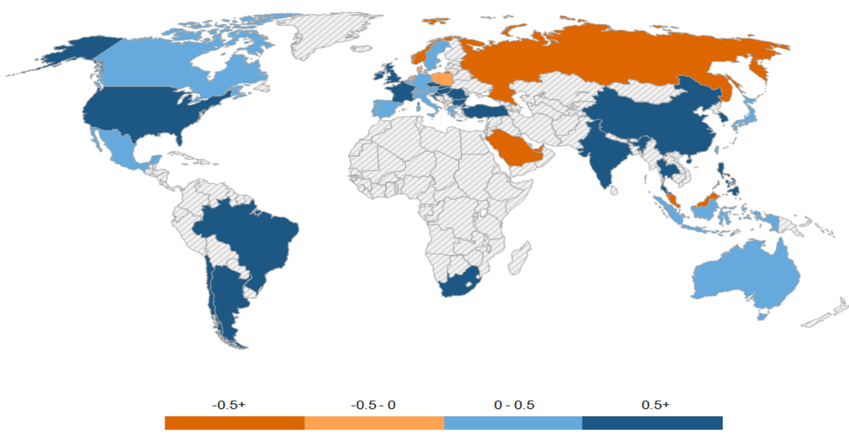
[8] Hille, K. & Atkins, R. (2014). Russian companies face credit crunch danger. *Financial Times*. Accessed on 3/17/2015 at: http://www.ft.com/intl/cms/s/0/70a578b4-4d70-11e4-9683-00144feab7de.html.

In the past, some countries experiencing currency volatility and/or large drawdowns of foreign reserves have looked to capital controls as a way to limit the effects of further instability. Both Russell Indexes and FTSE view such restrictions on capital mobility unfavorably, and in some instances such actions have resulted in country classification changes or removal from index membership.

Oil exporters under pressure

Figure 1 illustrates the impact of cheap oil on GDP. Lower oil prices are positive for net oil-importing countries, because of the resulting increase in consumers' disposable income. When oil prices drop, governments are able to reduce subsidies, and input costs in the manufacturing and agricultural sectors are lower. Most economies are consumers (rather than producers) of oil, and the IMF estimates that a sustained 10% drop in oil prices results in an approximately 0.2% gain in global GDP.[9] The biggest projected beneficiaries of sustained low oil prices include Philippines, South Africa and Thailand. On the other hand, low oil prices hurt net oil-exporting countries, because most of them depend on the proceeds of oil sales to balance fiscal budgets. Countries more likely to be negatively impacted by cheap oil include Saudi Arabia, Russia and the United Arab Emirates.

Figure 1: Cheap oil hurts oil-exporting economies: percentage change in GDP at $40 per barrel of oil



Data table [list of countries by %]

-0.5+ GDP
Saudi Arabia
Russia
UAE
Norway
Malaysia

-0.5 - 0 GDP
Netherlands
Denmark
Poland

0 - 0.5 GDP
Sweden
Taiwan
Australia
Greece
Japan
Indonesia
Austria
Canada
Italy
Portugal
Germany
Spain
Belgium
Switzerland
Singapore

0.5+ GDP	
South Korea	Turkey
Argentina	China
France	Bulgaria
Brazil	Romania
UK	Chile
Ireland	Hong Kong
Hungary	Thailand
Czech Republic	South Africa
India	Slovakia
U.S.	Philippines
Croatia	

[9] http://www.businessinsider.com/ubs-gdp-impact-of-10-decline-in-oil-2014-12

Mexico

Sources: Russell Indexes, IMF as of 12/31/2014.

Supply up, demand flat

The 2014 decline of oil prices can be attributed to a mix of factors rather than one single event. To begin with, the United States has experienced a technological breakthrough in the field of hydraulic fracturing, also known as fracking. This unconventional oil-extraction method has allowed the harvesting of hydrocarbons from shale and other tight-rock formations, enabling a significant increase in domestic oil production. Production in the U.S. has increased by around 80% from 5 million barrels per day in 2008 to 9 million barrels per day by the end of 2014, helping to saturate the global market.[10]

While the U.S. has grown its presence as an oil supplier, the Organization of the Petroleum Exporting Countries (OPEC) has strategically defended OPEC's market share by refusing to curb production, driving oil prices to lows unseen since the global financial crisis. But OPEC's actions are not aimed at keeping global consumers happy; rather, they would like to drive competing oil producers, including the United States, out of the market. In the minutes of a November 27, 2014, meeting, OPEC's conclusion was to maintain production at 30 million barrels per day, believing the market will reach a new equilibrium and prices will eventually increase.[11] Despite threats of political instability within several OPEC member countries, production has not been adversely impacted. Libya's production rebounded after the government reached a deal with rebels and protesters, which led to the reopening of several oil fields. ISIS has overrun portions of Northwestern Iraq, but Iraq's major oil fields are all located in the Southern region.

Furthermore, global demand for oil from Asia and Europe has slowed. Last year saw falling demand from many of the largest oil-importing countries, further slackening supply. China, which became the world's largest oil importer in 2013, saw a net decline in oil consumption in 2014, led by the contraction of its manufacturing sector in the face of heavy competition and weak demand from both domestic and global consumers. Japan slipped into a recession during the second and third quarters of 2014 as sluggish domestic demand and slowing inflation led to drops in industrial production, which resulted in decreased oil consumption. Likewise, many European countries – which already consume less oil per capita than North America and parts of Asia – are still attempting to recover from the global recession, during which demand for oil fell sharply. Adding to that, many developed countries have invested in alternative energy sources and technologies that have resulted in increased fuel efficiency and decreased oil consumption. In summary, the increase in oil supply coupled with decreased demand drove the price of oil down significantly in 2014.

[10] http://fortune.com/2014/12/02/oil-prices-us-energy/

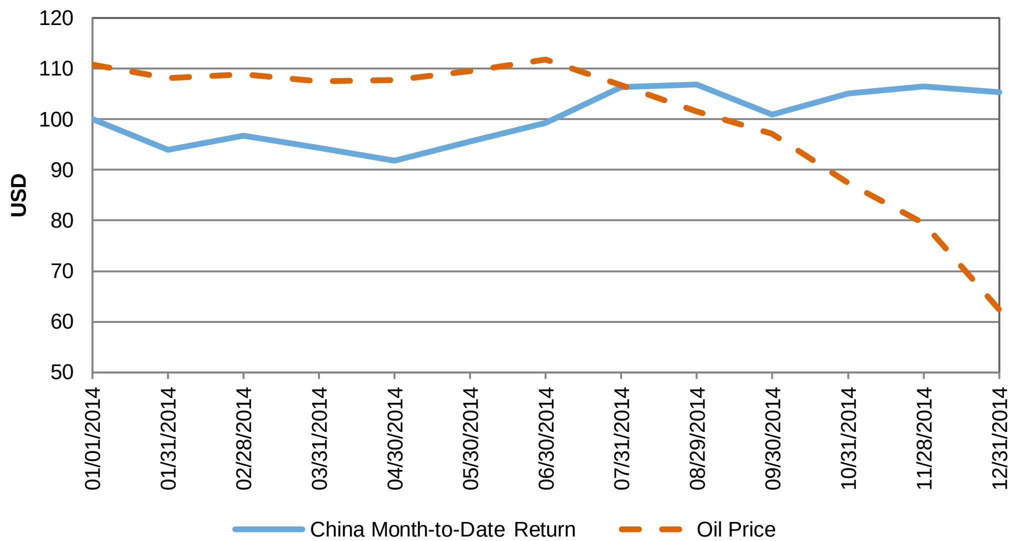
[11] http://www.opec.org/opec_web/en/press_room/2938.htm

Impact of oil prices on the equity markets of China, Russia, OPEC nations and the United States

China

As shown in Figure 2, oil prices were negatively correlated with USD-based index returns for China in 2014. As one of the world's largest importers of petroleum products, China is able to save $2.1 billion annually for every $1 drop in oil prices.[12] Declining oil prices contributed to lower input costs for China's manufacturing and agricultural sectors. In 2014, exports rose 6.1%, but the gains were absorbed by overcapacity in China's industrial sectors.[13] Chinese consumers, manufacturers and transportation companies are major beneficiaries of the drop in oil prices.

Figure 2: Oil's slide allows Chinese equities to tread water



Source: Russell Indexes as of 12/31/2014. Oil prices represented by monthly Europe Brent Crude spot prices.

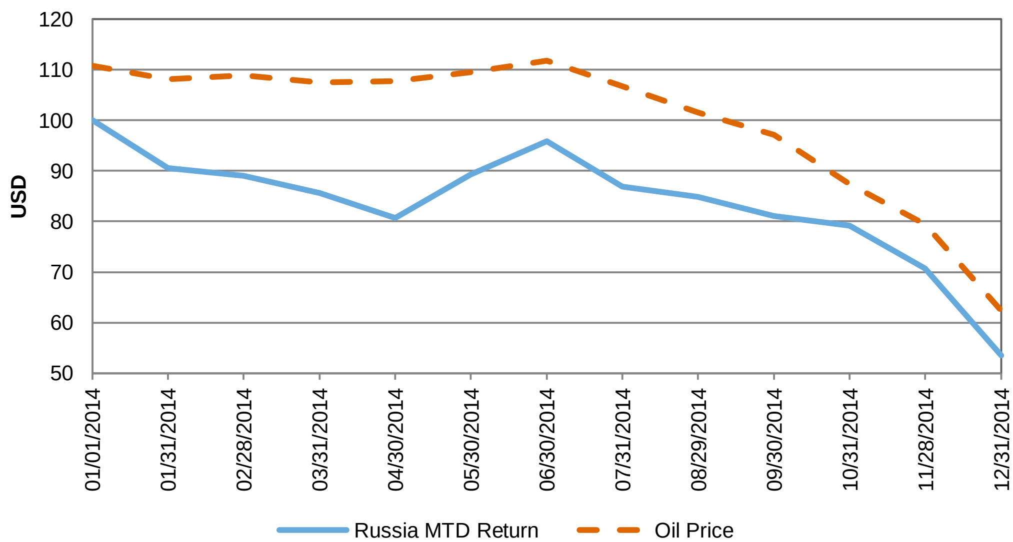
[12] http://www.economist.com/news/international/21627642-america-and-its-friends-benefit-falling-oil-prices-its-most-strident-critics

[13] http://www.wsj.com/articles/china-exports-come-with-low-prices-heard-on-the-street-1421150893

Russia

Along with Saudi Arabia and the United States, Russia is one of the world's largest oil producers. The Russian ruble tends to move in step with oil prices, and as one could expect, oil prices were positively correlated with USD-based market returns for Russia in 2014 (shown in Figure 3). Sagging oil prices, together with trade and financial sanctions, have significantly devalued the ruble, which fell from a USD exchange rate of 30:1 in January 2014 to 70:1 by the end of October 2014.[14] In an attempt to defend its currency, the Russian central bank increased interest rates to 17% in December, but the USD/ruble exchange rate has since slipped back to a range of around 60:1.[15] Further sanctions by the West could push the country into a full-blown currency crisis.

Figure 3: Russian equities were held over a barrel…of oil



Source: Russell Indexes as of 12/31/2014. Oil prices represented by monthly Europe Brent Crude spot prices.

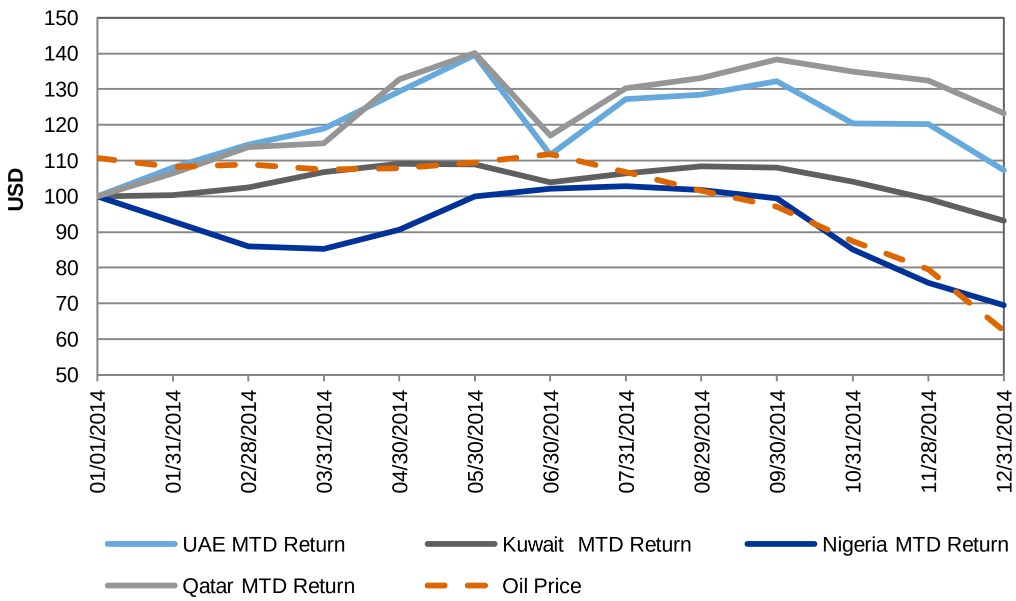
[14] http://www.xe.com/currencycharts/?from=USD&to=RUB&view=1Y

[15] Bloomberg as of 12/31/2014.

OPEC

As shown in Figure 4, oil prices were positively correlated with USD-based market returns in 2014 for select OPEC members included in the Russell Global and Russell Frontier indexes. Kuwait, Nigeria, Qatar and the United Arab Emirates all experienced declines in market returns during the last quarter of 2014 as the price of oil continued to fall. While OPEC members have the world's lowest average oil-production costs, current oil prices are insufficient to cover all 12 members' 2015 fiscal budgets.[16] If oil prices were to remain near $50 per barrel, every OPEC country is expected to run a budget deficit.[17] Nevertheless, oil revenues are used to finance government spending and social programs, so OPEC is incentivized to sustain production levels, so long as production costs do not exceed oil prices.

Figure 4: Equity returns in OPEC markets sagged in the second half of 2014



Source: Russell Indexes as of 12/31/2014. Oil prices represented by monthly Europe Brent Crude spot prices.

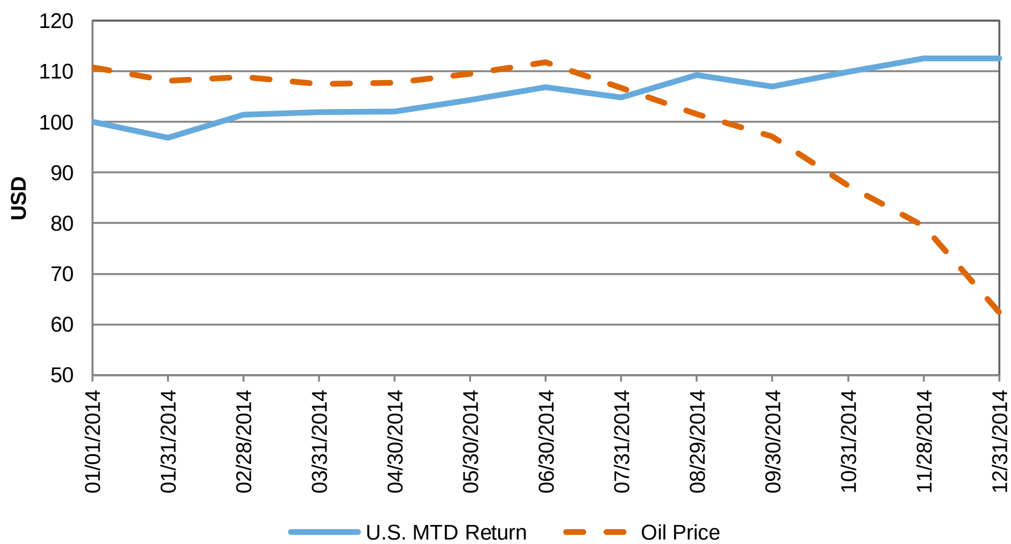
[16] http://graphics.wsj.com/lists/opec-meeting; see 2015 fiscal breakeven prices in Appendix I.

[17] Please see Appendix I

United States

As shown in Figure 5, oil prices were negatively correlated to U.S. market returns in 2014. The rapid fall in oil prices did not contribute to a proportionate boost in market returns, because the U.S. is both a producer and a net consumer of oil. Besides, lower oil prices tend to contribute to increased consumer spending, and consumer spending accounts for two-thirds of all U.S. economic activity. During third-quarter 2014, consumer spending helped fuel the biggest economic expansion in the U.S. since third-quarter 2003.[18] Airlines especially benefited from the drop in oil prices, given that jet fuel is their largest single operating expense.[19]

Figure 5: More consumer spending power in the U.S. helped market gains



Source: Russell Indexes as of 12/31/2014. Oil prices represented by monthly Europe Brent Crude spot prices.

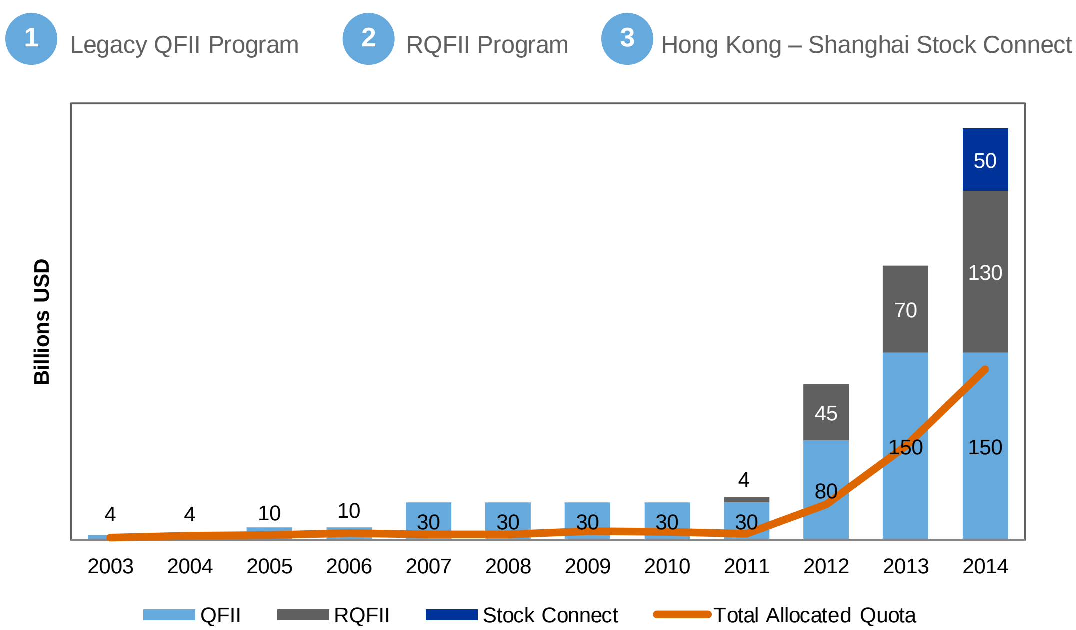
[18] http://www.bloomberg.com/news/2014-12-23/economy-grows-by-most-in-a-decade-on-u-s-consumer-spending-gain.html

[19] http://www.bloomberg.com/news/articles/2014-12-31/bull-market-lasts-another-year-in-sp-500-on-economy-fed

Developments in accessing the China A-share market

China's A-share equities market, which was formerly accessible only to domestic investors, has opened up to foreign investment rapidly in recent years. From 2002 to 2010, the USD-based Qualified Foreign Institutional Investor (QFII) program was the single method of entry to the approximately US$3 trillion A-share market. During its first nine years, participation in the QFII program grew nominally, slowed by regulations that limited access and slowed allocations of quota. In 2011, China picked up its pace with the introduction of the Renminbi-based RQFII program, which increased the points of entry, numbers of participants and availability of market capitalization. Access to China's mainland was further boosted in late 2014 with the introduction of the Hong Kong–Shanghai Stock Connect program. Routing trades into China through Hong Kong, Stock Connect is the first program to allow for buys and sells of eligible Shanghai-listed stocks without restrictions, up to predetermined daily (~US$2.1 billion) and aggregate (~US$50 billion) quotas. Now with three methods of entry (the QFII, RQFII and Stock Connect programs), the A-share equities market is more accessible to international investors than ever before.

Figure 6: Different modes of access give rise to China A-share participation



Sources: CRSC, SAFE, Hong Kong Stock Exchange as of 12/31/2014.

With the inertia surrounding access to the A-share market, the media and investors alike have begun speculating about when and how A-shares will be included in major global equity indexes. Some important concerns remain, which have caused Russell to maintain the view that a conservative, and ultimately customized, approach to tracking A-shares in an index is appropriate. Each of the three aforementioned methods of entry into the A-share market comes with its own set of rules, particularly where the freedom of the capital account is concerned. Add to that a varied quota system that, in the case of the QFII and RQFII, provides individual quotas, and in the case of the Stock Connect, provides an exchange-level quota. Because there is not a consistent experience among programs for global investors, including A-shares in a standard global equity index that is designed to track shares available to all investors is challenging. Accordingly, there is a need to create customized index options, in order to represent the different investor experiences when A-shares are added to global equity portfolios.[20]

Russell Indexes has not historically maintained a stand-alone China A-share index, but FTSE offers a full suite of China A-share indices that serve as the basis for some of the largest A-share-linked ETFs in the world.[21] FTSE offers three different approaches to replicating an A-share exposure within a global equity or emerging markets equity portfolio:

1. A full free-floated A-share representation with stocks weighted up to the 30% foreign ownership limit
2. A quota-based weighting of the A-share market based on the available total across the QFII, RQFII and Stock Connect programs
3. A quota-based weighting using a client's individually allocated quota

These customized options allow clients choose their A-Share allocation, and in line with their own target weights for China.

Ultimately, we believe global index providers will take a similarly gradual approach to adding A-shares to standard equity benchmarks. If the A-share market were added to the standard equity index today, even after being adjusted for free-float and foreign ownership limits, FTSE estimates that China's weight within FTSE's emerging markets index would jump from ~22% to ~34%![22] The magnitude of such a change could not be implemented over a single rebalance; rather, it would require a phase-in approach applied over time. Because of the large shifts in index weight that full inclusion of A-shares would create, an allocation based on the outstanding QFII, RQFII and Stock Connect quota may more closely approximate the path of incremental uptake of A-shares that index providers are likely to follow. FTSE estimates that including A-shares by the allocated quota would increase China's weight to a more achievable ~24% (from 22%). Finding the right balance in when and how to add A-shares will be one of the most high-profile, high-impact decisions index providers and their clients make in the coming years.

[20] For more details on each program and FTSE's approach to the China A-share market, please visit: http://www.ftse.com/products/downloads/Preparing_for_Chinas_Inclusion_in_Global_Benchmarks.pdf

[21] For more details on FTSE's China indices please visit: http://www.ftse.com/products/indices/china

[22] Estimates provided in: http://www.ftse.com/products/downloads/Preparing_for_Chinas_Inclusion_in_Global_Benchmarks.pdf

Conclusions

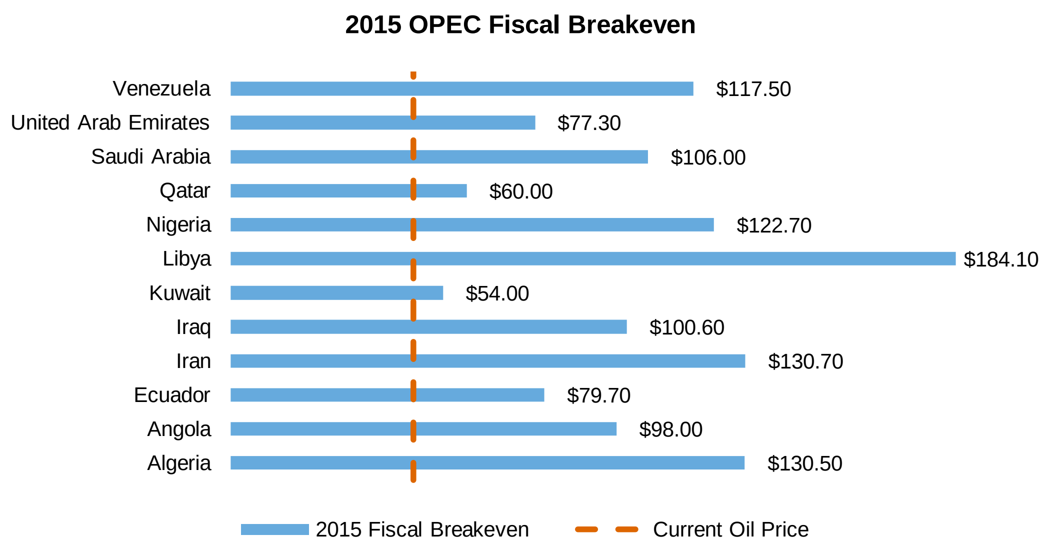
The Global Guidebook serves as a dashboard of sorts for countries around the world – assessing market size, liquidity, macroeconomic stability and trading environment. The Russia-Ukraine crisis threatened the regional stability of Eastern Europe in 2014. And as their effects continue into 2015, Western sanctions may further isolate the Russian equity market and continue to pressure Russia's currency. Adding to these geopolitical concerns is the potential impact of lower oil prices on large oil-exporting economies, such as Russia, Saudi Arabia and the United Arab Emirates. Yet if the price of oil remains low, oil-importing countries and end consumers stand to benefit.

One such beneficiary may be China, a major oil importer that is also seeking to import more foreign asset inflows via its domestic A-share equity market. Following the introduction of the Hong Kong–Shanghai Stock Connect program in November 2014, China now has three foreign investment programs that could allow foreigners to collectively own up to 10% of the A-share market. China appears committed to reaching a level of market openness that will allow the A-share market to be included in standard global equity benchmarks, but how and when that will happen in still uncertain.

In the current environment, FTSE's customizable approach to the A-share market can accommodate investors' needs, regardless of which path to A-share allocation they choose.

Appendix I: OPEC breakeven prices

Figure 7: 2015 fiscal breakeven oil prices required for OPEC. The current price of WTI crude oil as of Jan. 20, 2015 was $46.49.



Sources: Bloomberg, IMF.

About Russell Indexes

Russell's indexes business, which began in 1984, accurately measures U.S. market segments and tracks investment manager behavior for Russell's investment management and consulting businesses. Today, our series of U.S. and global equity indexes reflect distinct investment universes – asset class, geographic region, capitalization and style – with no gaps or overlaps. Russell Indexes offers more than three dozen product families and calculates more than 700,000 benchmarks daily, covering 98% of the investable market globally, 81 countries and more than 10,000 securities. As of December 31, 2014, approximately $5.7 trillion in assets are benchmarked to the Russell Indexes.

For more information about Russell Indexes, call us or visit www.russell.com/indexes.
Americas: +1-877-503-6437; APAC: +65-6880-5003; EMEA: +44-0-20-7024-6600

Disclosures

CORP-10357-04-2016E