

*June 2, 2014*

## **From Russia, Without Love**

On Sunday, May 18, the Ukrainian presidential election results showed the general population's vote loud and clear. The pro-European businessman Petro Poroshenko, dubbed the "chocolate king" due to his business interests, had claimed a landslide victory and thus could be declared the winner without the need for a coalition. People in the capital city, Kiev, celebrated in the streets. Yellow and light blue flags hung all over the capital. Civilians of all ages, socio-economic groups and ethnic backgrounds were congratulating each other, and hope was renewed that stability would be restored in all of Ukraine.

On this same election Sunday, the mood and circumstances in the city of Donetsk, about 350 miles southeast of Kiev, could not have been more different. Although the election stations were technically open, there were no civilians on the streets and hardly anyone had voted all day long. The desire to vote was strong in this conflict-stricken city, however, personal safety concerns kept citizens in their homes. Shooting could be heard all throughout the city as rebel gunmen rode around in trucks, shooting automatic weapons in random directions. Also on the same day, masked rebels had taken over a local TV station, threatening to broadcast Kremlin-backed shows. On Monday, president-elect Poroshenko vowed to fight back the rebels in eastern Ukrainian cities and return order. The government forces were somewhat successful in this quest, taking back the airport in Donetsk

with no casualties. However, the next morning, rebels shot down a government helicopter with a shoulder-fired missile. Fighting and political uncertainty continues in eastern Ukraine, even as the world becomes more optimistic that a solution will soon be found.

This week we will take an informal look at the implications of the rebel-military fighting on the lives of eastern Ukrainian citizens. We have a unique opportunity to look inside the crisis in eastern Ukraine as we have friends that live there and are able to convey information from local press reports. Our report is assembled from conversations with those friends as well as stories from local Ukrainian and Russian newspapers. We recount the events as they are told to us, and make every effort to provide balanced and accurate representations of the events taking place. However, we cannot confirm the accuracy of the statements as it is often hard to completely remove biases in highly emotionally charged environments. In the end, history will be written by the victors and we have yet to see how this crisis will be reflected.



(Source: [www.worldtravels.com](http://www.worldtravels.com))

**Who's Fighting Whom?**

Officially, reports of foreign fighters joining the fighting rebels in eastern Ukraine have not been confirmed and have been denied by some. However, in talking to local Ukrainians, they fully believe that the rebels are not pro-Russian Ukrainians, but are instead foreign fighters, mostly Chechens, who were moved into the region by Russia to cause instability. According to reports, Chechen President Ramzan Kadyrov called out to the fighters in his region to join forces to support their “brothers” in the People’s Republic of Donetsk. Russia has repeatedly denied any involvement in deploying foreign fighters. However, the general perception is that Putin is trying to destabilize the region, leaving the local and central Ukrainian governments powerless, in order to step in and provide protection and stability to the region in exchange for creating an ungovernable buffer region with Russia.

The word on the street is that Russia has been a major source of funds for Chechnya, rebuilding the region after gaining control following the annexation referendum in 2003. Allegedly, the silent understanding between Chechnya and Russia is that Russia would continue its financial aid to Chechnya, but that in return Chechen fighters would “return a favor” when called upon.

According to speculation, Russia moved convicts, criminals and militia men into the region by the busload during the beginning of the conflict. Some claim that these men were moved there under the auspices of “sight-seeing and tourism.” Allegedly, these “thugs” were then given weapons and allowed to roam freely. Often, these weapons were taken out of the local police stations, immobilizing the official law enforcement system.

The new president’s stance remains to be seen, but so far the current government has indicated that another country’s militia fighting on Ukrainian soil will be viewed as “exported terrorism” and dealt with accordingly.

The state of lawlessness has continued in the region, with civilians afraid not only for their property, but also for their lives. Although most people continue to go to work, civilians try not to leave their immediate regions. Roads are open, but driving on them can be dangerous. Rebels carrying weapons are on the roads and regularly stop vehicles. If they like your car, they will order people to get out of the vehicle and will confiscate the car. According to one person, if this happens, “you hope your car is all they will take and you don’t get shot.”

**Life Now**

On the outside, work life has resumed. People still go to work and get paid. However, workers leave their posts around 3:00 pm to run their errands and get home before it gets dark and the shooting starts. From dusk until dawn, civilians avoid going outside of their homes as gunmen roam the streets, often shooting at anything and everything.

Eastern Ukraine still uses its own currency, the hryvnia, and not the Russian ruble. The hryvnia has lost over 30% of its value since the beginning of 2014. Store shelves have become emptier, and prices of food and other household items have appreciated considerably. The only grocery items that have seen only modest price gains have been local products. Gasoline and natural gas prices have sky-rocketed and, consequently, anything that has gas as an input cost has surged. Additionally, the cost of keeping goods safe during transportation has

increased. Overall, civilians are trying to hoard what they can and, if they own land, grow what they can for themselves.

One of the first responses to a military crisis in a developed market would be a major move to liquid assets, especially cash. However, the thing to keep in mind with regards to Ukraine is that the financial markets are still in their infancy. People are paid via banks, but not many people have savings accounts, especially among the older population. People are still distrustful of banks and prefer to keep their savings in tangible things, such as their homes and jewelry.

Older Ukrainians generally tend to support merging with Russia, partially due to the fact that state pensions in Russia are three times higher than in Ukraine. However, as has been the case with Crimea, pension reform and equalizing pensions has proven to be a complicated issue.

### **What's Different Now?**

Ukrainians and Russians have lived together in eastern Ukraine for centuries. There are very few differences between the Ukrainian and Russian languages, and ethnic differences have never been a problem before. Russian and Ukrainian inter-marriages are very common and the cities do not necessarily have either purely Ukrainian or Russian neighborhoods. Aggression between native Ukrainians and Russians in eastern Ukraine is uncommon even now. Many locals believe that Putin's desires and actions do not reflect the desires and actions of all the Russian people, and that the Russian people are also suffering because of it. Again, as locals say, nobody was killing anybody for centuries, but now all of the sudden as the result of a publicity stunt these two groups have been portrayed to hate each other.

There is also very little religious strife in eastern Ukraine. For example, the city of Donetsk has beautiful churches—Eastern Orthodox, Catholic and Protestant. As with many ex-Soviet countries, religion is not a major part of anyone's life. In fact, about two-thirds of the population reported as non-religious according to a 2006 study. The Eastern Orthodox Church claims the largest religious base, with affiliation with about a quarter of the population.

### **What Next?**

The civilians in eastern Ukraine remain hopeful, but they do not see how things will turn around any time soon without a strong offensive against the rebels. Leaving is not an option for many. Although the roads are open, as we discussed above, travelling by car can be dangerous. Trains run occasionally and spuriously, and it is unclear whether traveling by train is any safer than travelling by car. Additionally, given the lack of financial assets and a uniform financial system to hold these assets, people leaving would essentially be escaping with whatever they can carry on their backs.

Speaking out against Russia in general or Putin in particular can carry a high enough price to keep the general population from protesting in the streets. Civilians could be shot if they speak up against Russia. Community leaders could suffer property damage or life threats if they are perceived to be anti-Russian. For example, a local businessman in Donetsk, who had been critical of the Kremlin, saw his sports stadium burned to the ground by the rebels.

Many in eastern Ukraine remain hopeful that a solution could be found soon, especially now under president-elect Petro Poroshenko. Poroshenko is viewed as having a favorable relationship with both Europe and Russia, so

it is hoped that he can reach a solution that would return stability to Ukraine. This path, however, is wrought with difficulty, and much of it depends on the actions of Russia and Europe.

### **Ramifications**

Although Western financial markets are viewing the Ukrainian situation as “manageable,” it is clear from these firsthand accounts that conditions are quite unstable. It is unlikely that NATO or the U.S. will take aggressive steps to contain

Russian aggression; however, it does appear that Putin has created an ungovernable buffer region in eastern Ukraine that will reduce the odds that the country will ally itself with the West. For the unfortunate civilians in eastern Ukraine, this means continued chaos. However, the impact on financial markets, barring a significant escalation, will probably be modest.

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*This report was prepared by Kaisa Stucke and Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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