

CONSEQUENCES OF SUBPRIME AND THEIR EFFECTS ON GLOBAL ECONOMY IN 2008



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...END OF 2007

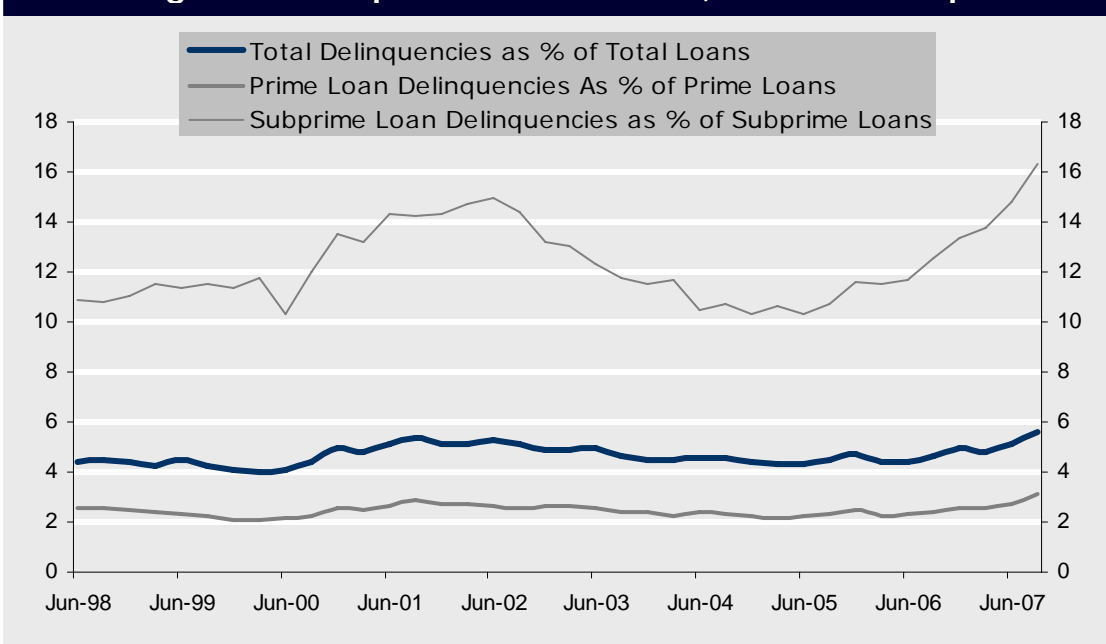
Contents:

| | |
|---|----|
| ◊ Everything started from the US subprime | 3 |
| ◊ The crisis spilled over into the real sector of the economy | 10 |
| ◊ The US Federal Budget and coming US elections year | 18 |
| ◊ The crisis extended into the world economy | 23 |
| ◊ The crisis caused reshuffles of investors' global portfolios | 28 |
| ◊ Negative consequences of portfolio assets re-allocation for the US | 33 |
| ◊ Hedge Funds passed difficulties and showed relatively good performance in 2007 | 38 |
| ◊ For sure there were those who faced large losses | 42 |
| ◊ Despite the recent sharp downward correction in EUR/USD, USD stays fundamentally weak | 46 |
| ◊ Major Interest rates could trend lower | 57 |
| ◊ The growth of global economy and world trade will decelerate in 2008 | 61 |
| ◊ Oil prices will trend lower next year | 68 |

Everything started from
the US subprime...

Delinquencies rose dramatically in the US subprime sector

Percentages of Delinquencies from Loans, Prime vs. Subprime



Source: Credit Europe Treasury Research, Bloomberg.

The decline of the US home prices brings the substantial US recession risk. Total US housing assets amount to ~\$21trio.

US households predominantly hold their assets in the housing market. Only in August-September home prices fell by ~1.54% which brought ~\$325bio losses for US housing assets.

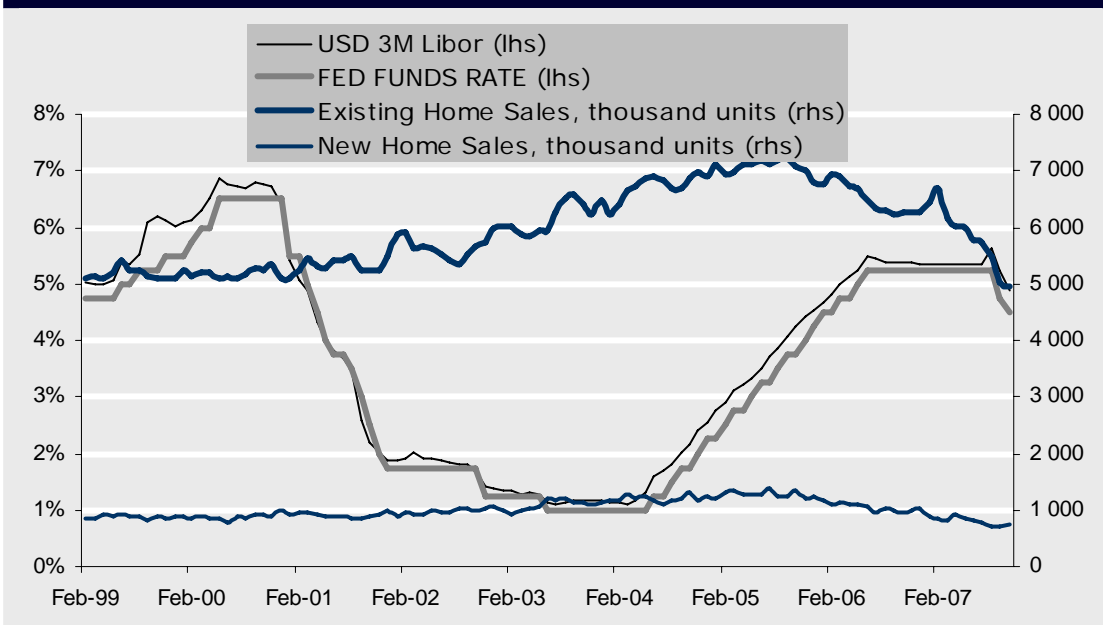
Since September prices fell much more so this is not difficult to estimate the consequences. This wealth effect has a considerable negative influence on the wealth of the US population.

Subprime delinquencies – most probably worse to come.

Subprime adjustments continue to affect liquidity.

The demand for homes is restricted by rising lending standards for subprime.
Home supply will continue to rise
on the back of rising mortgage delinquencies.

FED cuts, credit conditions are tighter, home sales go down



Source: US FED, Credit Europe Treasury Research, Bloomberg.

Existing home sales fell to a 9-year low of 4.97mio annualized in October from 5.03mio in September. The downward pressure on home prices is getting more intense.

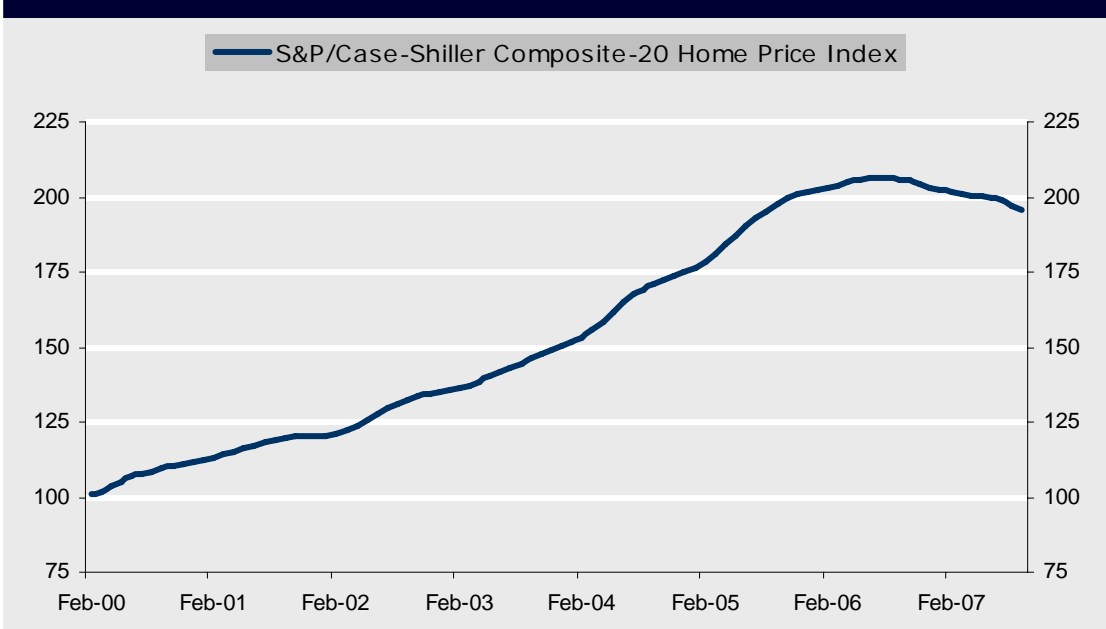
Excess home inventories are hitting new highs – thus the monthly supply of unsold homes increased from 10.4 to 10.8, and the monthly supply of unsold single family homes grew to a 22-year high from 10.1 to 10.5.

Falling housing prices will have a considerable negative impact on the consumption due to the wealth effect. Falling housing prices will also affect the credit market losses on mortgage-backed securities.

With housing prices going down, more and more homeowners will find themselves trapped in the negative equity and more and more mortgage defaults will rise.

Home sales do not go up and sellers made another attempt to get rid of the inventories by decreasing home prices

S&P/Case-Shiller Home Price Index



Source: MacroMarkets LLC + S&P, Credit Europe Treasury Research, Bloomberg.

The US new home sales grew from 716k in September to 728k in October. But the fact is that we saw this small rise due to the massive downward revision of the previous month from 770k to 716k. The October's figure, anyway, stayed below the market consensus of 750k.

Furthermore, we assume that the trend of downward revisions of previous figures will continue and at next showings we will, most probably, see previous figures revised lower.

As we expected the construction spending fell by 0.8% in October compared to a moderate 0.3% growth in September, which confirmed our views about a downturn in the commercial building.

Any temporary upward stabilization of home sales should not be thought as the end to the downturn of the housing crunch

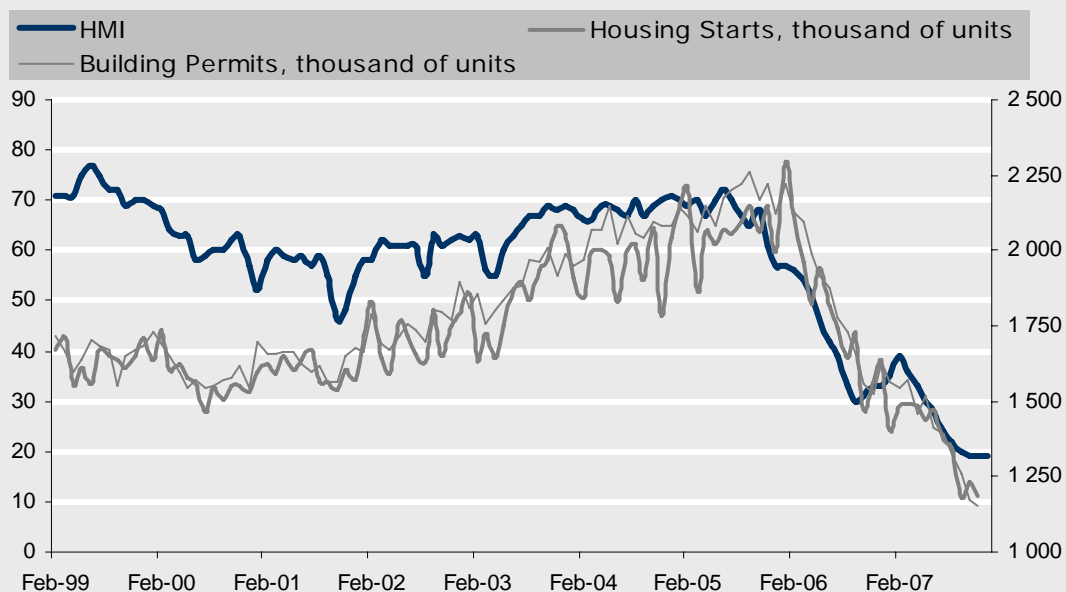
We assume that home sales could temporary stabilize which after major declines will not surprise. But the word “stabilize” does not necessarily stand for the rise. Home sales could stay unchanged or edge slightly lower. Anyway, even if we see some upward signs, this should not be thought as the end to the downturn of the housing crunch.

As we expected, housing starts showed some positive shift in October to 1.229mio from 1.191mio in September but that was normal after previous declines. And the market felt that a slightly positive figure did not change the further expected decline in housing starts. So basically the October’s report was not a strong one. The latest 3% rise was accompanied with a downwardly-revised 11.4% drop in September. November’s housing starts posted 1.187mio versus 1.232mio in October (revised slightly up from 1.229mio).

At the same time building permits fell by 6.6% in October to 1.178mio which was the lowest level since July 1997. November’s figure fell to even deeper to 1.152mio from 1.178mio in October (revised slightly up from 1.170mio). This added to the point that new construction will continue to contract over coming months, weighting on the GDP growth, which will motivate the FED to cut further its federal funds rate at coming FOMC meetings. So the FED will have to think twice because the decline in the housing sector has all the chances to have a significantly negative impact on the US employment and consumer spending.

Housing market remains the main focus of the risk to get worse

Housing Starts, Building Permits, and HMI



Source: US National Association of Home Builders, Credit Europe Treasury Research, Bloomberg.

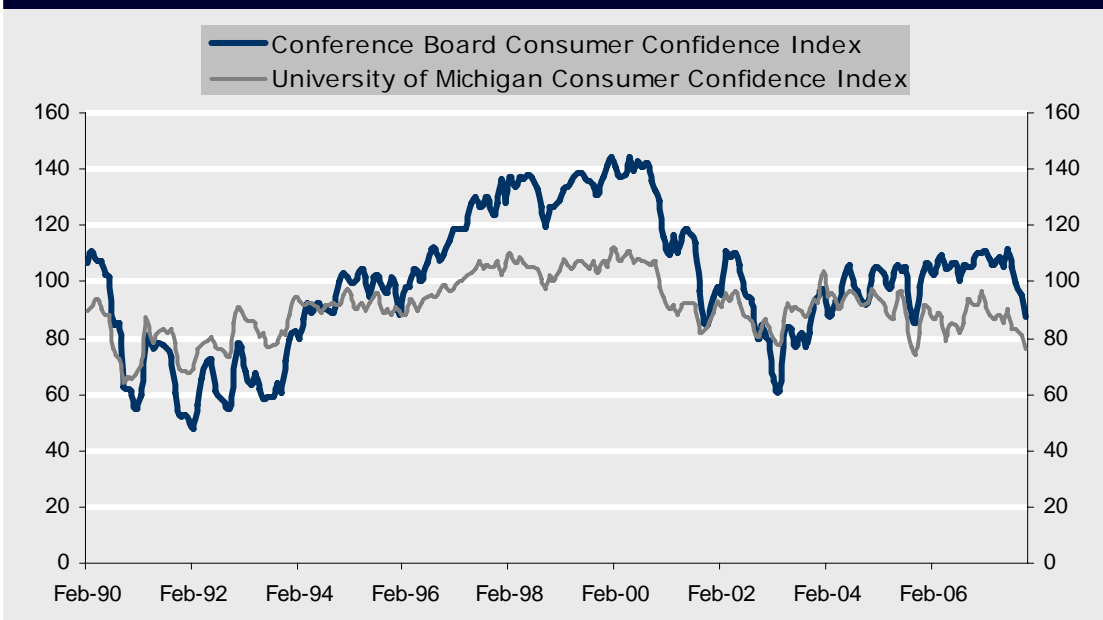
Inventories of unsold homes rise which leads to falling home prices. Home builders should have progress in reducing inventories, thus home sales should go up first followed by falling home prices.

The National Association of Home Builders' Housing Market Index (HMI) posted 19 in November against an upwardly revised level of 19 in October (was revised from 18). December's figure amounted to the same 19. The index is in a record low level and suggests about low expectations of Association's members.

Just to remind: NAHB conducts a survey of its ~900 members to evaluate the current situation on the market for new single-family home sales and assess builders' expectations of future trends. The report allows capturing views of those who have first-hand knowledge and educated opinions about current and future homebuilding trends.

US consumer confidence rushed down,
the domestic consumption is under attack

US Consumer confidence



Source: Credit Europe Treasury Research, US Conference Board, University of Michigan, Bloomberg.

The US consumer confidence continues to slump.

The Conference Board Consumer Confidence Index fell to a two-year low of 87.3 in November compared to 95.2 in October and a market consensus of 91.0 for November. We would better say crashed because the decline by 7.9 points is not just a fall.

Main reasons which affect consumers are surging energy prices, falling stock prices, and ongoing collapse in the housing sector.

Such big drops in the index were only after Hurricane Katrina and after the United States invaded Iraq in 2003.

The crisis spilled over to
the real sector of the
economy...

US –the recession or not?

Worries about possible coming recession in the US remain strong.

The overall picture does not look good for the United States. Surging energy prices shrink real incomes of the population which hurts the consumption growth rate. The contraction in residential investment, an expected end of the boom in the commercial real estate, and an expected negative contribution of inventories and military spending in the GDP growth in Q4, all these add to odds that the US recession could fairly come closer on the horizon.

Major latest economic data confirmed that the US economy is going into a recession phase. The industrial production which is still not in the right stance despite a 0.3% growth rate in November, lower and lower capacity utilization, employment problems, rising inflationary expectations and the housing crunch with all its consequences and impacts on the US economy, all these also drags the US economy into a recession.

It is interesting how far it could get worse before it goes better.

FED will cut the rate further – there still exist the room for maneuvers

We assume that the FED will cut the federal funds rate by further 50bp till mid-2008. Interest rates are not in emergency levels right now and FED still keeps the room for maneuvers. US Financial institutions continue to write down losses originated from sub-prime loan sector or subprime-related segments. Markets continue to price in further rate cuts.

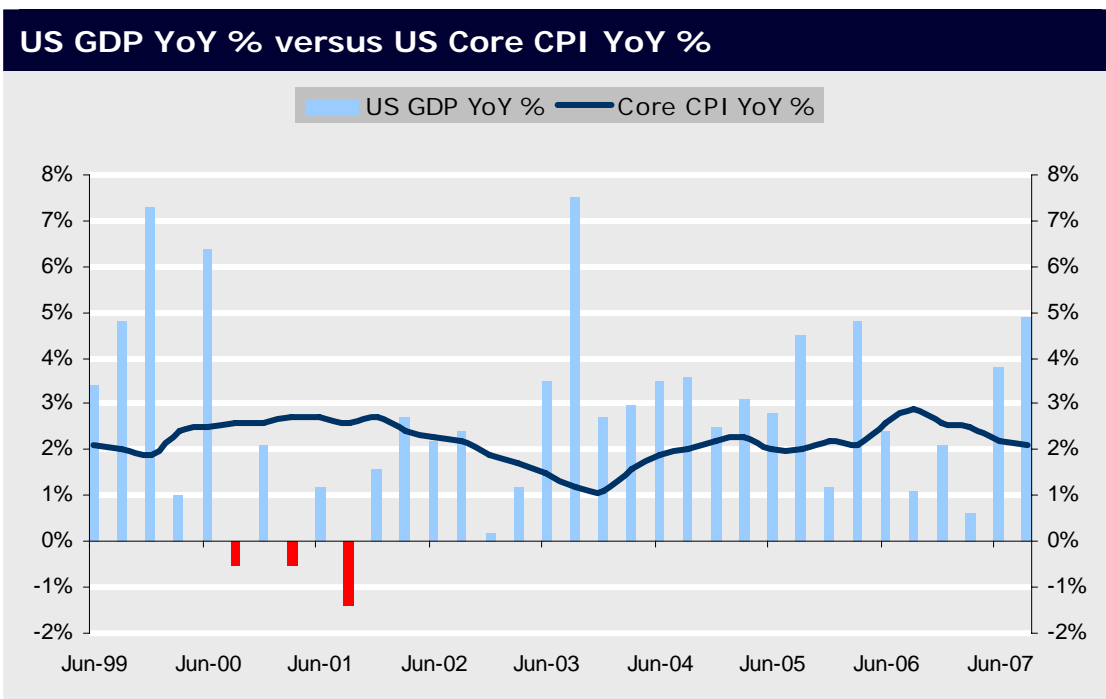
Markets remain very nervous which is confirmed by the volatility on the global currency market as well.

Inflation expectations remained reasonably well anchored. A sizeable increase in food and energy prices has contributed to pick up in US headline inflation this year. Commodity prices remain a major source of uncertainty in the overall inflationary outlook. US core inflation which does not include food and energy components has been moving in a more favorable direction. Energy prices have risen dramatic enough to have a negative impact on people's pockets.

The combination of high inflation and the weak economic growth remains a major US threat.

The new FOMC is coming. The decision about the rate is coming. The probability that the US economy will enter into a recession phase will increase if the FED does not ease again.

US GDP in Q3 2007 was revised up but this should not obscure the picture about the currently weakening US economy



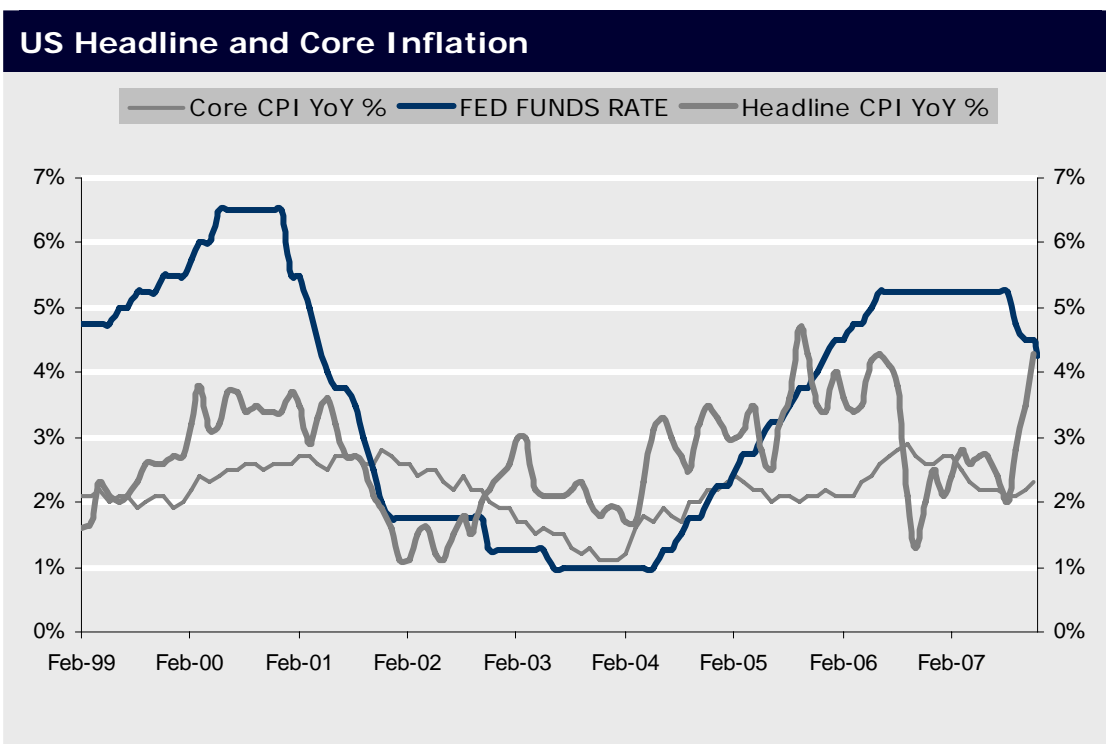
Source: Credit Europe Treasury Research, Bloomberg.

As we forecasted in our earlier reports, the US Q3 GDP was revised upwards from the initial estimate of 3.9% to 4.9% annualized which is the best showing in 4 years. The thing is that we should not be misled and think that the US economy has nothing to worry about because all this growth relates back to a time before the turmoil in financial markets. The situation has changed enormously since then and we continue to expect really bad figures for the Q4 US GDP. Moreover problems of money markets and credit markets are re-emerging now.

This strong revision of the US Q3 GDP was primarily due to two factors. First is higher inventories because producers experienced a big drop in the demand at the end of the third quarter. Second is stronger contribution from net exporters where the export growth was revised up and the import growth was revised down.

Moreover, corporate profits in the US fell by 1.2% despite the strengthened GDP growth in Q3.

Fueled by skyrocketed globally oil and food prices, US headline inflation showed the considerable upswing



Source: Credit Europe Treasury Research, Bloomberg.

Higher energy prices in November were the major movers in all price indices. High oil prices affected CPI, PPI and import prices which is already the usual pattern for the US.

US inflation data appeared to be USD-negative. CPI grew by 0.8% MoM in November versus 0.3% in October. Consumer prices grew by 4.3% YoY in November versus 3.5% in October.

Headline rates started to spill over into core inflation and raised concerns about stagflation. Core CPI increased by 0.3% MoM in November versus 0.2% in October. Core CPI rose by 2.3% YoY in November versus 2.2% in October.

Inflation remains one of the main concerns for the FED. Headline producer prices skyrocketed to 3.2% in November versus 0.1% in October. Producer prices ex. food and energy components grew by 0.4% in November compared to 0.0% in October.

Export prices grew by 0.9% in November versus 0.8% in October. Import prices advanced to 2.7% in November versus 1.4% in October. High oil prices for sure contributed to this.

The US economic growth has lowered sharply since the financial turmoil first hit in mid-August

ISM manufacturing report showed really bad figures. The headline index fell slightly from 50.9 in October to 50.8 in November. Negatives are inside the report where the employment fell from 52 to 47.8, and prices grew from 63 to 67.5. Rising price and employment components – again showed that things did not yet get better. Moreover inventories fell from 54 to 49. New orders grew from 52.5 to 52.6, the production grew from 49.6 to 51.9, export orders rose from 57 to 58.5, imports stayed at the same level of 47.5.

ISM non-manufacturing report also showed a worse picture. The major index fell from 66.8 in October to 54.1 in November. The picture here is worse than in the manufacturing report. The employment fell from 51.8 to 50.8, prices skyrocketed from 63.5 to 76.5, new orders fell from 55.7 to 51.1, export orders fell from 56 to 55.5, import orders rushed down from 55.5 to 49.5, business inventories grew from 49.5 to 50.5.

Durable goods orders fell in October as we expected. They fell by 0.4% in October which is the third consecutive monthly decline. The widespread of the weakness is evident. Autos orders fell by 1.4%, orders for non-defense aircraft fell by 5.2%, and orders in computer/electronics sector fell by 8.4%, which led to a 22% drop in orders for communications equipment. The most discouraging element of the DGO report is a 2.3% drop in capital goods orders, esp. defense and aircraft, which more than reversed a 1.2% gain of the month before.

Overall the US unemployment trends higher

The NFP report showed 94k in November versus 166k in October thus confirming that the employment remains one of major concerns for the US now.

It would be better not to get inside the report. But we did. The report showed that major sectors about which so much talks were held showed job cuts – those are goods-producing, construction, manufacturing, durable and non-durable goods producing and financial sector. The services sector is the only one which drags everything upwards.

The US international trade balance amounted to (-\$57.8bio) in October versus (-\$57.1bio) in September. The impact of high oil prices becomes evident from the US trade data. The level of imports boosted from spiking oil prices. Exports remained quite well but a decline in manufacturing output is expected to have a negative impact on exports in coming months.

The Federal Reserve changed the terms of publishing of economic forecasts

The Federal Reserve changed the terms of publishing of economic forecasts. The FED will publish the data 4 times a year instead of 2 and the forecasts will be updated at January, April, June, and October meetings and corresponding minutes will be released 3 weeks after those meetings.

This measure will serve to tighten the control over inflation and to better inform markets to maintain the price stability.

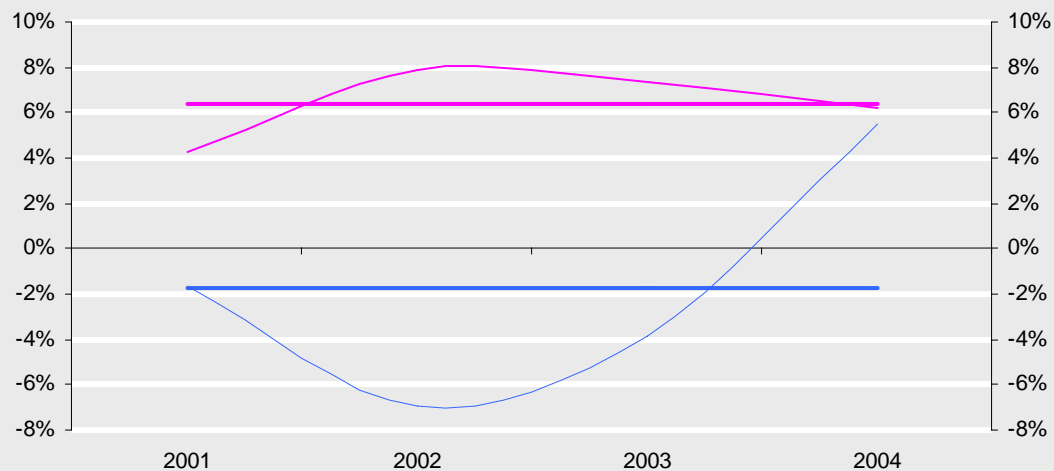
Furthermore, which is also good news, the FED will start publishing forecasts for headline PCE inflation as well as core. Forecasts will be also published for the GDP growth and the unemployment rate.

The US Federal Budget and the coming US elections year...

Decreasing the deficit of the US State budget – something for which Bush can get some credits

US Federal Budget, Revenues and Spending

— Budget Revenues, YoY % change — Average %ch of budget revenue 01-04yy
— Average %ch of budget spending 01-04yy — Budget Spending, YoY % change



Source: Credit Europe Treasury Research, US Treasury, Bloomberg.

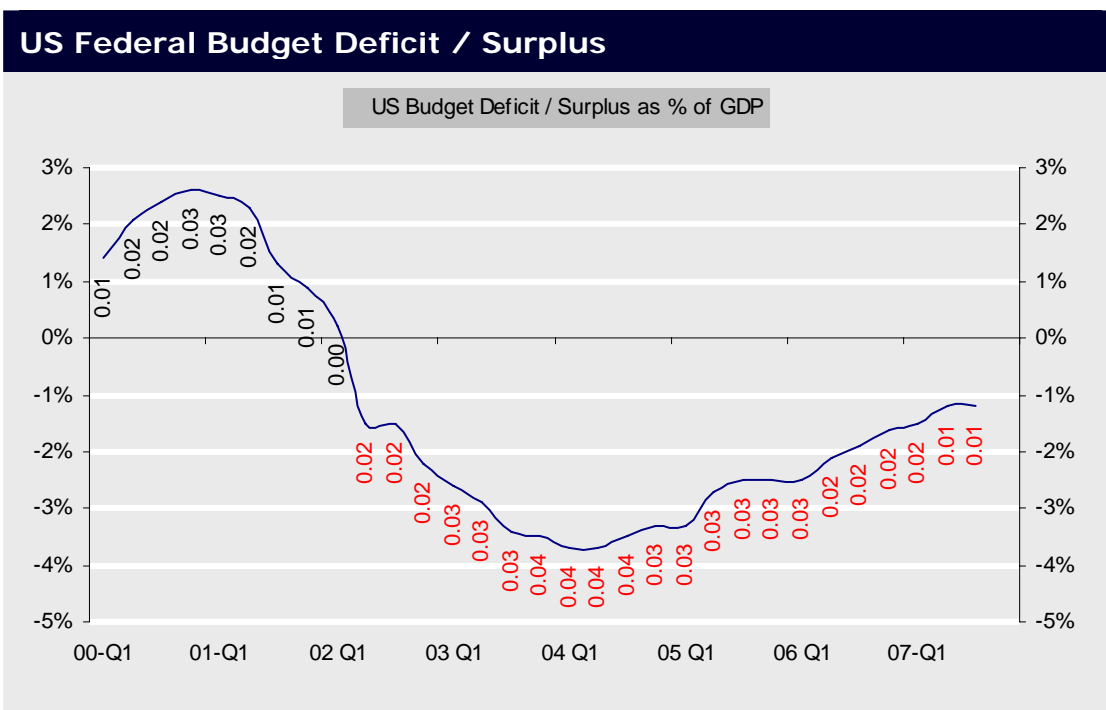
We would like to mention again a truly impressive improvement in the US Budget Deficit. In 2001 Bush inherited \$131.8bio deficit (1.3% of GDP).

In 2004 fiscal year (which runs from October 2003 to September 2004) the US budget deficit amounted to \$412.3bio (3.5% of GDP).

From 2001 to 2004 spending grew by 6.42%/year in the average, and revenues fell by 1.74%/year in the average.

The US beared costs of military operations in Iraq and Afghanistan. Than Hurricane Katrina also added to spending. In 2004 it was evident that controlling spending was not a priority for Bush's administration.

Improvements of 2005 - 2007



Source: Credit Europe Treasury Research, US Treasury, Bloomberg.

The situation improved in 2005-2007 fiscal years: tax receipts started the rapid advance following the accelerating GDP growth. Budget revenues grew by 11%/year in the average, corporate tax receipts grew by 26.2%/year and individual tax receipts grew by 12.9%/year in the average.

In 2007 fiscal year, which was recently finished, the deficit narrowed to \$163bio (1.2% of GDP). The US budget deficit is now below the mid-run average (2000-2007) of 1.45% of GDP. It's necessary to give some credits to Bush for this.

So in the long run the US economy has good chances to be put into a sustainable path.

At last two posting the deficit again turned to the negative side with the latest figure at -\$98bio. Anyway, the elections year comes and the US governors will do something about this to maintain latest achievements.

DEMOCRATS VS. REPUBLICANS on coming US elections ... / US Equity

Once more we would like to concentrate on the upcoming elections year in the US and share with you some of our observations.

The history shows that election years are good for the US stock markets – DJI rose greater in election years compared to non-election years.

The other observation is that stock markets did particularly well in years when a Republican candidate won, but years when a Democrat candidate won were disappointing in the average. Moreover market gains during elections year are strongest over the summer when the election campaign is boiling and following the election in early November for ~1.5 months. At the same time ~1.5 months before the results of elections become known are traditionally not good for stocks due to uncertainty surrounding the outcome.

One more observation is that in the average nominal GDP grew faster in election years than in non-election years.

Changes of fiscal and monetary policies to “buy” votes on coming elections?

Recently talks were held about possible changes in the US fiscal and monetary policies to boost the economic growth and create some preferentials for businesses thus “buying” votes on coming elections.

But...

First, the US Federal Budget deficit decreased before elections so, at least now it's clear that there is no monetary policy pressure. High enough taxes which allowed increasing budget revenues also do not show fiscal policy pressure.

Second, president Bush has already served two terms and can not be re-elected, thus he has little incentive to raise spending or cut taxes.

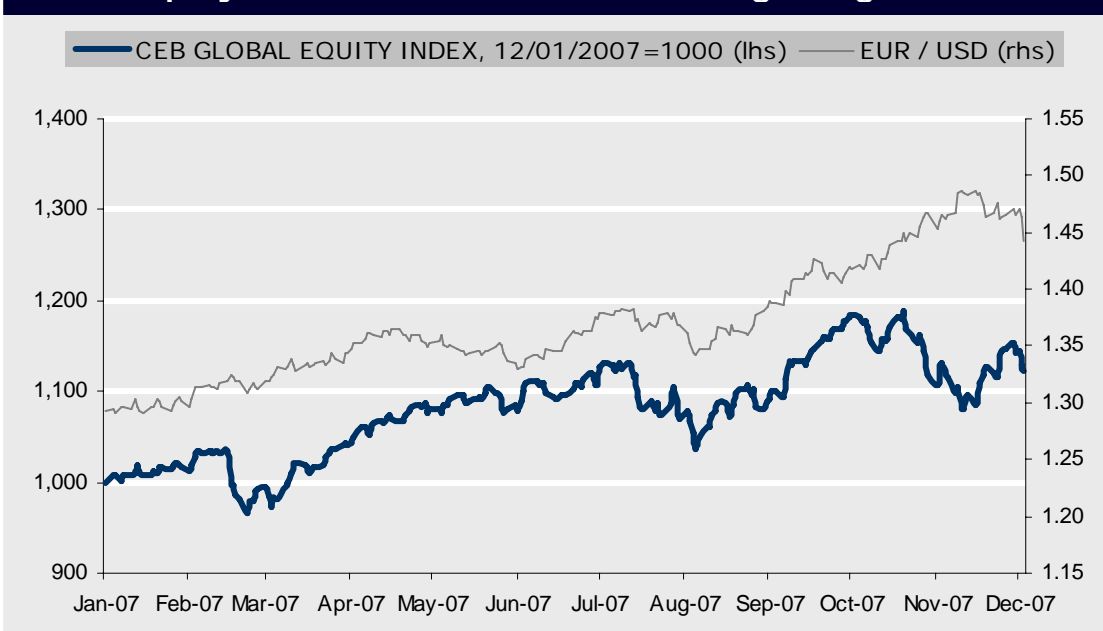
Third, decreasing budget deficit is one of major achievements of Bush's administering of the country and he will, most probably, try to save it.

Fourth, even if Bush wanted to do some sounding changes, for example, to loosen fiscal policy by giving a tax giveaway, then he would have to get the approval of the Congress, which is controlled by democrats, which will not support improving the chances of the republican candidate in elections. But Bush has also the veto right which he will, for sure, implement to every initiative from the Congress which is expected to improve the chances of the democrat candidate on coming elections. So there is somewhat kind of a balance.

The crisis extended into
the world economy...

Global Equity Market showed good performance in 2007 despite financial and housing turmoils

Global Equity versus EUR / USD since the beginning of 2007



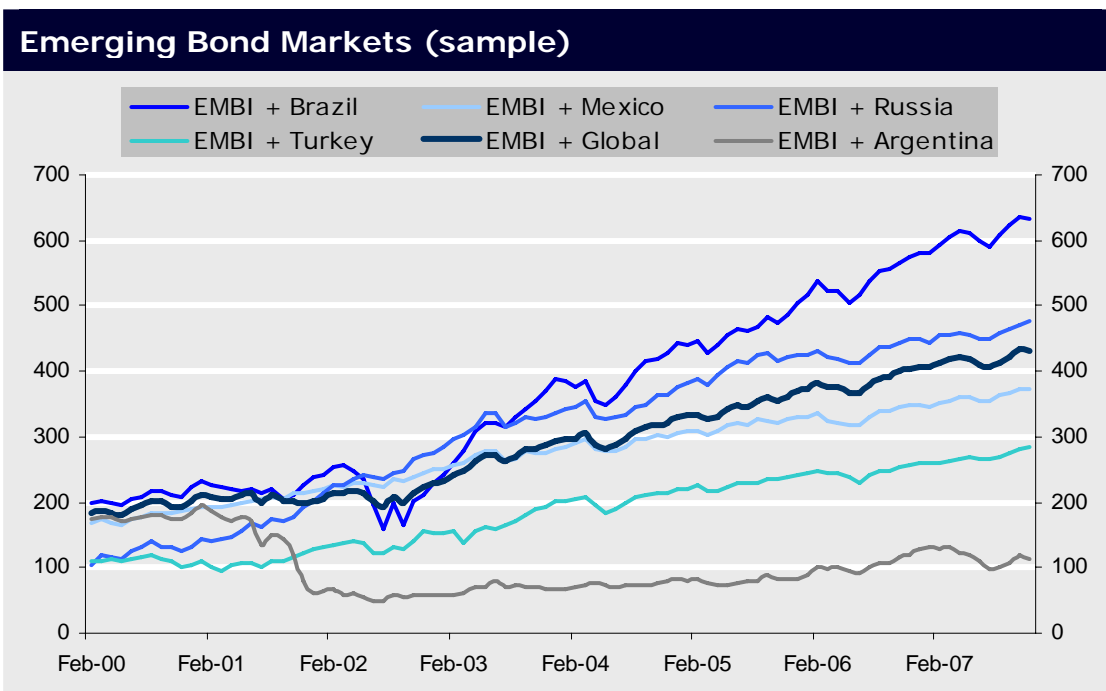
Source: Credit Europe Treasury Research, Bloomberg.

Our global equity index shows that despite all the difficulties of this year, global equities showed good performance.

The falls at the end of February, August, and November established the well-defined support level for this year's clear upside trend.

We assume that the story about growing emerging equity markets will continue. They are underperformed.

Large subprime losses and liquidity crisis pushed investors to sell assets in overseas markets especially EMs



Source: Credit Europe Treasury Research, JPMorgan, Bloomberg.

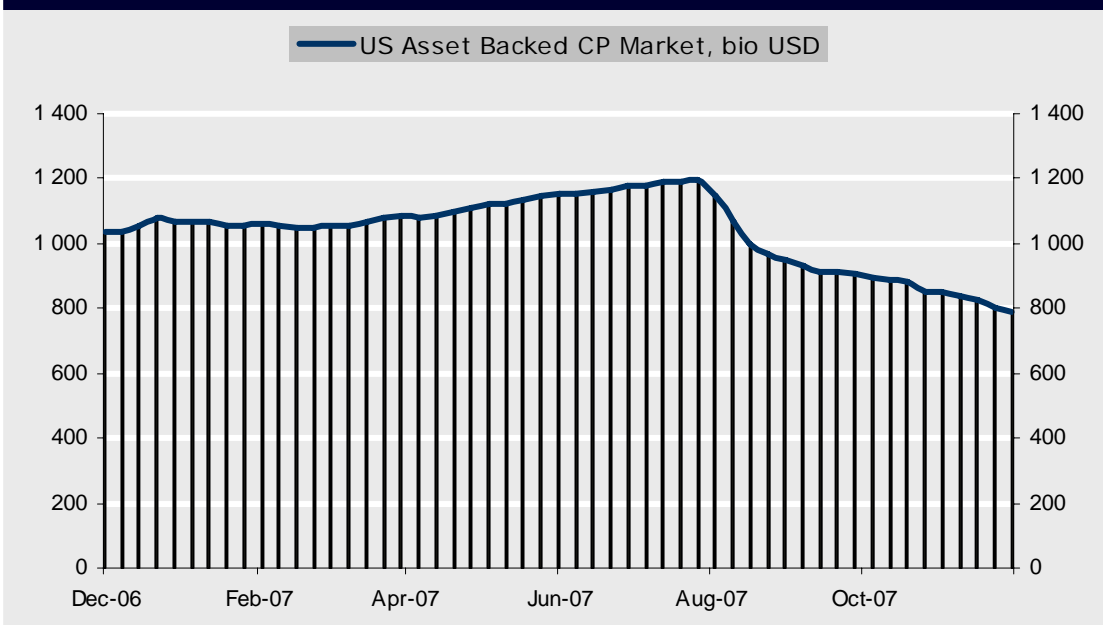
The decline on the US subprime mortgage market continues to send shockwaves to European and Emerging markets. Foreign markets frightened domestic bond markets of emerging countries.

Fluctuations in risk appetite will continue to drive all asset prices over the coming months. The fact is that spreads between emerging markets and the US bench increased considerably. The EMBI+ basket of emerging bonds is now trading at much higher premium to UST10.

This was mainly driven by a combination of rising yields in emerging markets and falling US yields which is the impact of risk aversion, where the riskiest countries are hit the hardest prompted a general sell-off.

The sharp decline of the refinancing supply led to liquidity troubles in the US

Asset Backed Securities



Source: Credit Europe Treasury Research, Bloomberg.

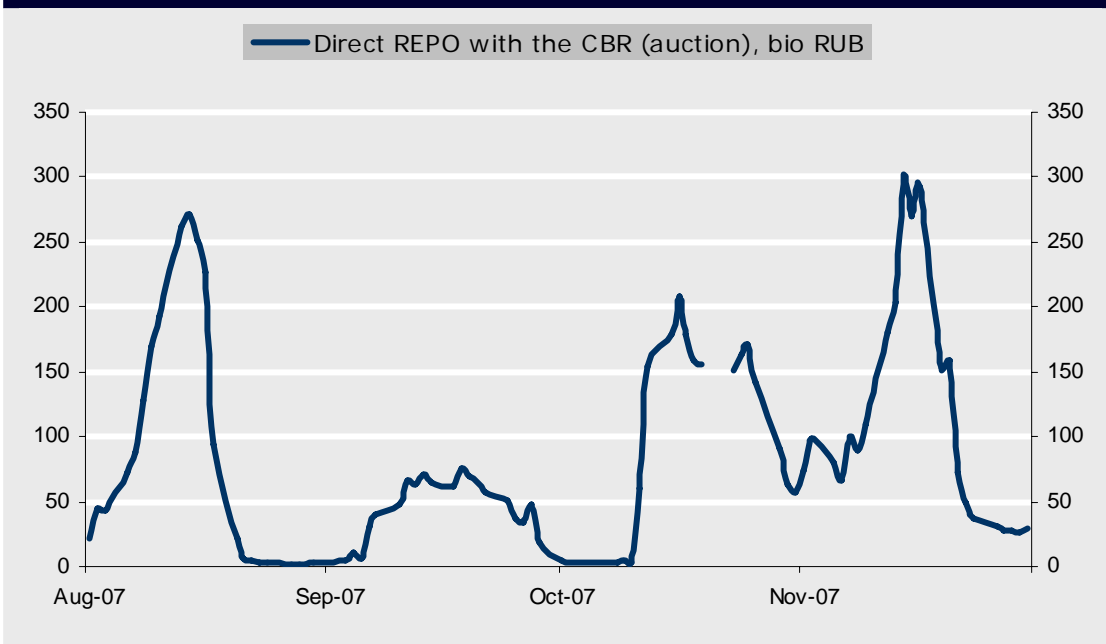
The US Asset backed CP market is shrinking due to strains on the money market which makes central banks increase liquidity injections the same as it makes large banks inject liquidity to their SIVs.

It is clear from the chart on the left that the decline started in mid-August and is still continuing.

We assume that this trend will, most probably, continue in the first quarter of 2008 at least.

The liquidity crisis spilled over the world and hit heavily EMs
 Some EMs just sat over difficult times,
 some EMs learned the lesson and strengthened

Russian Banking Liquidity



Source: Credit Europe Treasury Research, Bloomberg, CB RF.

* CBR = The Central Bank of Russia

Russia is a good example here. In mid-August overnight rates on the Russian domestic money market grew up to 13% against ~2.5-3.0% before the crisis. This pushed banks to intensify borrowing from the CBR through REPO instruments, and actively use currency swaps.

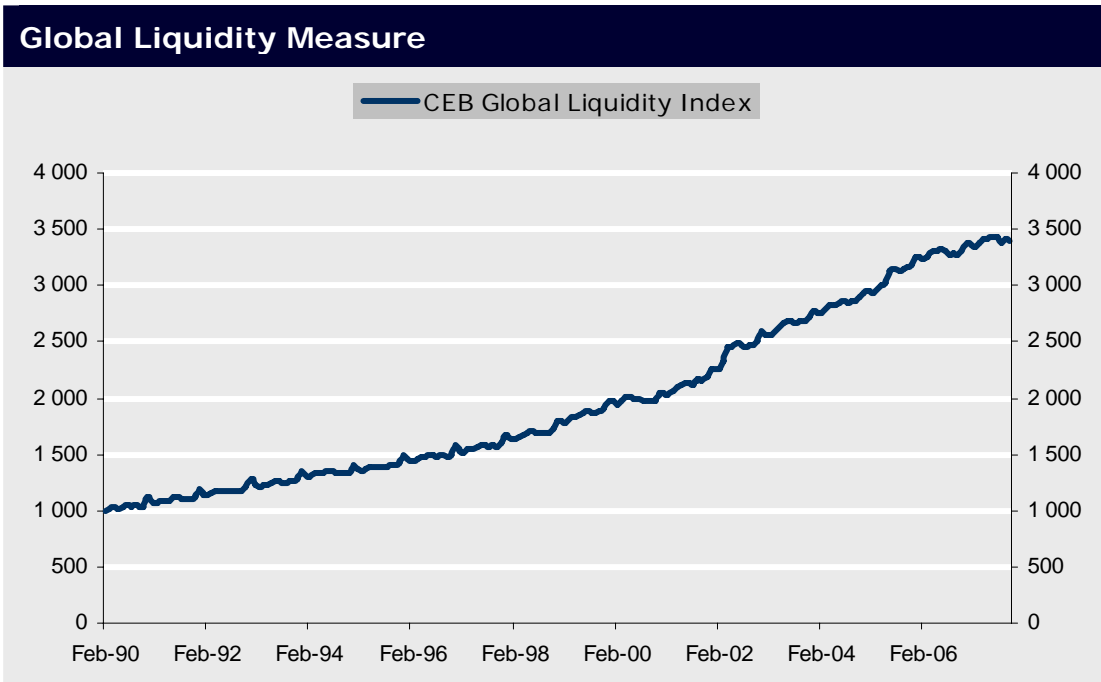
But the Russian banking system passed the crisis, learned the lesson and strengthened.

The Central Bank of Russia took some measures to support the liquidity: it decreased mandatory reserve requirements for credit organizations, extended the number of assets accepted as collateral for REPO with the CBR, decreased the interest rate for ruble swaps with the CBR to 8%, introduced new refinancing instruments.

In the period of a spike in REPO volume up to RUB300bio at the end of November, money market overnight rates did not exceed 8.5% (we did put exactly same target at the beginning of September in our Russian Money Market Report) which showed that the Russian financial system quickly and effectively built up the stronghold against possible further liquidity troubles.

The crisis caused
reshuffles of investors'
global portfolios...

The growth of global liquidity decelerated since mid-August



Source: Credit Europe Treasury Research, Bloomberg.

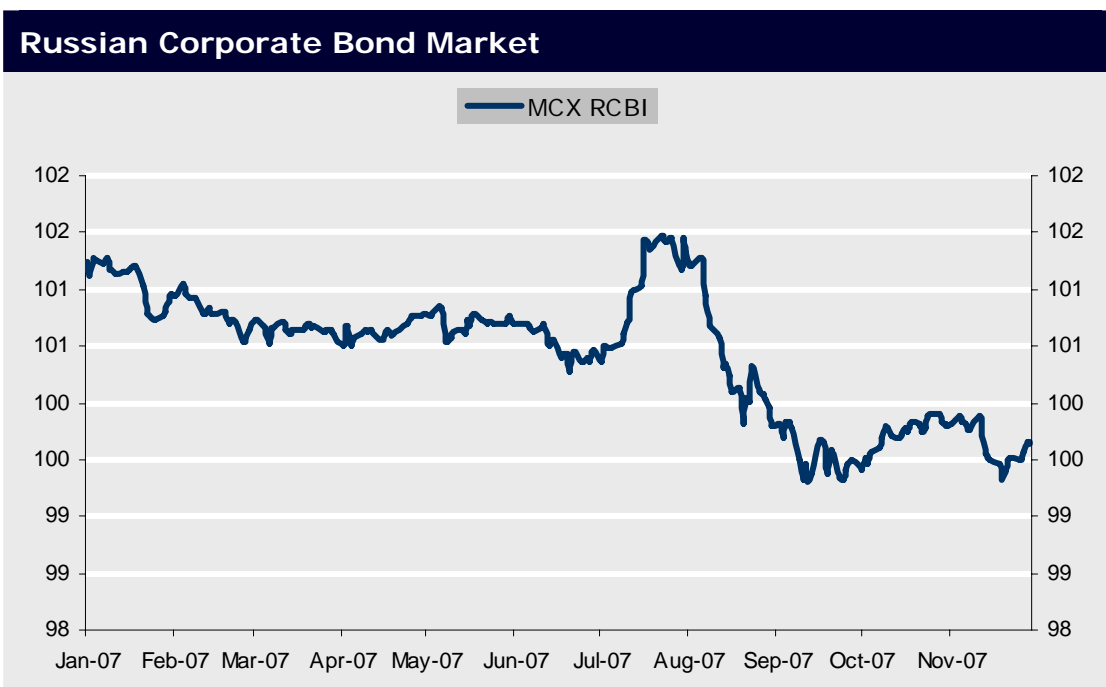
Global liquidity has clearly accelerated since 2000.

But...

We calculated our own Global Liquidity Index according to which it became clear that the growth of global liquidity decelerated considerably since mid-August and even slightly declined.

Liquidity is the driver in risk perception right now – the influence of commodities and credit declined.

Liquidity became much more important for global investors



Source: Credit Europe Treasury Research, MICEX, Bloomberg.

Let us look at the example with Russia in this extent.

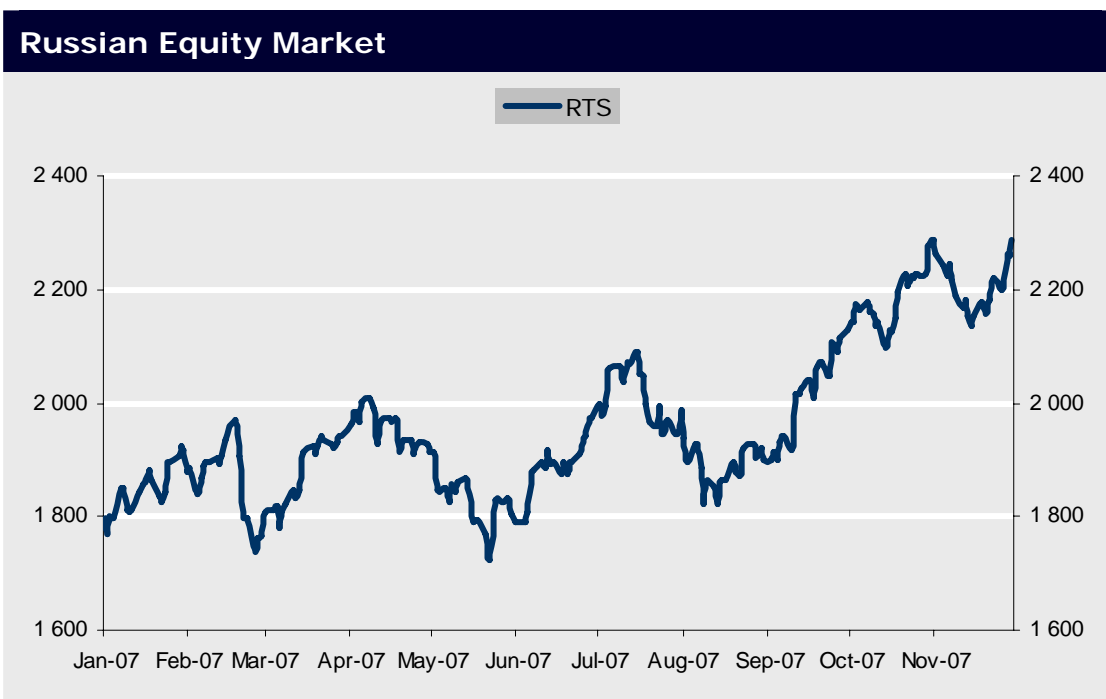
Aggressive sell-offs of Russian bonds took place in mid-August. The Russian bond market was hit. In some cases bids just disappeared – many did not want to forecast how deep the fall of the market would be.

The market felt some easing since then and showed some upward move but it is far not a rebound yet and it will take time to restore the confidence. Anyway investors continue to execute bond options and prefer not to wait till maturities which puts pressure on bond issuers.

The EMBI Global debt spread has recently widened to the year's high. The threat for EM debts remains persistent because further US equity weakness could trigger a deeper correction in EM equity and debt markets.

Some EMs, such as Russia, proved to perform effective during the recent crisis. This links as to Russian equity market as to the Russian banking system which effectively fought the liquidity problem recently raised all over the world. Moreover large reserves will allow Russia to manage the USD/RUB currency exchange rate in "difficult times". However, some EM countries are under threat compared to Russia.

EM equity markets rebounded very fast compared to debt markets and hit new all-time highs



Source: Credit Europe Treasury Research, RTS, Bloomberg.

Lots of market players reshuffle their global portfolios. Selling pressure was everywhere on the Russian stock market due to the negative effect of the US credit crunch. Western investors continued to withdraw their investment from rather shaky Russian stocks. Many upward attempts were killed by sell-offs. However, Russian stock market rebounded very fast and posted new all-time highs.

From the fundamental prospective, Russia takes a good position to weather such global financial storms. The money supply is rising at a fast pace in Russia, providing one of the most supportive domestic liquidity environments in the world.

The economic growth of the country is proven to be very strong being driven by booming domestic and foreign investments. All these confirm that Russia is at the very beginning of a very-underestimated investment boom.

High crude prices still support the Russian market and "Russian oil stocks". But important is that Russian indices have already reached levels, which were predicted for the end of this year. This could generate locking profits despite the support from commodity prices. We believe that the Russian stock market will advance in the long-run.

The possible shift of investment allocation to EMs and local markets

There is the probability of the shift of the investment allocation of some countries from foreign markets esp. US markets to local markets. Reasons for the shift are somewhat simple. We project that interest rates of US, EU and UK will fall, which together with higher inflation which eats returns could push investors search for something which at least gives profits.

If favorable terms on domestic markets appear (such as pick up in corporate activity, M&A, hikes in dividend payout ratios), it could return a portion of capital flows from overseas and allocate it in domestic markets.

Interesting is that here both developed and EM countries could be triggered.

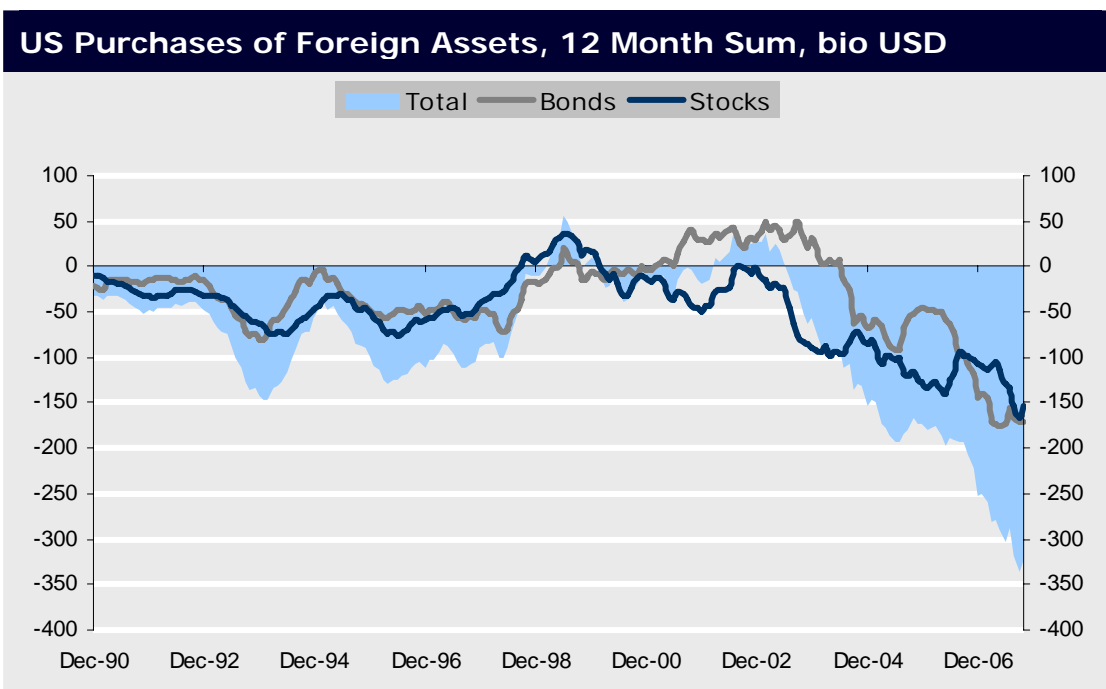
Developed economies, for example Japan, having excessive reserves, could shift a larger investment portion to EMs or local equities.

EMs quite the opposite could strengthen local currencies to make necessary for the fast development imports cheaper (for countries which mostly put a bet not on crude exports), which will make assets denominated in local currencies attractive.

Such a shift could boost the relative performance of local markets relative to their global peers.

Negative consequences of
portfolio assets
re-allocation for the US...

The risk of a massive outflow of foreign capital from the US



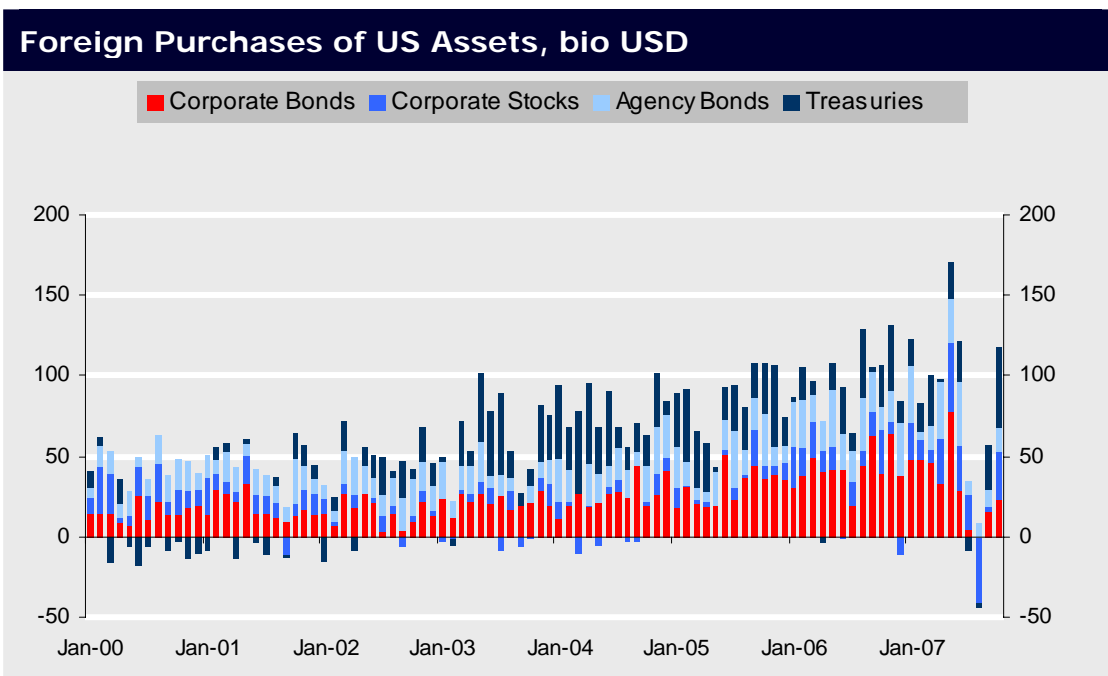
Source: Credit Europe Treasury Research, US TIC, Bloomberg.

Investors are strongly diversifying out of the US. The question is whether central banks will follow?

US foreign liabilities are very high and there is an increasing risk that foreign investors may reduce their purchases of US assets.

Foreign investment in the US is heavily bond biased. Attractiveness of such investments declines as soon as high inflation can eat all the return on investment into lower-yield bonds.

There appeared doubts that the US current account deficit can still be financed via long-term portfolio flows



Source: Credit Europe Treasury Research, US TIC, Bloomberg.

The demand for US assets could trend lower with weaker USD, continuing credit crisis, rising inflation and growing uncertainty. Recently the share of corporate bonds in the net capital outflow grew, the share of stocks is also high. All these raise doubts that the US Current account deficit can still be financed via long-term portfolio flows.

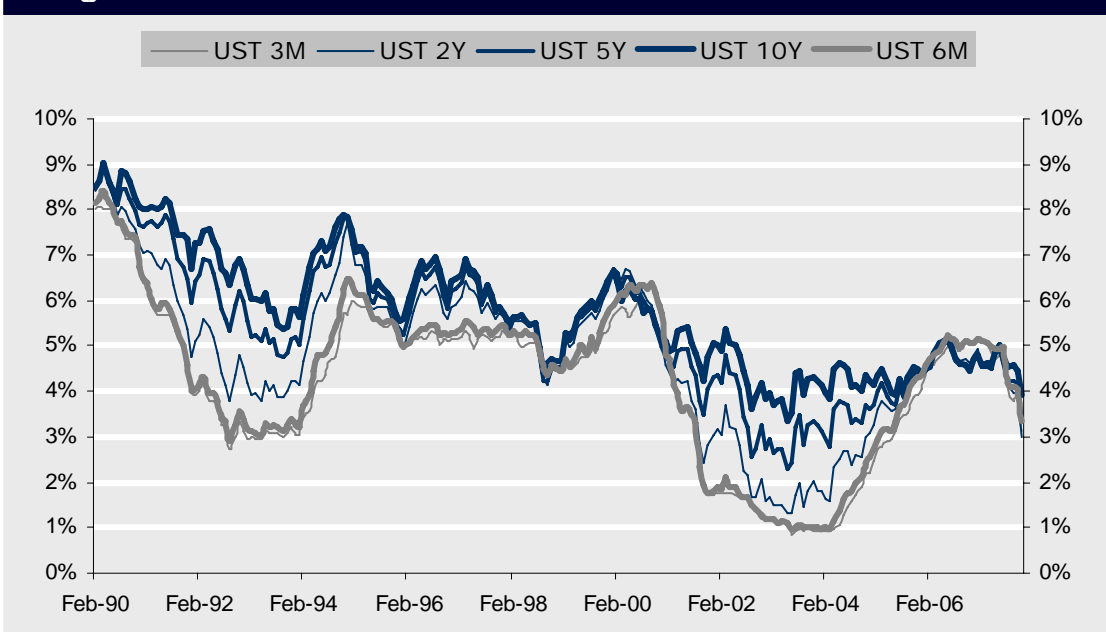
Thus the US faces the risk of massive disorderly sell-off of its assets with the corresponding fall of USD.

August's TICs showed the record selling of US securities, which indicated about falling appetite for USD-denominated assets.

The composition of the report showed that foreigners actively sold US papers and US-residents accelerated buying of foreign papers which resulted in such high negative capital outflow.

US Treasuries still stay the safe haven for many investors but the demand for USTs decreases

Long and short US Treasuries



Source: Credit Europe Treasury Research, Bloomberg.

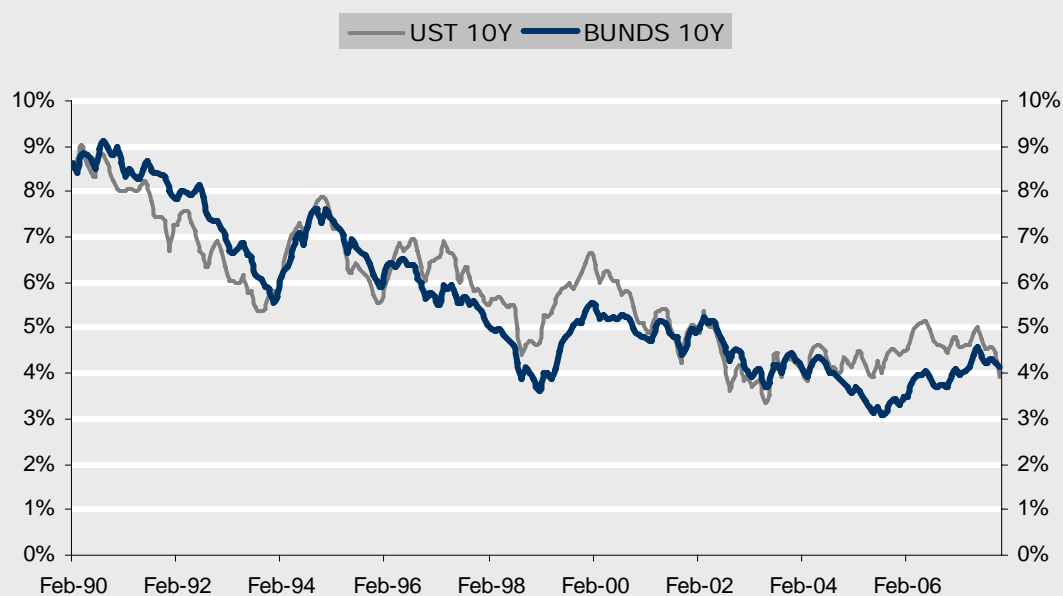
What we actually see right now is how bond markets are increasingly pricing in a recession scenario as the most likely outcome.

Nevertheless investors continue to keep holdings in US Treasuries because of their worries about the risks of holding other debt or equity pushes them to accept limited losses in UST against possible much worse outcomes in holding of other assets.

Buyers of USTs pushed the yield of UST10 below 4% and the yield of UST2 below 3% recently. Now the buying pressure decelerated and yields rose slightly above mentioned above yield-levels.

US Treasuries market is pricing all the US housing problems and uncertainties in a very hard manner

German Government Debt versus UST



Source: Credit Europe Treasury Research, Bloomberg.

The US treasuries market is pricing all US housing problems and uncertainties in a very hard manner while ignoring upside risks to inflation.

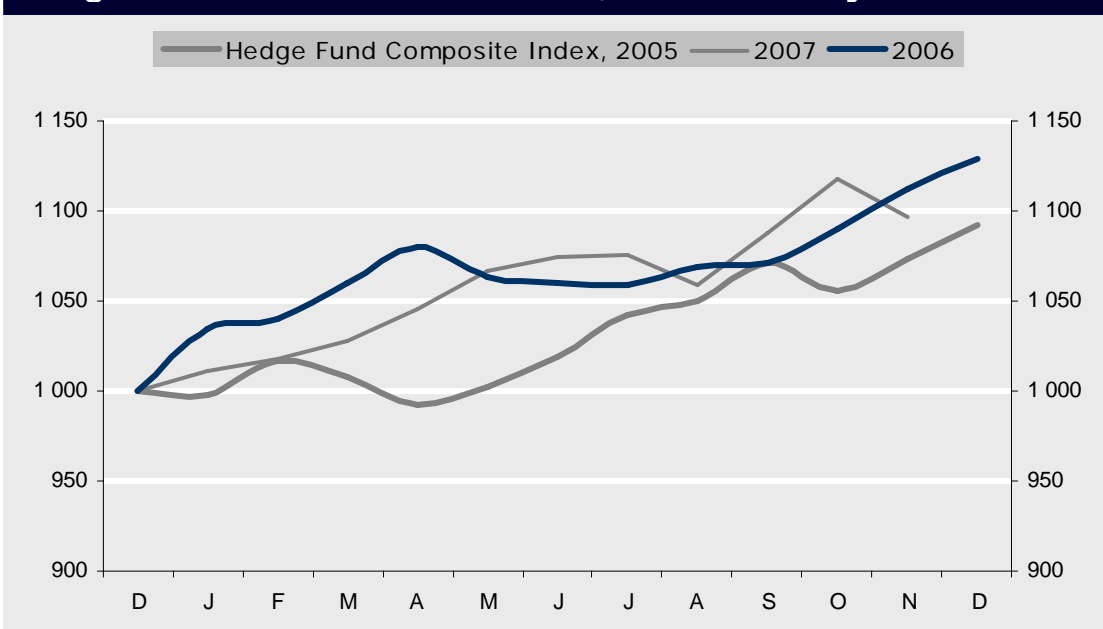
In case the US economy withholds all the difficulties, we could see an upside move in US treasuries' yields.

The yield of BUNDS 10Y also trends lower following the US bench.

Hedge Funds passed difficulties and showed relatively good performance in 2007...

US hedge funds showed relatively good performance in 2007 compared to 2006

Hedge Funds Relative Performance, Jan 1 of each year = 1000



Source: Credit Europe Treasury Research, Bloomberg.

Recently a lot of talks were circulating about whether hedge funds will survive after difficulties connected with the mortgage crisis in the US. The US mortgage crisis had the impact on hedge funds, this comes true, which is obvious.

When the crisis in the US started, many wrote and said that the mortgage crisis could lead to the crisis in the entire hedge fund industry.

Investors worried and it was expected that there would be a mass outflow of money from hedge funds. Many largest investment houses reported about losses which came from mostly mortgage-related sectors.

Investments are risky from their nature – so sometimes investors have to take losses. BUT... Let us look deeper at some statistics (see next page).

Some hedge funds received profits being short in mortgage-related investments

The fact is that there was no mass outflow of money from hedge funds. Moreover in September-October many funds reported positive return.

Hedge funds industry continues to develop despite recent falls. Hedge funds indices started to go down in July and the downward culmination took place in August when funds showed 1.5-2.5% losses. However, already in September losses were covered by profits, which in many funds exceeded 3%. Funds whose strategy was primarily devoted to equity hedging showed return closer to 4%.

From January to November 2007 hedge fund indices grew by ~9.7% and they have one more month to improve this figure. We do not observe the considerable growth deceleration, quite the opposite, in 2006 totally hedge fund indices showed the growth of ~12.9%.

In August 2007 hedge funds started selling most liquid assets due to the credit crisis. Also hedge funds decreased the amount of borrowed money in their portfolios in the second half of August. As it was expected, after confidence was somewhat little restored on the market and many reported about losses, hedge fund managers started to open new positions.

Moreover some funds received profits being short in mortgage-related investments.

Hedge funds' investment activity could intensify on emerging markets

When the US crisis hit in mid-August, hedge funds were selling EM securities to minimize risks. However, everybody remembers that sell-offs were temporary and soon EM equity indices, in particular, topped new life-time highs. So risk appetite returned quite quickly.

This, furthermore, shows that the correlation of emerging markets to US troubles decreases. This, intern, makes more probable that the hedge funds' investment activity could intensify on EMs. Russia, Asia and South America look then very prospective.

We assume also that this shake-up of financial markets allowed countries' governors, central banks, and hedge funds' managers think heavily about risks and allowed them to optimize investment strategies which will help them further weather such storms easier.

For sure there were those
who faced large losses ...

Major investment houses faced large losses due to the crisis

Losses of major investment players

| Name | Losses in 2007, bio USD |
|------------------------|-------------------------|
| UBS | 13.5 |
| Citigroup | 11 |
| Morgan Stanley | 9.4 |
| Merrill Lynch | 8 |
| HSBC | 3.4 |
| Bear Stearns | 3.2 |
| Deutsche Bank | 3.2 |
| Bank of America | 3 |
| Barclays | 2.6 |
| Royal Bank of Scotland | 2.6 |
| BNP Paribas | 2.1 |
| Freddie Mac | 2 |
| Credit Suisse | 1 |
| Wachovia | 1 |
| IKB | 1.1 |

Source: Companies' reports, BBC, Credit Europe Treasury Research, Bloomberg.

Large Asian funds and financial institutions use difficult for many time to buy into US investment leaders – the trend which the US governors do not like much. For example, China Investment Corp acquired 9.9% stake in Morgan Stanley. The Chief Director of Morgan Stanley John Mak refused to get bonus for 2007 because of the bank's losses.

Some of top-managers left leading investment houses on their own will or were fired. For example, the head of Merrill Lynch Sten O'Neil, and the head of Citigroup Charles Prince left their positions.

By moment total declared losses from subprime-related sectors amounted to ~\$70bio.

We assume that total losses could reach ~\$300bio.

The shortage of refinancing on global financial markets is not over. That's clear.

Reporting about subprime related losses will continue

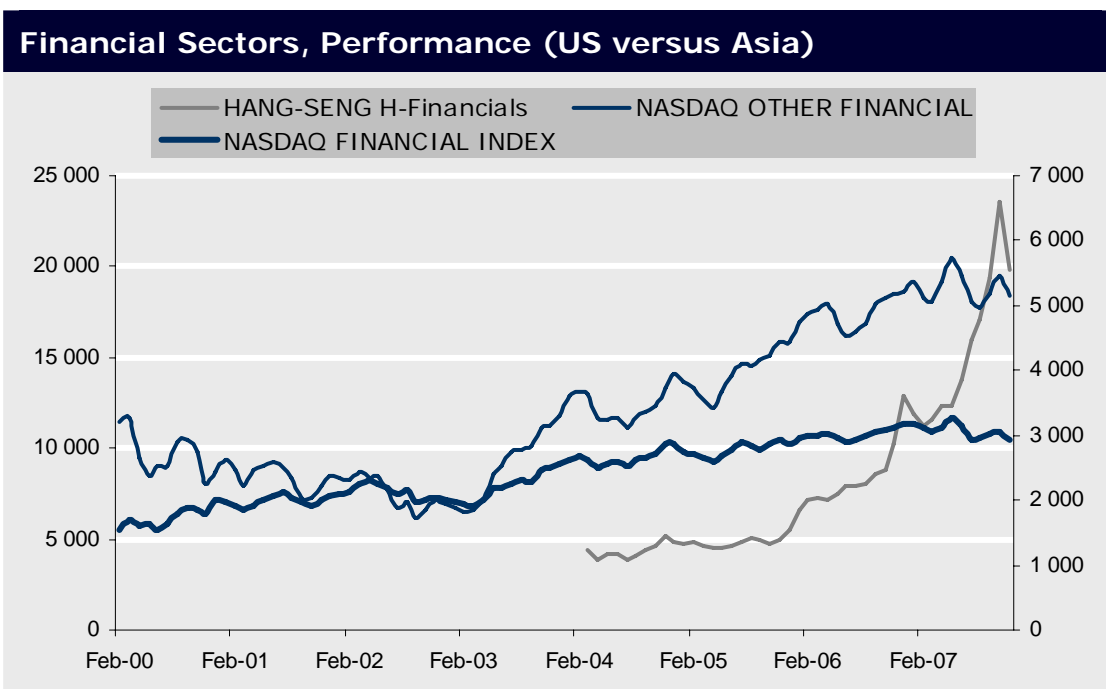
Recently UBS announced that it intended to write down additional CHF10bio on subprime holdings which again reminded that financial markets did not normalize yet.

Anyway, we assume that really few banks are likely to report considerable losses in the 2007 financial year despite huge mortgage-related losses being currently reported which will limit the extent of a balance sheet stress.

Recently some equity and debt instruments approached local lows once more but this time without a panic which we observed in the summer.

Some investment houses accepted losses performed managing clients' assets as their own losses and strengthened their reputation.

Trends of banking sectors are clearly down after the credit crisis started



Source: Credit Europe Treasury Research, Bloomberg.

Whether the financial services sector will start recovering in the mid-run or in the long-run is the question. A lot should be done for this. There should be structural changes to ease the credit bubble. All these will take time and we do not expect the fast recovery.

The deceleration of the US banking development is clear and it is showing that credit conditions become tighter. It is expected that borrowers will grow up with more intelligent approach to whether they can afford the stuff they are going to borrow now and pay for it during many years and not just take "the American dream" from the bank at any rates offered just because all used to do this.

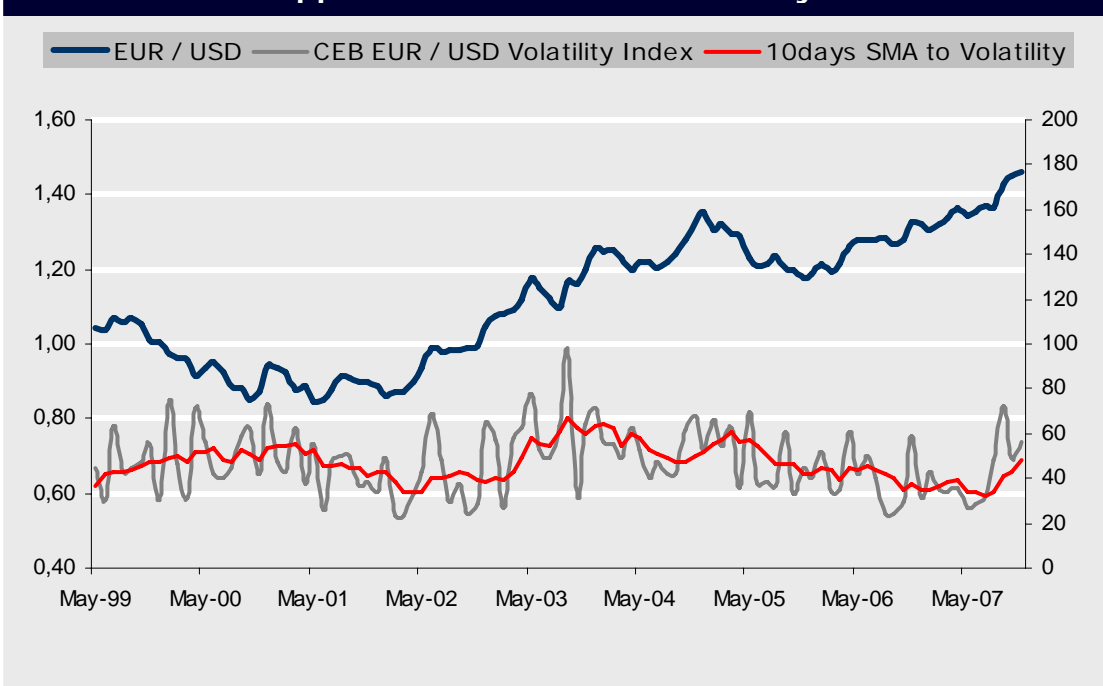
That would be great if the US put somewhat control over its subprime mortgage rates and their links to other rates for some period of time till the process improves.

Despite the recent sharp downward correction in EUR/USD, USD stays fundamentally weak...

We are still bearish on the greenback

We are still bearish on the greenback

EUR / USD and applied CEB EUR / USD Volatility Index



Source: Credit Europe Treasury Research, Bloomberg.

Markets remain very nervous which is confirmed by the volatility on the global currency market as well.

Last week USD strengthened versus major currencies. The spike-up of USD Index is the best confirmation for this. EUR/USD fell closer to 1.43 last week.

Anyway the situation somewhat changed. The fall of EUR/USD became weighting enough to assume that this year could get limited on the upside by the level of 1.48.

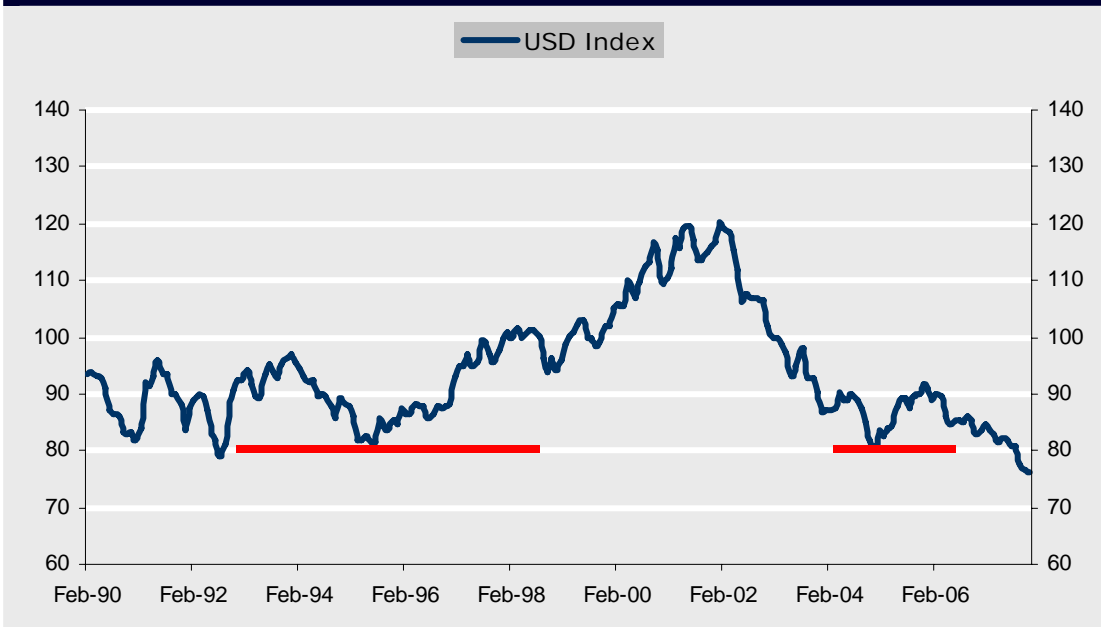
Still there is a scope for USD recovery if the troubles triggered by US credit crunch spill over to major economies. So the reversal in EUR/USD is possible.

However, the market is still long the EUR. The year-end is closer and closer and many close their Euro-longs to book year-end. Thus it could be more difficult for EUR/USD to go to new highs this year. Next year the situation will change.

We continue to assume that fundamentally the US is still weak and some positive things such as higher retail sales at the end of this year will hardly change our view. USD bearish outlook remains well established. We assume that EUR/USD will reach at least 1.50 by mid-2008.

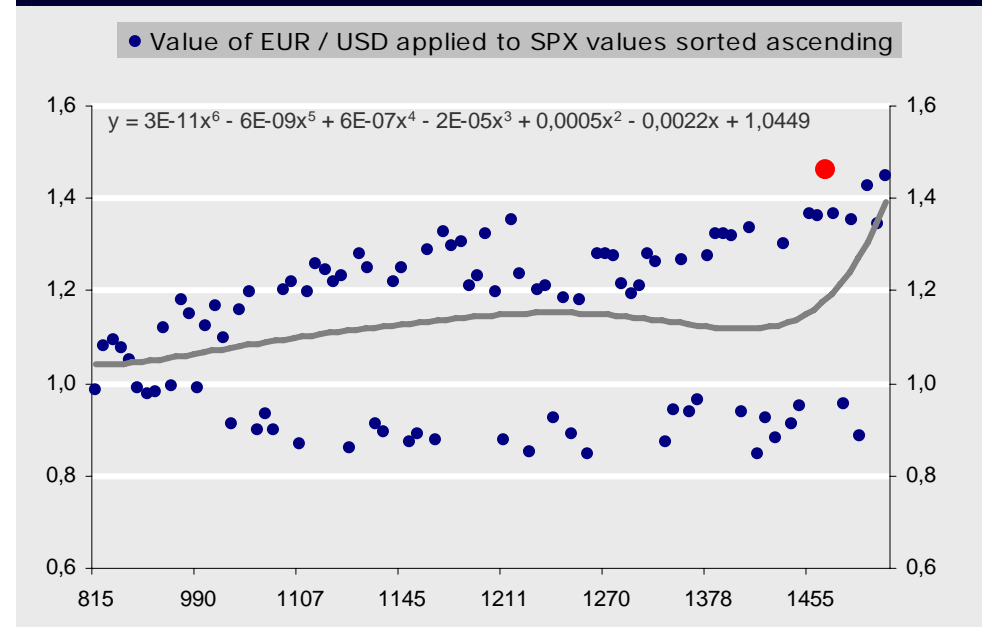
The US dollar will continue to be offered

USD versus major currencies, Deep Snap



Source: Credit Europe Treasury Research, Bloomberg.

Correlation of EUR / USD (X) and S&P500 (Y)



- * Monthly values are taken from 2000-2007
- * Grey line – the polynomial trend
- * Red dot – the value of EUR / USD at 30.11.2007

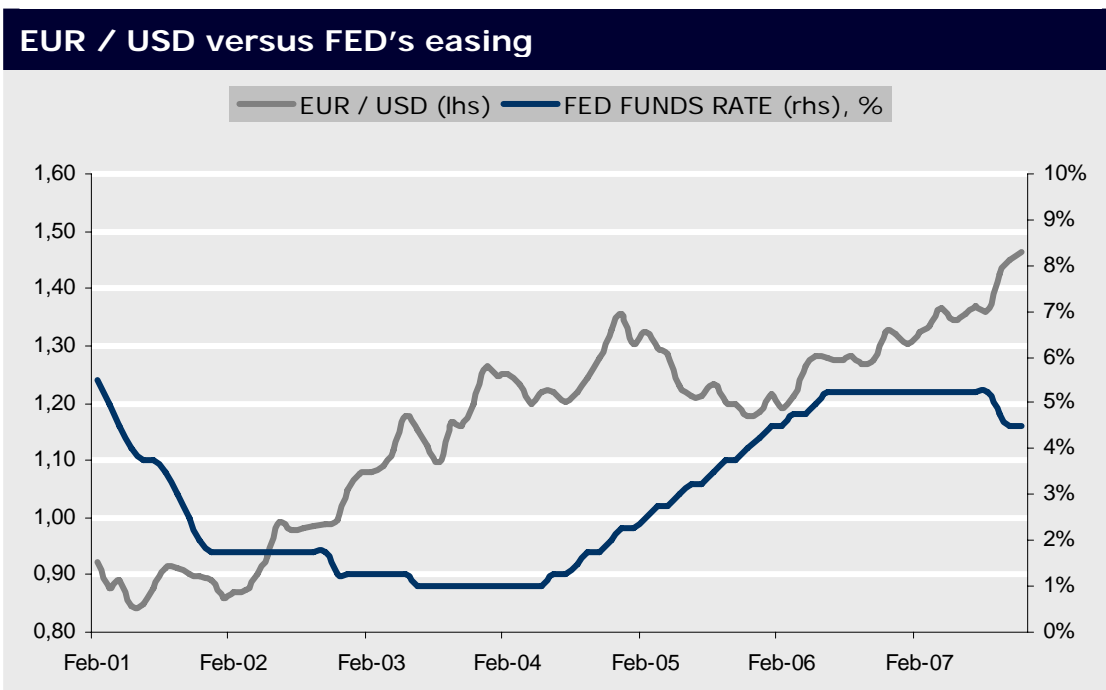
The USD Index broke down deeper than lows of 1993 indicating continuing USD weakening against major currencies. The correlation of EUR/USD and S&P500 Index shows that EUR/USD stays far above the distribution of values of S&P500 Index which were common for such values of EUR/USD historically.

Which is better for the US – strong or weak USD?

From one hand, weak USD is a good thing for the US because it leads to the shrinking of the US international trade deficit. From the other hand, weak USD brings damages to the US, because USD started to lose its status of the reserve currency as from the point of view of the global population, as well as from those countries which keep reserves in USD. The latter is much more dangerous.

Having a huge trade deficit with China, the US is much more concerned about weak Yuan than expensive Euro. Furthermore, the US government is much more of a concern about slowing economic growth than about inflation.

By not mentioning the depreciating USD, the G7 flagged its approval of the orderly USD depreciation, which argues in favor of more USD losses in the months to come.

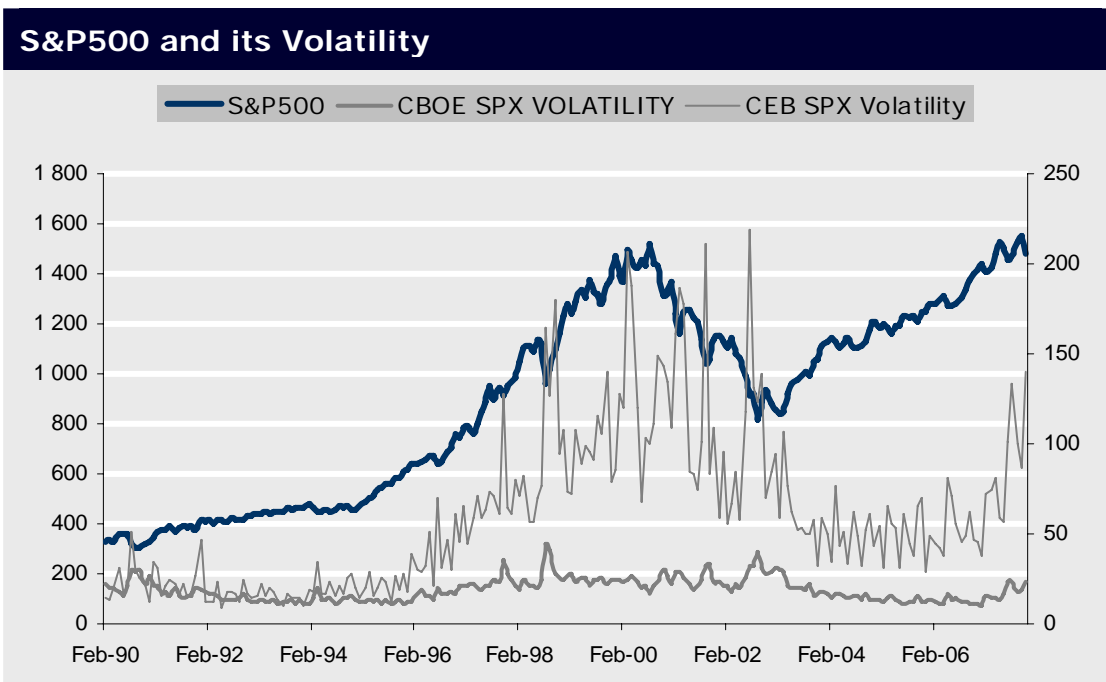


Source: Credit Europe Treasury Research, Bloomberg.

The fall of USD was fueled by G7. In mid-October **G7**, IMF and World Bank meetings were held which gave a “green light” to the selling of USD. Despite many talks about dangers of weakening USD for the global economy, G7 said that there is “nothing dramatic” in the current EUR/USD high rate. At the same time “big boys” worried about China’s policy of not weakening Yuan. As a result EUR/USD started to rise fast.

G7 finance ministers and central bankers blamed China for not allowing the CNY to appreciate faster. However, it remains questionable whether this will have any impact on the China's FX policy. We assume that China will continue to intervene heavily in the FX market to limit the CNY appreciation against the USD. China's FX reserves will, most probably, rise further (\$1.434trio as of the end of September 2007).

US Equity volatility also rose considerably in 2007



Source: Credit Europe Treasury Research, Bloomberg.

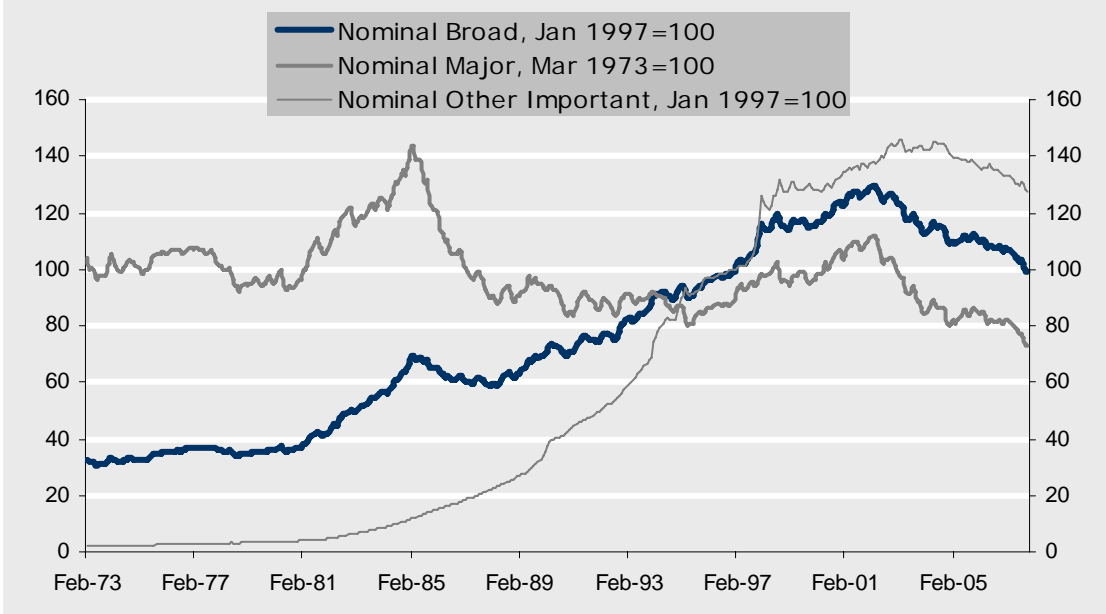
Equity volatility rose considerably since the middle of this year compared to the beginning of the year. And if the credit crisis and liquidity crisis persist, volatility will most probably remain elevated or even get higher.

We assume that high volatility will keep active since, given all happened in the second half of this year, the overall investment sentiment will hardly improve soon.

US earnings estimates for 2008 declined. An interesting fact occurred this year – US equities did not fall sharply since the financial crisis started. We could make an assumption that the US equities could be vulnerable now and could probably price the full extent of the US slowdown in 2008.

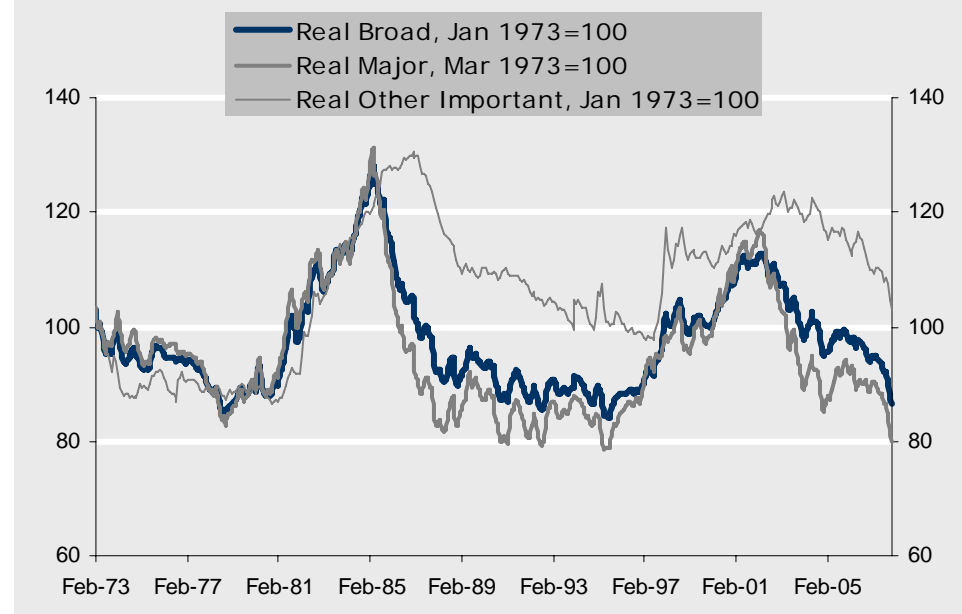
Actually USD did not fall that far according to US trade weighted USD indices

Nominal Trade Weighted USD Indices



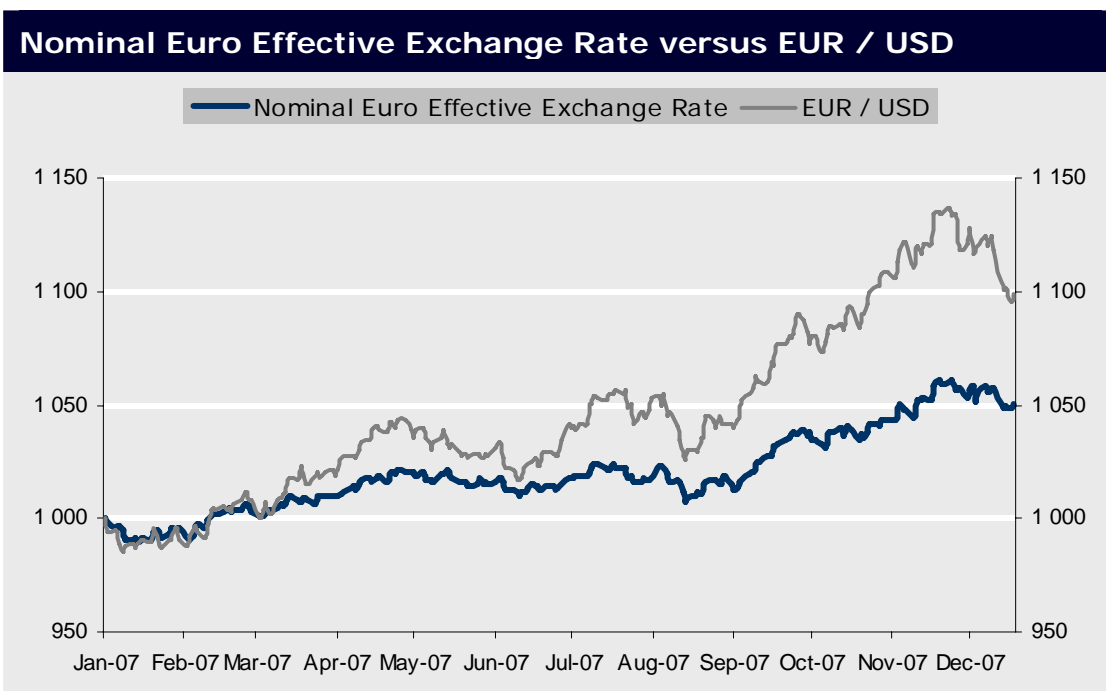
Source: Credit Europe Treasury Research, Bloomberg.

Real Trade Weighted USD Indices



The USD decline has been large but we assume still not enough to adjust to mid-term macroeconomic fundamentals. And real trade weighted USD indices confirm that the room for further USD decline exists.

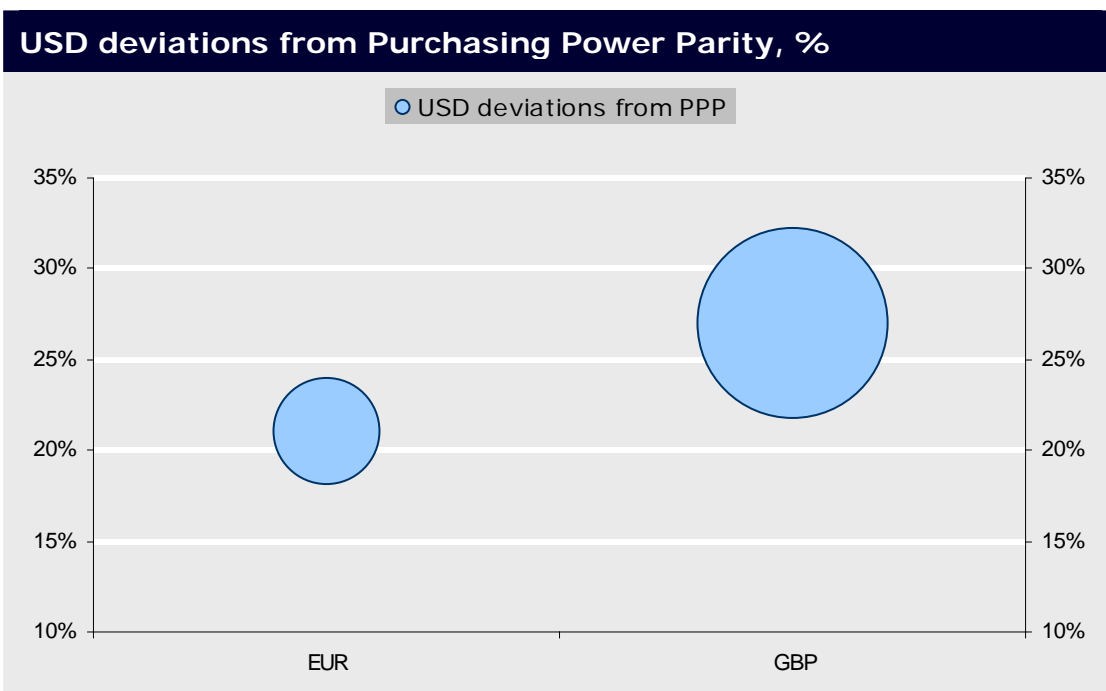
Trade weighted EUR also gives a “green light” for further USD weakness



Source: Credit Europe Treasury Research, ECB, Bloomberg.

Trade weighted EUR rose ~2 times less than EUR/USD over the passed year. Thus it comes clear that the ECB is not concerned about rising EUR which also opens the road for further USD weakness.

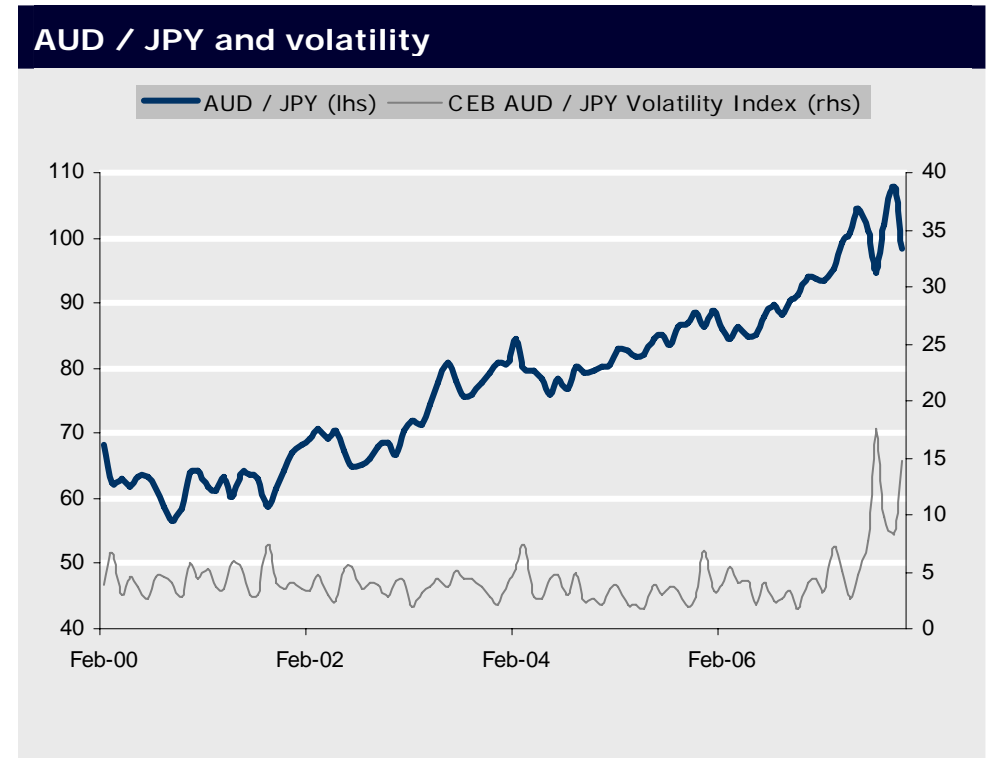
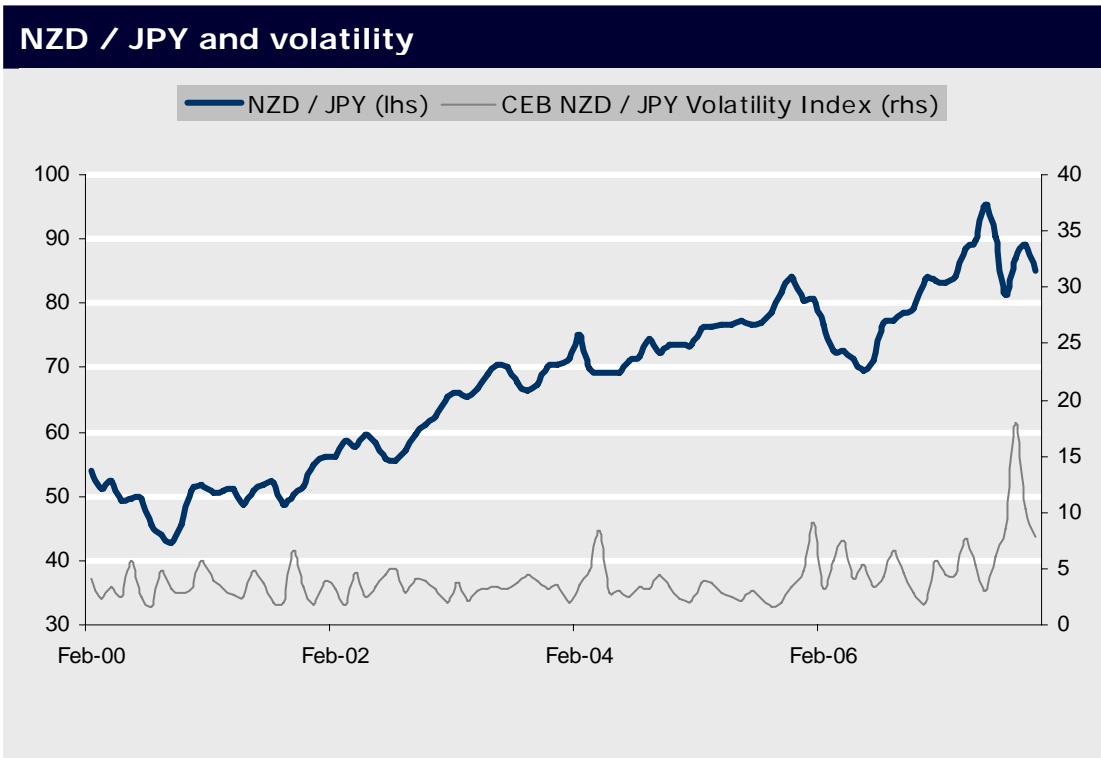
According to Purchasing Power Parity USD is clearly undervalued



Source: Credit Europe Treasury Research, Bloomberg.

If we look at price-related metrics, such as purchasing power parity estimates, then we will see that the USD is significantly undervalued against EUR and GBP. Thus according to this model, USD can meet the flow of overseas buying if foreign investors feel USD assets as cheap which could reverse the USD's weak stance.

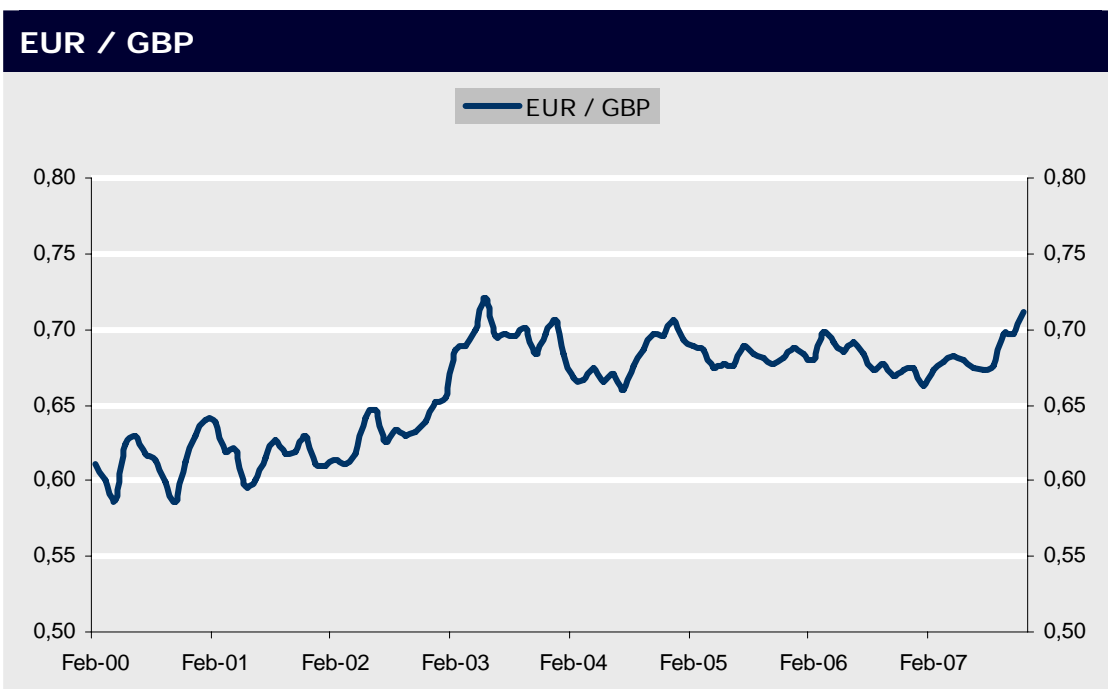
Carry Trade –volatility increased considerably



Source: Credit Europe Treasury Research, Bloomberg.

It becomes clear from charts about rising carry's volatility over the recent year.

EUR/GBP – fundamentally and technically looks upwards



Source: Credit Europe Treasury Research, Bloomberg.

GBP is at risk of losing its high yield status thus there is a firm upside risks for EUR/GBP.

Major indicators show that the UK economy will suffer a slowdown in 2008. The slowing growth will push BoE to cut rates by 50bp or even more which will weight heavily on GBP/USD and EUR/GBP.

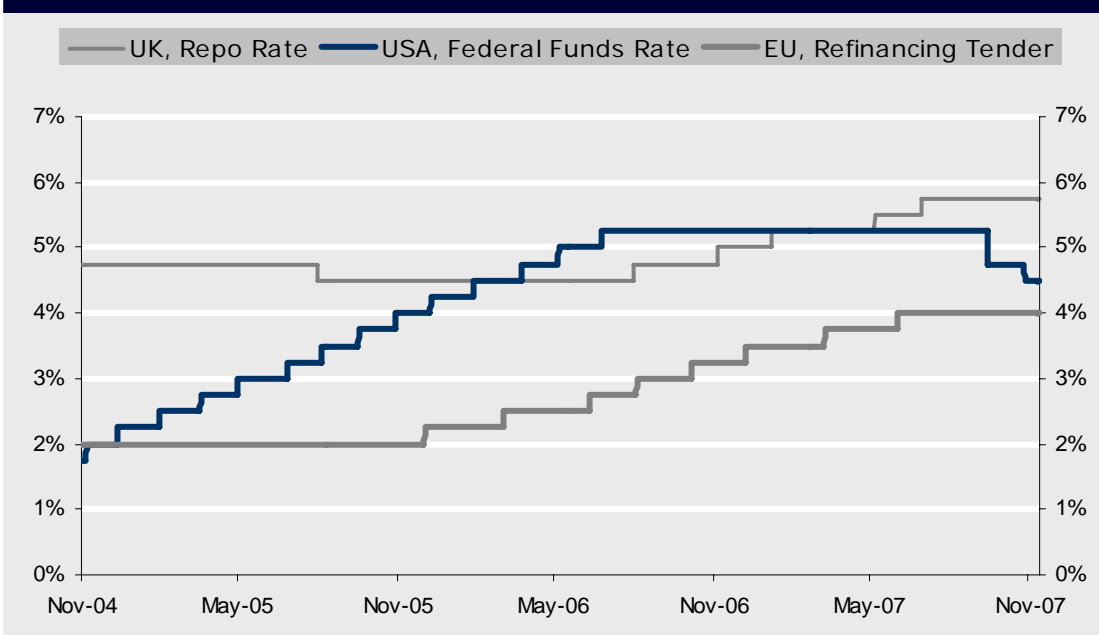
UK consumers look exposed to tighter credit conditions, which is dangerous taken into account the fact that liabilities of UK households as a percentage of annual disposable income are much higher than those in the US. So from the point of view of the negative impact on the economy, UK could compete with the US. But UK was not the originator of these troubles.

Moreover the slowing global environment will also weight. We expect a decline of UK consumption growth and UK GDP growth in 2008. We assume that an upswing of GBP/USD this year among other UK fundamentals and USD weakness was fueled by skyrocketed M&A activities in the country. Foreign companies were heavily acquiring UK stocks. But the evident fall in credit availability for leveraged buy-outs makes GBP not further supported.

Major Interest rates could trend lower...

Stagnating US Economy will push FED to cut rates further

Major Interest rates



Source: Credit Europe Treasury Research, Bloomberg.

Stagnating US economy will lead further at least 50bps of FED easing by the next mid-year providing further fundamental weight to the dollar depreciation risk.

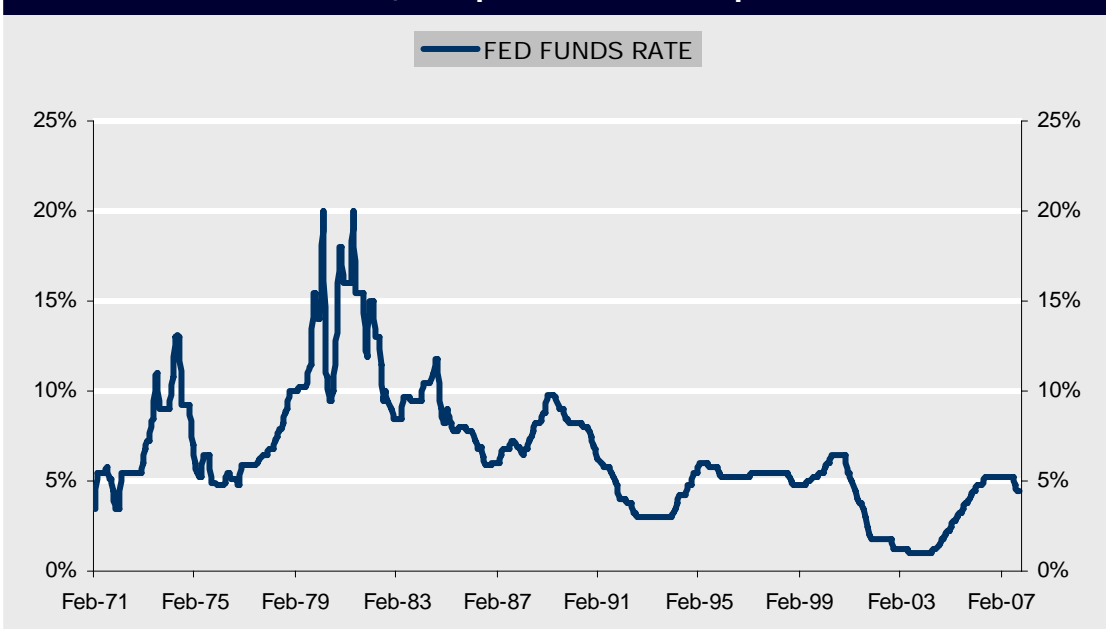
There is the higher probability that this could trigger other major central banks (such as ECB and BoE) to cut interest rates following the FED but in a more moderate scope.

Thus we assume that ECB can cut its main interest rate by 25bps till mid-2008. Overall we think that mid-2008 will be the pivot point for the US economy.

Despite expectations of many the US trade and current account deficit are now shrinking and we assume that this trend being supported by election-year background will continue throughout 2008.

We assume that the FED will continue to ease in the beginning of 2008

US Federal Funds Rate, Deep Historical Snap



Source: Credit Europe Treasury Research, Bloomberg.

The probability that the US comes into recession is still high and we assume this will force the FED to cut rates as soon as there is the evidence that weakening housing market hits the consumption and hardly inflation concern will prevent.

We assume that the FED will cut the rate by at least 50bps more by mid-2008.

Remember on December 11 the federal funds rate was decreased by 25bps from 4.5% to 4.25%. Markets continue to expect that the FED will cut the rate once more in the beginning of 2008. Fed funds implied probability shows that 47.1% of market participants expect another 25pbs cut at FOMC on January 30, 2008.

FED's DECISION on December 11

Fed's decision on interest rate at December's FOMC obviously dominated on markets weeks before the meeting and a size of the Fed's cut was the subject of intense discussions.

Still, the decision of the Fed was evident and met our forecast. The Fed eased to offset the tighter credit conditions triggered by the credit crunch. The cut was also aimed to prevent a dramatic fall-off in the growth of the US aggregated demand.

However, the Fed cut the discount rate by only 25bps to 4.75% against 50bps cut which the market anticipated.

The Fed's statement reflected concerns about the economic outlook. The Fed raised a concern about uncertainty. Take at least this phrase: "Developments in financial markets since the committee's last regular meeting have increased the uncertainty surrounding the economic growth and inflation."

It is important for the FED to put the US economy into the sustainable path in the next year.

The US economy continues to counter the consequences of the housing crunch. US Financial institutions continue to write down losses originated from sub prime loan sector or related to it segments.

Still the situation on money markets remains distorted.

Low interest rates clearly support financial markets. This helps the FED to reduce expenditures on servicing debts and reduces the impact of mortgage troubles. From the other hand such policy ignores the weakening of the USD and expectations of its further decline.

In general we could assume that the USD is becoming less attractive in general as a currency for reserves worldwide as it lost some portion of confidence after latest happenings on global markets.

Global economic growth
and world trade will
decelerate next year...

Cross-Country Comparison / Real GDP Growth and Inflation (annual averages, %)

| Country | REAL GDP GROWTH | | | Inflation (CPI) | | |
|-----------------------------|-----------------|-----------|-----------|-----------------|-----------|-----------|
| | 1990-1999 | 2000-2007 | 2003-2007 | 1990-1999 | 2000-2007 | 2003-2007 |
| Developing Economies | | | | | | |
| Argentina | 4.3 | 3.4 | 8.6 | 253.7 | 9.0 | 9.6 |
| Brazil | 1.7 | 3.3 | 3.6 | 854.8 | 7.3 | 7.2 |
| China | 10.0 | 9.9 | 10.6 | 7.8 | 1.7 | 2.6 |
| India | 5.7 | 7.0 | 8.5 | 9.6 | 4.5 | 4.8 |
| Indonesia | 4.3 | 5.1 | 5.4 | 14.4 | 8.7 | 8.6 |
| Korea | 6.3 | 5.1 | 4.4 | 5.7 | 3.0 | 2.9 |
| Malaysia | 7.2 | 5.4 | 5.9 | 3.7 | 2.0 | 2.2 |
| Mexico | 3.4 | 2.9 | 3.2 | 20.4 | 5.2 | 4.1 |
| Philippines | 2.8 | 5.0 | 5.6 | 9.7 | 5.0 | 5.3 |
| Russia | -3.8 | 6.8 | 6.9 | 222.2 | 14.2 | 11.0 |
| South Africa | 1.4 | 4.2 | 4.5 | 9.9 | 5.3 | 4.4 |
| Thailand | 5.3 | 4.9 | 5.4 | 5.0 | 2.5 | 3.1 |
| Turkey | 3.9 | 5.1 | 6.6 | 76.7 | 26.8 | 12.0 |
| Developed Economies | | | | | | |
| Australia | 3.3 | 3.3 | 3.3 | 2.5 | 3.2 | 2.7 |
| Canada | 2.4 | 2.9 | 2.7 | 2.2 | 2.3 | 2.2 |
| France | 1.9 | 2.0 | 1.8 | 1.9 | 1.9 | 2.0 |
| Germany | 2.3 | 1.4 | 1.4 | 2.4 | 1.7 | 1.7 |
| Italy | 1.4 | 1.3 | 1.0 | 4.1 | 2.4 | 2.3 |
| Japan | 1.5 | 1.7 | 2.0 | 1.2 | -0.3 | -0.1 |
| United Kingdom | 2.1 | 2.8 | 2.8 | 3.3 | 1.6 | 1.9 |
| United States | 3.1 | 2.5 | 2.8 | 3.0 | 2.8 | 2.9 |

Source: World Economic Outlook Database, IMF, Credit Europe Treasury Research, Bloomberg.

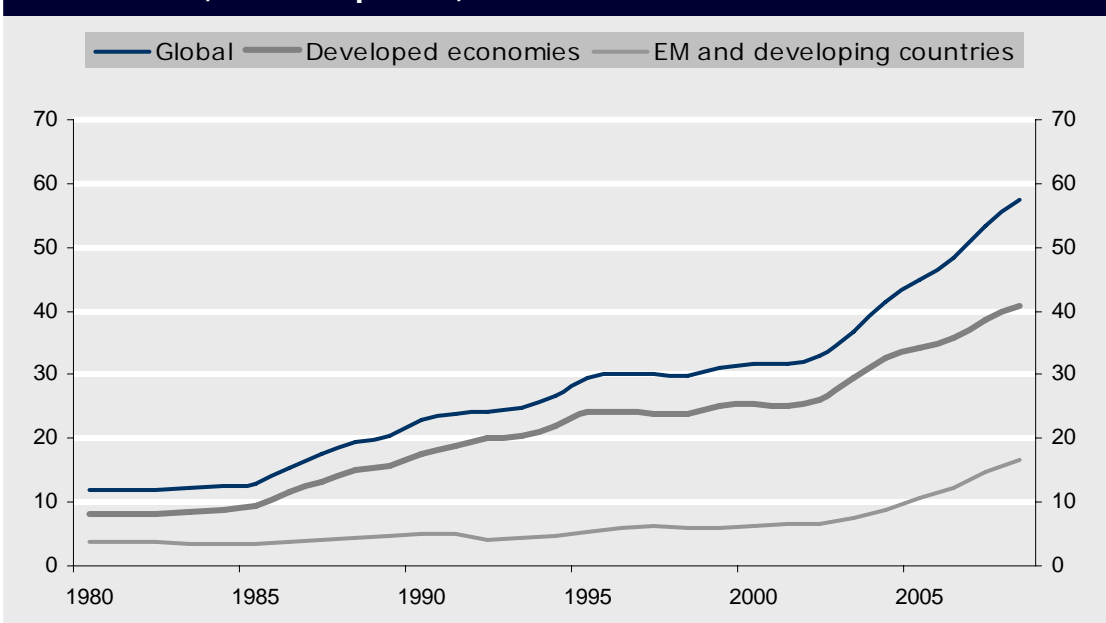
Cross-Country Comparison / Banking Indicators (Percentages)

| COUNTRY | REGULATORY CAPITAL TO RISK-WEIGHTED ASSETS (CRAR) | | NONPERFORMING LOANS TO TOTAL LOANS | | PROVISIONS TO NONPERFORMING LOANS | | RETURN ON ASSETS (ROA) | |
|-----------------------------|---|------|------------------------------------|------|-----------------------------------|-------|------------------------|------|
| | 2002 | 2006 | 2002 | 2006 | 2002 | 2006 | 2002 | 2006 |
| | | | | | | | | |
| Developing Economies | | | | | | | | |
| Argentina | - | - | 18.1 | 3.4 | 73.8 | 130.2 | -8.9 | 2.0 |
| Brazil | 16.6 | 18.9 | 4.5 | 4.1 | 155.9 | 152.8 | 2.1 | 2.5 |
| China | - | - | 26.0 | 7.5 | - | - | - | 0.9 |
| India | 12.0 | 12.4 | 10.4 | 3.5 | - | 58.9 | 0.8 | 0.9 |
| Indonesia | 20.1 | 21.3 | 24.0 | 13.1 | 130.0 | 99.7 | 1.4 | 2.6 |
| Korea | 11.2 | 12.8 | 2.4 | 0.8 | 89.6 | 175.2 | 0.6 | 1.1 |
| Malaysia | 13.2 | 13.5 | 15.9 | 8.5 | 38.1 | 50.7 | 1.3 | 1.3 |
| Mexico | 15.7 | 16.3 | 3.7 | 2.1 | 138.1 | 207.4 | 0.7 | 3.1 |
| Philippines | 16.9 | - | 26.5 | 18.6 | 30.1 | 37.4 | 0.8 | 1.3 |
| Russia | 19.1 | 14.9 | 5.6 | 2.6 | 112.5 | 159.3 | 2.6 | 3.2 |
| South Africa | 12.6 | 12.3 | 2.8 | 1.2 | 46.0 | - | 0.4 | 1.4 |
| Thailand | 13.0 | 13.8 | 15.7 | 7.5 | 62.9 | 79.4 | - | 2.3 |
| Turkey | 24.4 | 21.1 | 12.7 | 3.2 | 64.2 | 90.8 | 1.2 | 2.4 |
| Developed Economies | | | | | | | | |
| Australia | 9.6 | 10.4 | 0.4 | 0.2 | 106.2 | 204.5 | 1.4 | - |
| Canada | 12.4 | 12.5 | 1.6 | 0.4 | 41.1 | 55.3 | 0.4 | 1.0 |
| France | 11.5 | - | 4.2 | 3.2 | 58.4 | 58.7 | 0.5 | - |
| Germany | 12.7 | - | 5.0 | 4.0 | - | - | 0.1 | 0.5 |
| Italy | 11.2 | 10.7 | 6.5 | 5.3 | - | 46.0 | 0.5 | 0.8 |
| Japan | 9.4 | 13.1 | 7.4 | 2.5 | - | 30.3 | -0.7 | 0.4 |
| United Kingdom | 13.1 | 12.9 | 2.6 | 0.9 | 75.0 | - | 0.4 | 0.5 |
| United States | 13.0 | 13.0 | 1.4 | 0.8 | 123.7 | 137.2 | 1.3 | 1.3 |

Source: Global Financial Stability Report-2007-IMF, Credit Europe Treasury Research, Bloomberg.

The growth of global economy will decelerate in 2008

Global GDP, current prices, trilo USD



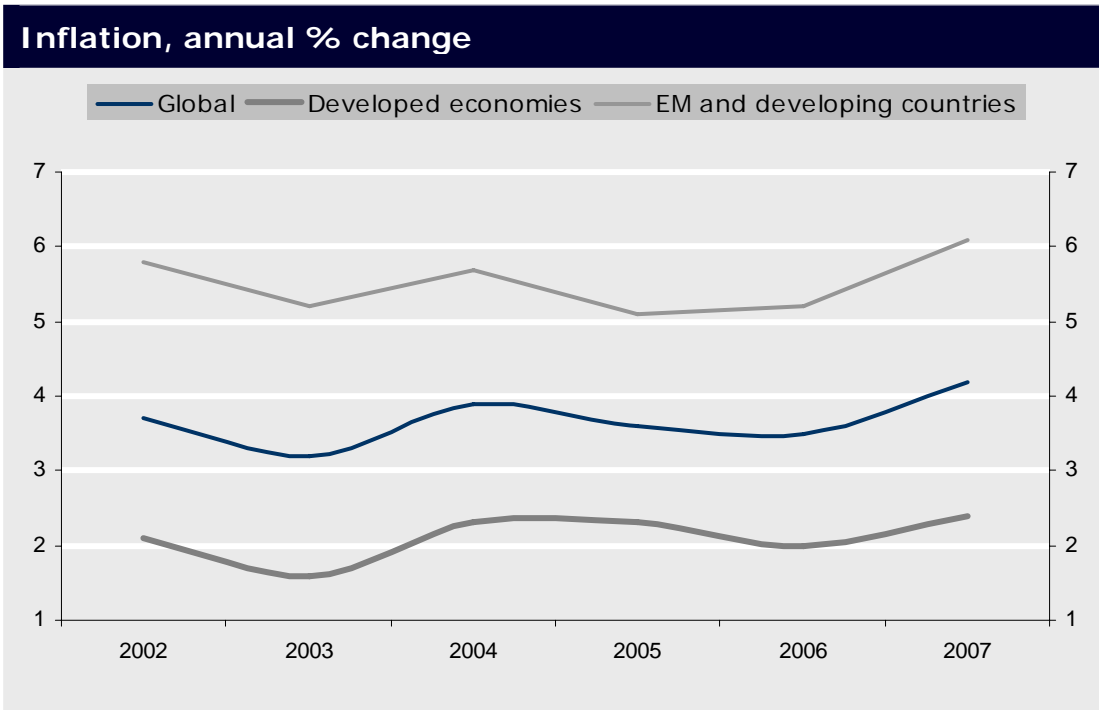
Source: Credit Europe Treasury Research, Bloomberg.

We assume that global GDP growth will decelerate in 2008 by ~3%, still it will be ~1.5% above 28 year-average growth rate. The growth rate of developed economies will fall ~1% below 28year-average growth rate. Emerging market will heavily contribute to the total growth but their growth rate will also decelerate.

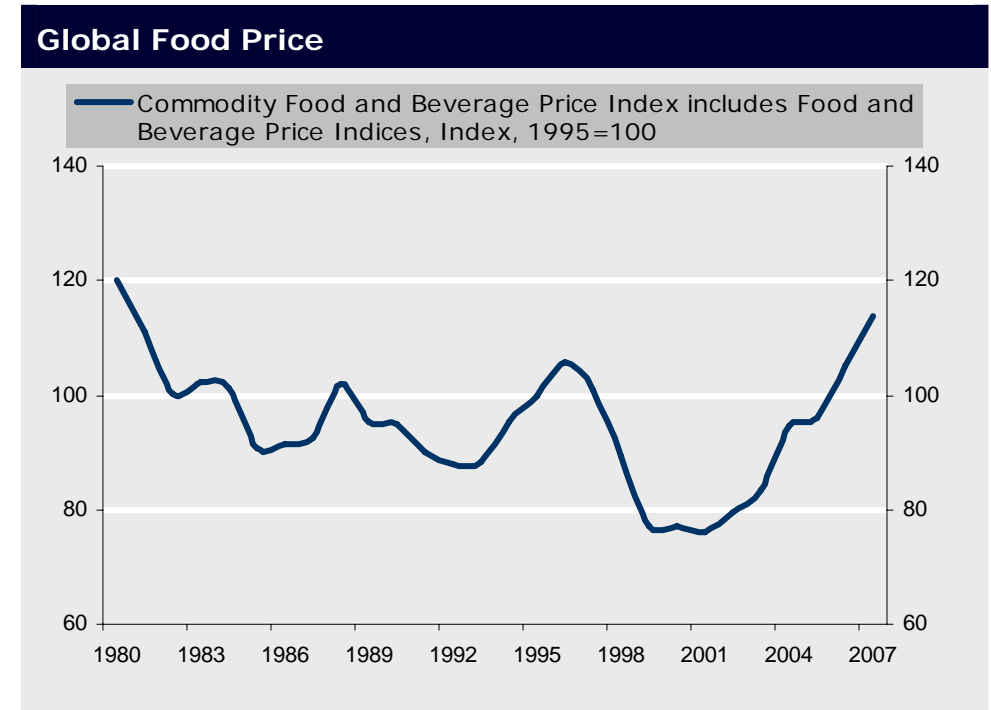
We expect that the growth global economy will slowdown in 2008 mostly due to the ongoing recession in the US housing sector, the impact of higher energy prices and more restrictive financial and credit conditions.

The slowdown is expected to concentrate in developed economies with emerging market economies also facing difficulties due to expected decline of consumption and demand from developed economies.

Global inflation will continue on the upside

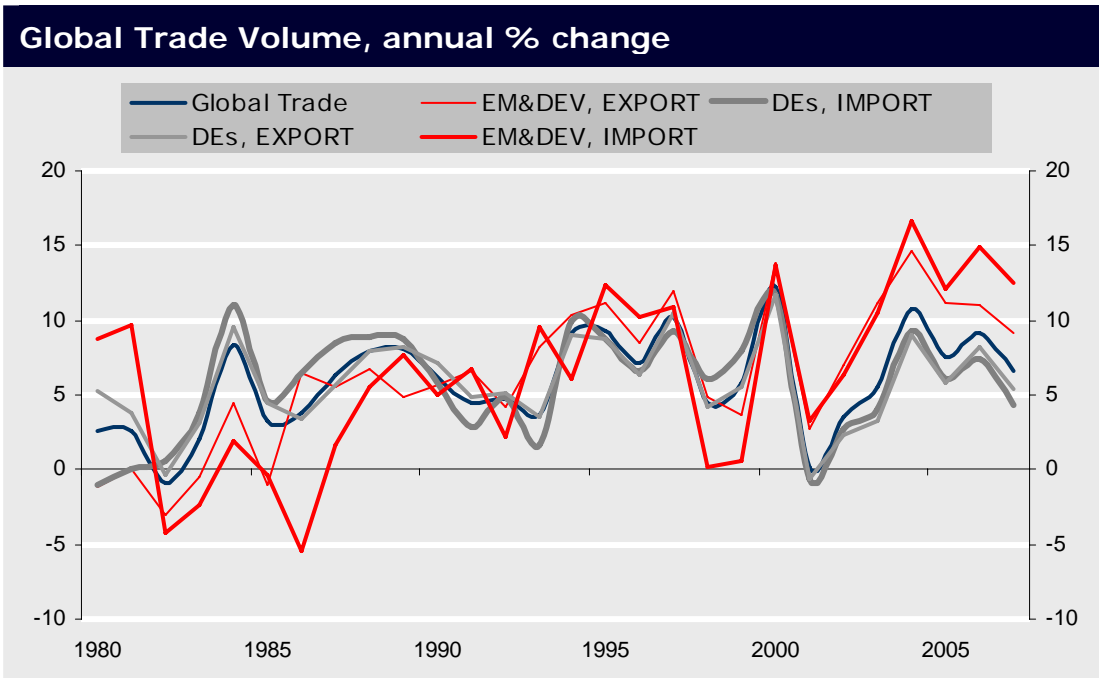


Source: IMF, Credit Europe Treasury Research, Bloomberg.



Those countries which are commodity intensive in production and consumption will be affected by inflationary pressures due to the rising at the end of this year influence of skyrocketed food and energy prices. Among these countries could be China and Brazil. The influence of energy component will most probably decline in 2008.

The growth of the global trade will also decelerate



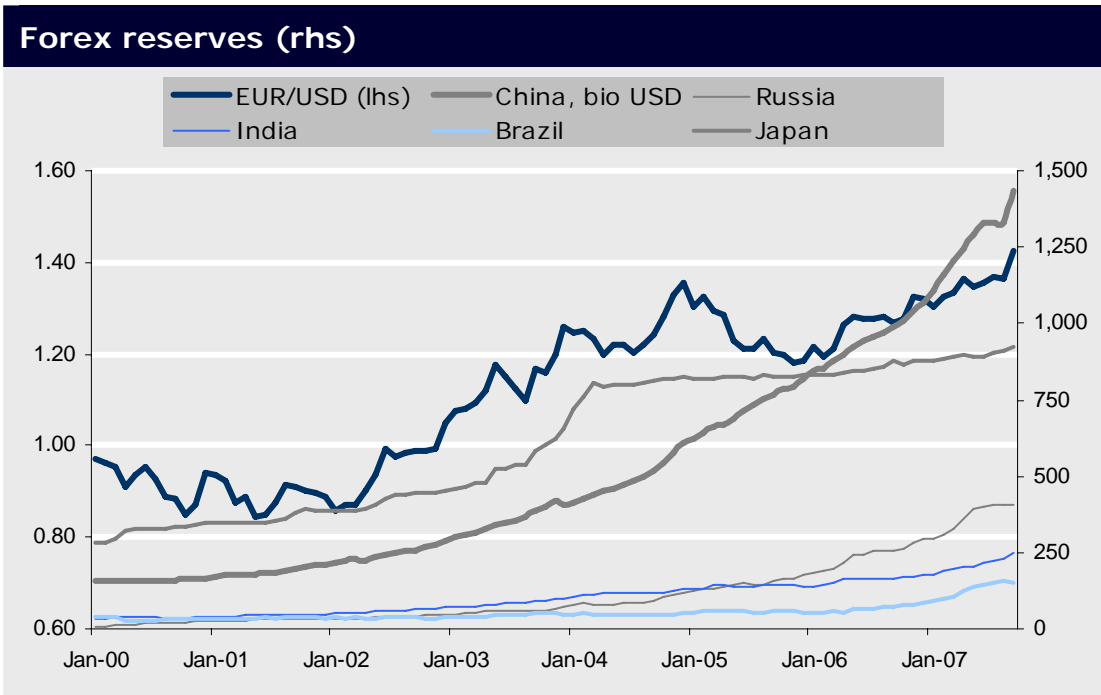
Source: Credit Europe Treasury Research, IMF, Bloomberg.

*DEs = Developed Economies

*EM&DEV = Emerging markets and developing countries

We assume that the growth of world trade will somehow decelerate next year due to general projected deceleration in global economy and also due to the upcoming recession in US housing sector, and its spreading over to the global economy.

Forex reserves of many countries overperform their needs



Source: Credit Europe Treasury Research, Bloomberg.

From the other side, it is easy to notice that forex reserves of many emerging countries overperform necessary levels of these reserves.

Simply many EM countries do not need reserves which exceed in some cases 50% of the GDP.

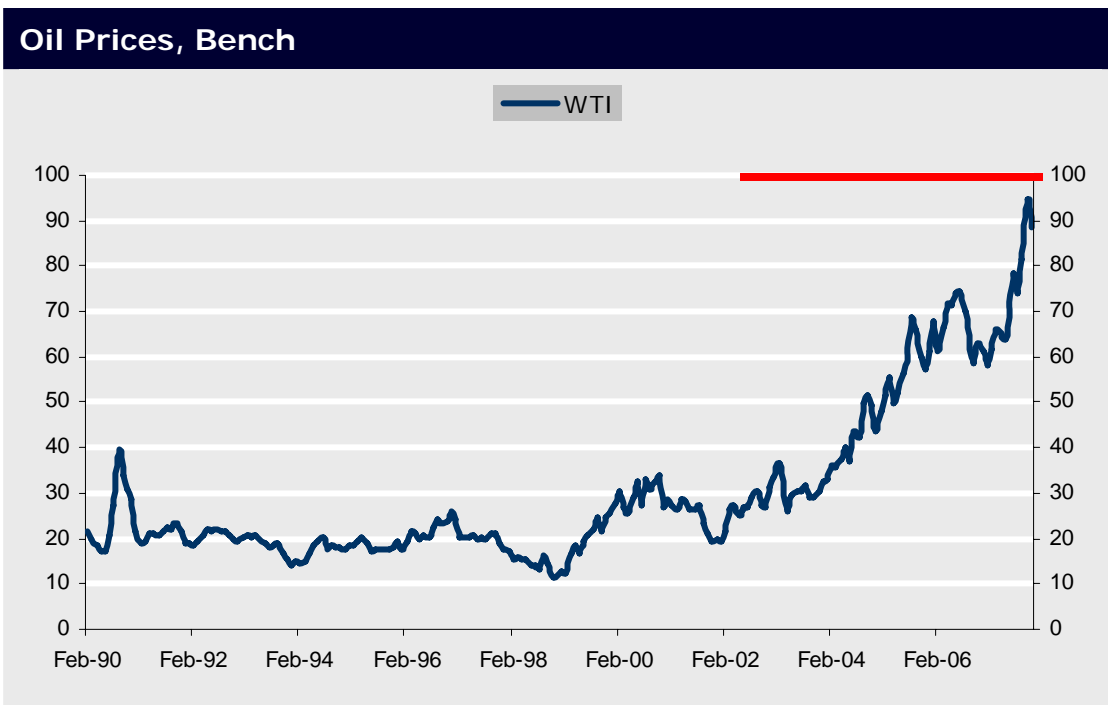
A considerable part of these reserves is held in USD-denominated assets. With falling USD the attractiveness of keeping reserves in USD-denominated assets decreases.

If some leading EM countries will decrease reserves this will also hurt the financing of the US current account deficit.

We do assume that in 2008 the growth rate of Global FX reserves will remain strong but will decelerate.

Oil prices will trend lower
next year...

Oil prices will most probably trigger \$102/bbl
and then trigger \$75/bbl in 2008



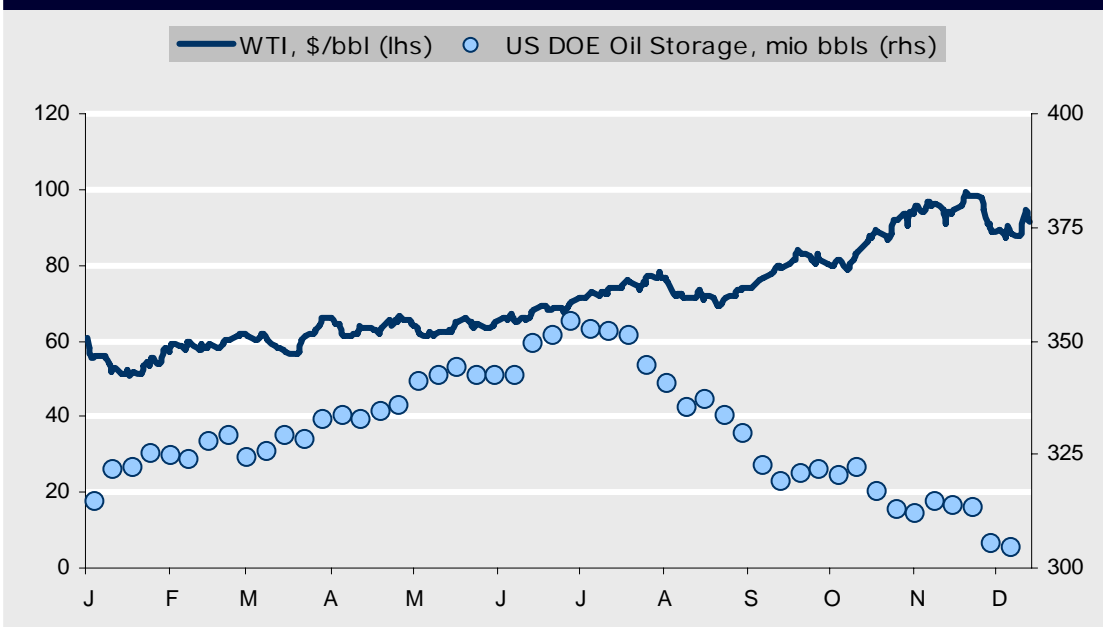
Source: Credit Europe Treasury Research, Bloomberg.

The story about oil prices hitting \$100/bbl is not over. We assume that oil prices will continue to press the \$100/bbl-stronghold. There is a high probability that after prices trigger \$102/bbl there could follow a sharp plunge. The road to \$100/bbl in the short-run has recently been stuffed by 2 things. First, the US weather agency reported that it forecasts softer weather this winter which could balance relatively tight heating oil inventories in the US. Second, US oil inventories could show some gains after several consecutive sharp declines. But oil prices already tried to correct aggressively when they recently hit \$88/bbl however the fall was stopped and now prices are consolidating strongly above \$90/bbl which is a good signal for oil bull-runners.

The demand for oil linked to the growth of global economy, increasing role of OPEC's production which is close to maximum capacity, geopolitics (mostly from the US) especially recent tensions around Iran, Iraq, and Turkey, the appearance of new oil exporters, growing demand from news accelerators of the economic growth such as China.

The US oil stores fell considerably since July 2007

Oil Price versus US DoE oil storage data



Source: US DoE, Credit Europe Treasury Research, Bloomberg.

Oil prices will be under some downward pressure in 2008. Interesting is whether there will be changes in pricing structure in the global oil market as soon as some OPEC countries already accept payments in currencies other than USD.

Oil stores in the US continued to fall. Oil prices tested supports below \$90/bbl and started to grow again. Last week major oils rose by 3.8% in the average. We continue to stick to our earlier stated target that oil prices will climb to \$102/bbl in 2008 before the major move down will start. The trend is still upwards and after testing supports the road higher is opened.

Still waiting for triggering the top of the oil bubble at \$102/bbl before the major move down

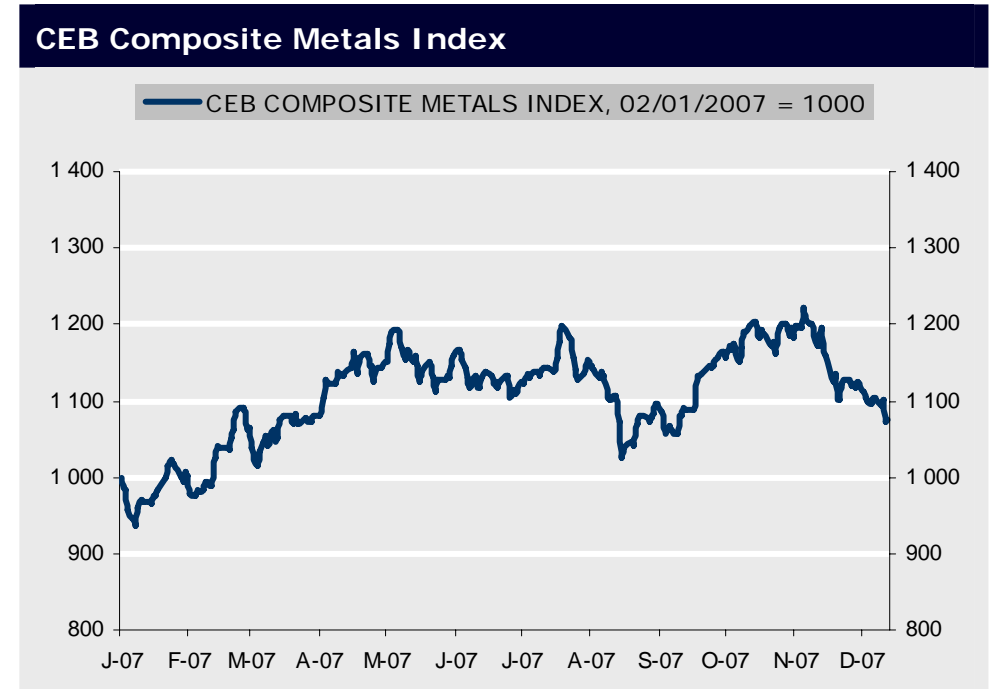
There were lots of reasons for attributed to oil prices strong upside movements this year. Some of them are the following. First is the geopolitical tension around USA-Iraq, also some tension near Turkey's border. For example, prices were pushed up backed by fears that actions near Turkey-Iraq border could disrupt supplies (there are two oil pipelines - Kirkuk-Ceyhan and Baku-Ceyhan). Second, weaker USD also added to higher oil prices. Third, the price of \$100 is an extremely psychological and technical level. Hazard of traders could technically push crude oil prices to approach this \$100. Fourth, according to OPEC the demand for oil will increase to 85.72mio bbl/day, and to 87.09mio bbl/day. OPEC specialists increased these two figures by 20,000bbl/day for 2007 and for 2008. This was explained by better that expected reaction of the US economy to the financial crisis. Important also is the fact that hedge-funds and traders continue to accumulate long positions in crude oil contracts according to the CFTC commission's data. Moreover it was expected that this winter will be cold and there will be shortages in supplies in winter period. Furthermore general perception that the US weathers out the financial crisis led to the inflow of speculative capital to crude oil trading which also pushed oil prices up. Below is the forecast for world oil demand in 2007 and 2008 (data taken from Reuters). In mio bbl/day

| | 2007 | | | 2008 | | | | |
|--|-------|-------|------------------|-------|-------|-------|-------|------------------|
| | Q3 | Q4 | Average per year | Q1 | Q2 | Q3 | Q4 | Average per year |
| OPEC | 85,57 | 87,07 | 85,75 | 87,33 | 85,6 | 86,68 | 88,73 | 87,09 |
| International Energy Agency | 85,5 | 87,6 | 85,9 | 88,3 | 86,7 | 87,4 | 89,4 | 88 |
| Energy Information Administration | 85,61 | 87,41 | 85,78 | 87,6 | 85,91 | 86,7 | 88,37 | 87,15 |

Gold Still Remains the best safe haven for many investors



Source: Credit Europe Treasury Research, Bloomberg.



Prices of nickel and aluminum moved very close to this year's lows. Gold, which is the proved safe haven, stayed near all-time highs.

CONSEQUENCES OF SUBPRIME AND THEIR EFFECTS ON GLOBAL ECONOMY IN 2008

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