

# Russian Bonds in 2004: Are Profits Likely?

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**Figure 1. Current Values and Price Forecasts of Russian Foreign Debt**

	Maturity date	Issue volume, mln \$	Duration, years	Coupon rate	Current level		Forecast for June 2004			Forecast for year-end		
					Closing price at 03/02/04	YTM	Price Change, %	YTM	Price Change, y-o-y	YTM		
MinFin-5	14/05/08	2 707	3.97	3.000%	90.2	5.7%	93.0	3.1%	5.0%	89.8	0.1%	5.8%
MinFin-6	14/05/06	1 750	2.18	3.000%	97.2	4.3%	99.1	2.0%	3.5%	96.8	0.5%	5.5%
MinFin-7	14/05/11	1 750	6.39	3.000%	80.8	6.4%	85.5	5.9%	5.6%	81.5	-0.2%	6.7%
MinFin-8	14/11/07	1 322	3.13	3.000%	92.6	5.5%	96.0	3.6%	4.5%	94.2	-0.1%	5.7%
Russia-07	26/06/07	2 400	2.97	10.000%	117.1	4.5%	118.3	1.0%	3.5%	112.8	-3.8%	4.5%
Russia-10	31/03/10	2 800	3.58	8.250%	112.0	5.0%	115.0	2.7%	4.2%	108.5	-3.0%	5.3%
Russia-18	24/07/18	3 467	8.50	11.000%	136.2	7.0%	142.0	4.3%	6.4%	129.5	-3.9%	7.5%
Russia-28	24/06/28	2 500	10.56	12.750%	160.2	7.4%	172.0	7.4%	6.7%	156.0	-1.8%	7.6%
Russia-30	31/03/30	19 529	8.92	5.000%	97.4	7.0%	102.0	4.7%	6.5%	95.0	-0.9%	7.5%

Sources: Reuters, Alfa Bank estimates

## Investment Summary

- **We expect the first rate hike to occur after the U.S. presidential election**

The first increase of the Fed rate will have a significant impact on the U.S. debt market, as investors will price in not only that move, but further rate hikes as well. By year's end the YTM of 10-year U.S. notes may exceed 5%.

- **We expect the prices of Russian sovereigns to decline by up to 4% this year**

In the first half of the year 3-6% price growth will likely prevail (the price of Russia-30 may reach 102% of par given stable oil prices). Sales of Eurobonds will begin in September and become aggressive by year's end (the price of Russia-30 should return to 95% of par).

- **Nevertheless, profits this year are likely and may total 8-14% based on price fluctuations**

We recommend that investors buy sovereigns maturing in 2018-2030 at current prices. At the end of the summer we recommend that investors take profits and open short positions in these issues.

- **Major domestic events include the awarding of investment grade by Fitch and S&P, and the March presidential election**

Upgrades of Russia's rating to investment grade by Fitch and S&P are practically embedded in yields and will cause only short-term and insignificant (i.e. within 1%) price growth. The major influence on the Russian market will come not from a presidential election win by Vladimir Putin, but rather from his determination to pursue economic and structural reforms after the election.

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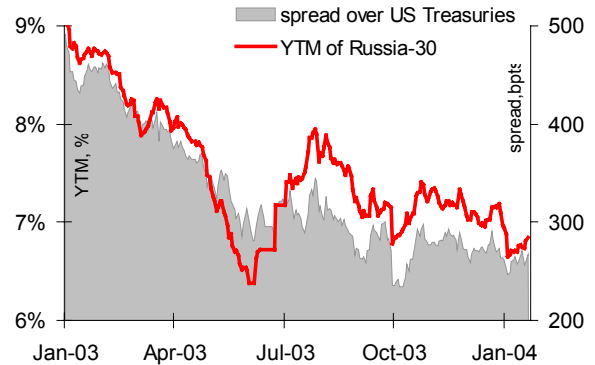
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**2004: Growth, Consolidation and Sharp Decline**
**Figure 2. Alfa Index of Sovereign Prices**


Source: Alfa Bank estimates

**Figure 3. Dynamics of Russia-30 Yields**


Sources: Reuters, Alfa Bank estimates

The period of volatile price growth on the Russian debt market has come to an end and the market has entered a consolidation phase. Unlike in previous years, 2004 will not bring outsized profits to speculative investors. Although we expect prices to fall this year (by up to 4%), profits are still achievable if investors take advantage of price fluctuations throughout the year. The major events this year will be:

- 1) the March presidential election;
- 2) the probable awarding of investment grade by Fitch and S&P, and;
- 3) the likely change in U.S. monetary policy, which will have the main influence on all debt markets, including Russia.

According to our forecasts, given stable oil prices the price dynamics on the Russian foreign debt market may be divided into three main phases. However, **a sharp decline in oil prices may force investors to re-assess the risk/yield ratio for Russian Eurobonds.**

## Our recommendations

Based on these forecasts, a reasonable strategy would be to buy Russian Eurobonds maturing in 2018-2030 at current price levels. In 5-7 months we would recommend that investors take profits and open short positions on long issues, which are more sensitive to a general downward trend. By following such a strategy, the profit on debt market transactions may reach 8-14% by year's end.

## Price growth will prevail during 1H04

Over the first six months of 2004 an upward price trend will prevail on the Russian debt market supported by stable prices of U.S. Treasuries. The Federal Funds Rate, which remains at an historic low, will have a favorable effect on all debt markets, including Russia.

Domestic factors could add to positive sentiment. First, conservative investors will invest funds in Russian assets by gradually substituting speculative short-term funds. The upgrade of Russia's sovereign rating to investment grade by Moody's has provided conservative investors (particularly Japanese investment banks and U.S. pension funds) with access to the Russian market.

Price growth on the eve of Russia's presidential election is unlikely to develop into a rally. Nevertheless, 1-3% price growth is quite probable. Thus, **in the first half of the year we expect prices of Russian sovereigns to rise by 3-6% on average.**

**Figure 4. Expected Price Levels on the Russian Market in June**

	Maturity date	Issue volume, \$ mln	Duration, years	Coupon rate	Current level		Forecast for June 2004		
					Closing price at 03/02/04	YTM	Price	Change, %	YTM
MinFin-5	14/05/08	2,707	3.97	3.000%	90.2	5.7%	93.0	3.1%	5.0%
MinFin-6	14/05/06	1,750	2.18	3.000%	97.2	4.3%	99.1	2.0%	3.5%
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Source: Reuters, Alfa Bank estimates

## Dead season: Consolidation and summer doldrums

After the potential price growth is exhausted, the quotes of Russian Eurobonds should consolidate at achieved levels. The high cost of Russian debt coupled with concerns about growth in U.S. rates will result in lower demand. However, active profit-taking is unlikely, as during the summer lull investors normally do not make important investment decisions. As a consequence, the quotes of Russian debt will likely drift sideways amidst low trading activity until as late as September.

**Prices to fall by 5-9% in 2H04**

The end of the summer vacation season will be marked by a downward trend on the Russian debt market. A number of investors will prefer to take profits in response to fears of a sharp increase in U.S. Treasury yields. A probable shift in U.S. monetary policy will provoke aggressive sales of bonds across the board, including in Russia. The price fall will be intensified by the traditional increase in bond supply at the end of the fiscal year (for most funds the fiscal year ends on December 31). As a rule, quotes decline in December since investment funds take profits before they sum up their financial results at year's end. Thus, under the influence of these negative factors, **Russian debt will become 5-9% cheaper for a few months.**

**Figure 5. Expected Price Levels on the Russian Market at YE2004**

	Maturity date	Issue volume, \$ mln	Duration, years	Coupon rate	Current level		Forecast for year-end			
					Closing price at 03/02/04	YTM	YTM	Price	Change from June 2004	Change, y-o-y
MinFin-5	14/05/08	2,707	3.97	3.000%	90.19	5.7%	5.8%	89.80	-3.4%	0.1%
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Sources: Reuters, Alfa Bank estimates

## Domestic Events Already Priced In

### No rally after Putin's victory

Most experts agree that Vladimir Putin will not face a serious challenger during the presidential election in March. Moreover, Russian debt has already reached record high price levels. We therefore expect the price rally before the election to be limited to a 1-3% increase in quotes.

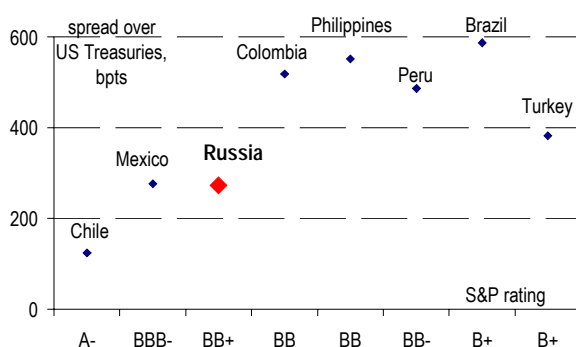
Thus, the political component of risk is relatively low despite the forthcoming election. The main question confronting investors is whether the newly elected president will continue with structural reform. For this reason, the market will pay more attention to the profile of the new government as well as its plans. **If the new government's economic policy disappoints the investment community, then profit-taking in Russian sovereigns will commence in late April – early May.**

### Investment grade is already priced in

Moody's investment rating of Russia is currently Baa3. The assessments of S&P and Fitch remain one step lower (BB+), which is still a speculative level. If the government demonstrates a determination to pursue structural and economic reforms after the election, then Fitch will likely raise Russia's sovereign rating to the level of investment grade. Also, it cannot be excluded that S&P will make another rating revision this year (the agency upped Russia's sovereign rating to BB+ on January 27).

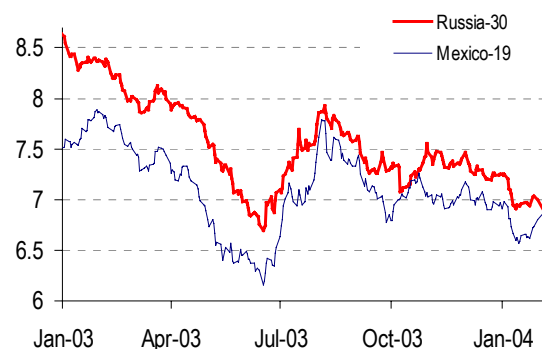
In any event, **the rewarding of investment grade ratings by Fitch and S&P are almost embedded in Russian bond prices.** This news will have a psychological effect by causing only slight (i.e. up to 1%) and short-term price growth. Russian debt is currently traded with a negligible premium over Eurobonds of countries with investment grade ratings (see Figures 6 and 7). Therefore, there is practically no potential for price growth in response to a rating revision.

**Figure 6. Rating/Spread of Global Bonds**



Source: Reuters, S&P, Alfa Bank estimates

**Figure 7. Premium Reduction of Russian Debt Over Mexican Debt**



Source: Reuters

\* Mexico-19 is used for comparison with Russia-30 because their durations are comparable. The duration of Mexico-19 is 9.5 years, while that of Russia-30 is 8.8 years.



## Issue of Eurobonds under USSR debt restructuring

In 2004 the Finance Ministry will continue to issue Eurobonds maturing in 2010 and 2030 under the restructuring of former USSR debt. In particular, over the next few months a deal may be closed that settles the “commercial” debt of \$700 mln to the International Investment Bank (IIB).

In our opinion, **the flowing of these Eurobonds to the secondary market will provoke only short-term and insignificant price decreases.** The Russian debt market has become more liquid and will be able to absorb such a volume without much harm. Moreover, some banks that plan to sell Eurobonds immediately after the end of the restructuring process will open short positions in advance. Thus, the decline in prices of Russian debt will probably be insignificant and not exceed 2%. If Eurobonds are issued over the next 1-1.5 months, we would recommend that investors take advantage of a possible correction and buy long-term sovereigns.

## U.S. Fed Determines the Dynamics of Debt Quotes

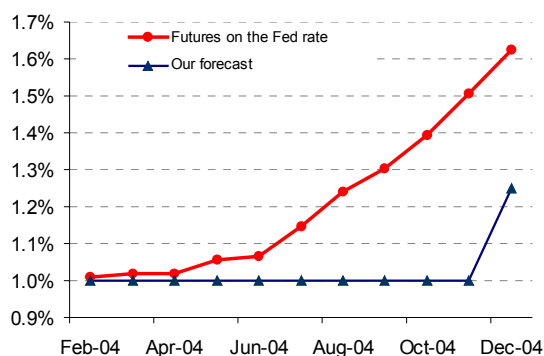
The spread of Russian sovereigns over U.S. Treasury yields narrowed in 2003 by 106-230 bpts on average (and by up to 260-270 bpts on long-term sovereigns). This increased the sensitivity of Russian debt to the dynamics of U.S. Treasuries. Sharp fluctuations in U.S. debt prices began to influence the Russian market to a greater extent than domestic news. As a consequence, **the level of U.S. Treasury obligations will be the determining factor for Russian Eurobonds in 2004.**

Starting in mid-2003 the global debt market became tense and highly sensitive to any comments by Fed officials regarding possible changes in its monetary policy. The instability of the U.S. labor market and the threat of deflation were obstacles for the transition in 2003 to a policy of rate hikes. According to our forecasts, this year U.S. rates will remain at low levels. A change in monetary policy will most likely take place only at the end of the year, particularly in December, and the first increase will probably be by 25 bpts to 1.25% (in previous periods rate increases commenced with a Fed rate hike of 25 bpts).

### YE2004: Change in U.S. monetary policy

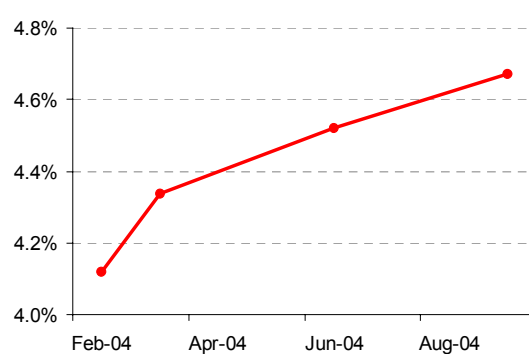
The volatility of U.S. employment indicators has encouraged participants on the debt market. Despite favorable industrial production and consumer demand data, the issue of sustainable economic growth remains an open question. Thus, there has been no stable increase in levels of employment, although lower unemployment is often the result of specific methodologies rather than a real reduction in the number of unemployed. If before investors had forecast a change in U.S. monetary policy in June, now most experts expect the first rate increase to occur only in the second half of 2004, particularly in August-September.

**Figure 8. U.S. Federal Reserve Rate Futures**



Sources: Chicago Board of Trade, Alfa Bank estimates

**Figure 9. 10-Year U.S. Treasury Futures**



Source: Bloomberg

However, we believe that decisions about higher rates will not be influenced by the condition of the U.S. economy, but rather by the U.S. presidential election in November. We believe that a change in the Fed's monetary policy is unlikely before this election occurs.

### Change in U.S. monetary policy unlikely before election

Naturally, in his desire for a second term in office, President George Bush will spare no effort to prevent instability in the financial markets and the U.S. economy. We therefore believe a shift to a policy of higher interest rates is very unlikely before the presidential election on November 2. To ensure liquidity in the economy and support for the debt market, **the U.S. authorities will keep rates at low levels even in the case of sustainable economic growth.**

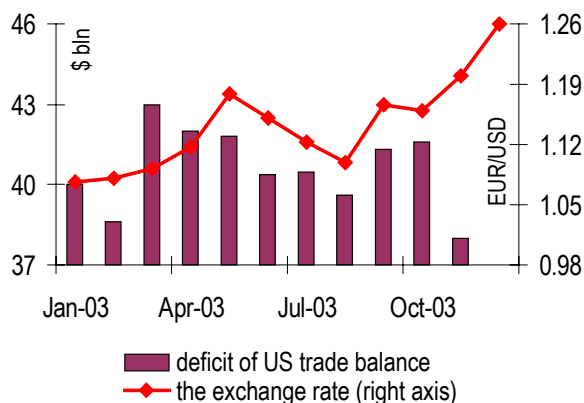
Otherwise, the government will face a sharp drop in debt prices (investors will begin to price in future rate hikes). Sharp growth in U.S. Treasury yields would make borrowing more expensive, which is what the current government wants to avoid. Expectations of a continued downward trend will also reduce demand and make new placements more difficult. In addition to the negative economic effect, the psychological component would be equally unfavorable for the Bush administration. As a consequence, **we reiterate our forecast that the next rate increase will most likely take place at the meeting of the Fed's Open Market Committee (FOMC) on December 14.**

### Is the weaker dollar harming the U.S. economy?

The only factor in favor of a U.S. rate hike may be a potential devaluation of the U.S. dollar against world currencies. However, given a closer look, devaluation of the dollar would have several positive effects on the U.S. economy. First, such a dynamic would benefit domestic companies and support industrial growth.

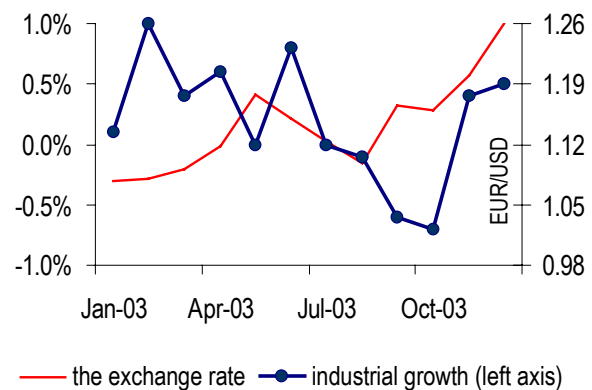
Second, a weaker dollar helps lower imports (in physical terms), which may in turn help narrow the trade deficit, which has already reached a record \$41-43 bln per month.

**Figure 10. Influence of Dollar Exchange Rate on the Trade Balance**



Source: Bloomberg

**Figure 11. Weak Dollar Supports Economic Growth**



Source: Bloomberg

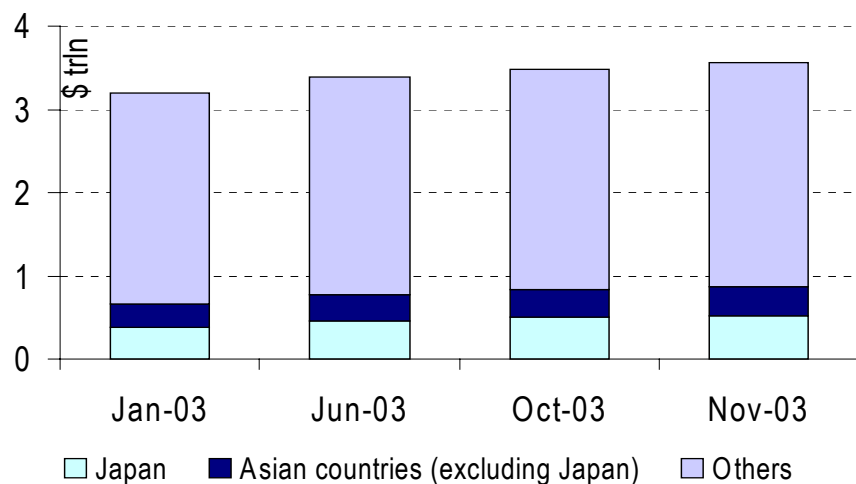
In addition, and however counter-intuitive it may sound, **a weaker dollar ensures a stable inflow of foreign investment to the U.S. debt market.** Asian countries buy large volumes of dollars in order to prevent strengthening of their national currencies and to support economic growth. The bulk of purchased dollars is invested in U.S. Treasuries, thereby encouraging stable demand. Thus, the largest holders of U.S. public debt are now Japan and China. According to data as of November 2003, Japan currently holds \$525 bln, or almost 15% of the total U.S. public debt, while China holds \$143.8 bln, or 4% of the debt.

**Asian currency policies are important for U.S. debt**
**Figure 12. Largest Holders of U.S. Public Debt in 2003, \$ bln**

Country	November	October	June	January
Japan	525.5	501.9	454.4	384.8
China	143.8	141.9	138.1	120.7
Great Britain	111.7	113.6	92.7	80.9
Hong Kong	55.5	52.0	51.2	46.6
Germany	45.7	46.3	41.3	50.1
Korea	43.1	42.4	39.5	36.7
Taiwan	45.8	43.3	37.9	37.4
Singapore	18.5	18.9	19.8	17.3
Thailand	12.1	14.0	15.1	17.1
India	14.7	13.5	9.1	8.6
Volume of government bond portfolio held by investors from Asian countries	859	827.9	765.1	669.2
– as a percentage of total U.S. public debt	24.1%	23.5%	22.6%	20.9%
Total volume of traded U.S. government securities	3,563	3,519	3,379	3,197

Source: U.S. Treasury Department

Adherence by Asian countries to a policy of preventing excessive strengthening of national currencies can thus provide powerful support to the U.S. debt market. For example, in 2003 the Japanese government bought over \$200 bln during intervention in support of the dollar. (YTD the volume of intervention has already reached \$68 bln, or one-third of last year's total volume.) The bulk of this amount was invested in U.S. Treasuries. The same policy is maintained by China – the second largest investor by size in U.S. public debt. As a result, active borrowing (the U.S. public debt grew by \$378 bln from January to December 2003) did not push up yields on U.S. Treasuries. More than half of new placements have "settled" in the investment portfolios of Asian investors.

**Figure 13. Distribution of U.S. Public Debt**


Source: U.S. Treasury Department

In 2004 the U.S. budget deficit is estimated at more than \$500 bln, or about 4.5% of GDP, and experts forecast the same level for 2005. Only stable demand would allow the U.S. Treasury Department to make new placements without provoking sharp growth of yields. In our opinion, the level of interest rates (including forecasts of a change in the Fed rate) will not be the only factor influencing the level of demand for U.S. Treasuries in 2004. A no less important factor for the U.S. debt market will remain the foreign currency policies of Asian countries (primarily Japan).

It is clear that **the adoption of flexible foreign currency policies by Asian governments (i.e. the rejection of national currency devaluation) may cause a serious decline in demand, which could destabilize the U.S. debt market.** However, according to the statements of Japanese government officials, the country has no plans at present to end intervention in support of the dollar. Such a policy would ensure demand for U.S. debt obligations, which would constrain growth in yields in an environment characterized by greater borrowing.

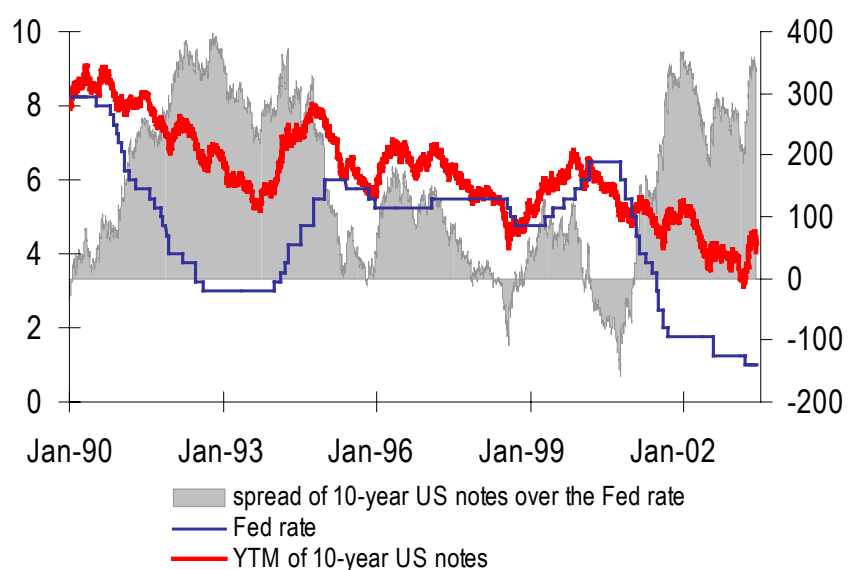
### **The effect of the first rate hike on U.S. bonds**

According to our forecasts, yields on U.S. Treasuries are unlikely to increase significantly before September, although volatility on the U.S. debt market will grow. While attempting to time the first rate hike, investors will overreact in response to U.S. macroeconomic data and the Fed's statements. Thus, the yields of 10-year bonds will fluctuate within a range of 3.9-4.6% per annum. In September-October the debt market will start to price in a probable shift in U.S. monetary policy. **By year's end sales may become aggressive, which would push yields on 10-year Treasury bonds to above 5% per annum.**

Investors are convinced that the U.S. economy will face a prolonged period of rate increases. For this reason, alongside the shift in U.S. monetary policy, the debt market will start "embedding" in the prices of bonds not only the first hike, but also further changes in the Fed rate. Investors will begin to aggressively sell bonds as a downward price trend becomes established. The first increase in the Fed rate will have the strongest impact on the debt market. In particular, the first rate hike (likely by 25 bpts) may push up yields on U.S. Treasuries by at least 50 bpts over a period of 2-3 weeks.

Figure 14 shows that yields on U.S. Treasuries grew at a faster pace than the Fed rate in the first months of transition to a tightening policy. As a result, in some periods the spread of 10-year U.S. notes to the Fed rate was as much as 300-400 bpts (compared to 309 bpts at present). Conversely, while the Fed rate was expected to decline, the spread did not exceed 100 bpts and was even negative in certain months.

**Figure 14. Dynamics of Interest Rates on the U.S. Debt Market**



Sources: U.S. Federal Reserve, Bloomberg

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