



# Russian Bonds: Following U.S. Treasuries

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Figure 1. Forecast Price Levels as of the Beginning of March 2004

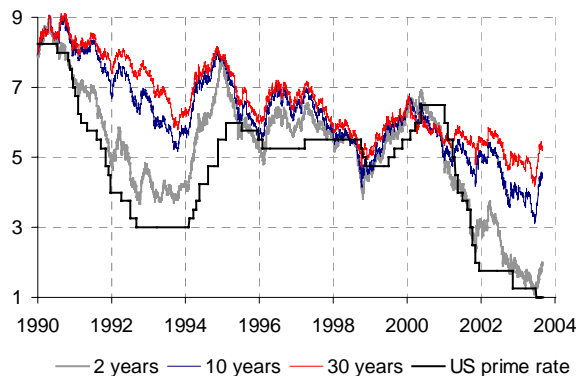
	Maturity	Duration, years	Closing price as of September 15, 2003	YTM, %	Price as of early March 2004	Change, %	YTM as of early March 2004, %
MinFin-5	14.05.08	4.36	89.750	5.6	93.0	3.6	4.87
MinFin-6	14.05.06	2.58	97.000	4.2	99.0	2.1	3.48
MinFin-7	14.05.11	6.76	79.000	6.6	85.0	7.6	5.56
MinFin-8	14.11.07	3.48	92.000	5.2	95.0	3.3	4.54
Euro-07	26.06.07	3.23	119.375	4.4	120.0	0.5	3.53
Euro-10	31.03.10	3.84	113.250	4.9	115.5	2.0	4.05
Euro-18	24.07.18	8.54	136.625	7.0	144.0	5.4	6.30
Euro-28	24.06.28	10.55	162.500	7.3	173.0	6.5	6.65
Euro-30	31.03.30	9.00	95.000	7.1	103.0	8.4	6.34

Sources: Reuters, Alfa Bank estimates

## Executive summary

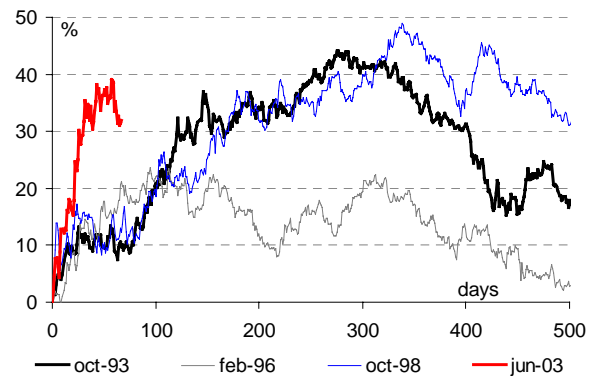
- Since mid-June, US Treasuries have suffered one of their sharpest price declines ever**  
 Over a ten-week period the compound yield volatility of 10-year US Treasuries approached 40%, which is comparable with the price collapses seen in 1993 and 1998. Any further strong yield growth before the Fed begins raising interest rates appears unlikely.
- The upward price trend in the Russian market will persist until mid-March 2004**  
 The bulk of the price growth will occur in January-February 2004. The increased demand will be driven by a greater share of Russian debt in investment portfolios in anticipation of revision of Russia's sovereign rating to investment grade. The upward dynamic will also be supported by bullish speculation in the run-up to Russia's presidential election.
- The Fed is expected to switch to a tightening bias in the second quarter of 2004**  
 A shift in the Fed's interest rate bias to tightening would trigger aggressive bond sales, with a prolonged downward trend settling in on the Russian debt market as well.
- We recommend that long-term investors BUY Russian sovereigns maturing in 2018-2030 and TAKE PROFITS in early March 2004.**

Figure 2. Rate Dynamic on the US Debt Market



Sources: Bloomberg, US Fed

Figure 3. Compound Yield Volatility



Sources: Bloomberg, Alfa Bank estimates

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### Three sharp price declines on the US debt market

**US Treasuries showed the sharpest declines in 1993-1994 and 1998-1999,...**

**...as well as June-August 2003**

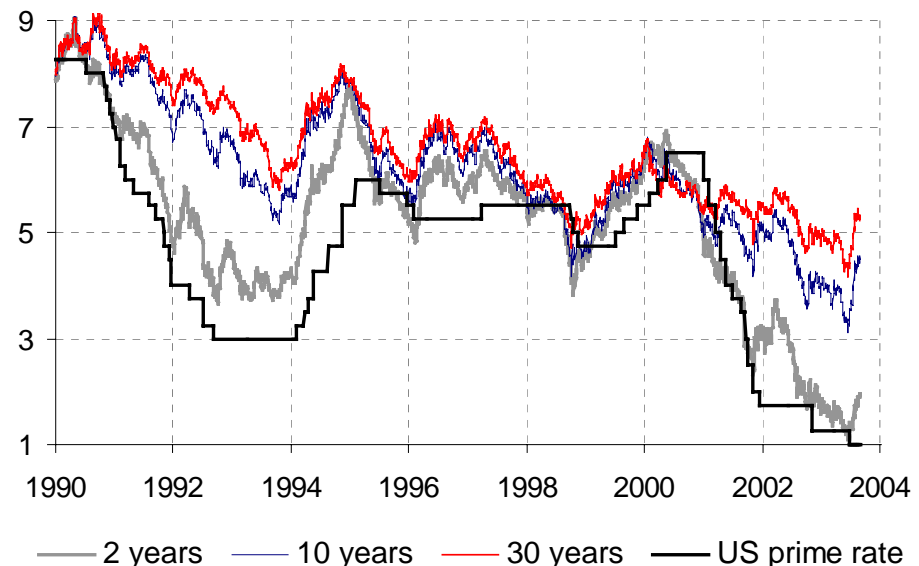
**Yield curve flattens before a period of rising prices**

Since 1990, the US debt market has experienced several periods of sharp price declines. US Treasuries registered the most substantial yield growth during the 1993-1994 and 1998-1999 periods, following moves by the Federal Reserve to raise interest rates.

During the June-August period this year the US debt market witnessed another price collapse of at least the same magnitude. The slope of the yield curve became much steeper (note the gap between the yields on 2-year and 10-year Treasuries in Figure 4). The yield curve usually forms this pattern in anticipation of an increase in interest rates. It had exactly the same shape in 1994, just before the long period of interest rate hikes by the Fed.

By the time the Fed relinquishes its tightening policy, the yield curve assumes a flatter shape, with yields registering their highest levels. The yield gap between short- and long-dated issues narrows, and therefore the market sees a reversal of the price dynamic.

**Figure 4. US Treasury Yields and the Fed's Prime Rate**



Sources: Bloomberg, US Federal Reserve

The period between 1998-1999, when prices were strongly affected by the crisis in global financial markets (including Russia's default in August 1998), was at variance with the usual pattern. Prices were falling despite the Fed's continuing rate cuts (interest rates began rising on July 1, 1999, or nine months after the beginning of the price collapse, and this supported the downward trend). As a result, the yield curve maintained its flat pattern. Moreover, starting from February and during all of 2000 the yield on the 2-year issue was noticeably higher than that on longer-dated bonds. This reflects expectations of aggressive rate cuts by the Fed.

## In 2003 the pace of yield growth reached a high

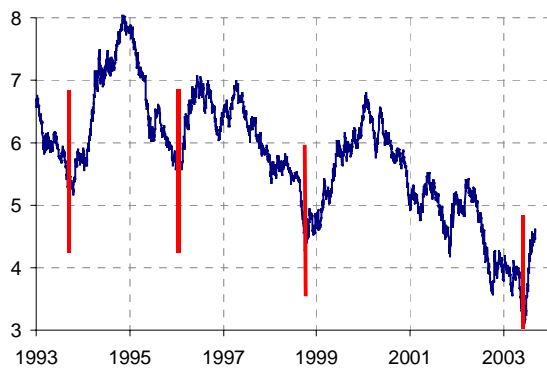
**Compound yield volatility is an indicator of changes in market rates**

One of the indicators of the scale and speed of the yield growth dynamic is the compound yield volatility. We calculated this figure for 10-year Treasuries, taking as a reference point the starting dates of aggressive sales in 1993, 1996, 1998 and 2003. Figure 6 indicates the duration and intensity of yield increases during periods of collapsing prices.

**The pace of yield growth in 2003 reached a high,...**

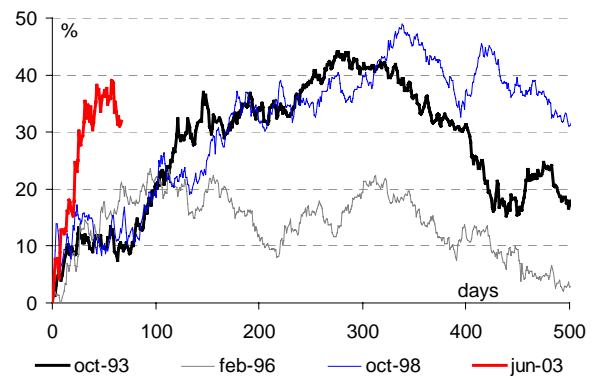
The chart shows the steepest recorded increase in yields, which was reached in June 2003. During that period the compound yield volatility of 10-year Treasuries nearly reached 40% within ten weeks. However, unlike in previous periods of falling prices, sales continued against the backdrop of stable Fed rates. In comparison, in 1994 the compound yield volatility only reached the 40% level after prices had declined for a year. In addition, the period in question saw five increases of the Fed's benchmark federal funds rate (totaling 175 bpts, down from 3% pa).

**Figure 5. Yield on 10-year US Treasury bonds**



Source: Bloomberg

**Figure 6. Compound Yield Volatility**



Sources: Bloomberg, Alfa Bank estimates

**...and the scale of its fall was close to that during the crisis year 1998**

The period between 1998-1999 coincided with the longest ever price decline on the US debt market. Bond sales began in October 1998 driven by the crisis in global financial markets, and the downward price trend was later reinforced by the adoption (on July 1, 1999) of a tightening bias. Against this background, the compound yield volatility reached an all-time high of 48.9% in the period between October 5, 1998 and January 20, 2000, while the yield on the 10-year bond rose from 4.16% to 6.79% pa.

**Figure 7. Yield on 10-year US Treasuries and Compound Yield Volatility During Periods of Falling Prices**

	Start of period of falling prices			Compound yield volatility reached 40%				Maximum compound yield volatility						
	Date	Yield, %	Fed rate, %	Date	Yield, %	Change, bpts	Fed rate, %	Change, bpts	Date	Yield, %	Change, bpts	Yield volatility, %	Fed rate, %	Change, bpts
1993-1994	15.10.93	5.17	3	05.10.94	7.76	260	4.75	175	07.11.94	8.03	287	44.11	4.75	175
1998-1999	05.10.98	4.16	5.25	14.12.99	6.22	205	5.5	25	20.01.00	6.79	263	48.90	5.5	25
2003	13.06.03	3.12	1			*			02.09.03	4.60	149	39.02	1	0

Sources: US Federal Reserve, Alfa Bank estimates

Note \* - For 2003 the line is left empty, as the compound yield volatility has not exceeded 40% year to date

## Substantial growth in Treasury yields is unlikely

**Yields on 10-year notes will not exceed 4.8% over the next six months**

In our opinion, the high yields on US Treasuries are not justified by current fundamentals. Provided the Fed does not revise its policy, their upside potential will be very limited. In particular, the yield on the 10-year issue will most likely stay within a range of 4.0-4.8% pa while approaching that of the 30-year note. Yields will stay at this level until the Fed reverses its monetary policy. The dynamics of US Treasury prices will be determined by indicators such as budget deficit forecasts for 2004-2005, the results of US Treasury auctions, and economic fundamentals.

**Weaker demand is the main risk for US bonds**

1. The greatest threat to the US debt market is the decrease in demand from foreign investors, especially those from Asia with large holdings in US bonds. In this regard, the results of auctions to place 2- to 10-year bonds will serve as an indicator of interest in the American debt market. Any serious fall in demand evidenced by the auctions may provoke heavy selling in the secondary market and destabilize the US debt market.

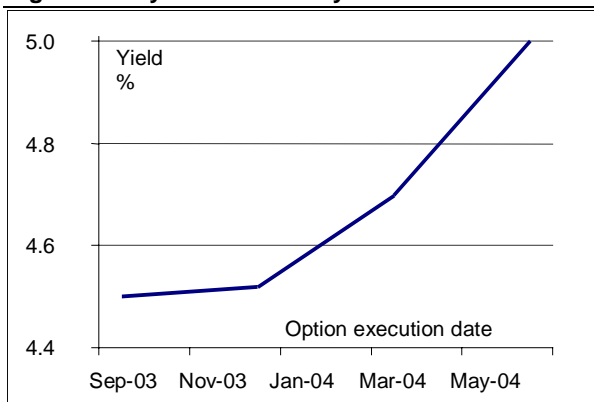
**New borrowings may be soaked up by the market without increasing yields**

2. The accumulating US budget deficit is a lesser threat for the debt market. On the whole, investors are upbeat about the economic situation in the US, especially against the backdrop of weakening eurozone economies. Therefore, the global financial market will be able to soak up substantial volumes of new borrowings without any considerable difficulty.

**The labor market will remain the key concern among investors**

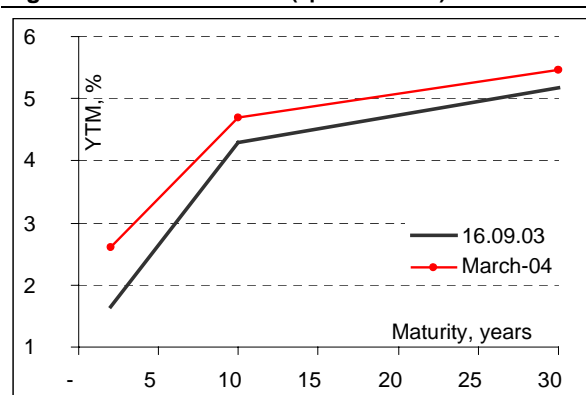
3. On the whole, the macroeconomic data points to a revival of the US economy. However, the weak labor market still represents a cause for concern. As a consequence, the impact of US employment figures on bond prices will be felt immediately.

**Figure 8. 10-year US Treasury Futures**



Source: Bloomberg

**Figure 9. US Yield Curve (spot + futures)**



Source: Bloomberg



### Fed will start raising interest rates in 2Q04

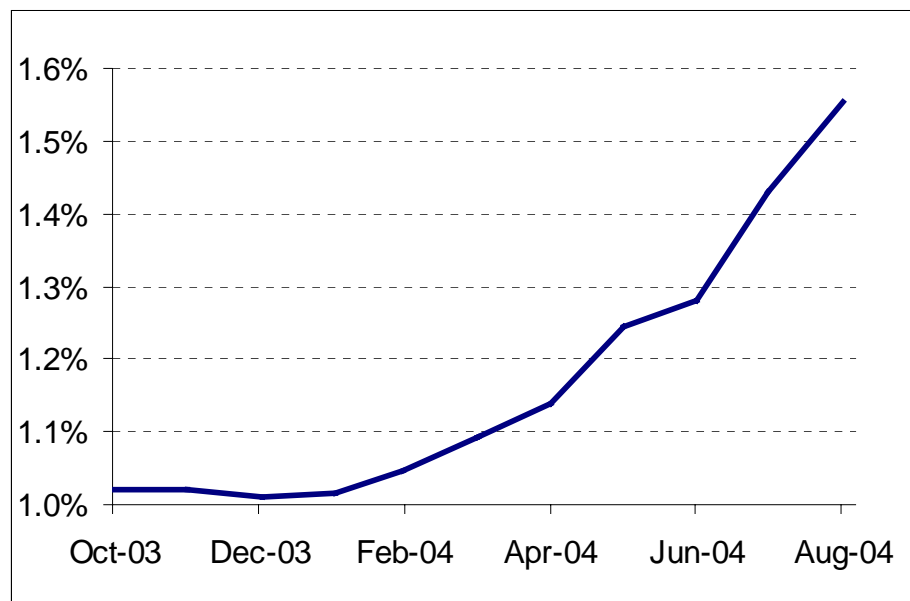
*Fed will likely keep rates unchanged until April 2004,...*

*...after which the debt market will see a period of aggressive sales*

Most experts agree that the US economy is currently showing signs of instability, especially on the labor market. Therefore, despite signs of economic recovery, the US Federal Reserve will keep rates low over the next six months. Furthermore, Fed officials have repeatedly confirmed their intention to keep rates unchanged for a considerable period of time. Such investor expectations are priced into Fed interest rate futures.

A switch to a tightening bias is unlikely to occur before 2Q04. A change in the Fed's policy would have psychological effects and spark aggressive sales over the first several months, and thus the debt market will price in the anticipated increases in Fed rates well in advance.

Figure 10. Futures on Fed Interest Rates



Source: Chicago Stock Exchange

## Russian bond prices will follow the US market

**Correlation of Russian debt prices and US Treasuries will increase,...**

The sensitivity of Russian debt to movements on the US debt market has greatly increased as a result of narrowing spreads of Russian debt over US Treasuries, with news from emerging markets affecting Russian bonds to a lesser degree. This trend will become more pronounced in the future, supported by a further narrowing of spreads.

**...with the exception of the presidential election period in Russia**

On the other hand, the Russian presidential election and an upgrade of the country's rating might temporarily ease the effects of the US market on Russian debt. We believe the price dynamic on the Russian debt market over the next 1.5 years may be divided into two principal phases.

### Phase of price growth will last until mid-March 2004

**The bulk of the price growth will likely occur in January – February 2004**

Provided the situation on the US debt market remains stable, Russian debt prices are likely to grow until mid-March 2004, with the bulk of the growth taking place in January-February 2004. By late 2004 Russia's rating might be raised to investment grade, and in anticipation of such a decision some investment funds will likely increase their limits on Russian debt instruments in their portfolios and boost purchases early in the year. The upward trend on the Russian market will also be supported by bullish speculation ahead of the presidential election scheduled for March 2004.

**By March 2004, growth in Russian debt prices is unlikely to exceed 10%**

However, such an increase in prices is unlikely to exceed 10%, as we do not anticipate any perceptible lowering of yields on the US debt market. Appreciation of Russian bonds against the background of virtually unchanged risk-free rates would result in their spread over US Treasuries shrinking by some 100 bpts. Narrowing of spreads will continue throughout 2004 in anticipation of an upward revision of Russia's sovereign rating to investment grade.

**Figure 11. Projected Price Levels, early March 2004**

	Maturity	Duration, years	Closing price as of September 15, 2003	YTM, %	Price as of early March 2004	Change, %	YTM as of early March 2004, %
MinFin-5	14.05.08	4.36	89.750	5.6	93.0	3.6	4.87
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Euro-30	31.03.30	9.00	95.000	7.1	103.0	8.4	6.34

Source: Reuters, Alfa Bank estimates

**We recommend taking profits on longer-dated issues in early March 2004**

According to our forecast, Russian bond prices will reach their maximum in early March. We recommend using this level for profit-taking on long-term issues carrying the highest price risk. In our opinion, the best strategy will be to sell sovereign Eurobonds maturing in 2018-2030 and reinvest in shorter-dated issues. One attractive option in particular will involve Eurobonds maturing in 2007. Their high coupon rate (10% pa) will lessen the risk of losses caused by the falling market. The issue maturing in 2010 is not expected to suffer a substantial drop either. Amortization of principal starting from 2006 and the market coupon rate (8.25% pa versus 5% for Russia-30) have reduced the duration of this issue to 3.8 years, which is only slightly above the 3.2-year duration of the 7-year Eurobond.

### Downward price trend will settle in starting mid-March 2004

*The second quarter will see a reversal of the price trend*

The second quarter of 2004 will most likely witness a reversal of the price trend under pressure from rising interest rates in the US. We believe a change in bias by the Fed will trigger aggressive sales of US Treasuries and, in turn, Russian bonds. During the first months of that period bond yields will climb faster than the Fed rate, as investors will be pricing in later rate increases. The duration of the decline in bond prices will depend entirely on the duration of the Fed's tightening policy.

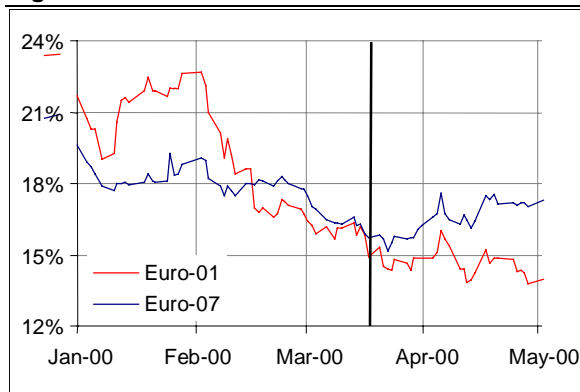
### Price rally to begin ahead of the presidential election

*Before the last election, a price rally began two months in advance*

Russia's presidential election will take place on March 7, 2004, and Vladimir Putin's chances of re-election for a second term are very high. For this reason, the price dynamics of Russian debt might resemble the market situation before the previous presidential election on March 26, 2000. At that time, investors were also confident of a Putin victory, and the resulting price rally started two months in advance of the election. Moreover, investors used the results of the vote to take profits, which pushed up yields immediately after the election.

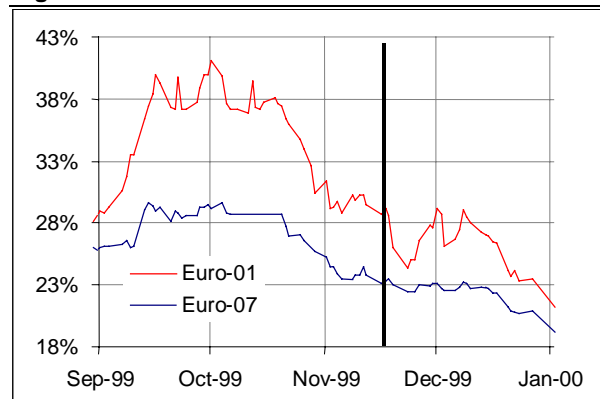
Similar price dynamics were observed in 1999 prior to the State Duma elections. This year, however, the Duma elections will not have any noticeable effect on the Russian debt market. Putin's position within the government is sufficiently strong, and the results of the vote are not expected to bring any surprises.

**Figure 12. Russian Presidential Election on 26.3.2000**



Source: Reuters

**Figure 13. Elections to the State Duma on 19.12.1999**



Source: Reuters

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