



## Strategy

### Russia

S&P Moody's	BB (Stable) Ba2 (Stable)
Russia 9% 3/04€	(102.9/103, €L+107)
Russia 9 3/8% 3/05€	(108/108.13, €L+146)
Russia 8 3/4% 7/05\$	(110.25/110.5, L+120)
Russia 10% 6/07\$	(119.16/119.54, L+160)
Russia 8 1/4% 3/10\$	(112.9/113.9, L+191)
Russia 11% 7/18\$	(136.64/137.64, L+232)
Russia 12 3/4% 6/28\$	(162.34/162.84, L+272)
Russia 2.5% 3/30\$	(94.89/95.02)

#### Oil and Gas

Rosneft 12 3/4% 11/06\$	(113.63/114, L+547)
Sibneft 11 1/2% 2/07\$	(112.38/112.75, L+477)
Gazpru 9 1/8% 4/07\$	(107.5/108.00, L+392)
Tmenru 11% 11/07\$	(113/113.5, L+437)
Sibneft 10 3/4% 1/09\$	(111.5/112, L+462)
Gazpru 10 1/2% 10/09\$	(114.13/114.5, L+394)
Gazpru 9 5/8% 03/13\$	(107.5/108, L+396)

#### Telecoms

Mobtel 10.95% 12/04\$	(106.63/107.38, L+378)
Vip 10.45% 04/05\$	(106/106.5, L+475)
Mobtel 9.75% 01/08\$	(108/108.5, L+439)
Sisfin 10.25% 04/08\$	(105.25/105.88, L+550)

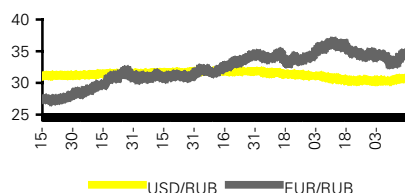
#### Banking

Alfaru 10.75% 11/05\$	(105.38/105.88, L+597)
Mdmbk 10.75% 12/05\$	(104/105, L+651)
Uralsi 8.875% 07/06\$	(98.25/98.75, L+688)

#### Others

Alrosa 8.125% 05/08\$	(98/98.5, L+506)
Wbdfu 8.5% 05/08\$	(103.13/104.5, L+416)

#### Dynamics of RUB exchange rates



Source: Bloomberg

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# Russia

## Economic trend favours corporates

We maintain our marketweight investment recommendation on Russian sovereign debt and overweight stance on corporate bonds ahead of December's Duma elections. The strong macroeconomic trend remains intact and we upgrade our growth, fiscal and BoP projections for 2003-04. Renewed reform impetus after the elections should lead Russia to investment grade status in 2004.

### Investment strategy

We maintain our marketweight recommendation on Russian sovereign bonds. Sovereign spreads should be less volatile than other EM credits due to sustained local demand, but we believe any considerable spread tightening to be unlikely in the current adverse global fixed income environment.

We continue to see more value in the corporate sector, which is likely to benefit from the strong economic fundamentals, increased FDI inflow and domestic consumption growth. **We like telecoms on booming demand for services and other industrials on consumption growth.**

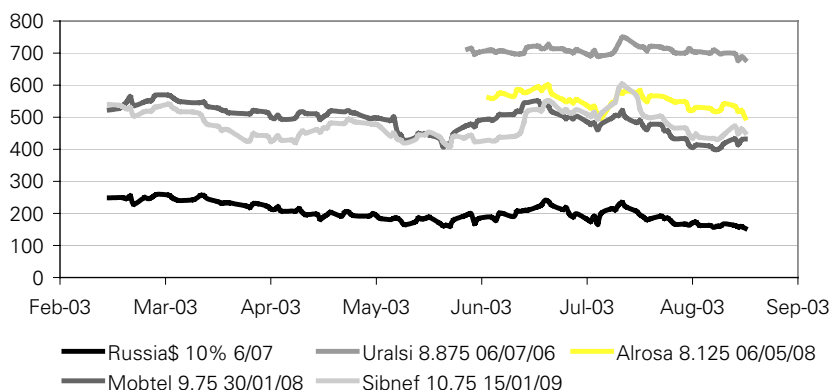
### Political and economic outlook

We expect the Duma and presidential elections to confirm the present political status quo with the pro-administration political block maintaining a majority in the new parliament. **Important legislative changes, in our view, will have more visible impact on the Russian financial markets.**

**The strong macroeconomic trend remains intact** and we upgrade our growth, fiscal and BoP forecasts for this and next year. In addition, we expect a better balanced growth structure in the years ahead supported by fixed investments, and export and private consumption growth.

With fiscal and external accounts in considerable surplus, and increased inflow of FDI, Russia's debt service capacity remains robust despite sizeable debt payments in 2004-05. We project external debt to drop to 35.5% and 31% of GDP by end-2003 and 2004 from 44.5% of GDP at end-2002.

CHART 1: Spreads dynamics for selected credits



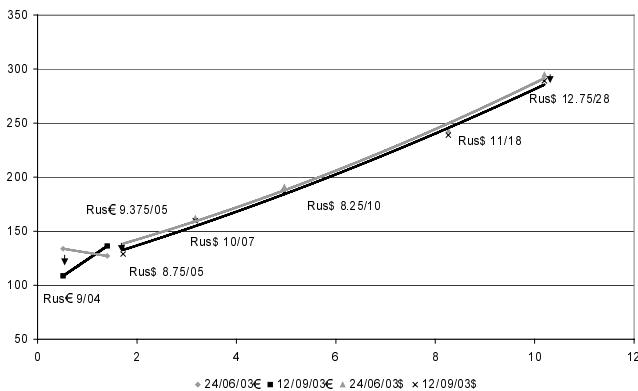
Source: Commerzbank Economic Research

## Investment summary

We instituted our marketweight investment recommendation on Russian sovereign bonds in late June and continue to maintain the same position for the period ahead. At the same time, we recommend an overweight position in Russian corporate bonds, particularly in telecoms and other industrial segments on an expected increase in FDI and healthy growth of domestic consumption.

We are satisfied with our marketweight investment recommendation on Russian sovereign bonds, which we instituted in June. Since then, the sovereign bonds spreads have remained almost unchanged (Chart 2). Under the current global economic environment we maintain our marketweight recommendation for Russian sovereign credit. We believe that due to strong support from domestic financial institutions, the sovereign spreads would be less volatile than other similar EM credits. On the other hand, in terms of absolute yields, we remain cautious on the performance of the sovereign bonds.

CHART 2: Russian \$ and credit curves



Source: Commerzbank Securities

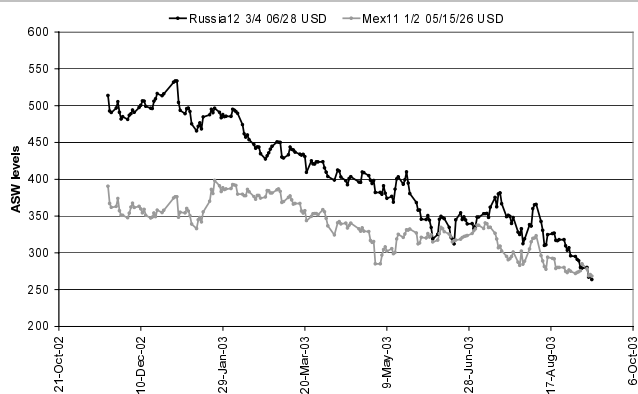
CHART 3: Dynamics of the 3Y vs 25Y credit spreads



Source: Commerzbank Securities

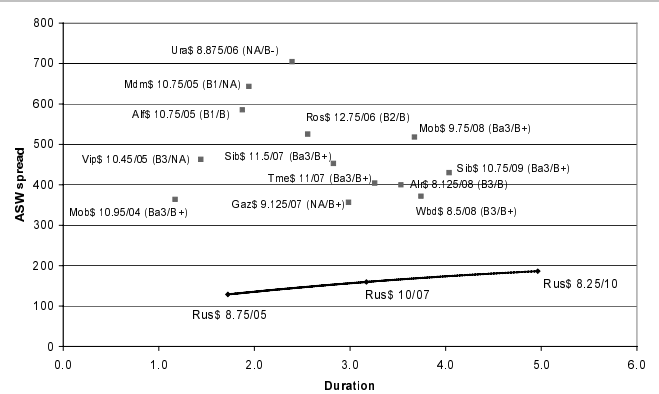
We continue to see more value in the corporate sector, which is likely to benefit from the strong economic fundamentals, increased FDI inflow and domestic consumption growth. From various economic sectors, we prefer credits that enjoy high spreads and are least correlated to sovereigns and the price of oil. The banking segment also looks less attractive to us due to a possible decrease in profit margins and the sector's high capital needs. Therefore we would recommend telecoms on booming demand for services and other industrials on consumption growth.

CHART 4: Relative dynamics of Russian and Mexican ASW



Source: Commerzbank Securities

CHART 5: Russian corporate vs sovereign credit spreads



Source: Commerzbank Securities

## Political outlook

The political campaign for the State Duma (parliament) elections scheduled for 7 December 2003 and the following presidential election in spring 2004 could be seen as sources of potential uncertainty and volatility for the bond market. In our view, however, both campaigns will lead to expected outcomes and therefore we see more value in following closely changes in the legal system that are likely to impact future development of the Russian financial markets.

### Pre-election view

On 2 September President Putin signed a decree on general elections and officially opened the State Duma elections campaign.

*The upcoming Duma elections are likely to confirm the majority of pro-administration's political block*

There are, in our view, two main political events that are likely to influence Russia's fixed income instruments in the pre-election period. Firstly, the formation of any new political alliances on the left or right sides (Yabloko and the Union of Right Forces) of the political spectrum. Secondly, and more importantly, the likely winner of the elections and the balance of power in the new Duma. We are of the view, however, that the pre- and post-election political landscape will remain broadly unchanged with the pro-administration political block maintaining a majority. Thus we expect politics to have a minor, if any, impact on the hard-currency bond performance in the pre-election period.

The early polls suggest that the pro-presidential block - United Russia - leads with 21%-24%, followed closely by the Communist Party of the Russian Federation (KPRF) with 17%-20%. Even assuming broadly a similar performance of the two biggest political forces, the pro-presidential votes in the new Duma are likely to outweigh the KPRF's, as non-partisan, single-member district candidates are likely to ally themselves with the administration. There appear to be only three other parties that are likely to bridge the 5% threshold for gaining a seat in the Duma - the Liberal Democratic Party of Russia (LDPR) led by Vladimir Zhirinovskiy; Grigory Yavlinsky's Yabloko party and the Union of Right Forces of Boris Nemtsov. The table below provides a brief update on the main parties' orientations and the latest polls' estimates.

TABLE 1: **Russia: Poll of polls (early-to-mid September)**

Political party	Orientation	Poll of polls	Current Duma share
United Russia	centre, pro-presidential	21-23%	40.4%
KPRF	left-of-centre	17-20%	18%
LDPR	national-liberal	7-9%	3%
Yabloko	right-of-centre	6-7%	4%
Union of Right Forces	right-of-centre	5-6%	7%

Source: FOM, ROMIR-APRI, VTSIOM, Commerzbank Securities

### Legislative initiatives

A number of pieces of new and important legislation will be discussed and likely voted by the Duma in the weeks before the elections. We see the following legislation as crucial for Russia's economic outlook for 2004 and for the development of the country's financial markets in the years ahead:

- **The 2004 Budget law:** the first reading is scheduled for 19 September and the final reading for 28 November 2003. We expect this law to go through before the elections as almost all positions have been already agreed during consultations between the government and the parliament;
- **The Law on Deposit Insurance:** the first reading is to take place on 17 September. This controversial law has been under development for the last ten years and is crucial for further development of the Russian banking system. According to the draft proposals deposits under 20,000 roubles are 100% insured, above 20,000 roubles are compensated in the amount 20,000 + 75% of the

remaining amount, and the maximum payment before the bankruptcy of the bank is 95,000 roubles. Currently, only the Sberbank (Savings Bank) enjoys full insurance of deposits and therefore has a competitive advantage that allows Sberbank to attract 70% of all deposits. Therefore, Sberbank is lobbying against the legislation, according to which it should join the system in 2007. We do not expect this law to be adopted before parliamentary elections;

- **The Law on Bankruptcy of Banks:** the first reading is to take place on 17 September. This law is crucial for the restructuring of the Russian banking system and decreasing the number of commercial banks, thus improving their soundness. We believe the CBR is awaiting this law before starting a major restructuring;
- **The Law on Financial Derivatives:** the first reading is expected to take place in late September. In the current version, the law provides a very broad definition of derivatives and therefore all market activities will be regulated by the instructions of the CBR. The law is important for the development of the forward market and swap market. Adoption of this law will stimulate the development of the local bond market. Currently, the law has received positive references from all institutions: SEC, CBR, and the government. Since this market is not developed, and is not politically biased, we do not see any political obstacles for an adoption of this law before presidential elections;
- **The Law on Currency Regulation:** the second reading is also expected to take place in late September (the first reading was on 14 March 2003). The major obstacle currently is of how much freedom should be left to the CBR and how much should be put explicitly in the law;
- **The Law on Mortgage Securities:** the document passed the second reading on 20 June 2003 and the next reading is expected in late September. A controversial issue here is giving the right to issue mortgage securities to banks or only to specialised agencies. In the current draft, the right is given to both. This law would boost local housing markets in the regions, but also might lead to a messy and illiquid market if this results in a large number of relatively small issues.

## Economic outlook

### Strong growth to continue through 2004

Real GDP growth reached 6.9% in the first eight months of the year driven by a strong export performance, rising corporate investments and strengthening private consumption. The year-on-year economic performance in H1 was very strong with exports rising 24.7%, industrial production accelerating to 6.8% and real fixed income investment increasing by 13%. The retail sales also rose by 9.3% y-o-y in Q2. The latest data for July-August also confirm the sustained strong economic growth trend with industrial production growing by 7.1% and 5.5% y-o-y in July and August respectively.

*Better balanced economic growth in the years ahead*

In line with the strong economic momentum, we revise our GDP growth projections for this and next year to 6.0% and 5.0% respectively. We expect further improvement in the growth structure as fixed investments have already become the main growth-driving factor in the economy, supported by healthy export and private consumption growth. For 2004 we revise upwards our projection for investment demand growth to 10% and expect only a slight decline in private consumption growth from 7.0% this year to 5.0% in 2004. A further reduction of the tax burden next year and the recovery in Euroland will likely provide a base for the favorable cyclical trend to continue. A further impetus should result from fresh reform momentum after the presidential election next year. In addition, the recent success in attracting foreign direct investment in the energy sector should encourage the government to improve investment conditions further. We project foreign direct investment inflow of \$4.5bn this year and \$4.0bn in 2004.

### Inflation, monetary policy and the rouble

*Administrative price hikes to slow down the disinflation trend*

Inflation still runs at an annualized rate of 14%. Although consumer prices posted the first monthly decline in eight years in August, the year-on-year rate remained at 13.9%. The August data does not indicate a change in the price trend, since the price fall has been triggered by a surprisingly strong fall of food prices. The same conclusion can be drawn from the producer prices. Recent data show producer price inflation still above 13%. Inflation is being pushed up by a high money supply and real wage growth, as well as by the delayed impact of administered price hikes. At year-end we expect CPI at 13.5%, which is higher than the Central Bank's target range of 10%-12%. Further administrative price hikes in 2004 – gas prices will be increased by 25%, electricity prices are set to rise 15% and railway tariffs will probably be raised by 12% – will likely slow down the disinflation process. We project 2004 CPI at 12.0% at year-end.

The Central Bank targets an annualized broad money growth of 20%-26%. Recent data show, however, M2 growth slightly below 50% y-o-y. The key problem for the Central Bank is the lack of monetary instruments with which to sterilize foreign currency inflows generated by high oil prices, pushing the rouble stronger against the dollar.

*The rouble to continue appreciating in real terms*

According to our estimates the real effective exchange rate appreciated by about 5.0% year-to-date. This is the result of continuous portfolio inflows and a rather slow deceleration of inflation. With portfolio inflows projected to remain high, an increase in direct investment inflows will likely result in the rouble remaining under pressure to appreciate. Therefore, we revise our forecast for end-of-period rouble/dollar rate to 30.5. This means a slight nominal appreciation compared to year-end 2002, whereas we project a nominal depreciation of 3.8% next year to 31.3 against the dollar at year-end 2004. Despite expected weaker pressure on the currency due to a moderate decline in oil prices in 2004, the real appreciation is likely to remain higher than the central bank's medium-term target range of 4%-6%. We also do not expect the parliamentary elections in December and the presidential elections in March 2004 to bring about any considerable weakness on the currency.

## Fiscal performance on track

*Fiscal performance remains enviable*

The government aims for a revised fiscal surplus of 1.4% of GDP this year. This projection looks realistic, although we expect a slight undershooting due to higher spending in the run-up to the elections. We expect a fiscal surplus of 1.2%. For 2004 the government has lowered its budget surplus target from 0.6% of GDP to 0.5% of GDP. We remain a bit more cautious, expecting a surplus of 0.2% of GDP, taking into account the value-added tax (VAT) changes next year (the value-added-tax rate will be reduced from 20% to 18% as of 1 January 2004). VAT is by far the most important tax and it contributed over one-third of total tax revenue in 2002. It is not clear if other tax measures will fully compensate for the VAT revenue shortfall. The government is planning to raise gas export duties and oil extraction taxes, and also targeting higher regional taxes to make up the loss of the regional sales taxes.

*2004 fiscal assumptions look conservative*

The government's budget plan for 2004 is based on what we consider to be conservative assumptions that underline the prudent fiscal policy in recent years. The key variable, the average oil price for Urals Blend, is expected at \$22/barrel. This implies a Brent Blend price of around \$23.5/barrel that is in line with our projection. We estimate only a drop in the oil price to below \$20/barrel for a sustained period of time would make spending cuts necessary to avoid a shift into deficit. The vulnerability to oil price shocks has been not only lowered by a prudent fiscal policy, but also by the tax reforms that have increased the percentage of tax revenue from labour income.

## External accounts remain in considerable surplus

*We revise upward our projections for trade and current account surpluses*

The current-account surplus reached \$21.3bn in the first half of 2003 according to preliminary estimates from the Central Bank. In the same period of 2002 the surplus posted was \$14.8bn. Therefore, we revise our annual projection upward to \$34.8bn, which is equivalent to 8.3% of GDP. The trade surplus also rose by a third during January–July to \$41.8bn compared to the same period in 2002. The trade data point to some abating of export growth. In the first quarter exports grew 42% y-o-y, while in second quarter the export growth declined to 20%. Imports followed a similar pattern, with a growth rate of 24% y-o-y in Q1 and 22% in Q2. We expect both trends to continue, so that the trade surplus is projected to reach \$50.0bn this year. In 2004, the surplus will probably decline to around \$40.0bn, assuming a significant fall of the oil prices during the course of the year. This implies a sizeable current-account surplus of 5.0% of GDP.

## Structural reforms to gain new impetus in 2004

Politically controversial reform measures have been largely put on hold before the elections, but this does not imply a complete halt to reform. Tax and financial sector legislation is in the process of approval and some measures will be implemented from early 2004. President Putin also signed a decree on amendments to the state program of railway privatization, thus allowing a restructuring of the monopoly. The progress on other far-reaching initiatives, such as natural monopolies restructuring, however, is only likely to gain speed after the parliamentary and presidential elections.

## Debt sustainability and external cash flow

*Debt indicators have improved considerably over the past years*

One of the main achievements of the Russian administration over the past few years was the rapid reduction in the country's debt burden. Russia's foreign debt-to-GDP ratio fell from 94.5% in 1999 to 44.5% at end-2002 and is projected to drop further to just above 30% by end-2004. The public sector debt is expected to decline to 33.8% of GDP (including external debt of 27.8% of GDP) by end-2003 and further to 29.9% (external debt 23.5% of GDP) by end-2004. The government's debt management strategy for 2004-05 is to increase the share of domestic debt in total public debt. This would lower the currency risk and the government would benefit from the strong excess rouble liquidity due to the large foreign currency inflows. The vulnerability to oil price changes has also been significantly reduced by a cautious fiscal policy and the establishment of an economic stabilization fund.

*Strong external cash flow picture*

Russia's debt service repayments remain sizeable – \$14bn in 2004 and \$15.4bn in 2005 - but we estimate the fiscal and current account surpluses, combined with increase inflow of FDI are more than enough to cover all payments due. Our external cash flow projections in the table below show a considerable financing surplus this year and a smaller but still positive number in 2004.

TABLE 2: **Russia: External debt obligations**

\$bn	2003E	2004E	2005E	2006E	2007E
Original amount due	19.5	12.9	15	13.25	13.5
Projected amount due	15.7	14	15.4	13.25	13.5
of which,					
Principal	9.1	8.5	9.7	8.5	8.8
Interest	6.6	5.5	5.7	4.75	4.7

Source: Commerzbank Securities

TABLE 3: **Russia: external cash flow**

\$bn	2003E	2004E
<b>Uses</b>	<b>3.4</b>	<b>-8.4</b>
Current account surplus(+)/deficit(-)	34.8	24.3
Bond and loan amortizations	-31.4	-32.7
o/w medium and long term	9.1	8.5
o/w short term	22.3	24.2
<b>Sources</b>	<b>16.5</b>	<b>12.2</b>
Financial reserve account	6.3	4.0
Budget surplus	5.0	1.0
Equity investment, net	5.0	4.7
FDI	4.5	4.0
Portfolio investment	0.5	0.7
Multilateral loans (IMF, WB, EBRD)	0.2	0.3
Other bilatrel financing	0.0	0.2
Eurobond issuance	0.0	2.0
<b>Financing Surplus (+)/Gap(-)</b>	<b>19.9</b>	<b>3.8</b>

Source: Commerzbank Securities

*We see Russia gaining investment grade status in 2004*

Strong economic fundamentals, renewed impetus for structural reforms after the election period, rising foreign direct investments and improving debt indicators are likely to lead to Russia gaining investment-grade status next year.

**TABLE 4: Russia: Main economic indicators and projections**

		1999	2000	2001	2002	2003F	2004F
Nominal GDP	RUBbn	4545	7063	9041	10831	12997	15206
Nominal GDP	\$bn	184.6	251.1	308.6	344.9	419.3	485.8
GDP	real % growth	5.4	9.0	5.0	4.3	6.0	5.0
Private consumption	real % growth	-3.0	8.0	9.0	6.0	7.0	5.0
Public consumption	real % growth	-2.8	1.4	-1.5	2.4	2.0	1.0
Gross fixed capital formation	real % growth	4.5	15.5	10.5	3.0	10.0	7.0
Exports	real % growth	-4.6	5.0	4.0	5.0	7.0	6.0
Imports	real % growth	-21.7	23.0	14.0	9.0	11.0	9.0
Unemployment	%	12.6	12.3	9.7	8.5	7.6	7.3
CPI total	%, e-o-p	36.7	20.1	18.6	15.0	13.5	12.0
CPI total	%, average	85.7	20.8	21.6	15.8	14.0	12.0
RUB/USD, e-o-p		27.0	28.2	30.5	31.9	30.5	31.7
RUB/USD, average		24.6	28.1	29.3	31.8	31.0	31.3
RUB/EUR, e-o-p		27.2	26.9	27.3	32.6	35.7	35.5
RUB/EUR, average		26.2	29.7	26.2	29.4	34.7	35.7
Fiscal balance (central gov.)	RUB bn	-56.6	173.5	262.0	151.6	156.0	30.4
Fiscal balance	% of GDP	-1.2	2.5	2.9	1.4	1.2	0.2
Current account	\$bnI	24.7	46.4	35.1	32.8	34.8	24.3
Current account	% of GDP	13.4	18.4	11.3	9.2	8.3	5.0
Exports (of goods)	\$bn	75.7	105.6	103.2	106.0	120.0	113.0
Imports (of goods)	\$bn	39.5	44.9	53.8	61.0	70.0	73.0
Trade balance	\$bn	36.2	60.7	49.4	45.0	50.0	40.0
FX reserves ex gold	\$bn	8.5	24.3	32.5	47.0	67.0	70.0
Foreign debt	\$bn	174.4	161.4	151.0	153.5	149.0	150.6
Foreign debt	% of GDP	94.5	64.3	48.9	44.5	35.5	31.0
Debt service	\$bn	12.0	12.0	18.0	15.3	18.0	14.0
Debt service	% of GDP	6.5	4.7	5.8	4.4	4.3	3.0
FDI net	\$bn	1.1	-0.5	-0.1	0.1	4.5	4.0

Source: Commerzbank Securities

### Recommendation Definitions

Terms: BUY - 15% or more outperformance; ACCUMULATE - 5% to 15% outperformance; HOLD - 5% underperformance to 5% outperformance; REDUCE - 5% to 15% underperformance; SELL - 15% or more underperformance.

Period: During the forthcoming 12 months, at any time during that period and not necessarily just at the end of those 12 months.

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