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HOLD ONTO YOUR RUBLE BOND BUYING HORSES

The last time we commented on Russian bond market strategy outside of our brief daily comments was in March, and before that at the end of January¹. In both cases we recommended that investors should stick to short-dated papers from issuers with transparent credit profiles, taking into the account the consequences of the global credit crunch and liquidity squeeze, as well as the possible reaction of regulators and issuers.

In this research note, we would like to systematize our view on the most recent changes in the market landscape:

- On the global markets front, credit crisis noise has somewhat eased, as banks have largely recapitalized, and instead inflation has become the most important issue on the agenda. Inflation's impact on the Russian ruble bond market is not straightforward
- Despite a certain revival in the primary segment of the Russian bond market, the overhang of new bond issues in the pipeline has only increased
- Significant cash inflows are expected to arrive from Russian state-controlled 'development institutions'
- Recent defaults in ruble bonds are making investors nervous, which further adds to already high refinancing risks

We believe that in 2H08, negative factors are likely to outweigh the positive ones. That said, we do not anticipate an avalanche-like reduction in price quotes, first, because ruble bonds issues have a short average duration (approximately 1.1 years), and second, as we note that today, when investor activity on the secondary market decreases, market-makers are efficiently resisting price corrections, setting the quotes above 'fair value'. Nevertheless, we expect that the re-pricing process will continue through new issues and new coupons being set.

Given the above, we advise maintaining a defensive structure of ruble bond portfolios, avoiding papers with long durations. Our main recommendation is that investors should not to rush into buying. Negotiating power has clearly moved from borrowers to investors, a trend unlikely to reverse in the next 12 months, at least. There is a huge volume of deferred supply, meaning that if one doesn't buy something today, there will likely be the same risk for a comparable or more attractive price available tomorrow. And of course, one should now allocate more resources to credit risk analysis.

¹ "Ruble bond yields de-couple from short-term rates" from March, 25 and "CBR tightens monetary policy" from February, 4.

Credit crisis is no longer a key theme...

Rhetoric in media and analytical publications has visibly changed in recent weeks. The volume of news concerning the credit crunch and financial losses from the subprime mortgage crisis in the US is constantly declining. This trend may be illustrated by the following chart:

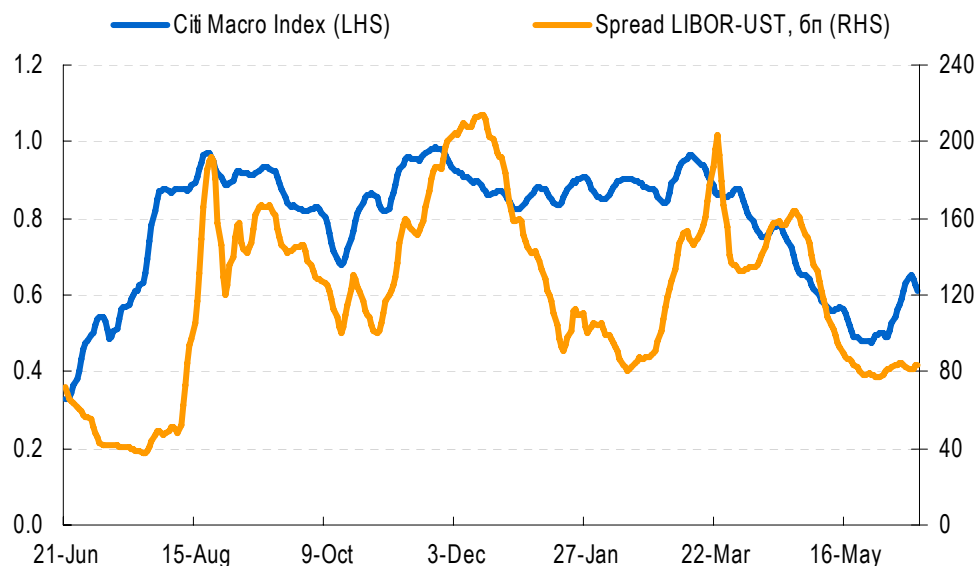
Chart 1. Index Google trends on the inquiry "subprime crisis"²



Source: Google

On the back of this decline in subprime related hysteria, global risk appetite has noticeably increased, as measured by the widely used indicators such as the TED spread (3 month LIBOR vs. 3 month T-Notes) or the Citi Macro Risk Index.

Chart 2. "Risk appetite" indicators



Source: Bloomberg, MDM Bank estimates

This has become possible on the back of decisive actions of the world's key monetary regulators led by the FOMC. Central banks have flooded the market with liquidity, by both cutting interest rates (FOMC, Bank of England, Bank of Canada) and introducing various liquidity facilities such as TAF auctions, TSLF, etc.

² Index Google Trends reflects the popularity of the inquiry in Google search. This may be considered as an indirect confirmation of the importance of the certain topic.

The successful recapitalization of the world's largest banks, which managed to attract considerable funds (mainly from SWFs) has also contributed to the increase in global risk appetite. At present, according to Bloomberg (WDCI <GO>), the banks globally have covered around 80% of their losses from subprime.

The subprime threat appears to have become easier to assess. In March, S&P published a report arguing that the market had already recognized approximately half of its subprime losses; by May, Fitch had assessed this ratio at 80%. One has to remember though that these considerations refer only to mortgage-related losses, while adjoining segments (car loans, credit cards) have also suffered from subprime fallout. But still, the positive trend is there.

We believe the increase of global risk appetite may be also attributable to the start of the new financial year, when investors had to become more active, notwithstanding the risks, as "money should work".

In the Russian bond market, the improvement in the global sentiment virtually cauterized the capital outflow and provided for the recommencement of new Eurobond issues. Within the first half of the year, 26 issues of approximately USD14.9 bn were placed, which may be considered a sign that the market has started to recover (during 6M07, the total volume of placements was around USD27 bn).

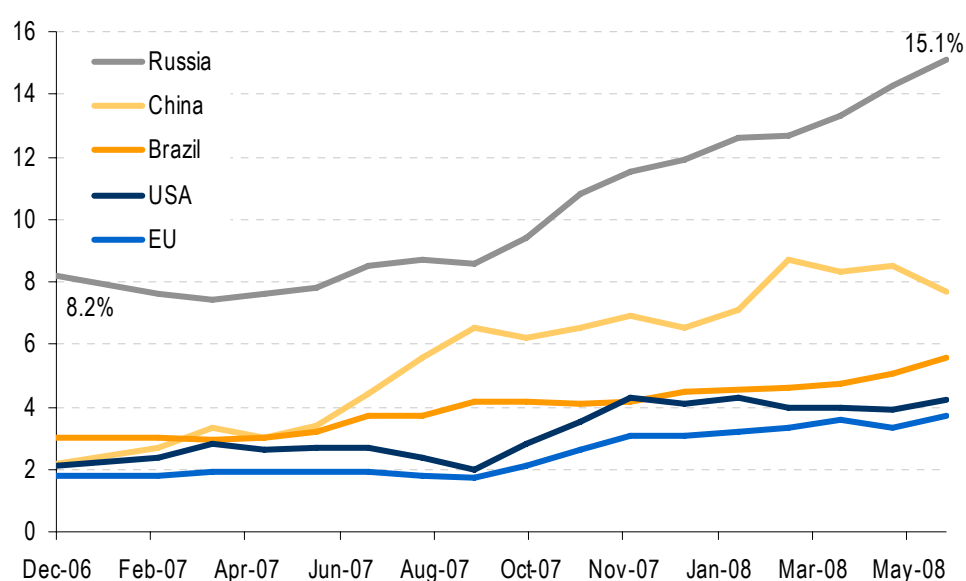
Inflation is now at the top of the agenda

The US subprime crisis hit just as emerging countries faced powerful inflationary pressures, first of all in China, India, Brazil and Russia. Rapid economic growth in these emerging markets, often combined with a currency peg, provoked booming investment and consumption activity from local corporations and households. The related rally in energy, metals and soft commodities prices was enthusiastically supported by speculative investors searching for an alternative to plummeting equities. USD depreciation and the easing of monetary policy by the main central banks in response to the credit crunch also fanned the inflation fire.

As a result, the US and Europe have also been infected by the inflation virus, despite a decline in house prices and certain financial assets. For example, CPI in the US has now reached 4.2% y-o-y (compared to 2.1% at the beginning of 2007), in Russia and Brazil inflation index has almost doubled, and in China it has more than tripled.

Spiraling prices have put hawkish statements back into the rhetoric of central banks, even in US, where the financial sector and the real estate market would still appreciate a soft monetary policy.

Chart 3. Global inflation (y-o-y, %)



Source: Bloomberg, MDM Bank estimates

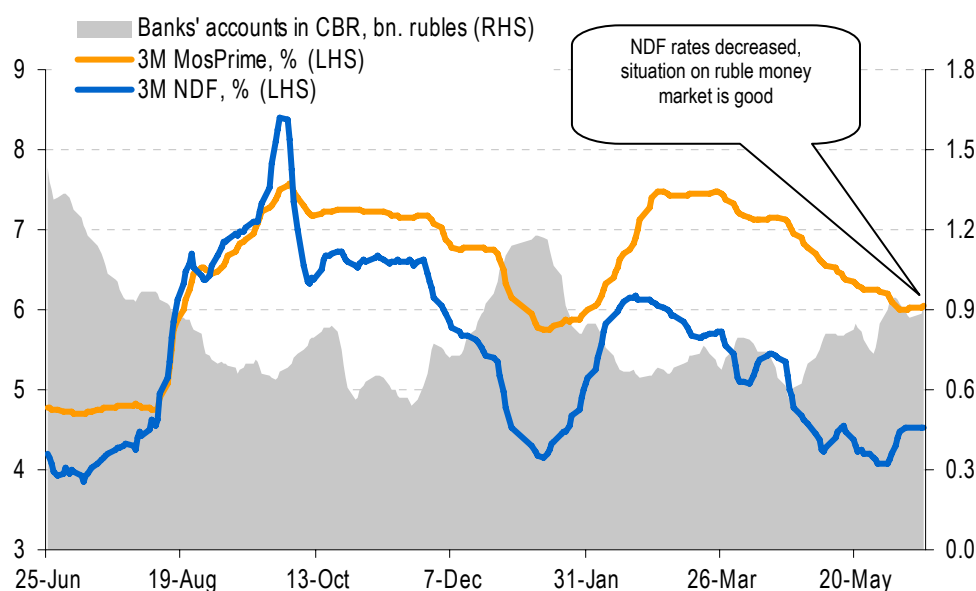
Global inflation for ruble bonds: good and bad

The impact of global inflation on the Russian ruble bond market is not straightforward. On one hand, skyrocketing oil and metal prices sustain the rather favorable situation in the money market and increase the attractiveness of ruble bonds for foreign investors. The reasons are evident:

- Growing export sales increase pressure on the ruble to appreciate and allow for benign conditions in the local money market
- NDF implied yields are decreasing
- Capital outflow has stopped, and in fact some capital inflow has been registered in 2Q08
- The Central Bank of Russia has to increase the volume of ruble expansion in order to prevent it from unreasonable appreciation

Thanks to almost daily CBR interventions in the FX market, the total amount of banks' accounts in the CBR exceeds RUB900 bn and short-term rates are near their lows. The latter provides certain support to the bond market (but of course it's not a silver bullet, as we wrote in our commentary "*Ruble bond yields de-couple from short-term rates*" of March 25).

Chart 4. Ruble money market performance



Source: Bloomberg, MDM Bank estimates

On the other hand, growing inflation has a number of negative consequences that exert upward pressure on ruble interest rates.

First of all, the propensity of corporations and households to save is declining. Russian banks have to raise interest rates, as they need to strengthen their funding base (international capital markets are almost closed and the CBR is actively suggesting that banks should work harder on the deposit side). The process of re-setting deposit rates is already ongoing, so funding costs for banks are going higher and they are passing this increase into required return on assets i.e. in loans and bonds.

Second, households' and corporations' appetite for borrowings is growing along with inflation, as they understand that it makes sense to do spending now vs. doing it later.

The final, and perhaps most important consequence of the inflation seems to be that the nature of CBR monetary policy is changing. Since the beginning of 2008, the CBR has raised key rates by 75bp, as well as it has tightened the levels of obligatory reserves for banks.

If no miracle happens and inflation in Russia stays high in the coming months, the CBR is likely to continue its tightening cycle. According to CBR representatives, the bank will changing rates very carefully. The regulator

will have to pay attention to so called carry trade risk, i.e. the risk of capital inflow that would play the interest rate differential and offset the anti-inflationary efforts. In our view, this risk is in fact not significant for the following reasons:

- 1) The inflationary effect from the inflow of cash on banks' deposit accounts in the Central Bank is insignificant, as this cash is in fact "frozen" and does not contribute to credit expansion
- 2) Outside the Central Bank's overnight and weekly deposits, other ruble fixed income assets (local sovereign curve, corporate bonds) are quite overpriced vs. the NDF curve, so pure arbitrage there is impossible; also the bond market is not too liquid, hence not much money can be played there with a short-term horizon
- 3) By increasing levels of obligatory reserves for banks on certain types of liabilities, the CBR can make carry trades less profitable
- 4) The hawkish tone of Fed and ECB is also helping to avoid significant widening of interest rate differential

We believe that key CBR interest rates are likely to be raised another 50bp before the end of 2008. As before, the regulator will likely combine interest rate policy with a tightening of reserve requirements, in our view.

The gap between supply of financing and demand for it has widened

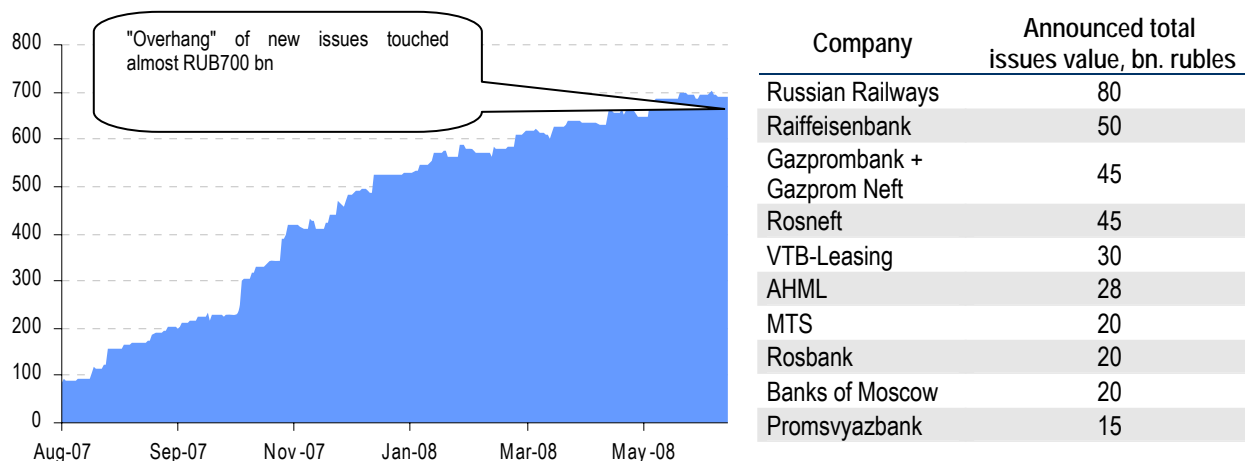
For obvious reasons, in 2H07 the Russian debt market has not been functioning very well. Despite certain pick up in credit expansion and new bond issuance in the recent months, we believe that the gap between supply of financing and demand for it has only widened.

The Russian banking system didn't solve its problems with funding – banks' total assets in January-May increased only by 11% compared to a 44% growth rate for FY07 (Source: Table 10 in the CBR's monthly "Banking sector overview"). When it comes down to individual stories, e.g. Russia's leaders in consumer finance, where one can observe stagnation of loan portfolios.

At the same time, the economy is growing at breakneck speed (GDP increased 8.5% y-o-y in 1Q08), and it appears that corporations are not ready to tame their investment appetites quite yet. In some cases it has already resulted in certain companies with healthy businesses "hitting the wall" (e.g. producer of paper packs GOTEK defaulted on its bond after implementing an overly aggressive investment programme).

Throughout January-June 2008, the local bond market digested some RUB355 bn worth of new bond placements (excluding non-public placements. However, the overhang of registered, but yet not placed (and not out-of-date), issues continued to grow. By our estimates, the pipeline of ruble bonds reached RUB700 bn by the end of June 2008, which is almost 4 times more vs. August 2007. Of course, we cannot track the issues that are being planned by corporates, but have not yet been officially registered.

Chart 5 and Table 1. Value of registered issues, RUB bn; and TOP-10 issuers



Source: CBonds, Interfax, MDM Bank estimates

Obviously, this kind of overhang in the primary market will not be eliminated anytime soon. We believe that for at least the next 12 months the debt market will stay 'heavy', leaving investors, tipped back in their armchairs, without any semblance of urgency, able to pick the ripest plums from the vast orchard of new issues. And in each deal there would be a premium to the secondary market.

Due to the shortening of ruble bonds' average lives, borrowers would have to appeal to investors more frequently. In June 08, the average term of a ruble bond was approximately 450 days; a year ago it was 512. With the total amount of outstanding issues exceeding 700, even simple market "reproduction" (i.e. re-issuance or setting of new coupons on an "old" bond as it approaches put) assumes that investors will have more than one proposal every day.

And by no means should one count on good conscious from potential issuers. It is likely that companies will not repress their appetite for new debt, and will use every moment of brightening in the market to issue new bonds, rather than holding for better market conditions which would naturally occur after a spell of reduced issues. Given, that there is no "regulator" to temper this predisposition for immediate issues – one that would coordinate the "queue" for the new deals – banks and corporations, vying with each other, will likely issue new paper at every turn.

Cash from "development institutions" will help, but not the whole market

One of few bright spots on the market's current gloomy palette is the expected inflow of temporarily excess cash balances from the so-called "development institutions" – Rosnanotech, Olimpstroy, the Bank of Development and the Housing & Utilities Fund. These entities have recently received gigantic equity injections from the federal budget, but won't be able to spend all this money in the short-term. Incidentally, President Medvedev recently gave directions to establish a regulatory structure that would allow the "unpacking" and investment locally of an even bigger cash pile – the National Wealth Fund. However, this is not something that will happen within the next 12-18 months.

Meantime, it makes sense to speak about the wallets of the four "development institutions". Thus far, the Bank of Development and Olimpstroy have already parked temporary liquidity (\approx RUB115 bn and 30 bn, respectively) in banks' deposits. Rosnanotech, it was revealed recently, decided to put its excess liquidity (near RUB130 bn) in bank deposits, too. In our view, this is a sound decision considering the interest rates offered by Russia's top banks (*Vedomosti* reported 10-12%), the low liquidity of the bond market for short-term investments, and the Russian Ministry of Finance-set restrictions for Rosnanotech whereby the Ministry could change the currency of cash allocation every three months.

We can therefore argue that the funds of these three state corporations will not affect the debt market directly. Nevertheless, there will be an indirect positive impact : Cash parked as deposits partly solves banks' funding problems and improves the abovementioned supply-demand picture in the system as a whole.

As we have been hearing recently, near RUB40 bn from the Housing & Utilities Fund's spare cash balances will likely be allocated to banks' deposits; approximately RUB60 bn transferred to already selected asset managers and invested in ruble bonds. We have learned that actual transfer of RUB60 bn will happen soon, possibly within the next 1-2 months. The investment horizon for this money is four years.

One of the key criteria set for the allocation of the Communal Fund's money in bonds is that the securities should be of decent quality, issued by entities that are rated at least Ba3/BB-. We believe that respective investments will be done mostly in the primary market, given the fact that secondary market is not liquid enough and comparatively largely overpriced, while the new issuance pipeline is huge with juicy premiums in every deal.

To conclude this section, we believe that cash inflows from development institutions are supporting and will continue to support the local debt market. When it comes to the ruble bonds, those inflows, combined with general flight to quality effect, will help spreads on local high grade bonds widen less compared to the 2-3 tier issues. However, the money of development institutions will not be sufficient to reverse the re-pricing trend that is currently taking place. There could be certain price appreciation episodes in specific bonds related to arrival of this money. But in order to bet on that one would have to be an insider.

Conclusions and recommendations

We believe that in 2H08, the combined influence of negative factors – CBR monetary tightening, gigantic appetite for financing including the huge bond pipeline, and fear, which arose after recent defaults – will slightly outweigh the positive effect of a strong ruble, a benign money market situation, and the arrival of cash from “development institutions”, including RUB 60 bn from Housing & Utilities Fund, which will be invested in bonds.

Our key recommendation therefore is not to hurry into buying bonds, keep a short portfolio duration and look for opportunities among new primary market deals or old bonds with re-set coupons. Our experience shows that these bonds are the ones which offer the best value.

Attention to credit risk should increase

Indeed, after the recent mini-wave of defaults (all except one company, Minnesko, have repaid), there are clear reasons to tread with caution when choosing issuers, as the systemic risks of refinancing are as high as they have ever been. The best option is to keep a large amount of first and second tier bonds in portfolio (B and above rated issuers, yielding from 8% to 11%). At the same time, we think that there are still a number of bonds outside this segment that make sense to look at.

In the high yield bond segment, our top recommendation is financial institutions. The main factors supporting our point of view on this group’s credit risk (explained in our special comment of September 28, 2007) are:

- The high probability of the state support to the financial sector in a stress-scenario. A default from any significant financial institution could paralyze the economy’s blood-circulatory system, which is why regulators are keen to steer clear of default by any possible means. (Northern Rock and Bear Stearns cases have only confirmed the too big to fail approach). Local banks now have a number of instruments which allow to obtain refinancing at the Central Bank. Finally, a troubled bank can be acquired by a state-controlled giant with assistance of the Central Bank (Guta-bank scenario);
- The short-term asset structure of most Russian financial institutions, which allows to rapid accumulation of liquidity cushions
- The still strong appetite for the Russian banking sector. It is not too difficult to find a buyer for part of a loan portfolio or the entire bank
- Shareholder support. Banks’ owners in many cases have incentives and ability to support
- Last, but not least: a more adequate understanding by Russian banks of the changed financing environment compared to treasurers/CFOs of Russian corporates (esp. mid-sized and small ones) simply because financing is banks’ core business

Another high yield group which we feel bold enough to recommend as something acceptable in the current environment are issues of companies that have wealthy shareholders. To name a few: RSK MiG (owned by the Russian state, Baa2/BBB+), Kopeyka (owned by FC Uralsib’s beneficiary, Nikolai Tsvetkov), ZhilSoclpoteka and ZhelDorlpoteka (owned by Russian Railways, A3/BBB+), and numerous infrastructure companies owned by the administration of the Moscow Region (Ba2/BB).

Our guess is that the latter recommendation could look arguable, especially after the recent unpleasant situation with the one-day delay in execution of a put option by MOITK (a subsidiary of Moscow Region). Frankly, in some cases, we do not particularly like the quality of corporate governance in companies controlled by federal or municipal authorities. Quite often one can see there what is usually referred to as a moral hazard problem. Nor are we confident that the activities of such companies are a natural area of responsibility of the public sector, i.e. taxpayers’ money is managed efficiently. However, in our view, the shareholders’ willingness and ability to support such companies is so strong, that the ultimate credit risk is quite acceptable.

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