

AB-ICI February: Index Flat on Cabinet Dismissal

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Investment Summary

- Cabinet dismissal fueled currency volatility; CBR reserves remained virtually flat in February
- Equity market performed well, favoring growth of Index, but the bond market underperformed
- CBR reserves growth is key issue in coming months, may be weak due to capital outflows

Cabinet dismissal slowed capital inflows

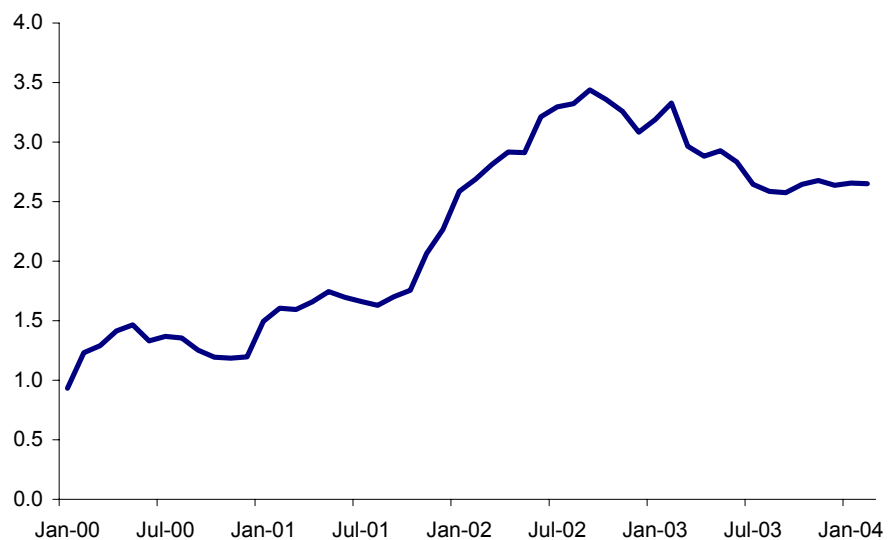
Index unchanged in February, as market growth was not followed by capital confidence

Stagnation in CBR reserves in February-March is surprising, as oil prices were rising

For the second month this year the Alfa Bank Investor Confidence Index (AB-ICI) has shown that investor attitudes towards Russia remain mixed. As we mentioned in our previous report, in February the AB-ICI was supported by impressive growth on the equity market. However, the main area of intrigue was that CBR reserves failed to grow.

Fluctuations in CBR reserves around a level of \$84 bln were surprising given the continuing increase in oil prices. Fundamentally, the lack of reserves growth may be explained by the high \$3 bln foreign debt payments due in February, but this factor alone cannot justify the shift in the trend. In our view, the perception among holders of Russian capital, who were previously sending capital back to Russia, is now changing.

Figure 1. Alfa Bank Investor Confidence Index Flat in February



Sources: New School of Economics, Alfa Bank

Ruble deposits in Russia were offering a return of more than 20% in dollar terms versus 6-7% international

In 2003 Russian and foreign capital was attracted to Russia by the wide spread between ruble and dollar domestic rates, which failed to react rapidly to the change in currency trends and continued to price in ruble depreciation. A simple comparison of deposit rates underscores the importance of potential gains: international borrowing cost Russian companies 6-7% while domestic dollar-denominated deposits were offering a return of 8%, ruble-denominated deposits paid 14% and more than 20% in dollar terms. This was the key



reason why the net capital outflow dropped from \$8.1 bln in 2002 to just \$3 bln in 2003.

As long as capital inflows are not invested in long-term projects, CBR reserves will remain vulnerable

Interest rate spreads in the Russian banking sector dropped substantially by 2004, which restricted such arbitrage opportunities. This made the exchange market more sensitive to political and economic changes. As an example, the dismissal of Mikhail Kasyanov cost the CBR \$2 bln in intervention in a single week. As long as FDI flows invested in the real sector remain modest compared to the total inflow of capital, which is largely speculative in nature, the exchange rate and CBR reserves will remain vulnerable to heightened volatility. We do not exclude that the recent stagnation in CBR reserves represents the beginning of a new trend of capital outflows.

Bond market is no longer supporting the Index due to limited upside

It should also be noted that the Russian bond market is no longer playing a supporting role for the Index. The spread between Russian and peer bonds is widening, which indicates that Russian bonds are already pricing in investment grade status and that their upside is quite limited.

Equity market to provide key support for the Index

Equity market believes in revaluation of Russian assets due to deeper global integration...

In our view, the strong rally on Russia's equity market in March will boost the Index. The revaluation of a number of Russian assets, supported by greater interest in IPOs by domestic companies, reflects expectations of faster convergence between Russia and the global economy. One obvious example is Russia's expected entry to the WTO, which should take place before 2006. Second, the fact that Russian companies invested \$2.6 bln in 2003 and continue to purchase foreign assets is helping to improve the perception of Russia among investors.

...and an abundance of liquidity

Another key argument is that after S&P grants the country investment grade status, which is expected to occur later this year, more foreign funds will be open to investment in Russia. Even if CBR reserves do not grow rapidly, foreign liquidity will then flow into the Russian equity market.

Market will focus on steps taken by the new Cabinet

More generally, we believe that the government must proceed with concrete reform measures over the next two months if the equity market is to maintain its current high level. In particular, administrative reform, the taxation of oil companies and the reform of natural monopolies will play a crucial role in terms of the Index dynamic.

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