AB-ICI February: Index Flat on Cabinet Dismissal

Natalya Orlova (7 095) 795-3677 NOrlova@alfa-bank.com

March 23, 2004 www.alfabank.com Moscow

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

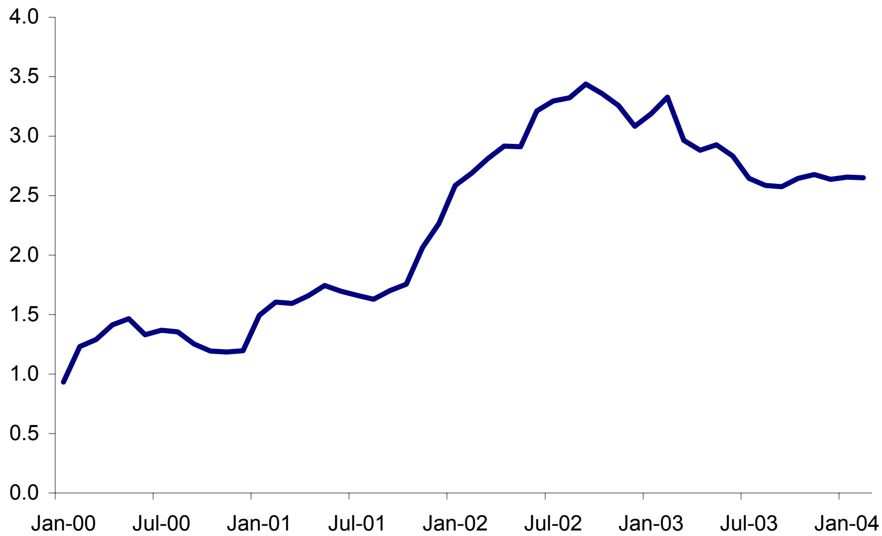
Index unchanged in February, as market growth was not followed by capital confidence

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.

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

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.

Contact Information

Alfa Bank (Moscow)

Head of Equities	Dominic Gualtieri
Telephone Facsimile	(7 095) 795-3649 (7 095) 745-7897

Research Department

Telephone Facsimile	(7 095) 795-3676 (7 095) 745-7897
Co-head of Research, Telecoms	Andrei Bogdanov
Co-head of Research, Chief Strategist	Chris Weafer
Oil & Gas Team	Matthew Thomas, Anna Boutenko
Macroeconomics, Banking	Natalya Orlova
Utilities	Vitaliy Zarkhin, Natalya Devetyarova
Telecoms/Internet	Andrei Bogdanov, Svetlana Sukhanova
Metals & Engineering	Maxim Matveev CFA, Natalya Sheveleva, Pavel Sokolov
Consumer Goods	Alexander Svinov
Russian Client Support	Angelika Henkel
Fixed Income	Valentina Krylova, Ekaterina Leonova, Oksana Klypina
Technical Analysis	Vladimir Kravchuk
Editor	Erik DePoy
Translation Team	Rinat Gainoulline
Production Team	Pavel Sokolov, Robert Broadie, Natalya Sheveleva

Equity Sales & Trading

Telephone Facsimile	(7 095) 795-3712 (7 095) 745-7897
International Sales	Kirill Surikov, Alexander Zakharov
Domestic Sales	Oleg Martynenko, Alexander Nasonov, Konstantin Shapsharov
Capital Markets, Structured Products	Armen Petergov, Alexei Gourianov, Tamara Zarechneva
Address	12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Securities (London)

Telephone Facsimile	(44 20) 7588-8500 (44 20) 7382-4170
Head of Equities	Guven Giray
Equity Sales	Maxim Shashenkov, Steve Downer, Peter Bobrinsky
Address	City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones Facsimile	(212) 421-8564 / 1-866-999-ALFA (212) 421-8633
Sales Trading	Nicholas Beech
Research Sales	Michael Kaplan
Address	540 Madison Avenue, 30th Floor, New York, NY 10022