



EASTERN EUROPE FIXED INCOME: WEEKLY OVERVIEW

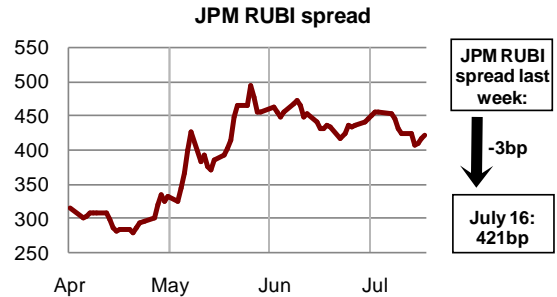
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- **Russia's fixed income market grew by 0.75% during the week, while spreads narrowed by 3bp (JPM RUBI)**
- **Cyclical sectors outperformed, while banks underperformed within the RUBI Index**
- **Ukraine and Kazakhstan rallied by 1.4% and 1.0% respectively**
- **Industrial production declined in Russia and Ukraine, but jumped in Kazakhstan**
- **To meet the new IMF programme requirements, Ukrainian government hikes internal gas prices by 50%, other utility tariffs to follow**
- **Ukraine postpones \$2b eurobond placement**
- **Corporate news: Kazakhgold, KKB**
- **We foresee generally favourable environment for emerging market debt for the nearest term, yet the "easy money" appears to be behind us. In Eastern European debt markets we continue to prefer Ukraine and Kazakhstan to Russia, yet in all markets security selection remains critical. As usual, in Central Europe's eurobond market bottom-up approach is the basis for investing**



General news

In June, industrial production statistics showed an easing recovery trend in some of major CIS economies. In Russia the industrial output declined by seasonally adjusted 0.4% m/m, while comparing to the previous June it still showed an impressive rebound of 9.7% y/y. In Ukraine industrial production declined 0.5% m/m primarily on the back of a contraction in the metallurgical sector (-11% m/m). To note, only steelmakers with poor liquidity and/or lack of inputs demonstrated output declines in June. In Kazakhstan industrial production jumped 1.7% m/m, which favourably compares to -1.8% average June performance in 2005-2007. The growth is primarily attributable to the non-commodities segment of the economy which increased production by 5.2% m/m in June.

To meet the new IMF programme requirements Ukrainian government raised industrial gas prices and gas prices for population by 50%. As a result, Naftogaz will no longer be subsidizing consumers at the expense of State budget. Ukrainians are expected to face an increase in all other utility tariffs of the similar magnitude. The news is positive for the eurobond market, as budget deficit will be cut and IMF deal will progress, but negative for the popularity and stability of the new government, raising country's political risks.

Ukrainian government announced it is not going to issue the \$2b eurobond at this time. According to the Ministry of Finance, the country is to place the bonds sometime in the future, based on market situation and liquidity position of the country. In our view, the step is logical, as MinFin currently has no liquidity needs due to recent borrowing from VTB, as well as due to high borrowing costs – the government wanted to issue at 7%, while the market yields for 10-year paper are above 8%.

Corporate news

During the previous week, two Russian government controlled financial institutions raised additional money on foreign markets. The second largest commercial bank VTB placed a new CHF-denominated bond worth 300m (equivalent to \$283m) at a coupon of 4% and maturity in 2013. Currently, the new bond trades slightly higher at yield of 3.9% with relatively small 80bp premium over another VTB's CHF-denominated bond maturing in 2011. For investors with positive outlook on CHF, we recommend to remain with the old VTB'11 due to shorter duration, as the new bond provides insufficient premium for two-year longer tenor, in our view. Later, the country's bank for development and foreign economic affairs (VEB) in private placement quickly tapped the recently placed \$1bn bond with maturity in 2020 by \$600m at yield 6.6%. The offering was made some 150bp below the market price, thus the deal was closed almost immediately.

Integra, oilfield services provider, made a public offer to buy back its RUB 3bn local bond at price of 110.1% per nominal and pay accumulated coupon interest. Prior to the announcement the company's bond was trading at 108% per nominal, thus Integra's proposal to bondholders seems rather generous. We recommend Integra's bondholders to participate in the buyback

that closes on July 28, as proposed buyback price translates into yield of 9%, which does not seem attractive from a risk/return perspective. Besides, following the tender offer the bond with initial maturity in November 2011 will remain rather illiquid.

Kazakhstan's Ministry of Industry and New Technologies announced it cancelled its earlier decision to allow Polyus Gold acquire Kazakhgold shares. The ministry gave no detailed explanation of the move. For Kazakhgold bondholders the action is negative only if it is legally possible for Polyus to challenge its guarantee on Kazakhgold bonds. Otherwise, Polyus Gold has to service its liability. It is hard to judge whether there is a legal ground for such an action by Polyus, as the information on the deal cancellation is conflicting and obscure.

KazMunaiGas E&P announced it is going to reduce the amount of deposits held at Halyk and KKB to \$1b by the end of 2010. Currently, the company holds \$2b deposit at Halyk and \$1.3b deposit at KKB as a governmentally directed liquidity support to those banks. In our view, the news is negative for KKB, as its liquidity position would be significantly impaired by the withdrawal. On the other hand, in our view, the withdrawal from KKB would be only made if the bank would retain sound liquidity afterwards, given strong governmental indirect support. For Halyk the news is neutral, as the bank is over-liquid, and the withdrawal would only improve the bank's profitability.

Our strategy

We foresee generally favourable environment for emerging market debt for the nearest term, and we expect some further gains, yet the "easy money" appears to be behind us – the markets are not cheap. Our global inflation outlook foresees that liquidity will remain abundant for a prolonged period of time. On growth front we do expect negative surprises in H2'10, yet we do not subscribe to the "double-dip" thesis. Sovereign risks will continue to weigh on the market sentiment, but should also indirectly support emerging markets where fiscal fundamentals are indeed stronger. On relative terms, in Eastern European debt markets we continue to prefer Ukraine and Kazakhstan to Russia, yet in all markets security selection remains critical. As usual, in Central Europe's eurobond market bottom-up approach is the basis for investing.

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