Russia's investment grade status: Another new landmark

- The recent decision by Moody's to increase the long-term foreign currency ratings on the Russian Federation to investment grade is obviously an important landmark for the country's transition process. Nevertheless, with both Standard & Poors and Fitch retaining their sub-investment assessments of Russia, this highlights the range of international sentiment towards the underlying country risk and the existing cautious approach.
- By paving the way for a wide range of investors, the impact of this move is likely to add further impetus to Russia's debt and equity markets, of which the RTS Index has advanced by around 5.6% since the announcement to reach a new all-time high of 643. At the same time, the tightening in the sovereign yield curve contributed to the Russian EMBI+ falling to a new low of 215 bp over US treasuries.
- While some elements of profit taking may occur over the near term, the implications of attaining investment grade status over the medium term for Russia's economic prospects are more profound. In particular, it is likely to promote a more stable source of investment inflow to Russia's real economy and also implies a cheaper cost of funding for both the sovereign and the increasing number of Russian corporates that are using international debt markets as an integral source of funding.

The upgrade by Moody's to investment grade is clearly recognition of the scale of Russia's recovery over the past five years, the increasing predictability of the political process under President Putin's administration, favourable macroeconomic conditions and more importantly, the reduction in perceived country risk. At present, the economy is currently undertaking its fifth consecutive year of positive growth, GDP is expected to exceed 6% for 2003 as a whole, both the current account and fiscal account are in surplus, international reserves of over US$63 billion (equivalent to over 8 months of total import cover) and external debt as a percentage of GDP has fallen to under 40%.

Earlier this month Moody's increased the ratings on Russia's country ceiling for foreign currency bonds and notes and the ratings on all outstanding eurobonds of the Russian Federation from Ba2 to Baa3, a two-notch move that resulted in Russia attaining the sought after 'Investment Grade' status. At the same time, the agency raised the local currency ceiling to Baa3, the ratings on the Russian Federation tranches of Ministry of Finance debt (MinFin's VI and VII) to Ba1 from Ba3 and MinFin V to Ba2. The outlook on all ratings is stable and Moody's highlighted the following influential factors inherent in their decision making process:

- The strengthening of the government's commitment to prudent fiscal and debt management policies, resulting in improvements in the country's debt and liquidity ratios and the formation of a 'stabilisation fund' to offset any downturn in commodity prices.

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- Following the substantial accumulation of foreign currency reserves and opportunities taken to prepay on foreign currency debt repayments, Russia is able to endure a significant downturn in commodity prices over the medium term without any risk to comprehensive and timely debt servicing.

- The growth of pension funds will assist in strengthening the country's local capital markets during the medium term.

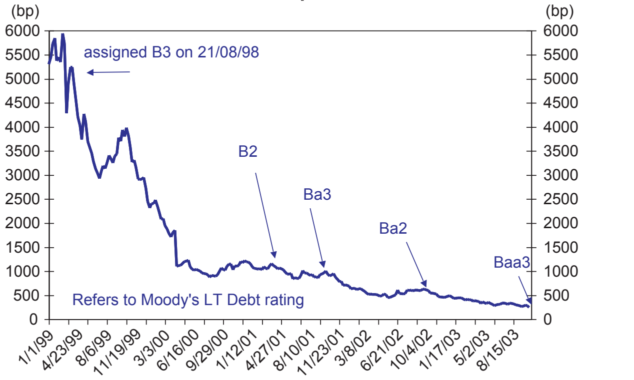
- Due to a lessening of the political power of the regional authorities, there has been a notable reduction in the pressures associated with fiscal federalism. At the same time, the infighting both inside and outside the centre of power in Russia, the presidential administration, is not seen as threatening in anyway to the broad direction of pro-market economic reform and development.

- Finally, it is argued that it is unlikely that any party configuration resulting from December's Duma elections will have a significant impact on the country's fundamental medium to long term economic performance and direction.

While this move clearly represents a new landmark in Russia's transition to a functioning market economy, it is important to note that Standard & Poors (S&P) and Fitch currently assign sub-investment grades to Russia's foreign currency ceiling, BB and BB+ respectively. Notwithstanding the progress achieved in both of their ratings profile, it seems unlikely that an upgrade to investment grade will occur until after the Presidential election in March 2004. Moreover, both S&P and Fitch appear to place a stronger emphasis on their ratings rationale with regards to the implementation of structural reform measures, particularly in the banking sector, and the moves to reduce the country's dependency on energy related activities. S&P are scheduled to conduct their annual review towards the end of the year and Fitch's review usually occurs during the Spring period.

The chart below outlines the gradual improvement in Russia's perceived country risk, as measured by the EMBI+ (a benchmark spread of Russian external debt instruments over US treasuries), and the associated developments in the country's long-term foreign currency ratings assigned by Moody's. Indeed, the transition to investment grade status has been accompanied by a marked compression in spreads, falling from a high of around 6000 basis points (bp) in early 1999 to the current range of 230-220 bp. At these levels the Russian EMBI+ trades at around 170 bp under the overall EMBI+, the perceived benchmark for the wider emerging market asset class.

EMBI+ Russia Spread over UST



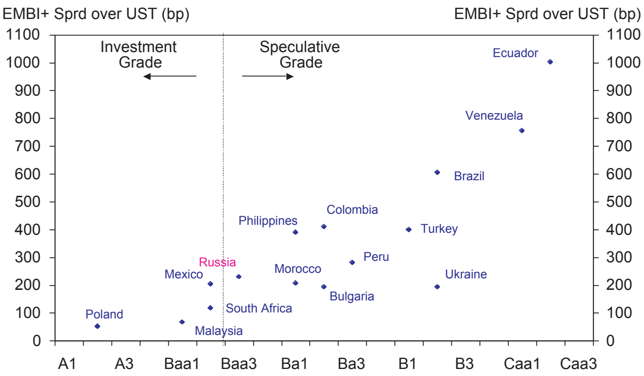
Source: JP Morgan Chase, Bloomberg

With regard to the new perceived peer group, Russia is now rated on par with Bahrain, Croatia, El Salvador, Kazakhstan, Thailand, Trinidad & Tobago and Mexican eurobonds. The chart below details the relationship between Moody's long-term country ratings and the respective EMBI+ spreads across a wide spectrum of emerging market economies, and despite being one notch below countries such as Mexico, South Africa and Malaysia and also a higher spread over US treasuries, Russia's economic performance has been more impressive in recent years and prospects over the medium-term appear more favourable.

While some form of upgrade had been expected from Moody's, a two notch gain was not anticipated by most market participants and is likely to add further impetus to the country's strong performing debt and equity markets. Indeed, the RTS index advanced by around 3.1% on the day and has since surged to a new all time high of 643, significantly higher than the 350 level that prevailed at the beginning of the year. At the same time, the benchmark Russia ‘30 rose by around 4 points to reach an intra-day high of 98¼, implying a yield at the long end of the curve of around 6.8%. Moreover, this heightened international investor sentiment was further highlighted by the reported over subscriptions of recent Russian corporate issuers, including Sberbank’s US$1 billion 3-year, which was offered at a 175bp spread over 3-month LIBOR and represented the first investment grade bond by a Russian based issuer, and Gazprombank’s US$750 million issue, which offered a 7.25% coupon rate. In part, these factors have also contributed to the recent strengthening of the exchange rate, with the Rouble appreciating to below the key RuR30 level against the US dollar to reach its highest level since November 2001.

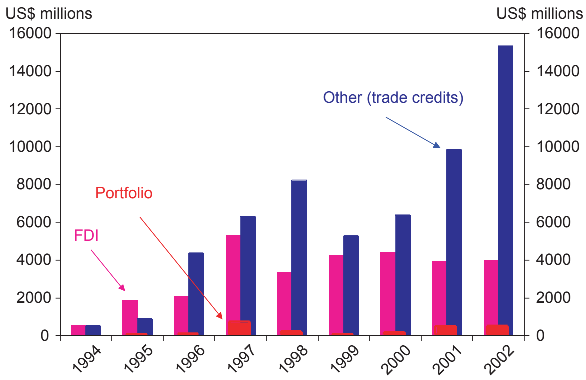
(includes trade credits and loans) and highlights the need for a re-balancing of the composition of Russia’s foreign investment inflows, which are still primarily an oil play. With portfolio inflows amounting to only US$0.5 billion in 2002, it is expected that the new accessibility of Russia’s debt and equity markets to international mutual funds will act as a stimulus to encourage holding longer positions and thus contribute to supporting price levels. In particular, the larger and more liquid issuers such as Gazprom and Sberbank are likely to be the main beneficiaries. While BP’s US$6.75 billion acquisition in TNK implies a higher FDI total for 2003 compared to 2002 (US$4 billion), it is envisaged that with full convertibility of the Rouble expected in 2007, this trend will continue and promote a more stable source of investment in Russia’s real economy. More importantly, this should enable Russia to surpass its Eastern European neighbours as the largest recipient of FDI inflows to the region.

Moody's Ratings Spectrum



Source: Moody's, JP Morgan Chase

Foreign Investment in Russia



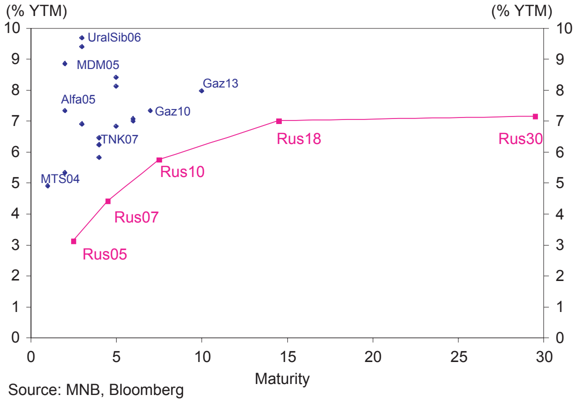
Source: Goskomstat

Given the recent bout of investor enthusiasm it is usual for some elements of profit taking to occur over the near term. Nevertheless, over the medium to longer term the implications of attaining investment grade status for the country’s economic prospects are more profound.

First, notwithstanding the ratings by both S&P and Fitch, the Moody’s upgrade paves the way to Russia’s capital markets for a wide range of investors that were previously constrained by the sub-investment grade status and is likely to lead to an influx of higher foreign investment inflows. As seen in the chart below, both inward portfolio investment and foreign direct investment (FDI) are dwarfed by other inflows

Second, the combination of tightening spreads and higher creditworthiness implies a cheaper cost of funding for both the sovereign and also the wide range of Russian corporates that are increasingly using the international debt markets as an integral source of funding (see below for Russian sovereign and corporate yield curve). Indeed, issuers such as MMK, MTS, Sberbank and Gazprombank were all fortunate with their recent placement timing and have all benefited from the ratings upgrade by offering lower than expected yields.

Russian Eurobond Yield Curve



Source: MNB, Bloomberg

Third, from a macroeconomic standpoint the upgrade is likely to act as a catalyst to the authorities to advance the implementation of key reforms, thus continuing the momentum and attempting to secure investment grade status from both S&P and Fitch.

While the upgrade by Moody's to investment grade status represents a significant landmark in Russia's transition process and the potential benefits vast, certain risks remain. Against a background of relatively tight supply of foreign currency denominated instruments, any excessive investor demand is likely to create the potential for asset price inflation. In addition, as expectations of Russia's performance have grown considerably in recent years, this remains heavily dependent on continued macroeconomic stability, progress on microeconomic reform and increasing political transparency.