

Strategy

Fed decision – not a panacea

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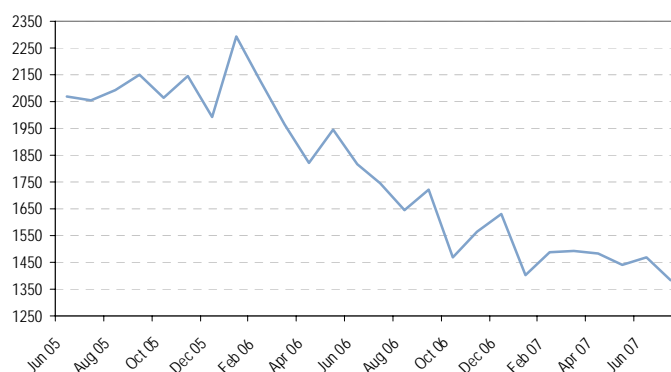
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Analysis of situation

Past two years brought correction to US housing market, negatively affecting prices of houses, resulting in serious decrease of their price. US consumers, who buy most of things using credits then faced serious problems, as pledge price dropped down, hence terms of credit worsened as well, lowering overall buying power. Then appeared decrease of demand for houses accompanied by drop of new houses construction. Scale of crisis over housing market reached international level. Mortgage credits failures to pay rose first. Then a range of largest companies and hedge funds, holding high risk US bonds supplied with mortgage, started to experience financial damage.

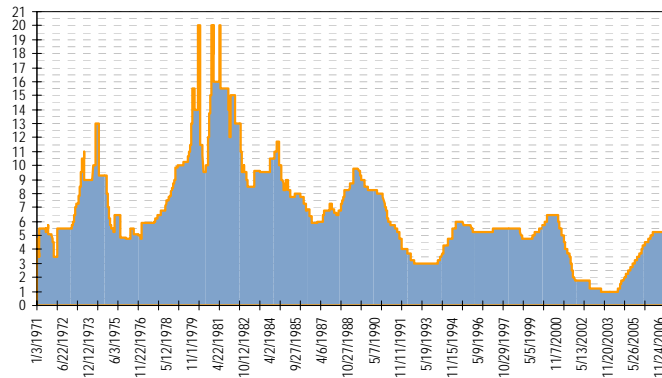
New houses



Among victims of drop was a range of European, Asian and Australian companies and hedge funds. Probably the best example is one of France's largest banks – BNP Paribas, which lost significant share of cash from its funds. BNP Paribas was the first solid proof that crisis of mortgage market affected other things, beyond US business, influencing finance of other countries. On its part it led to formation of trust crisis over world financial market. Rates of interbank credits in London (LIBOR) went to years' highest values. Central banks of Japan, Eurozone and US Federal Reserve had to inject enormous amounts of money to compensate for lack of liquidity. However, all these actions of monetary officials brought only short stop for fall of stock markets. US president then had to take action. George Bush promised help to house owners, then unable to pay for their mortgage, obliging Federal Housing Agency (FHA) to guarantee their credits, supporting possible refinancing of loans at more comfortable rate.

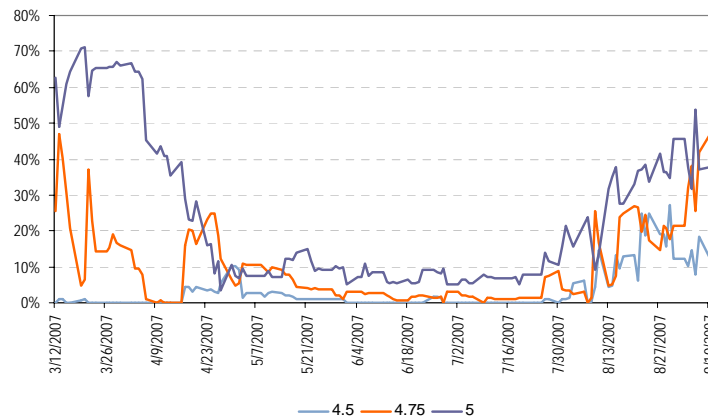
This eased situation a bit, but only for US citizens, not financial structures. August 17th, Feds had to take more serious actions, committee of open markets approved cut of account rate, which is used to credit not the most steady borrowers, rate was cut from 6.25% to 5.75%, reducing spread to base rate by 0.5 p.p. This decision cooled off situation of financial markets. However, improvement of situation was also contributed by expectations of Feds cutting base rate after account rate.

Fed's rates, % per annum

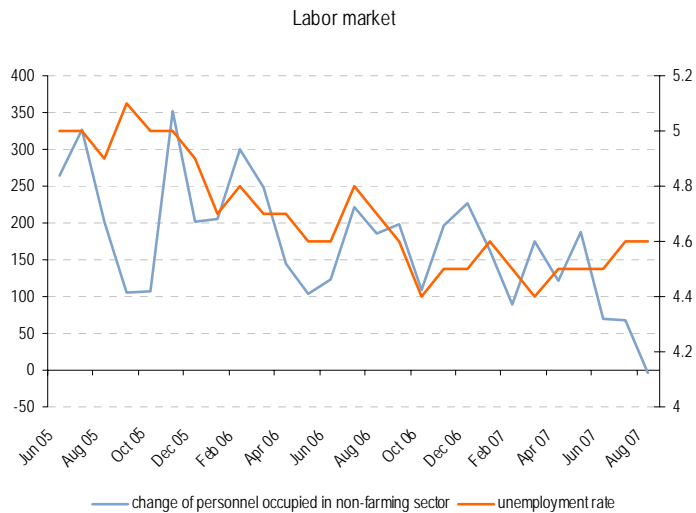


History remembers when Feds had to take on such measure, despite of inflation pressure due to financial crisis. However, then Federal Reserve was led by Alan Greenspan, now US central bank is led by Ben Bernanke, a person to witness such situation while in seat for the first time. Until this moment, he proved to be a person, when it comes to media and pressure. Nevertheless, due to worsened situation over credit market and slowed rates of economic growth, many investors started to think that base rate will be cut during the upcoming meeting of Feds. Though, according to future contracts on base rate, probability of 0.5 p.p. cut is estimated even higher than 0.25 p.p. cut – 53.2% versus 36.4%. Though 10.4% say that rate will be reduced by 0.75 p.p. to 4.5%.

Fed's rate future quotes



Aside from three possible scenarios expected by US market. There is still a possibility that Fed's rate could be left unchanged, as inflation risks still present, while there is no solid evidence that economy hits recession. But, at the same time, latest data from US labor market was a sensation, showing decrease of workplaces at first four months of year. We say that recession begins right with fall of population's employment, however in order to make conclusions for this we have to see recession of given value through several months in a row.



European Central Bank went towards economy of Eurozone, stopping cycle of base rate increase. Bank was not just lending overnight credits, but at September 13th bank gave out one billion for 3 months. Federal Reserve is also active over financing of borrowers. Nevertheless, it is still a mystery whenever feds change monetary and credit policy in order to help economy.

In our opinion, all three scenarios could occur. Federal Open Market Committee should either reduce base rate by 0.25 p.p. or 0.5 p.p. during the next meeting of Federal Reserve, however, committee may decide to keep rate intact.

Possible announced reason by US monetary officials to cut rate is increasing possibility of economy recession. And if that happen it is most likely that officials will also tell about existing crisis of trust over credit market. So, rate cut will be forced decision, especially considering inflation pressure dropping to comfort level, but there is still a possibility of it going up again. Nevertheless, in order to block negative influence over macroeconomic situation in country, Feds may have to decide it that way. Authorities may cut rate by 0.5 p.p., which may influence financial market even deeper than lesser cut. Even so, cut of 0.25 p.p. looks quite realistic. It should not affect stock markets seriously, as it is already almost included in prices. Credit market should be affected even less. But, such decision will bring some calm, as it show that Feds help markets and if such help is required again, they will cut rate once more.

If Feds decide to save the base rate at 5.25%, a continuous inflation pressure is possible over stock markets all over the world, pushing serious price correction, which will obviously touch Russian market as well. Such turn of events is imminent in this case, as rate cut was already set into prices by the market.

What next?

Whatever decision is taken by US monetary officials, we have to understand that rate cut is not panacea for Russian financial market. Very important role in decrease of stock and debt market, plus Russian credit market was further undermined by non-residents, who were actively transferring their capital beyond borders of Russia. Non residents were pushed to that by crisis of international financial market, not changes of base rate. Besides of that, US Federal Reserve is not a single entity to influence situation, there are other Central Banks. Especially ECB, which already halted cycle of hardening monetary and credit policy. However, life showed that it did not solved all problems over credit market. It is absolutely obvious that ECB and other Central banks to actively refinance existing banking sectors during hard periods of world financial system – will not let further worsening of situation. But, they are still unable to bring everything back in its place, and primary reason for such downfall is time. Time is required to confirm whenever world economy suffers serious problems due to latest shocks. For now that is not clear as macroeconomic data have still not fully affected the after crisis period. Though, fall is the end of financial year, hence data and reports by companies will be very important.

In our opinion – Russian economy is highly protected in given situation. Not so long ago Standard & Poor's already confirmed that, saying that Russia is one of the most stable emerging markets. Besides of that, we have to remember that oil prices are still around highest values ever, which is an undisputable benefit for Russia. While refinancing system of banking sector works perfect, confirmed by late August events. Back then Bank of Russia proved its readiness to actively refinance banking sector of Russia. Senior vice chairman of CB – Alexey Ulyukaev said that in second half of fall it is possible that liquidity crisis occurs again, while demand on direct REPO auctions may reach 300-400 bn USD. However, he also said that it should not be a problem; CB will give enough cash to support stability. While the so called "lombard list of securities" under which CB issues credits to banks, will be highly expanded to that time, increasing depth of market.

In other words we think that despite of Feds decision, Russian financial market will suffer no serious fall or growth. At the end of November – beginning of December we expect non-residents to come back to ruble assets, hence it will make stock market grow and restore debt market.

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