Alfa-Bank

AB-ICI: A still air of 2010

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Investment Summary

- The AB-ICI was down 11% last year; of its three components, only market confidence was up
- Import growth and debt payments will continue to exert pressure on the balance of payments in 2010
- Foreign confidence will likely remain weak, as the Russian asset prices remain expensive

AB-ICI down 11% in 2009

The AB-ICI was down 11% last year...

Russia's GDP fell sharply in 2009, declining 9%. This translated into an equally significant decrease in the AB-ICI, which fell 11% last year. This drop resulted from a contraction in both economic and foreign confidence, while market confidence saw only a modest recovery in 2009.

…reflecting dollarization…

- **The economic confidence indicator** fell 6% last year. A lack of trust in the ruble has weaken the confidence indicator; though the ruble exchange rate started to appreciate in 1Q09, the share of foreign-currency-denominated deposits in Russia remained at 30%, three times the pre-crisis level. In 2009, the CBR reported a current account surplus of $47 bln, while the bank's reserves rose only $12 bln owing to the ongoing outflow of capital.

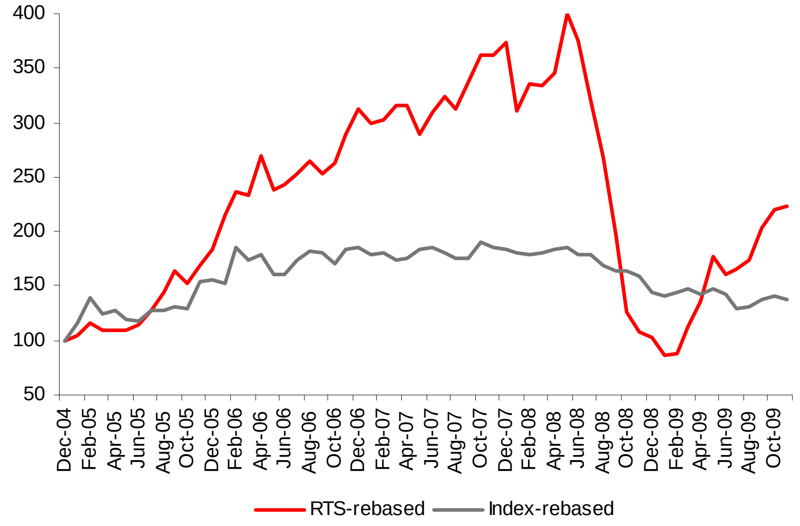
…a sharp 50% drop in FDI…

- **Foreign confidence** suffered the most, falling 25% y-o-y. The main reason for this was the sharp contraction in FDI, which fell 50% y-o-y to just $13 bln last year, or 1.1% of GDP;

…and a modest 3% recovery in market confidence

- **The market confidence indicator** was up 4% last year, reflecting the recovery on the RTS. The local bond market continued to expand on the back of weak bank lending and Russian companies' continued appetite for foreign borrowing.

Figure 1: AB-ICI was down 11% last year



Source: New School of Economics, Alfa Research

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Why growth is likely to be modest

Last year's sharp drop in GDP has created an opportunity for Russia's to catch-up with its previous level of production, and we also expect the AB-ICI index to recover somewhat. However, we see a number of reasons why this rebound could be modest.

Balance of payments will not improve in 2010

Economic confidence is still very fragile. The Russian government's ability to restore trust in the ruble is the key to restarting lending growth and boosting economic activity. However, the Russian public is still keeping 30% of its deposits in foreign currency, a figure that remained steady in 2009. Russian banks and companies are facing $104 bln in foreign-debt redemptions this year and will therefore have to accumulate foreign currency ahead of these payments. Another negative development is the 25% q-o-q increase in imports in 4Q09, which suggests Russia's current account will likely continue shrinking in 2010. All these balance of payments considerations imply that CBR reserves are unlikely to grow strongly in 2010, putting pressure on the AB-ICI.

FDI from developed countries may not accelerate

Foreign confidence was hurt by rapidly declining FDI inflows in 2009. This year will most likely see an increase, albeit limited. Developed countries now look to the emerging-markets universe as a source of capital more than a destination. The flow of capital from developed to emerging countries, which was the norm in previous decades, is now less pronounced and may even be reversing.

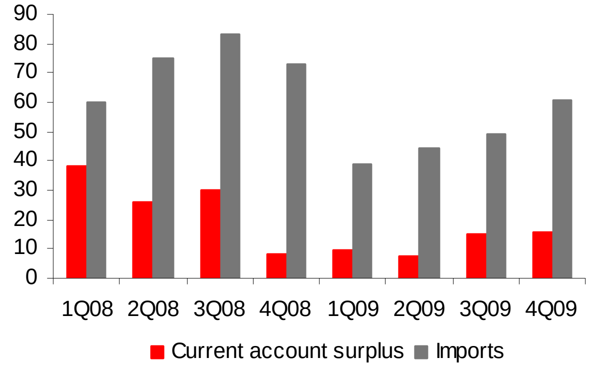
Foreign banks may take wait-and-see approach to Russia

The key question regarding foreign confidence is the behavior of foreign banks. Because developed countries' banking markets are fully saturated, foreign banks are very interested in penetrating the Russian market. However, these banks can also expand into Eastern European markets, which offer good upside potential and are much more transparent and easier to navigate than the CIS in general and Russia in particular. In addition, state banks are becoming more important in Russia, and it is difficult to compete with them. All of these factors may prevent Russia from experiencing growth in banking sector in the short term.

Financial markets likely to follow real sector

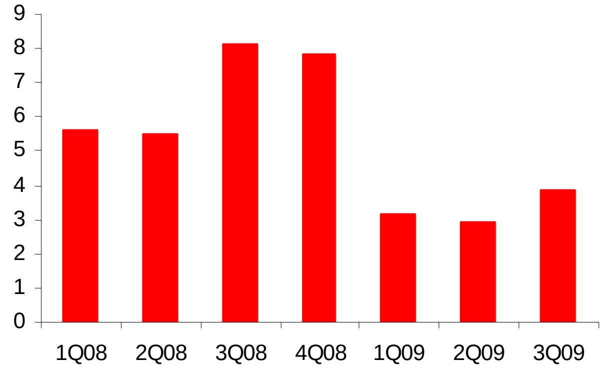
It will be hard for financial markets to continue growing without an economic recovery. Unfortunately, both the economic and foreign confidence indicators suggest the recovery will modest, hampered by low predictibility and therefore low trust.

Figure 2: Current account and import statistics



Source: CBR, Alfa Bank

Figure 3: FDI inflows to Russia, $ bln



Source: Rosstat, Alfa Bank

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