

AB-ICI: A temporary stabilization

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) declined 2.6%, reflecting a temporary stabilization of negative economic trends in February.
- We are expecting a further depreciation of the ruble, leading to a further contraction in consumer spending

The AB-ICI showed a 2.6% decline

The AB-ICI declined 2.6% in March

The AB-ICI declined by only 2.6% last month, an improvement over the 9.7% drop in February, which is a reflection of the slowdown in the deterioration of leading indicators.

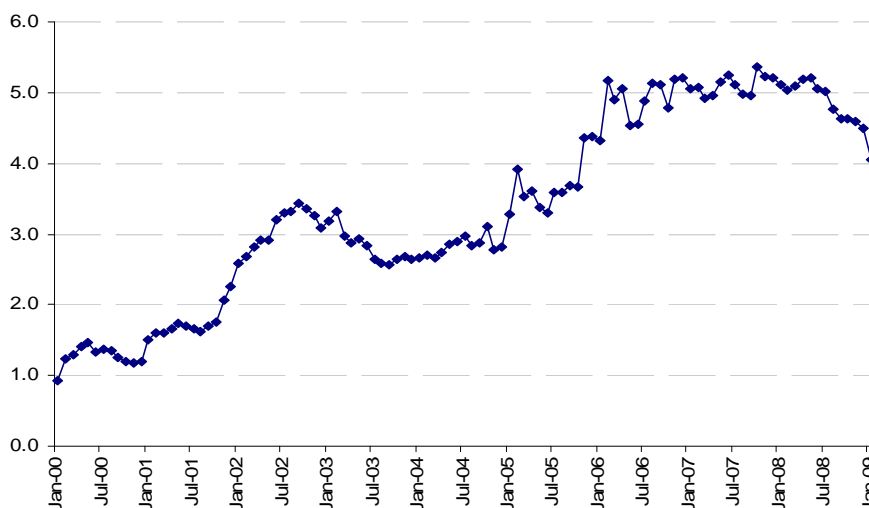
Capital outflow was minimal as the ruble showed some temporary strength and the dollar depreciated on international markets

- The index's **economic confidence** dropped by 14.3% last month, reflecting a slowdown in capital outflow as well as a slight increase in banks' ruble deposits, temporarily reversing the trend of dollarization of retail deposits. The drop in GDP for 2M09 was 8% y-o-y, slowing slightly from the strong 9% drop in GDP in January, which undermined trust in the ruble and encouraged further capital outflow;

Decreasing role of SMEs in Russian markets

- **Foreign confidence** was flat due to a lack of fresh figures;
- **The market confidence** declined slightly in March as the trend of SMEs getting squeezed out of the Russian financial markets carried on and the RTS average for the month decline. However, with ruble exchange rate stability, a number of investors see the short-term opportunity to enter the market at the current stage.

Figure 1: AB-ICI dropped 2.6% last month



Source: Alfa Bank Research, New School of Economics

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A slight improvement, for now

AB-ICI declined significantly less than last month as a result of the improvement in leading indicators

The slight decline in the AB-ICI this month, as compared to the sharp fall in February, reflects the slight improvement in major indicators such as machine building and industrial output overall. Russia's GDP declined 8% y-o-y in 2M09, a slight improvement on the 8.8% y-o-y drop in January. The recovery in the machine-building sector, which shrank by only 21.2% y-o-y in 2M09 after declining 45.9% y-o-y in January, was a major reason for the improvement in the 2M09 GDP figure. This improvement could reflect a one-off project for a large company, such as Gazprom or a utility, which leads us to believe that the figures simply reflect the highly volatile nature of economic indicators rather than a sustainable recovery.

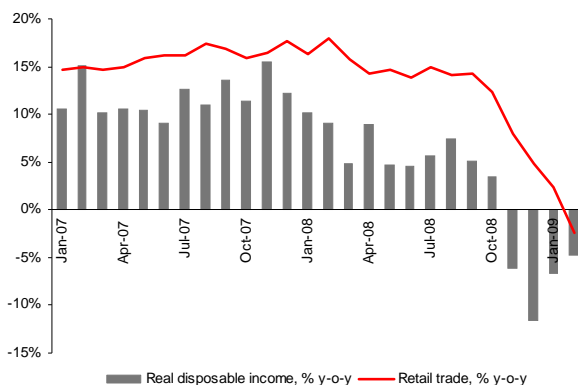
Two leading indicators – construction and transportation – are still declining sharply

In fact, we expect a further decline in 1H09 for three reasons. Firstly, the decline in the construction sector accelerated from 16.8% y-o-y in January to 18.8% in 2M09. Secondly, the transportation sector, which is also a good indicator of economic trends, reported a decline of 17.4% y-o-y in January and a deeper drop of 18.2% y-o-y in 2M09. Since both the construction and transportation sectors are leading indicators of economic growth, our outlook for 2Q09 is negative.

Retail trade down 2.4% y-o-y in February and will likely continue to decline, pulling down the AB-ICI

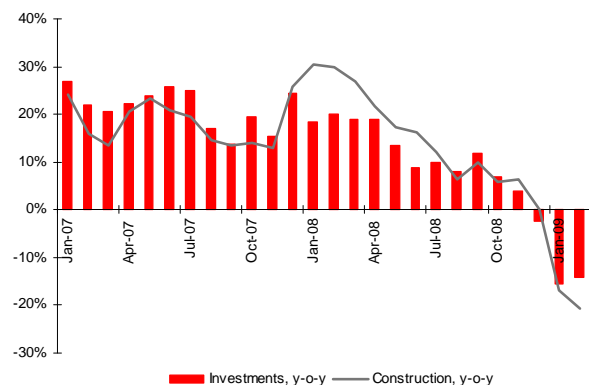
Finally, as we pointed out last month, the Russian economy in the recent past was significantly driven by consumer spending, which is finally showing some signs of a slowdown. In February, retail trade turnover declined by 2.4% y-o-y, the first monthly decrease since 1999. We view this as a sign that households are finally cutting back on spending owing to the drop in disposable income. This leads us to expect an additional contraction in consumption-focused sectors in the coming months.

Figure 2: Disposable income, retail trade, y-o-y



Source: Rosstat, Alfa Research

Figure 3: Construction and investments, y-o-y



Source: Rosstat, Alfa Research

Ruble depreciation will continue, putting further pressure on consumers' disposable income

Consumer spending is particularly affected by ruble depreciation, which is squeezing consumer's disposable income and causing prices to skyrocket on indispensable imported goods such as medicines. We expect ruble depreciation to continue in 1H09 for the following reasons: (1) given the significant drop in GDP, Russia would likely have difficulty coping with any real appreciation of the ruble, meaning that the ruble exchange rate has to mirror inflation. Since the Russian government is not able to curb price growth, ruble depreciation looks inevitable; (2) the stabilization fund is in foreign currencies, so ruble depreciation increases the government's ability to finance its fiscal deficit without borrowing from the market; (3) we believe the problem with NPLs will become huge, and one way of recapitalizing banks without providing them with direct support is to depreciate the ruble exchange rate to allow the banking sector to report FOREX gains. Thus, we do not believe the current stability of the ruble exchange rate is sustainable in the long run.

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