AB-ICI: Growth Facing Obstacles

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) has remained flat despite strong capital inflow.
- Inflationary fears are increasing, while growth is not strong enough to offset the increase in the monetary supply.

The AB-ICI remained flat in April

The AB-ICI was up just 1% despite strong capital inflows

The AB-ICI was up just 1% in April 2007, remaining virtually flat.

- The index's **economic confidence** continued to grow, backed by strong capital inflows. The CBR's reserves are increasing by $20-30 bln a month since March, driven by receipts from VTB and Sberbank's share placements and borrowing by state companies;

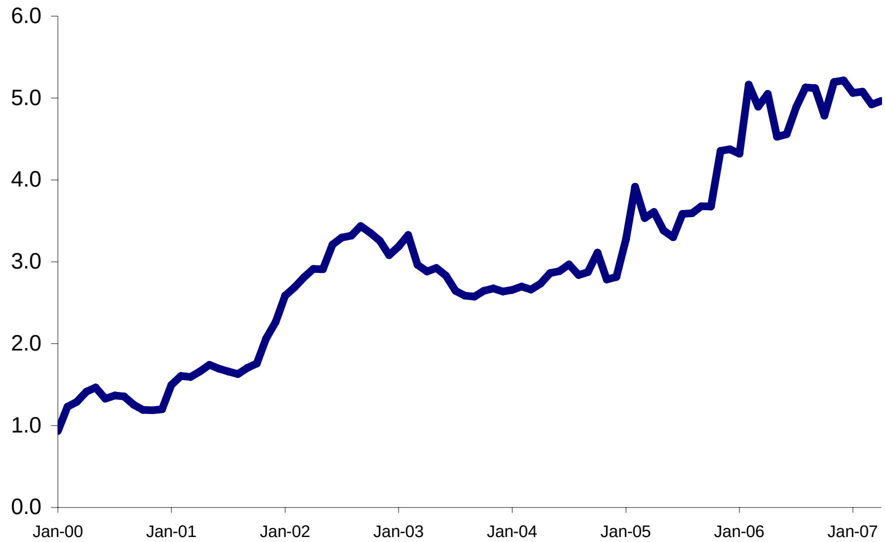
The presence of foreign banks is below 10% of the banking sector, but portfolio investments into banking capital are higher

- **Foreign confidence** has increased slightly, reflecting an increasing share of foreign banks in banking sector assets. While the CBR recently indicated that foreign investments in banking sector capital represent 18% of its total size, the direct presence of foreign banks (controlled by foreigners) is still below 10% of banking assets and capital. The 18% figure in fact reflects the interest of portfolio investors.

The financial market has stagnated

- **Market confidence** changed slightly in April. Despite two IPOs from MMK and Nutritec, the Russian financial market stagnated on the lack on catalysts.

Figure 1: The AB-ICI was flat in April, constrained by a lack of catalysts on the RTS



Source: Alfa Bank Research, New School of Economics

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The weak financial market is an obstacle for the AB-ICI performance

AB-ICI is down 5% YTD on weak RTS dynamic

In our index update last month, we mentioned that the poor performance of the financial markets is becoming a serious constraint to the growth of the AB-ICI. Despite the good macro fundamentals, increasing capital inflows and above expected GDP growth, the index is still down 5% YTD.

IPOs are absorbing money, while a number of sectors have modest upside

The Russian financial markets will remain quiet in the coming months. First, the huge number of IPOs on the market are absorbing the additional money inflow to the market and are preventing the market index from rising higher. Secondly, a number of Russian sectors are considered either expensive (like the consumer goods sector), or not having clear growth potential (like oil). The banking sector, which has been seen as a safe haven, is unable to improve the performance of the market as a whole.

The low relative performance of the RTS may push foreign as well as local investors to put their money in foreign markets

In addition, the relative performance of the international markets may push a number of investors to reduce their exposure to local stocks. Other emerging market countries have been doing better than Russia since the beginning of this year. If the political uncertianty is not resolved in coming months, it could push not only foreign investors, but also local investors to invest outside the Russian market. Just couple of days ago, Credit Suisse arrived on the market with a new variety of private banking services, offering local investors an opportunity to invest in global markets. This is a very good illustration of the increasing local demand for international financial products.

The population has stopped investing in residential real estate

A very important illustration of the “wait and see” attitude is also the stagnation of the real estate market in Russia. Since the end of 2006, prices for residential real estate have stagnated, halting the record 70% growth seen in 2006. This market has traditionally been driven by investments of personal savings as approximately 30% of annual savings were previously being allocated to residential real estate. A more cautious attitude for the allocaiton of savings indicates that the population in general shares a perception of increased uncertainty.

Russia has faced a huge liquidity inflow since March, which is currently sterilized by deposits in the CBR

Not surprisingly, as financial and real estate markets are no longer absorbing the increase in monetary supply, Russia faces higher inflationary pressure. With a huge monthly average increase in CBR reserves of $25 bln, the Russian cabinet is becoming more and more concerned about its ability to stay in line with the 8% inflationary target. May inflation is expected to exceed the indicator for May 2006. At this time the CBR is successfully sterilizing increasing liquidity through its deposits, as Sberbank and VTB are still keeping a huge portion of their capital increases in these accounts. The amount of liquidity in CBR deposits went up from $10 bln a couple of months ago to $40-45 bln as of mid-May. In addition, the CBR sterilized $8 bln through placement of CBR bonds. However, the expected increase of bank lending growth in 2H07 suggests increasing pressure on prices.

Inflationary pressure is the main risk due to the end of dedollarization

The increase in inflationary pressure is a growing concern because there are fewer and fewer local factors able to offset this pattern. In previous years declines in inflationary pressure was largely caused by dedollarization. With the expected decline in the trade balance in coming years, more and more companies and banks are starting to price in the ruble depreciation trend.

GDP growth is too weak to offset inflation

Additionally, Russian GDP growth improved only slightly in 1Q07, exceeding 8%. However, this is not enough to offset the strong liquidity inflow which is currently occurring. The link between the increase in monetary supply and inflation is thus becoming stronger under the lack of accelerating growth and the end of dedollarization, resulting in a reduction in the real return from financial investments in the Russian markets. As a result, the AB-ICI lacks catalysts to continue its positive trend in the coming months.

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