AB-ICI: Financial Markets at a Crossroads

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was up 3% on the market rally.
- The decline in foreign debt is positive news, but the weak -9.5% GDP figure for 1Q09 suggests more downside

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After a rapid decline that mirrored the drop in real economic indicators and brought the index back to its level at the end of 2005, the AB-ICI rebounded by 3% last month, driven by the recovery in financial markets.

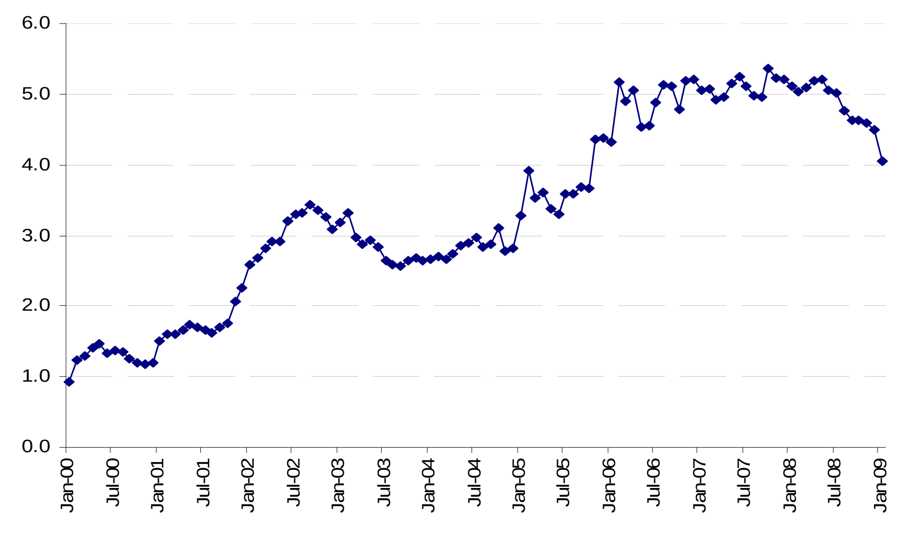
Increase in foreign-currency deposits damaged economic confidence

- The **economic confidence indicator** increased substantially, reflecting the higher share of foreign currency deposits. Their share of total deposits increased from 13% in summer 2008 to 34% in February;

Market confidence was boosted by RTS rally

- **Foreign confidence** was flat, since foreign banks' share of total banking assets stopped rising, and the sector's growth is now driven by state-owned banks;
- **Market confidence** increased substantially, boosted by the RTS rally and the recovery in bond prices.

Figure 1: AB-ICI recovered 3% last month



Source: Alfa Research, New School of Economics

Financial markets at a crossroads

Financial markets recovered because they were oversold and the ruble stabilized

The recent recovery of the financial markets was prompted by investors' belief that the Russian equity market was oversold and that the country's balance of payments will not deteriorate as had been expected. These assumptions turned out to be correct. In fall 2008, the RTS index plunged well below the levels of other emerging markets, and the improvement in the current account helped Russia to stabilize its exchange rate. In essence, there is a strong correlation between the recovery of financial markets and the stabilization of the ruble exchange rate.

Foreign debt payments also supported ruble exchange rate stability

The ruble exchange rate stabilized largely thanks to very positive figures on Russia's foreign debt. After showing a persistent increase until 3Q08, foreign debt declined by $88 bln between October 2008 and March 2009. Corporate debt accounted for $75 bln of this decline. A detailed analysis shows that $30 bln of this amount [of the total $88 bln?] reflected revaluation owing to a lower ruble exchange rate, suggesting that net foreign debt payments were $45 bln. However, we still believe this is positive news, as it pushes Russia's reserves-to-debt ratio to 88% from 73-79%, where it was fluctuating in fall 2008.

Figure 2: Russian banks and companies' foreign debt, $ bln

	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09
Banks	164	171	193	198	166	148
Companies	255	267	297	301	286	276
Total debt	465	479	528	542	485	454
Change in foreign debt	34	14	49	15	-57	-31

Source: CBR, Alfa Research

State expects GDP to fall 6-7.4% this year, which is negative

In the meantime, real economic indicators show no sign of improvement. The Ministry of Economic Development recently indicated that GDP likely declined by 9.5% y-o-y in 1Q09 vs. its initial estimate of 7%. In 2Q09, GDP is expected to fall by 8.7-10%. Deputy Economics Minister Andrei Klepach said that the new GDP growth forecast is expected to be negative 6-7.4%.

Figure 3: Russia's key 1Q09 economic indicators

	January	February	March	1Q09
Investment	-15.5%	-14.1%	-15.4%	-15.0%
Industrial output	-16.0%	-13.2%	-13.7%	-14.3%
Transportation	-16.9%	-19.1%	-16.9%	-17.4%
Construction	-16.8%	-20.7%	-20.3%	-19.3%
Retail trade	2.4%	-2.4%	-4.0%	-1.1%

Source: Rosstat, Alfa Research

Lower consumption and higher NPLs may damage the financial markets and AB-ICI

The key negative surprise was that investment growth was well below expectations, reflecting the delay in implementing fiscal spending plans and thus the government's inability to compensate for the slowdown in the private sector. Looking forward, we anticipate a significant decline in consumption owing to lower retail lending, salary cuts, a jump in unemployment to 9.5% and declining revenues from rent. Another major risk in 2H09 is bad loans, the extent of which are still unknown. On average, Russian banks are guiding for 10% NPLs this year; however, a higher figure would mean the need to recapitalize the entire sector, not only state-owned banks. As a result, we believe these two risks could damage financial markets and the AB-ICI's performance in the coming months.

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