

AB ICI: Market Volatility Hits the Index

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Investment Summary

- Equity and bond market volatility pushes AB-ICI down by 10% in May
- Russia's fundamentals remain strong: 5.5% GDP growth in 1Q06 and 10.5% income growth in 5M06

AB-ICI drops by 10% on market volatility

AB-ICI is down 10%...

...despite strong economic confidence...

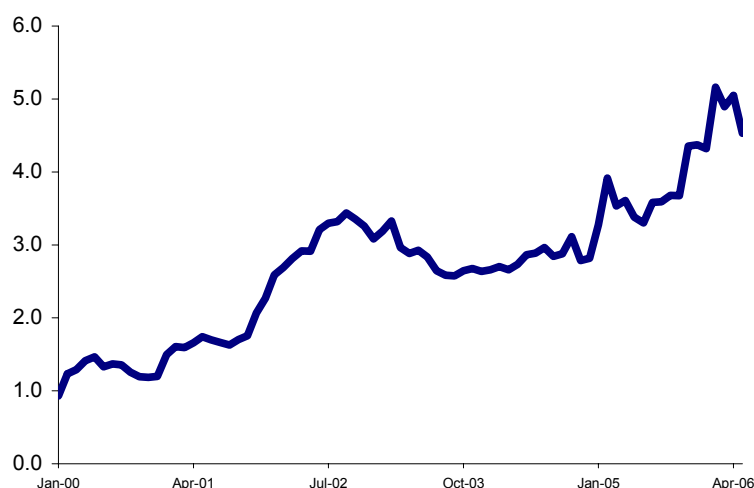
...driven down by stagnating foreign banking assets...

...and hit by international market volatility

The Alfa Bank Investor Confidence Index (AB-ICI) was down by 10% last month, reflecting increasing market instability on developed markets:

- The Index's **economic confidence** increased by 9%, reflecting good economic fundamentals. Russia continued to benefit from capital inflows and "de-dollarization." Shares of currency-denominated deposits dropped to a historical low of 22.7%;
- **Foreign confidence** indicators declined as the 1Q06 FDI inflow of \$3.8 bln turned out to be lower than the \$6.5 bln posted for 4Q05. The share of foreign banks in total Russian banking assets remained unchanged at 8.3% similar to the 4Q05 figure;
- **Market confidence** showed a negative trend due to international market volatility and widening spreads between Russian and international bonds. The financial instability hit market liquidity and as a result the share of small and medium enterprises in trading volumes declined compared to the share of large companies.

Figure 1. AB-ICI down 10% on international volatility, despite good fundamentals



Sources: New School of Economics, Alfa Bank

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Russia delivered very impressive 5.5% GDP growth

Given 5.5% GDP growth in 1Q06, we upgrade our 2006 GDP forecast to 6.6%

Rosstat has announced that GDP growth in 1Q06 was 5.5%, a positive surprise compared to the Cabinet's initial growth forecast of 4.4%. This year's first-quarter growth is much stronger than the 5.0% figure posted in 1Q05. Based on the 1Q06 figures, we upgrade our annual growth forecast from 5.9% to 6.6%.

Trade sector posted record growth of 11% y-o-y, disposable income up 10.5% in 5M06

The key reason behind the upgrade is strong growth in consumption. In 1Q06 the trade sector delivered record-high growth at 11%, outperforming the 10.2% growth rate posted in 1Q05. This segment maintained its leading position in the structure of Russia's GDP and increased its share from 22.5% in 1Q05 to 23.6% in 1Q06. The trade sector's solid performance is due to the increase in real (not nominal) growth of sector turnover. Positive consumption trend is also confirmed by 10.5% y-o-y increase in 5M06 real disposable income, which accelerated from 7.7% in 5M05.

Figure 2. Key Sectors by Value Added in GDP, % of total

	1Q05	1Q06
Trade	22.5%	23.6%
Manufacturing sector	17.7%	16.7%
State-regulated sectors, including	15.4%	15.7%
Public sectors, including	12.8%	13.0%
Commodity extraction	10.2%	10.8%

Source: Rosstat, Alfa Bank calculations

State sector's presence increased to 28.7% of GDP, but reflects only nominal growth

Another interesting indicator is the increase in the state-regulated and public sectors' share in GDP. While in 1Q05 these two sectors represented 28.2% of nominal GDP by value added, their share rose to 28.7% of GDP in 1Q06. However, their increased role was due solely to price growth – the state sector's real value actually declined despite acceleration in the growth of both state administration and the production and distribution of water, gas, electricity in 1Q06 (see Figure 2 below).

Increase in share of commodity extraction was also due to the price factor

The increased share of commodity extraction in the structure of nominal GDP from 10.2% in 1Q05 to 10.8% in 1Q06 was driven only by prices. In real terms, the role of commodity extraction declined in GDP production, in line with its weak 1.7% y-o-y growth in 1Q06.

Figure 3. 1Q05 and 1Q06 y-o-y Real Growth Rate

	1Q05 growth	1Q06 growth
Trade	10.2%	11.0%
Manufacturing sector	1.9%	4.6%
Production/distribution of water, gas and electricity	1.5%	6.2%
Transport and communications	9.9%	4.0%
State administration and security	2.5%	6.2%
Education	0.9%	1.5%
Wealth	0.5%	1.6%
Commodity extraction	2.3%	1.7%

Source: Rosstat

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