

# AB-ICI: Market Optimism Offsets Economics

Natalia Orlova

(7 495) 795-3677

NOrlova@alfabank.ru

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www.alfabank.com

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## Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was up 2.2% on market optimism
- Weak April trends contradicts index behavior and suggests downside potential over the next few months

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### The AB-ICI was up 2.2% last month

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The AB-ICI trend continues to be driven by optimism on financial markets, masking the continuing deterioration of economic trends.

**Dollarization did not decline, FDI was down...**

- The **economic confidence indicator** declined, as there was no improvement in terms of the capital flows, and the dollarization of local deposits remained significant. The share of foreign currency retail deposits is still 33-34%, while the share of foreign-currency corporate accounts rose to 46%;
- **Foreign confidence** was down as the FDI inflow into Russia in 1Q09 saw a virtually twofold decrease, and the share of foreign banks in the total banking sector balance sheet has stabilized. We believe that state companies and banks are now gaining importance, while the share of private segment and foreign entities is being squeezed;
- **Market confidence** continued to rise, boosted by the ongoing increase in commodity prices and the rally on emerging markets. Our take is that the ruble appreciation and the increase in market valuation in Russia is just a reflection of higher commodity prices, and if there is an oil price correction, investors will take profits.

**...but RTS continued to rally**

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**Figure 1: AB-ICI recovered 2.2% last month**



Source: Alfa Research, New School of Economics

## **April economic trends suggest crisis continues**

### **GDP dropped 10.5% y-o-y in April**

We view the AB-ICI recovery as a short-term event, as April's economic statistics do not indicate any improvement in trends. GDP fell 10.5% in April, signaling a new round of tightening: The feeling last month was that the decline in GDP had stabilized at around 9.5% y-o-y in 1Q09, and we had forecast an equal decline of 9.5% y-o-y for 2Q09. However, in 4M09 GDP was down 9.8% y-o-y. Therefore, the depreciation of the ruble has clearly failed to have a positive impact and fiscal stimulus is not bringing any relief.

### **Machine building declined 52% y-o-y in April**

A new round of declines in machine-building output was the key reason behind the deterioration in industrial output from -14.3% y-o-y in 1Q09 to -14.9% y-o-y in 4M09. After declining 20% in 2M09 and then 25% in 3M09, machine-building output fell 34.3% y-o-y in 4M09, or 52% y-o-y in April alone. The weaker output seems to mirror the 15.8% decline in investment in 4M09.

### **Business is suffering from poor demand**

Another observation is that business is suffering from a lack of demand rather than credit constraints. According to recent polls conducted by the Institute for the Economy in Transition, the credit availability indicator has increased from 17% as of December 2008 (the lowest since 2000) to 31% in April. Better ruble liquidity reflects the fact that the financing of the fiscal deficit equaled 11% of GDP in April. However, Russian companies noted that declining demand was the key constraint on growth, and May figures could mirror the continuing deterioration in trends.

### **Government may react to poor growth rate by increasing fiscal deficit**

We believe that there is an increasing risk of larger fiscal deficit, which would have a negative impact on economic trends. After the poor growth figure was released, a Finance Ministry representative suggested the fiscal deficit may reach 9% of GDP. We believe that given the decline in local tax collection in 1Q09 and NPLs, the fiscal deficit may be as high as 12% of GDP. Restructuring the banking sector without due diligence will be costly. A good illustration of this is the bankruptcy of KIT-Finance – the first victim of the 2008 financial crisis and Russia's 30th-largest bank – which will cost the Russian state R135 bln (0.3% of GDP).

### **NPLs remain a big risk**

Finally, the issue of NPLs has still not been resolved. While NPLs in March were officially 3.5% of corporate loans and 4.7% of retail loans, under IFRS the picture is different. The first indication of this came when Vozrozhdenie (Russia's 28th-largest bank) released 1Q09 results on May 27. While its NPLs under RAS were around 3-4% in 1Q09, under IFRS they hit 5.9%. The most surprising fact was that at the end of March, the bank guided for 5-6% NPLs as a base-case scenario for 2009 and for only 3.9% NPLs for 1Q09. This is an indication of the low transparency of banks' balance sheets and the high risk of hidden NPLs. For this reason we maintain a cautious view in terms of AB-ICI growth over the next few months.

## Contact Information

### Alfa Bank (Moscow)

Head of Equities  
Telephone

12 Akad. Sakharov Prospect, Moscow, Russia 107078  
Michael Pijolis  
(+7 495) 795-3712

### Research Department

Telephone  
Head of Research  
Oil & Gas  
Macroeconomics, Banking  
Telecoms, Technology, Internet, Media  
Utilities  
Metals & Mining  
Consumer Goods, Retail, Real Estate  
Transportation, Fertilizers, Machine-Building  
Russian Product  
Editorial  
Translation  
Production

(+7 495) 795-3676  
Ronald P. Smith  
Chirvani Abdoullaev, CFA, Alexander Bespalov  
Natalia Orlova, Ph.D.  
Ekaterina Balykina  
Alexander Kornilov, Ph.D., Elina Kulieva  
Barry Ehrlich, CFA, Maxim Semenovych, Sergei Krivokhizhin, Ph.D.  
Elena Mills, Vitaly Kupeev  
Roydel Stewart, Konstantin Beletskiy  
Angelika Henkel, Ph.D., Vladimir Dorogov  
David Spencer, Heather Dean  
Anna Sholomitskaya, Dmitry Dolgin  
Aleksei Balashov

### Equity Sales & Trading

Telephone  
Facsimile  
International  
Domestic Institutional  
Alfa-Direct Sales Team

(+7 495) 223-5500, 223-5522  
(+7 495) 745-7897  
Isai Pochtar, Michael Kotov, Roland Glasfors  
Dmitry Soloviev, Dmitry Demchenko, Mikhail Babaev  
(+7 495) 795-3680  
Sergey Rybakov, Valeriy Kremnev, Evgeniy Batelman

### Alfa Capital (Kiev)

#### Research Department

Telephone  
Facsimile  
Analysts

77-a Chervonoarmiyska St.(6<sup>th</sup> floor) Kiev, Ukraine 03150

(+380 44) 490-1600  
(+380 44) 490-1601  
Denis Shauruk, Oleh Yuzefovych

#### Equity Sales & Trading

Sales Trading  
Telephone

Sergey Grigorian, Ivan Shehvtsov, Denis Dolmatov  
(+380 44) 490-1600

### Alfa Capital Markets (London)

Telephone (office)  
Facsimile (office)  
Telephone (Sales & Sales Trading)  
Sales

City Tower, 40 Basinghall Street, London, EC2V 5DE  
(+44 20) 7588-8500  
(+44 20) 7382-4170  
(+44 20) 7382-4175  
Mark Cowley (+44 20) 7382-4173  
Julia Dawson (+44 20) 7382-4174  
Douglas Babic (+44 20) 7382-4178  
Mark McCracken (+44 20) 7382-4172

Sales Trading

### Alforma Capital Markets (New York)

Telephones  
Facsimile  
Sales  
Sales Trading  
Fixed Income Sales

540 Madison Avenue, 30<sup>th</sup> Floor, New York, NY 10022  
(+1 212) 421-7500  
(+1 212) 421-8633  
Robert Kaplan, George Kogan  
Roman Kogan  
Jeffrey Weichsel

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