

# AB-ICI: Countdown to Take-Off

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## Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) went up only 2% in June.
- Russia is delivering impressive investment growth, and the AB-ICI is expected to respond in coming months

### The AB-ICI improved only slightly in June

**AB-ICI up only 2%...**

Our AB-ICI index went up 2% in June as improved market performance was offset by a one-off capital outflow.

**...due to a one-off capital outflow,**

- The index's **economic confidence** slightly declined in June as the result of capital outflows. While huge capital inflows in the past few months were due to several one-offs, including Rosneft borrowing, the June outflow reflects another one-off, *i.e.* a \$9 bln debt repayment by the company.

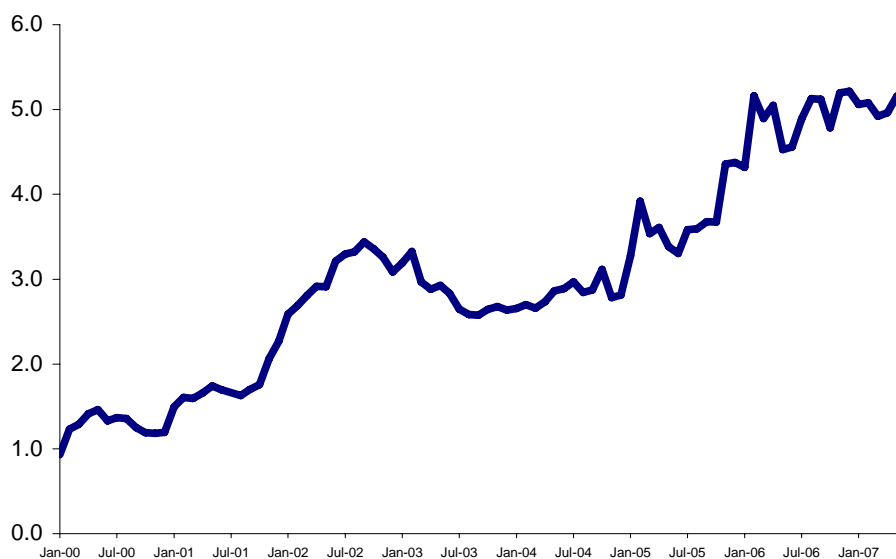
**flat foreign confidence, and**

- **Foreign confidence** stayed flat as most factors are only significantly affected by quarterly statistics. Meanwhile, we expect further improvement in this component due to the increased attractiveness of the Russian banking sector, which has resulted in numerous recent banking acquisitions.

**modest RTS recovery**

- **Market confidence** changed slightly in June. Despite the positive RTS performance and relatively big IPOs last month, the RTS is flat YTD, reflecting a lack of catalysts.

**Figure 1: The AB-ICI in June was up just 2% on the modest RTS dynamic and one-off capital outflow**



Source: Alfa Bank Research, New School of Economics

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## Investment growth supports economic trends

**Capital investment has accelerated from 11% in 1H06 to 22.3% in 1H07...**

**... largely thanks to state companies' investments**

**Ruble appreciation stimulates investment imports**

**Investment rises as industry growth rates improve from 4.4% in 1H06 to 7.7% in 1H07**

**Construction grew 25.5% in 1H07**

**Russia's GDP and industrial output will likely post 7.5% and 7% growth, respectively**

**The AB-ICI will be supported by capital inflows and a financial market recovery**

The key Russian economic story of the past several months is the transition from purely consumer-driven growth to investment-driven growth. Capital investments accelerated from 11% y-o-y in 1H06 (the level where they have stagnated for the past several years) to 22.3% y-o-y in 1H07.

The bulk of this growth reflects government investment programs and capital expenditures by the state companies, primarily in the utilities sector. In the near future we can expect that multiple state-sponsored programs will contribute to the trend.

However, the growing investment activity is not only the result of state programs. The continuing appreciation of the ruble has resulted not only in attracting speculative capital, but also in the increased ability of enterprises to modernize capacities by importing machinery and equipment. According to the federal customs service, the share of machinery and equipment in non-CIS imports has risen from 47.9% in 5M06 to 51.6% in 5M07.

Thus, investment activity that began blooming late last year has already started translating into accelerating industrial output. In 1H07 this figure rose 7.7% y-o-y, up from 4.4% a year ago. The trend established in the beginning of this year suggests that industrial output is driven primarily by manufacturing, which jumped 12.2% in 1H07, compared to 4.4% growth for the full year in 2006. Meanwhile, mineral extraction and regulated goods production remained stagnant in 1H07 with 3% growth and a 3.4% decline y-o-y, respectively.

Further proof of the investment-driven growth is the pace of construction sector expansion as construction is the core component of capital investment: growth rates accounted for 25.5% in 1H07, compared to 15.7% growth for the entirety of 2006 (8.3% in 1H06).

The trends established early this year leave no room for contemplation of "Dutch disease." The Russian economy is diversifying away from oil and gas, as manufacturing, construction and services are gaining in importance. Based on these new trends, we are upgrading our macroeconomic forecasts. We now believe that GDP in 2007 will grow by 7.5%, backed by the 7% industrial growth.

We anticipate the AB-ICI to respond to the accelerating economic growth in coming months. First, the economics will lead Russian companies and banks to borrow more actively from international markets, which will result in huge capital inflows. Secondly, Russian financial markets will respond to the improving economic trend and improve their performance in 2H07.

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