

AB-ICI: A Tug of War

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was flat last month
- The market's positive expectations belie the continued economic deterioration; we are concerned that there is further downside

The AB-ICI was flat in June

AB-ICI was flat last month

Retail deposits recovered, preference for foreign currency declined slightly

Growth of RTS lifted market confidence

In June, the AB-ICI was caught in a tug of war, pulled in opposite directions by negative economic trends on the one hand and market optimism on the other.

- The **economic confidence indicator** was up, reflecting an improvement in capital flows in response to ruble appreciation. The index's performance also reflected the recovery of retail deposits in the previous months and the slight decline in the share of foreign currency deposits from 34% to 32%;
- **Foreign confidence** was flat last month, as no new information was released;
- **Market confidence** continued to rise, boosted by the growth of the RTS index. In the meantime, appetite for Russian bonds remained limited, and fears of corporate debt restructuring are making fixed-income investors cautious.

Figure 1: AB-ICI was flat last month



Source: Alfa Research, New School of Economics

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May economic statistics show that bottom is near

Decline in GDP accelerated to 11% y-o-y in May and 10.2% y-o-y in 5M09

After rising modestly in April, the AB-ICI stagnated in May, as the markets failed to resist the downward pressure exerted by real economic indicators. GDP fell 11% y-o-y in May and 10.2% in 5M09 vs. 10.5% and 9.8% in April and 4M09, respectively, indicating that the economy is shrinking even faster than before. Moreover, the original 1Q09 GDP growth figure has been revised down 0.3 ppts. Altogether, these statistics lead us to believe that the Russian economy will contract by 10% y-o-y in 1H09 and at least 6.5% for the whole year, worse than what we had earlier forecasted. It is now clear that ruble depreciation has failed to stimulate the economy, so GDP growth will depend on fiscal spending, which is expected to increase in the second half of 2009.

Poor investment performance is reflected in May's 23.1% decline in industrial output

While the market is expecting an increase in state support, the Finance Ministry is actually cutting costs in line with shrinking revenues, financing mainly transfers to regional governments and social spending. The government has preferred to focus on social spending as a way to address the economic downturn, leading it to increase public-sector salaries, which helped boost disposable income in February-April at the expense of a further y-o-y decline in investment, which shrank 23.1% in May vs. 16.2% in April and 17.7% in 5M09 vs. 15.8% in 4M09. Industrial output, which is dependent on investment, also fell y-o-y, declining 15.4% in 5M09 vs. 14.9% in 4M09, dragged down primarily by the machine-building sector, whose output fell by almost 52% y-o-y in May.

5.6% decline in retail sales indicates weaker consumption

Consumption-related trends resumed their decline. After increasing a modest 1.4% in April, real disposable income declined 1.3% y-o-y in May. In addition, wage statistics indicated a 10.8% m-o-m increase in payment arrears, reflecting a lack of operating capital in the real sector. The decrease in disposable income seems to be putting pressure on retail sales, which shrank by 5.6% y-o-y in May vs. 4.5% in April. On a cumulative basis, 5M09 consumption growth was flat vs. 4M09 at -2.2%. However, since consumption generally reacts to an economic contraction after a considerable delay, we believe the decrease in the consumer sector has only begun.

Leading indicators suggest the rapid fall in investment may be coming to an end

Although May economic trends brought no relief, there are signs that the Russian economy may soon find a bottom. The rate of decline in construction and transport output stabilized. The fall in transport sector turnover decelerated from 21.3% y-o-y in April to 18.0% in May, while the decrease in construction output has been fluctuating around 18% y-o-y for the last couple of months on cumulative basis. Nevertheless, the fact that the bottom is near is no guarantee that the economic recovery will be fast.

Economic recovery depends heavily on lending, but the threat of NPLs prevents banks from providing new loans

The recovery of the Russian economy depends on state support. As the government has indicated that it prefers to boost lending rather than finance investments directly, the main question now is whether banks are able to transfer state money to the real sector through lending. May's monetary statistics indicate that banks prefer to deposit money with the CBR rather than provide new loans. This caution can be explained by the high risk of NPLs. The CBR is trying to address the issue by recapitalizing banks through an OFZ scheme; however, in order to allocate the R250 bln efficiently, the state would need to perform due diligence on all of Russia's largest banks, which may reduce the number of participants to 30. Therefore, we do not expect lending to recover until at least 2010.

The risk of ruble depreciation is high given the probable increase in the budget deficit towards year end

Another concern for 2H09 is the delay in state spending, which according to the latest indications from the CBR will be pushed back to the end of the year rather than spread evenly over the second half. That could put sudden and severe pressure on the ruble exchange rate, hitting the stock market and undermining household savings. The latter, according to the official deposits breakdown, are still mostly ruble-denominated. A weaker ruble would cause inflation, which has been falling, to rise again. Therefore, we expect the AB-ICI to decline rapidly towards the end of the year.

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