

Alfa Bank – Investor Confidence Index: July

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AB-ICI down in July on slight slippage in economic confidence and concern about the Yukos affair

AB-ICI down another 1.9% in July

Alfa Bank's Consumer Confidence Index dropped another 1.9% in July. The main trigger for the extension of the decline seen the previous month was the opening of investigations into Yukos and related shareholders, which weighed on economic, foreign and market confidence.

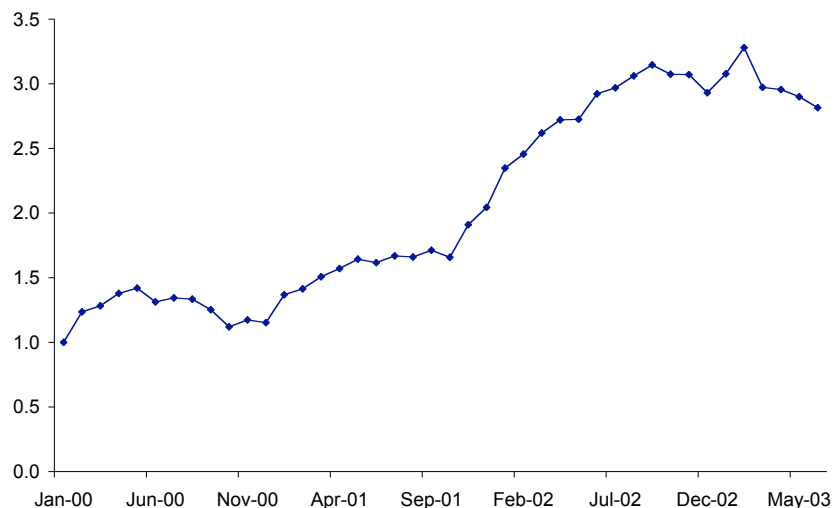
Reflects reversal of BOP trend from June...

In terms of economic confidence, the value of the previous Index reflected the substantial improvement in the balance of payments, as shown by the \$2.6 bln net inflow of capital to Russia in 2Q03. However, in June the trend reversed, as shown by the near \$452 mln fall in CBR reserves due to slow capital inflows and official intervention on the exchange market in July to stave off depreciatory pressure.

...as well as investor concerns about the Yukos affair

The decline in the Index also reflects the fall on the Russian equity market in July in response to the government's investigations of Yukos and investor concerns about heightened political uncertainty. However, the sell-off came to a halt once investors realized this was a company-specific issue that had little bearing on Russia's underlying economic fundamentals or investment case.

Figure 1. Alfa Bank Investment Confidence Index, as of July 2003



Sources: Russian Economic School, Alfa Bank



Resolution of situation surrounding Yukos is key for the market

In reality, the key issue for the equity market is whether:

- a) the conflict surrounding Yukos will weaken the ability of the oligarchs to lobby their interests (thereby strengthening the influence of the state, which we actually feel would be a positive development), or;
- b) if it really signifies the beginning of an attack on large business and the onset of wholesale property redistribution.

Corporate bond durations shortened

On the corporate bond market, durations shortened in response to the preference of investors for short-term instruments. As long as the market remains highly volatile, we cannot expect durations to lengthen.

Foreign investors likely to remain cautious

The direct activity of foreign entities did not change substantially in recent months. While we await FDI figures to be announced in July-August, we believe that foreign investors are likely to remain cautious until year's end.

Alfa Bank Investor Confidence Index – Methodology

Our partner

Built in cooperation with the New Economic School

The Index was prepared with the support of the New Economic School (NES), an independent graduate school of economics in Moscow established in 1992. The NES was founded as a partnership between the Central Economic Mathematics Institute of the Russian Academy of Sciences (CEMI) and the Hebrew University in Jerusalem, along with a group of Western economic professors. The Research Center at the NES was created in 1995 to encourage modern economics research in Russia.

Methodology

Combines indicators that reflect confidence levels amongst portfolio and strategic investors, both Russian and foreign, as well as bank depositors

The AB-ICI was constructed using carefully selected variables that reflect the level of confidence among foreign and domestic investors in Russia's security markets as well as Russia's macroeconomic performance. The variables include characteristics of the ruble and foreign-currency corporate bond markets (including spread, duration and diversification), the performance of the stock market (normalized returns and the entry of new companies), the sovereign spread, capital outflows, GDP and sector-based growth, and the composition of retail banking deposits. The Index also takes into account foreign direct investment and the share of foreign banks in Russia's banking sector.

Uses the Stock and Watson approach as used by major international economic monitoring agencies

The methodology is based on the approach developed by James Stock and Mark Watson (1989) when constructing the coincident index of economic indicators used by the National Bureau of Economic Research (NBER) to evaluate the state of the U.S. economy. This methodology assumes that each of the above variables depends on a common factor (the "confidence") as well as an idiosyncratic component with a certain degree of independence. Both the common factor and the idiosyncratic component are characterized by inertia (in econometric terms, both follow certain auto-correlated processes). An estimate using the Kalman filter then determines the best statistical decomposition of the joint behavior of the selected variables as expressed by a common factor (the confidence index) and the idiosyncratic part.

It is designed to smooth out any 'one-off' or 'extreme' readings

While the methodology produces dynamics similar to those generated by the principal component method, there is an important distinction. The principal component does not take into account the inertial (i.e. auto-correlated) nature of the confidence index. Rather, it simply summarizes the auto-correlations of all the variables and does not allow one to single out the dynamic process of the confidence index per se. Our methodology does allow for the determination of such a process. Therefore, the resulting index reflects long-term and medium-term fundamentals, and is smoother and less prone to short-term changes in the underlying variables.

The Index is calculated based on three main components:

1. an indicator reflecting capital markets confidence (with a weight of 20%),
2. an indicator reflecting foreign confidence (37% weight), and;
3. an indicator of confidence in the economy (43% weight).



*Trends in activity,
pricing and risk in the
capital markets*

Capital markets

Incorporates the trend in equity prices, the number and size of IPO issues, the spread of a range of Russian corporate and sovereign bond issues over a peer group, the duration of corporate bond issues and the activity of smaller Russian enterprises in the bond markets.

*FDI and banking sector
asset growth*

Foreign confidence

FDI per capita and the share of foreign banks in the overall assets of Russia's banking sector, both of which are designed to reflect the attractiveness of conducting business in Russia's financial sectors.

*In the economy and
currency*

Confidence in the economy

Combining capital inflows in the balance of payments, the increase/decrease in retail deposits and the share of foreign currency in overall deposits, all of which should capture both Russian and foreign confidence in the economic trend, the currency and development of the banking system.

The AB-ICI will be published on a regular monthly basis starting from June 2003.

For further information and updates on the AB-ICI, please contact:

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