

AB-ICI: Falling with Financial Markets

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was down 1% last month; a further drop is expected
- All economic trends are now weaker than in 1Q08; growth is expected to slow further
- Depreciation of the ruble exchange rate is a new and serious risk; however, our outlook remains positive

The AB-ICI was down 1% last month

AB-ICI keeps declining

Economic index was flat on poor economic trends

Foreign confidence fell

Market confidence under pressure

The AB-ICI index was down last month in line with worsening economic trends and unstable markets.

- **The index's economic confidence indicator** was virtually flat. The significant capital inflow of \$19 bln in July was offset by the slow industrial growth figure and mounting inflationary pressure. The high producer price index growth (5.4% in July) was very bad news;
- **Foreign confidence** was down on a 30% y-o-y decline in FDI inflows to Russia that reflected a significant squeeze in foreign markets;
- **Market confidence** reflected a significant deterioration of all market trends, starting with the decline of the RTS Index owing to the Mechel affair and continuing with the drop in small companies' activity on the bond market.

Figure 1: AB-ICI was down 1% last month



Source: Alfa Research, New School of Economics

Interest rate up, ruble under pressure

AB-ICI will decline further

Given the continuing deterioration of economic trends and the mounting nervousness of financial markets, we anticipate that the AB-ICI will be under pressure in the coming months, declining in line with the drop in Russia's financial markets. The two key factors will be a poor capital inflow resulting in an increase in interest rates, and pressure on the ruble exchange rate.

The CBR is preparing banks for higher interest rates

While in previous months the market expected a difficult liquidity situation in 2H08 that would be resolved with the help of financial injections from the CBR and the Finance Ministry, now the CBR is preparing banks for higher interest rates. The CBR's plan to closely monitor a list of 200 banks suggests that the central bank will focus its support on the "pillars" of the banking system. The plan to tighten the repo mechanism also suggests that the CBR is preparing the market for higher interest rates.

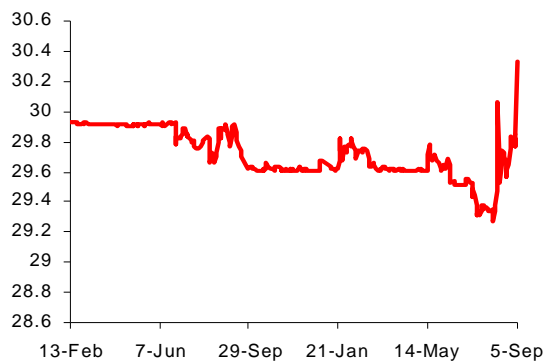
Local bond yields went up, pricing in default risks; state bonds are also trading lower

The bond market is also taking recent developments into consideration by re-pricing risk. Local corporate bond markets recently saw defaults by second tier-companies: retail trade company Marta defaulted on its R1,500 mln in bonds, and technical defaults occurred at Arbat-Prestizh, Mostransavto and others. As a result, bond yields went up by 2-3 ppts. Additionally, the price of state bonds has decreased 5-10% since the beginning of August. Market participants are expecting additional downward pressure on prices.

The CBR allowed the ruble to drop in order to reduce speculative activity

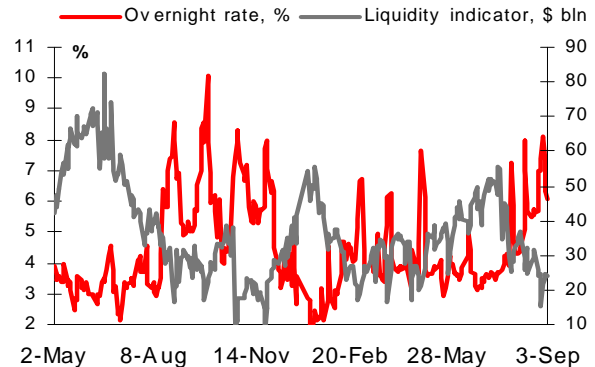
The flight from the ruble that began on August 11 was triggered by expectations that the military conflict in the Caucasus would deepen and the dollar exchange rate would appreciate significantly. As of September 4, the ruble had dropped 4% to the basket since the beginning of August. We interpret the CBR's position as demonstrating a willingness to reduce speculative activity on the market, and we believe ruble depreciation is an appropriate step to address capital flight.

Figure 2: Ruble exchange rate to the basket



Source: Alfa Research

Figure 3: Liquidity and interbank rates



Source: CBR, Alfa Research

NPLs are expected to rise, but state spending in 2H08 should offset declining growth

The combination of higher interest rates and an unstable ruble suggests a higher risk of non-performing loans and therefore banking sector instability. We anticipate that the economic growth rate will reflect these negative developments in the near term. However, the Russian government is expected to spend some \$20 bln on infrastructure development projects before year-end; this spending would indeed help to offset the decrease in economic growth.

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