

AB-ICI: All Factors Oppose Growth

Natalia Orlova

(7 495) 795-3677

NOrlova@alfabank.ru

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www.alfabank.com

Moscow

Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) fell 9% m-o-m, the biggest decline since January
- July's capital outflow and drop in FDI of 45% y-o-y in 1H09 were key driving forces behind the index decline
- We are concerned that the current liquidity overhang will hurt the ruble exchange rate and AB-ICI over the next few months

The AB-ICI dropped 9% m-o-m

**AB-ICI dropped 9%,
the biggest decline
since January**

**Capital outflow and low
FDI of 1H09 pushed
index down**

**RTS stopped
performing well**

Last month, the AB-ICI declined 9% from the previous month, as all three components fell markedly. Reported FDI statistics were very negative and support July's capital outflow, which in turn hurt the financial market's performance. The index's 9% drop is the largest since January this year.

- The **economic confidence indicator** declined, reflecting the drop in CBR reserves in July and volatility on the exchange rate market;
- **Foreign confidence** was down last month, as FDI dropped 45% y-o-y and the share of foreign banks in banking assets declined from 13% to 12.1%;
- **Market confidence** declined significantly as the strong increase seen on the RTS index came to a halt and the spread of Russian bonds widened vs. emerging market peers.

Figure 1: AB-ICI dropped 9% last month



Source: New School of Economics, Alfa Research

RESEARCH DEPARTMENT research@alfabank.ru

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Weak economic trend suggests more downside

The instability on financial markets is due to weak economic trends

The instability on financial markets in July reflects the lack of a strong improvement in the economic trend. While the economy has found bottom, it is too early to say if the recovery will begin soon. The Ministry of Economic Development has indicated that growth trends may deteriorate in August-September before growth resumes.

Investments and retail trade under pressure

Details on July's economic trend did not confirm that local demand is recovering. Even though industrial output declined only 14.2% y-o-y in 7M09 vs. 14.8%, in 1H09 the drop in investment and retail accelerated.

Investments are still at -18.8% y-o-y

Our initial take on industrial production in July was that it was coming from an increase in the manufacturing sector. However, this sector is still showing a drop of 34.2% y-o-y. Also, the 7M09 economic figures show that the drop in investment continued to deepen and therefore the recovery in industrial output did not come from the recovery in machine building. It is therefore likely that industrial output reflected higher capacity utilization in the export-oriented sectors, but that this was not enough to boost investments. The modest budget deficit of 4.3% of GDP is also not large enough to boost investment.

Retail trade dropped 3.8% y-o-y in 7M09

July marked a decline in real disposable income, which after being flat in 1H09 in y-o-y terms declined 0.9% in 7M09. In particular, retail trade dropped 3.8% y-o-y in 7M09 vs. a 3.0% y-o-y decline in 1H09. While we expected the retail trend to deteriorate, the unemployment rate was an unpleasant surprise, as it was flat at 8.3% in July and did not decline. Therefore, we conclude that even if the economy has found bottom, this stabilization is due to external factors while domestic demand is weaker than expected.

Figure 2: 7M09 economic indicators, y-o-y

	1Q09	1H09	7M09
GDP growth	-9.8%	-10.1%	N.A.
Retail trade	-0.1%	-3.0%	-3.8%
Real disposable income	-0.2%	0.0%	-0.9%
Unemployment rate	9.2%	8.3%	8.3%
Investments	-15.0%	-18.2%	-18.8%
Industrial output, including	-14.3%	-14.8%	-14.2%
...machine building	-25.7%	-34.6%	-34.2%
Transport	-16.3%	-17.5%	-16.3%
Construction	-19.3%	-19.3%	-19.0%

Source: Rosstat, Alfa Research

Increase in monetary supply will flow to the FOREX market

We believe that the weak economic statistics suggest that the ruble exchange rate will experience serious turbulence in the very near future. The Russian budget still has to spend around R1.7 trln before this year end, and this should push up the monetary mass and later flow to the exchange rate market. After monetary mass growth of 4.2% m-o-m in May and a 2.3% increase in June, the monetary mass declined 0.3% in July. However, it is expected to resume growth in August.

CBR reserves fell \$10.7 bln in July and are likely to decline in August

After a \$10.7 bln decline in CBR reserves in July, they are also likely to decline in August or, in the best case, remain unchanged. This implies that the ruble's fair value – defined as the ratio of monetary mass divided by CBR reserves – is around R33/\$ vs. the R31.5/\$ where it was staying for previous months. This depreciation of the ruble's fair value is likely to reflect the increase in the monetary supply and the inability to increase CBR reserves due to weakness in the balance of payments. We believe this ruble trend is an ongoing threat for the AB-ICI.

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.
Elena Mills, Ekaterina Balykina
Alexander Kornilov, Ph.D., Elina Kulieva
Barry Ehrlich, CFA, Maxim Semenovych, Sergei Krivokhizhin, Ph.D.
Elena Mills, Vitaly Kupeev
Georgiy Ivanin
Angelika Henkel, Ph.D., Vladimir Dorogov
David Spencer, Heather Dean
Anna Sholomitskaya, Dmitry Dolgin, Elena Elovskaya
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.(6th 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
Sales Trading

City Tower, 40 Basinghall Street, London, EC2V 5DE

(+44 20) 7588-8500
(+44 20) 7382-4170
(+44 20) 7382-4175
Julia Dawson (+44 20) 7382-4174
Douglas Babic (+44 20) 7382-4178
Mark McCracken (+44 20) 7382-4172

Alforma Capital Markets (New York)

Telephones
Facsimile
Sales
Sales Trading
Fixed Income Sales

540 Madison Avenue, 30th 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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