AB-ICI September: Up on Foreign Borrowing

Natalia Orlova (7 095) 795-3677 NOrlova@alfa-bank.com

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Investment Summary

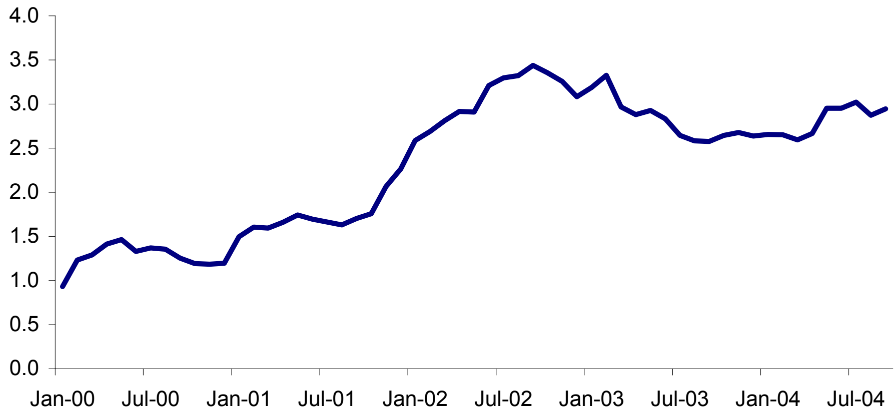
- **AB-ICI shows recent high volatility on mixed signals, up 2.5% in September**
- **Index supported by $4.8 bln increase in Russian corporate foreign debt, i.e. capital inflow**
- **Stagnant lending and squeezed corporate bond market remain chief risk-factors**

AB-ICI up 2.5% in September on Capital Inflow

AB-ICI's volatility is due to mixed economic signals

Alfa Bank's Investor Confidence Index (AB-ICI) shows that volatility has increased over the past few months due to mixed signals. On the one hand, the current economic trend indicates a slowdown accompanied by squeezing opportunities to borrow money (i.e., deteriorating conditions on the corporate bond market) and a decline in depositor confidence. On the other hand, an increase in FDI and high oil prices are supporting both our index and investor interest in Russia.

Figure 1. Alfa Bank Investor Confidence Index: Up 2.5% on Capital Inflow



Sources: New School of Economics, Alfa Bank

Net capital inflow in September helped improve liquidity and supported the AB ICI

AB-ICI performance in September resulted from the same combination of confusing signals. The key positive factor that pushed the index up was the net capital inflow posted in September, the best figures seen since January 2004. The persistent poor liquidity plaguing the Russian banking sector drove a number of banks and companies to issue Eurobonds and to attract syndicated loans totaling $2.0 bln and $2.8 bln, respectively.

Figure 2. Eurobond Placements in September-October 2004

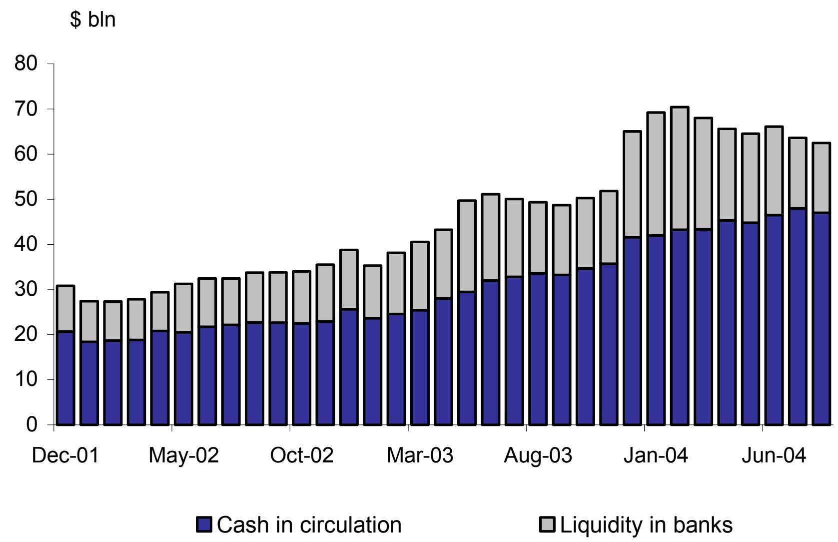
	Volume	Currency	Maturity (yrs)	Placement Date
MDM-bank	200	$	2	10/09/2004
Bank of Moscow	250	$	5	14/09/2004
Russky Standard	300	$	3	16/09/2004
Norilsk Nickel	500	$	5	19/09/2004
Alfa Bank	190	$	2	23/09/2004
City of Moscow	374	€	7	24/09/2004
Moscow Narodny Bank	200	$	3	28/09/2004
VTB	450	$	7	01/10/2004
Vimpelcom	300	$	7	14/10/2004

Source: Reuters, Alfa Bank

An increase in the CBR does not reveal much about liquidity as export revenues go to stabilization fund

This inflow of borrowed capital indicates an improved quality of growth in the CBR reserves. The reserves recently skyrocketed up $100 bln, largely due to oil export revenues, but the monetary mass created as a counter party to reserves growth is flowing to Treasury accounts, and not into the banking system. This explains the fact that despite the increase in total monetary mass and reserves, Russia is experiencing liquidity issues in the banking sector. The net capital inflow is therefore a way to resolve this problem and provide the banking community with liquidity. We expect capital to continue to flow to Russian banks from abroad in October-November, thus supporting the AB-ICI

Figure 3. Cash and Banking Liquidity in Russia



Source: CBR, Alfa Bank calculations

Uncetain Market Mood May Hit Index Growth

The current key risk factors are linked to the market performance component and are included in the calculation of our index.

The RTS is not predictable, as a number of equity stories have completely different triggers

The first factor is the high volatility of equity market dynamics. The infamous 'Yukos Affair' is keeping the market nervous, and no one knows just how much longer volatility will reign on the RTS. Moreover, RTS dynamics at present cannot be perceived a movement of the market as a whole, but rather a combination of separate stories. For example, Mosenergo's skyrocketing prices and the deep drop in Yukos shares contributed to the index's rises and falls, but both stories are being driven by completely different catalysts. The Russian market is no longer moved by the consensus on country performance; instead, it represents a number of independent corporate trends.

Another point is that the poor liquidity in the banking sector may push down demand for financial instruments in general. In particular, it already seems to be hampering development in the corporate bond market. The boom in recent years in the equity, fixed income and real estate markets was directly linked to an increase in the monetary base. Therefore we are keeping a cautious approach towards assessing the full potential of AB-ICI growth until year's end.

Figure 4. Growth in Monetary Base vs. Increase in Asset Prices

	2002	2003	8M04
Change in monetary base	26%	68%	-4%
Change in prices on OFZs (state bonds)	5.6%	9.6%	0.2%
Change in equity market (RTS)	38%	58%	8%
Change in real estate prices	25%	40%	0%

Sources: Alfa Bank, CBR

Contact Information

Alfa Bank (Moscow)

Head of Equities	Dominic Gualtieri
Telephone	(7 095) 795-3649
Facsimile	(7 095) 745-7897

Research Department

Telephone	(7 095) 795-3676
Facsimile	(7 095) 745-7897
Co-head of Research, Telecoms	Andrei Bogdanov
Co-head of Research, Oil & Gas	Matthew Thomas
Chief Strategist	Chris Weafer
Oil & Gas	Matthew Thomas, Anna Boutenko
Macroeconomics, Banking	Natalya Orlova
Utilities	Vitaliy Zarkhin, Natalya Devetyarova
Telecoms/Internet	Andrei Bogdanov, Svetlana Sukhanova
Metals & Engineering	Maxim Matveev CFA, Natalya Sheveleva, Pavel Sokolov
Consumer Goods	Alexander Svinov
Russian Product	Angelika Henkel, Vladimir Kravchuk, Pavel Sokolov, Natalya Sheveleva, Megan Lehmann
Fixed Income	Valentina Krylova, Ekaterina Leonova, Oksana Klypina
Technical Analysis	Vladimir Kravchuk
Editorial Team	Erik DePoy, Megan Lehmann
Translation Team	Rinat Gainoulline, Megan Lehmann
Production Team	Pavel Sokolov, Natalya Sheveleva

Equity Sales & Trading

Telephone	(7 095) 795-3712
Facsimile	(7 095) 745-7897
International Sales	Kirill Surikov, Mikhail Shipitsin
Domestic Sales	Oleg Martynenko, Alexander Nasonov, Konstantin Shapsharov, Nikita Permyakov
Capital Markets, Structured Products	Armen Petergov, Tamara Zarechneva
Address	12 Akad. Sakharov Prospect, Moscow, Russia 107078

Alfa Securities (London)

Telephone	(44 20) 7588-8500
Facsimile	(44 20) 7382-4170
Equity Sales	Maxim Shashenkov, Steve Downer, Peter Bobrinsky
Address	City Tower, 40 Basinghall Street, London, EC2V 5DE

Alfa Capital Markets (New York)

Telephones	(212) 421-8564 / 1-866-999-ALFA
Facsimile	(212) 421-8633
Sales	Michael Kaplan
Sales Trading	Harold Warren
Address	540 Madison Avenue, 30th Floor, New York, NY 10022