AB-ICI: Continued Decline

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was down 2.8% due to continued capital outflow
- Russia has accumulated fiscal savings, its economy is not overleveraged vs. peers
- High 67% of export due to fuel sector is setting pressure on the ruble exchange rate

The AB-ICI was down 2.8% last month

AB-ICI declined yet again

The AB-ICI index was down again due to continued liquidity constraints on the back of capital flight and uncertainty in the markets.

Economic index was down on significant capital outflows

- **The economic confidence indicator** was once again down significantly due to continued capital outflow. A drop in CBR reserves of another $26 bln in September reflects an accelerating capital outflow. The appreciation of the dollar exchange rate on the global markets is keeping pressure on the ruble exchange.

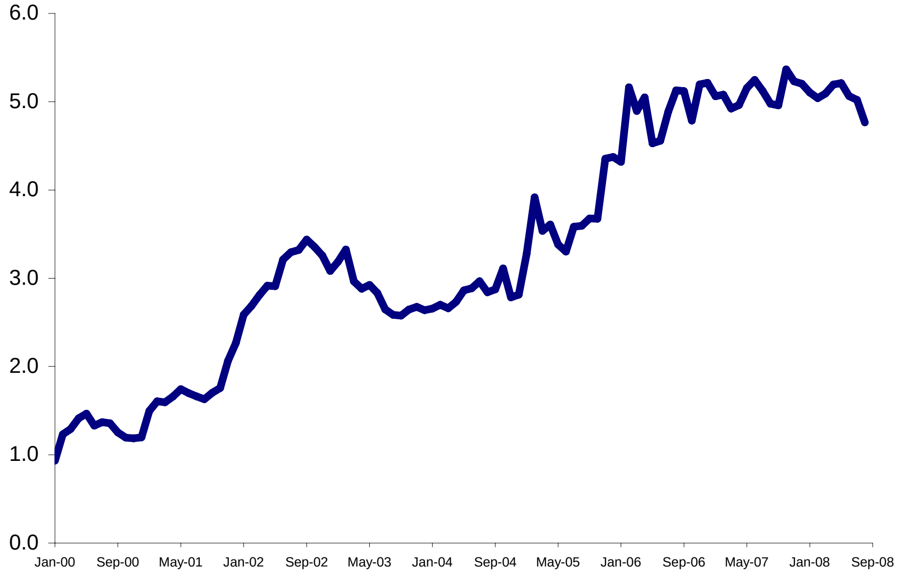
Foreign confidence is expected to stay weak

- **Foreign confidence** was flat again due to a lack of new statistics. However, given current liquidity constraints, we do not expect growth in foreign investments.

Market confidence remains under pressure

- **The market confidence indicator** continued to erode, demonstrating a significant deterioration of all market trends; both equity and bond market are in free-fall and it's difficult to see the bottom.

Figure 1: AB-ICI was down 2.8% last month



Source: Alfa Research, New School of Economics

Russia is in a better position than other EM

With the U.S. financial crisis as a backdrop to global woes, the AB-ICI is likely to decline further

After a protracted deliberation, the U.S. Congress approved a $700 bln bailout package that turned out to be much ado about nothing, providing only temporary relief to weary markets. A number of unknowns, including the possibility of further bankruptcies, the outcome of a U.S. presidential election, and the revised global growth forecasts, which are helping to push down commodity prices across the board. The downward pressure on commodity prices, continued liquidity constraints due to a delay in the implementation of the government rescue package domestically, and concerns over ruble exchange rate volatility pose threats to growth of the Russian economy. The continued decline in the AB-ICI index reflects these negative trends.

Russia can do better than its peers because it has accumulated fiscal savings and its economy is not overleveraged

Even though Russia failed to diversify from its dependence on oil, there are still a couple of reasons to expect it to do well on a relative basis. Firstly, unlike a number of other countries, Russia used recent years to accumulate fiscal savings; it also kept fiscal expenditures under control at 34% of GDP. Secondly, the Russian economy is not as leveraged as a number of other economies; the role of the financial sector is not as important as in other countries.

Russia's advantages: $190 bln stabilization fund, surplus equal to 7.7% of GDP, CBR reserves equal to 23 months of imports

The Russian government has implemented a very tight fiscal policy in recent years. The heavy taxation of the oil industry the state to accumulate $190 bln in the stabilization fund as of the beginning of October, equal to 11% of this year's estimated GDP. Russia's fiscal surplus of 7.7% in 1H08 was one of the highest in the world. Moreover, its CBR reserves are sufficient to cover 23 months of imports, the highest indicator in the EM universe. Rounding out this list of strengths is Russia's low sovereign foreign debt, which at only 2% of GDP is one of the lowest in world.

Figure 2: Fiscal balance, foreign debt and Central Bank reserves by country

	Budget surplus, % GDP	CB reserves, $ bln	CB reserves, months of imports	Total foreign debt, $ bln	Total foreign debt, % GDP	CB reserves/ foreign debt
China	4.0%	1,800	18.0	427	11%	422%
Korea	-1.1%	243	6.4	343	32%	71%
Brazil	-2.3%	205	15.0	201	12%	102%
Russia	7.7%	556	23.0	527	31%	106%
India	-5.5%	295	13.0	221	15%	133%
Mexico	0.0%	91	3.5	180	19%	51%
Turkey	-2.9%	79	4.4	250	29%	32%
Kazakhstan	-1.8%	45*	7.5	90	72%	50%
Ukraine	-2.0%	38	4.5	100	56%	38%

** Including stabilization fund*
Source: Reuters, Internet Securities, Alfa Research

With banking assets at 60% of GDP and mortgages 3%, the Russian economy is not overleveraged

While Russian private sector was building exposure to foreign debt, which reached $488 bln in 1H08, corporate sector is not overleveraged by international standards owing to the relatively modest role of financial services. Total banking assets equal only 60% of GDP, total corporate loans only 30%, and retail lending 10%. Around 50% of Russia's investments have been financed by enterprises' own resources. Additionally, despite rumors of the high leverage of some of Russia's largest groups we still believe that if the financial crisis starts to have an impact on Russia's real economy, some businesses will be able to get support from their shareholders. This aptly illustrates that while Russia will not be able to decouple from deteriorating global economic trends, it will likely do better than its peers.

Thus even though we expect AB-ICI to remain under pressure in the coming months, we believe its performance will not be nearly as bad as the performance of the stock market.

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