

AB-ICI: Weak Growth on Mixed News

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was up a modest 1.2% last month, supported by stable financial markets
- The expectation of ruble depreciation is the principal factor constraining index growth
- The possible failure of an economic recovery to materialize is the key concern for the months ahead

The AB-ICI rose 1.2% last month

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Last month, the AB-ICI rose 1.2% after collapsing by 9% in August. The weakness of the recovery reflects the fact that the economic news flow remains mixed: on the one hand, the CBR reported an increase in reserves, suggesting an improved balance of payments; however, expectations of ruble depreciation remain strong and flows to dollar-denominated deposits persist. Financial markets remained at strong levels but lack the fundamental support needed to reach new highs.

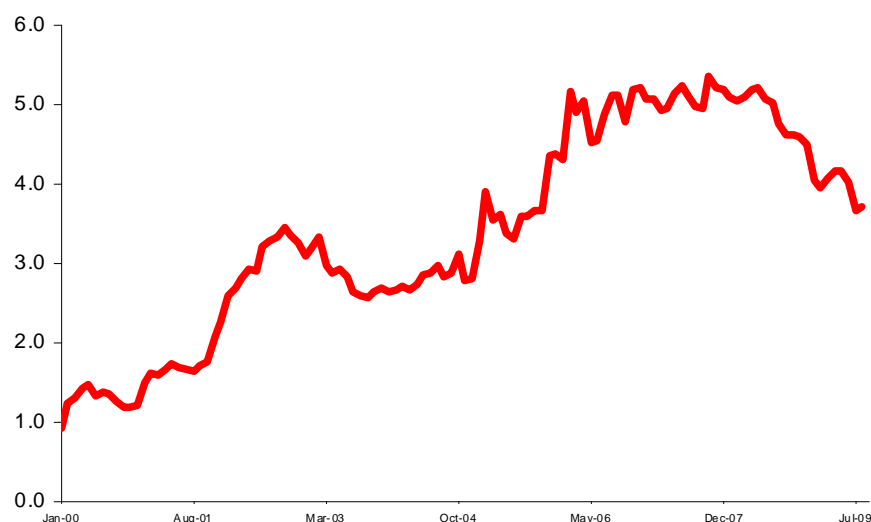
...as CBR reserves stabilized...

- The **economic confidence indicator** declined substantially in reaction to a new round of dollarization of retail deposits. According to preliminary information, foreign-currency deposits went up 4.2% last month compared with only a 1% increase in ruble-denominated deposits;

...and fixed-income and equity markets remained strong

- **Foreign confidence** was unchanged owing to a lack of updated statistics;
- **Market confidence** increased, as both fixed-income and equity markets managed to remain at high levels.

Figure 1: AB-ICI was up a modest 1.2% last month



Source: *New School of Economics, Alfa Research*

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Confidence in the ruble is low, share of foreign-currency deposits remains high

Expectations of depreciation are justified based on fundamental value

Under a 10% of GDP budget deficit for this year, we expect the ruble to fall to 36.6/\$

Ruble instability will delay economic recovery and limit AB-ICI growth

Concern over ruble constrains growth

In a nutshell, we believe the AB-ICI's performance will be constrained by lack of confidence in the ruble and expectations of depreciation. In August, foreign-currency deposits increased at a much faster pace than ruble accounts, reflecting mounting concern over where the ruble will go this fall. The share of foreign-currency deposits is slightly above 30%, still below the 2000-2009 maximum of 40%.

These expectations of ruble depreciation are completely justified if we take a look at recent changes in the monetary mass versus CBR reserves. The 2Q09 budget deficit and the related increase in the monetary supply decreased the fundamental value of the ruble, defined as the monetary supply divided by CBR reserves, from RUB31.1/\$ in May to RUB32.6-32.5/\$ in July-August. This explains the downward pressure on the Russian currency in summer.

Figure 2: RUB/\$ fair value in 2008-2009

Date	Monetary mass, RUB trln	CBR reserves, \$ bln	RUB/\$ fundamental value
Aug-08	14.2	590	24.1
Dec-08	13.5	427	31.5
March-09	12.1	384	31.5
May-09	12.6	404	31.1
July-09	13.1	402	32.6
Aug-09	13.3	410	32.5

Source: CBR, Alfa Research

The Russian government may spend up to RUB1.6 trln to finance the budget deficit before year-end, a policy which would put additional pressure on the currency. Assuming an oil price of \$55/bbl and a budget deficit of 10% of GDP this year, we would expect the ruble to fall to RUB36.6/\$ by the end of the year. If the government can keep the deficit below 8%, we believe the exchange rate will decline to RUB35/\$. We believe the latter is the best-case scenario. While we had initially forecast RUB38.4/\$ under a 12% of GDP budget deficit, it now appears that the Finance Ministry will not be able to increase spending fast enough to jump from a deficit of 4.7% of GDP in 8M09 to 12% by December.

Figure 3: RUB/\$ scenarios for YE09

Fiscal deficit	6%	8%	10%	12%
Oil prices				
20\$/bbl	43.9	46.3	48.8	51.1
45\$/bbl	35.3	37.3	39.1	41.0
55\$/bbl	33.0	35.0	36.6	38.4
60\$/bbl	32.0	33.9	35.5	37.3
70\$/bbl	30.2	31.9	33.4	35.1

Source: CBR, Alfa Research

Ruble instability will delay a sustainable economic recovery and limit the growth of the AB-ICI. It will likewise constrain the recovery of the real sector by complicating business planning for local producers and limiting access to lending resources. We are therefore pessimistic about the AB-ICI's performance over the next 12 months.

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