

AB-ICI: Going Down, but Looking Up

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Investment Summary

- The AB-ICI was down 7% in November, as justified by lower domestic market liquidity.
- Ruble appreciation and an expected increase in fiscal spending lead us to expect index growth.

The AB-ICI went down by 7% last month

The AB-ICI went down 7%...

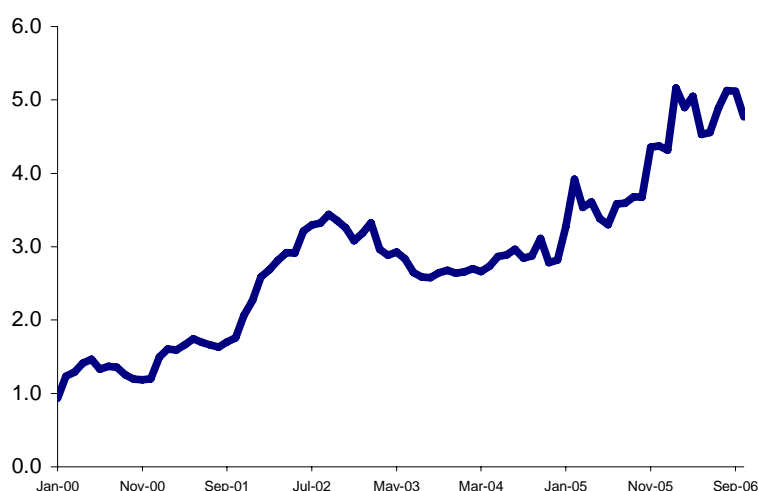
...despite a decline in currency savings...

...as financial markets were under pressure from lower commodity prices.

The Alfa Bank Investor Confidence Index (AB-ICI) went down 7% last month due to lower local liquidity:

- The index's **economic confidence** component was the only component that increased, albeit slightly. Despite persisting capital outflows, the economic confidence indicator was driven up by a decline in foreign currency savings (down to 18.6% of total bank deposits) and an increasing savings rate.
- **Foreign confidence** remained flat despite a modest increase of the foreign banks' share of total banking assets and despite some acceleration in inflows of FDI.
- **Market confidence** continued to be damaged by volatility in oil prices. Despite an active IPO season in October-November, the market confidence index declined.

Figure 1: The AB-ICI went down 7% last month due to weak market confidence



Source: Alfa Bank Research, New School of Economics

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The liquidity situation is expected to improve

The liquidity situation is clearly a crucial factor that will help to increase the economic confidence indicator as well as boost the markets.

Interbank rates jumped to 10% at the end of October, similar to 2005

Since the end of October, Russian interbank rates jumped to 10% from their normal level of 1-2%. This seasonal jump is explained by huge tax payments, and was also observed in October of last year. While interest rates are expected to come down in December due to fiscal spending flows, we believe that it will likely occur in the latter half of the month.

Banking liquidity started declining in August

The liquidity situation is illustrated clearly by the decline of the monetary base component, which we refer to as "banking liquidity" (see Figure 2). While this indicator reached a historic max in August, it then declined in both September and October. This illustrates how rapidly the decline in international oil prices, which dropped in August, affected the stability of the banking sector.

In 2005, banking liquidity improved only after December 15

There are rumors that the liquidity situation will improve in December as soon as budget funds are used to pay state enterprises and public employees. However, last year's pattern indicates that this liquidity inflow usually starts in mid-December and will not affect market dynamics until the second half of the month.

Figure 2: Monetary Base by Component, \$ bln

	Dec-04	Dec-05	Mar-06	Jun-06	Jul-06	Aug-06	Sept-06	Oct-06
Stabilization Fund	23.1	52.1	65.8	76.3	82.1	64.7	70.7	76.0
Correspondent accounts	17.5	17.6	11.5	15.9	13.5	13.8	16.6	12.9
Obligatory reserves	4.4	5.6	6.2	7.0	7.2	7.6	7.7	7.7
Deposits at the CBR+CBR bonds	3.6	1.4	5.7	10.1	10.9	14.9	10.1	8.8
Reverse repo	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserves on foreign operations	0.2	0.3	0.3	0.2	0.0	0.0	0.0	0.0
Total in banks	25.8	24.9	23.8	33.2	31.7	36.3	34.3	29.4

Sources: CBR, Alfa Bank Research

Ruble exchange rate appreciation will attract capital and is positive for liquidity

However, the recent ruble appreciation could be an important positive factor. It is likely to push some market players to reverse their currency positions (*i.e.* to sell dollars) and could also fuel a new round of capital inflows into Russia. The CBR is already the third largest national bank by size of reserves after China and Japan. Dollar depreciation will help Russia to accumulate at least \$290 bln by year end and will be POSITIVE for the financial sector in the short-term. We thus reiterate our view that liquidity is likely to improve in December.

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