Alfa-Bank

AB-ICI: The Recovery Unexpectedly Continues

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Investment Summary

- Last month, the Alfa Bank Investor Confidence Index (AB-ICI) rose 2% in response to capital inflows
- Increased ruble liquidity from the budget deficit will put pressure on interest rates but is unlikely to boost GDP
- We expect the refinancing rate to continue to decline, as inflation may fall to 6-7% in 1Q10

The AB-ICI rose 2% last month

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In November, the AB-ICI rose 2% mainly owing to improved economic confidence, while neither foreign nor market confidence posted any significant growth.

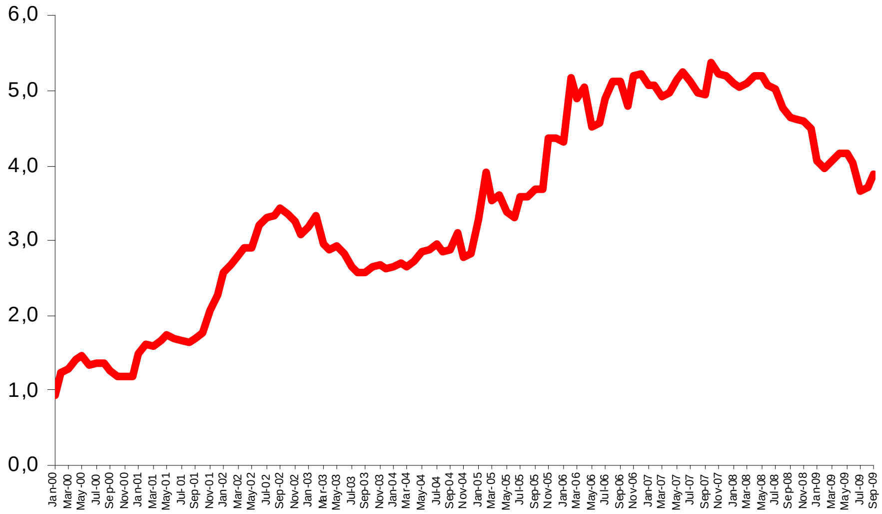
…thanks to a stronger ruble and capital inflows…

- The **economic confidence indicator** improved in November thanks to the dollar's depreciation on international markets. The stronger ruble prompted capital to flow into the Russian financial market and increasing the CBR's reserves by $32 bln. The stronger ruble pushed down the share of foreign-currency deposits;

…while the market's growth trend slowed

- **Foreign confidence** rose modestly, though foreign banks' share of total banking assets remained at around 12%, and FDI to Russia was still down 48% y-o-y in 9M09;
- **Market confidence** improved only slightly, which marks a major change compared with the previous months, when the market's recovery was the driving force reason behind the AB-ICI's growth.

Figure 1: AB-ICI was up 2% last month



Source: New School of Economics, Alfa Research

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Will lower interest rates help growth?

Interest rates are becoming volatile

The key change in the Russian financial sector in recent months has been the switch from a scarcity to an excess of liquidity. Interest rates are becoming highly volatile as a result, and the CBR is attempting to stabilize them.

The CBR announced it will exit banks' liabilities…

We believe the CBR's plan to exit banks' liabilities is intended to deal with this excess liquidity. This announcement came as a surprise because the amount of liquidity support provided to banks by the CBR had already declined steeply, from RUB3.4 trln in December 2008 to RUB1.3 trln currently, according to our estimates. This represents a decrease from 12% of total banking assets at the beginning of the year to only 5.6% today. Russian banks have already adjusted from scarce to excess liquidity of their own accord.

…implying that rates at money auctions will increase

The central bank's announcement, however, had another important dimension. Since October, the rates on unsecured CBR loans have decoupled from the refinancing rate. Even though the latter has declined, the cut-off rate for three-month loans at this week's auction increased to 12.5% from 11.8% the previous week. This signals that, instead of allowing an organic decline in its exposure to banks, the CBR intends to force them to redeem their liabilities.

CBR must also sterilize budget deficit and FOREX growth

We believe the CBR's move to speed up its exit from banks' liabilities is a sign not so much of economic recovery, but of the need to sterilize the increase in the monetary supply coming from the budget deficit and growth in FOREX reserves. Some RUB1.2 trln of the Reserve Fund will go to finance fiscal spending before the year-end. FOREX interventions have lifted reserves by $32 bln over the last two months. Both factors are putting pressure on interest rates and banks' margins.

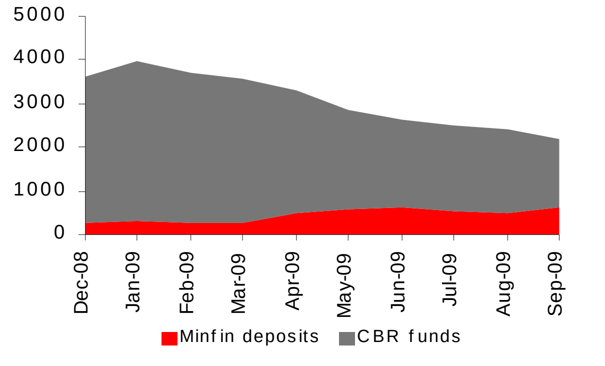
Rate hikes are also intended to cut CBR's exposure to second-tier banks

Another point is that at the beginning of October, the amount of unsecured loans taken out by banks stabilized at around RUB200-250 bln despite the high relative cost of these funds. This is raising concerns over the risks accumulated via this direct exposure to banks, which is one reason why the CBR is moving to cut refinancing support more quickly.

Lower rates do not guarantee economic or AB-ICI growth

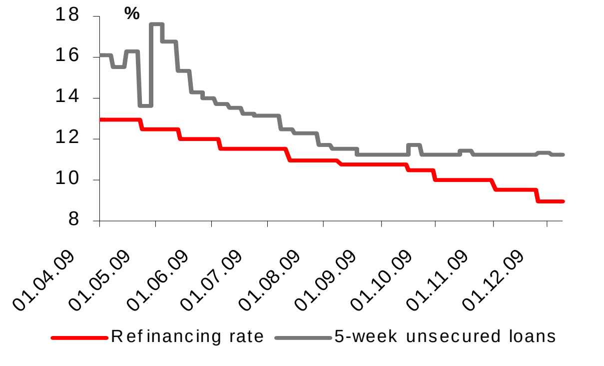
The sharp drop in inflation in the last three months suggests that in 1Q10, y-o-y price growth may fall to 6-7% from the current 9%. This implies that the refinancing rate can be cut further: we expect it to decline to 8.5% by year-end and then decrease an additional 1-1.5 ppts in 1Q10. We reiterate our view that deposit and lending rates will also remain under downward pressure. Unfortunately, we believe that hidden NPLs will prevent banks from increasing lending in spite of lower rates, so we doubt the AB-ICI's recovery is sustainable.

Figure 2: CBR & Minfin position in banks, RUB bln



Source: CBR, Alfa Bank

Figure 3: Unsecured-loan rate and refinancing rate



Source: CBR, Alfa Bank

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