



AB-ICI 2004: Optimism Not Shared by the Market

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Investment Summary

- AB-ICI rose 23% in 2004, which belies the deterioration of market sentiment
- Higher FDI and presence of foreign banks were fundamental triggers for Index growth
- Market sentiment becoming more important: tax claims seen as threat, WTO entry compensates

AB-ICI's optimism was not shared by the market

Recent growth in AB-ICI came as a surprise to market participants

The publication of the AB-ICI in December highlighted the wide divergence between its trend and market sentiment: in the past three months the RTS Index declined, even as the AB-ICI continued to rise at a significant pace. We tend to attribute this contradiction not to our Index methodology, but rather to the wave of pessimism that spread over the markets.

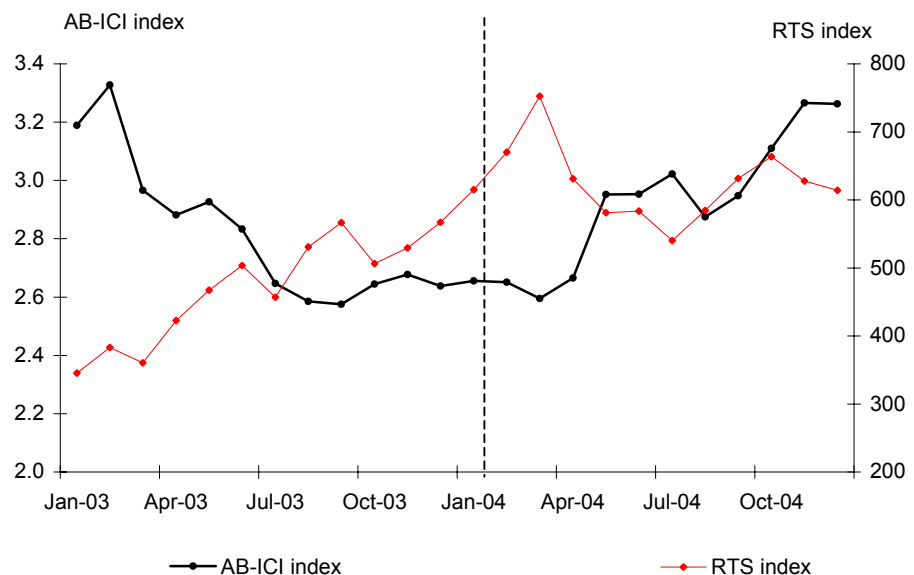
AB-ICI was down 14% in 2003 on a lack of fundamental improvements

In 2003 the AB-ICI declined 14%, reflecting the lack of significant fundamental changes. The net capital inflow posted that year was not backed by FDI and was of a speculative nature. The Index showed virtually no reaction to the onset of the Yukos affair, as was the case with the RTS Index, which continued to rise from the beginning of 2003.

Increase of Index in 2004 was due to higher FDI and new IPOs

The dynamic of 2004 showed the opposite: the AB-ICI rose backed by a substantial increase in FDI flows, penetration by foreign banks, and an increasing number of IPOs. These improvements, however, were not appreciated by the market, which believes that FDI is merely a reflection of Russians' willingness to sell. This deterioration of perception is the key unknown that dominates our 2005 outlook.

Figure 1. AB-ICI: Up 8% as fears following banking crisis receded



Sources: New School of Economics, Alfa Bank

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**Market component will gain in importance**

External conditions remain important for Russian economic performance

We believe Russia's macro development in 2005 will remain dependent on the external environment, i.e. commodity prices and international forex rates. We expect Urals crude to average \$30 p/bbl, a level that should result from a gradual correction in oil prices.

Inflation will accelerate and the ruble should be kept weaker

There do not seem to be any areas of uncertainty regarding domestic economic policy. The Cabinet proceeded to ease fiscal policy by monetizing social benefits, a reform that was initially assessed at \$6 bln but which now will apparently cost \$11 bln. However, this affects mainly the inflation forecast, which we downgraded from 13% to 15% for 2005E. A more inflationary environment will push the CBR to depreciate the ruble faster.

Tax claims for previous years are worse than an increase in current tax rates

While faster inflation and changes in fiscal policy could have implications for economic growth, in reality these factors are not the key elements for business decisions in 2005. Instead, the main issue is tax policy, or more specifically the authorities' intention to investigate tax compliance in previous years. If the authorities continue to replenish fiscal coffers by recalculating taxes for previous period, this would harm the economic climate more than an official increase in current taxes. This should be the key factor affecting market sentiment in 2005.

Decline in free-float of companies also weighed on sentiment

Another catalyst for the market is the number of liquid instruments available to investors. Huge export revenues flowing into the country reduced the government's appetite for borrowing, allowed companies to proceed with buy-backs or, in the case of strategic investors, to accumulate shares from the market. In recent years the free-float in several companies like UES and Surgutneftegaz has diminished, which has a deleterious effect since a smaller number of instruments reduces the attractiveness of the Russian market for foreign investors.

Market component of AB-ICI will gain in importance

The importance of the market dynamic for the AB-ICI will increase in 2005. FDI growth is likely to slow, at least over the two next quarters, after a number of deals were recorded in 2004. The net capital inflow that drove expectations of a stronger ruble rate in 4Q04 will turn into an outflow in the coming months as the dollar gains ground on international markets. Without firm support from these two factors, the AB-ICI will more closely follow the trend on financial markets.

Figure 2. Net Capital Flows, \$ bln

	1Q	2Q	3Q	4Q	Annual
2001	-7.0	-2.9	-1.5	-3.6	-15.0
2002	-3.2	1.2	-2.3	-3.8	-8.1
2003	-0.2	4.2	-7.6	1.7	-1.9
2004	-4.0	-6.2	-8.0	10.3	-7.8

Source: CBR

Investment grade from S&P and WTO entry are two positive catalysts

Nevertheless, there are two positive events that could positively affect the mood among investors. The first is the expected assignment of an investment grade rating to Russian sovereign debt by S&P, an event likely to occur this year and open the Russian market to a new group of foreign investors. Second, Russia will have to enter the WTO in 2005, as in 2006 it will assume the rotating presidency of the G-8 (by definition the president of the G-8 must also be a member of WTO). Neither event is likely to result in serious economic changes, but they might help improve Russia's image internationally.

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