Alfa-Bank

AB-ICI: What Lies Ahead in 2010?

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Investment Summary

- Last month, the Alfa Bank Investor Confidence Index (AB-ICI) was down 2.3% as the market rally came to an end
- AB-ICI was depressed in 2009 due to poor lending conditions, despite favorably high oil prices
- We believe that low economic growth and a flat AB-ICI are the most likely scenarios for 2010

AB-ICI down 2.3% last month

The AB-ICI was down 2.3% last month...

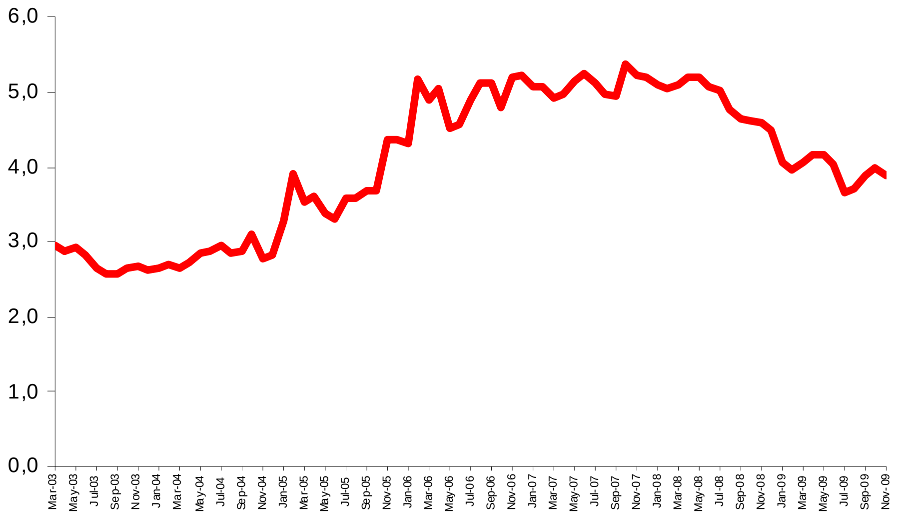
…despite a recovery in business activity…

…mainly owing to the end of the rally on the financial market

Even though economic confidence indicators continued to show signs of improvement, the AB-ICI was down 2.3% last month, mainly owing to the end of the rally on the financial market.

- The **economic confidence indicator** continued to perform well last month. The recovery in business activity in November pushed up retail deposits and resulted in a decline in the share of foreign-currency denominated deposits. The CBR’s reserves were high and reached the $440 bln level, suggesting that the capital account is still strong;
- **Foreign confidence** was flat as no new FDI statistics have been released;
- **Market confidence** declined for two reasons. First, the recent strong market rally came to an end, negatively impacting on the index’s performance. Second, the structure of the bond market is continuing to shift in favor of large companies, with the role of small and medium companies declining.

Figure 1: AB-ICI was down 2.3% last month



Source: New School of Economics, Alfa Research

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What lies ahead in 2010?

2009 brought a few surprises from the banking sector, budget implementation and the trade balance.

External environment in 2009 was better than expected

The external environment and the government's handling of the crisis were two key positives of the year. Even though the market initially expected oil prices to continue to decline, the reality turned out to be somewhat different. The recovery in commodity prices helped stabilize the ruble exchange rate and eased the liquidity crisis, which had paralyzed the banking sector back in autumn 2008. Thanks to rising oil prices, Russia's current account surplus will likely total $50 bln for FY09. The CBR's reserves are now almost $450 bln vs. $427 bln at the end of 2008.

Budget deficit was below expectations, suggesting lower risks in 2010

The recovery in oil prices helped the Russian government to post a much lower-than-expected budget deficit. At the beginning of the year the deficit was 8.5% of GDP, whereas for 11M09, the deficit was only 5% of GDP. The reserves fund is likely to total around RUB1.9 trln by this year-end, and this year's budget deficit is more likely to total RUB2.4 trln vs. initial expectations of RUB3.0 trln. This suggests that the reserves fund may be sufficient to cover next year's budget deficit without having to resort to foreign borrowing as initially announced by the government. S&P's recent upgrade of Russia's credit watch from Negative to Stable also suggests that the market perceives Russia's fiscal risks as modest.

Banking sector lending is stagnant

The only concern is that bank lending is still stagnant. Even though the liquidity crisis has been successfully resolved, NPLs continue to impact on the banking community. In a nutshell, this is forcing banks to maintain a high liquidity cushion, to limit exposure to the interbank market and to be very cautious with clients. Banks' retail loan books are down 11% YTD while corporate loan growth is flat.

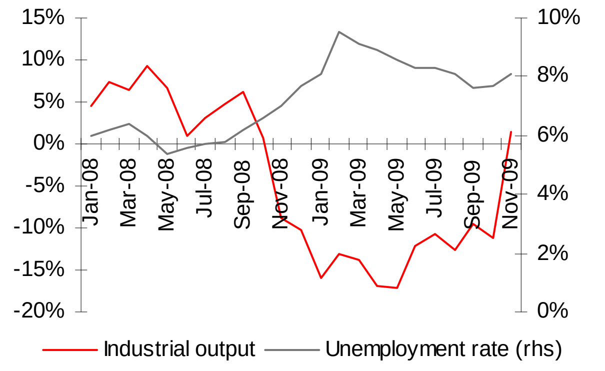
AB-ICI stabilized in 2H09

Our AB-ICI index remained depressed in 2009, reflecting the drop in economic activity. Nevertheless, it stabilized in 2H09 in response to positive external factors and a tight fiscal policy, which stimulated capital inflows. However, trends in 2010 are harder to predict.

While risks for 2010 are limited, chances of recovery are also not high

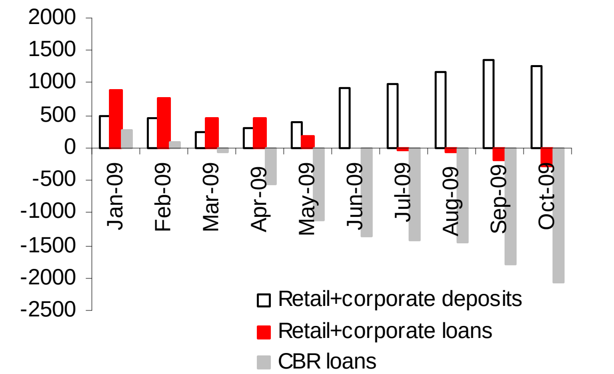
All the above-mentioned three areas are causes for concern in 2010. The external environment is still fragile, and even if a sharp drop in oil prices is no longer the base-case scenario, a gradual decline in prices should not be ruled out. The budget stability is obviously the function of global situation; however, this area is likely to bring fairly positive news. As fiscal support to GDP growth was very modest in 2009, the risk of budget stimulus withdrawal is equally non-existent in Russia. Huge uncertainty hangs over lending growth, which mirrors deteriorating demand and the low visibility of 2010-2011 trends. We therefore expect that the AB-ICI will likely remain flat in 2010.

Figure 2: Industrial output and unemployment



Source: Rosstat, Alfa Bank

Figure 3: Lending, deposits and CBR loans, YTD, RUB bln



Source: CBR, Alfa Bank

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