

AB-ICI: Down on Equity Market Uncertainty

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Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) dropped last month due to mixed market sentiment.
- The presidential address to the nation suggested a dilemma between investment and retail-driven growth.

The AB-ICI slowed in March

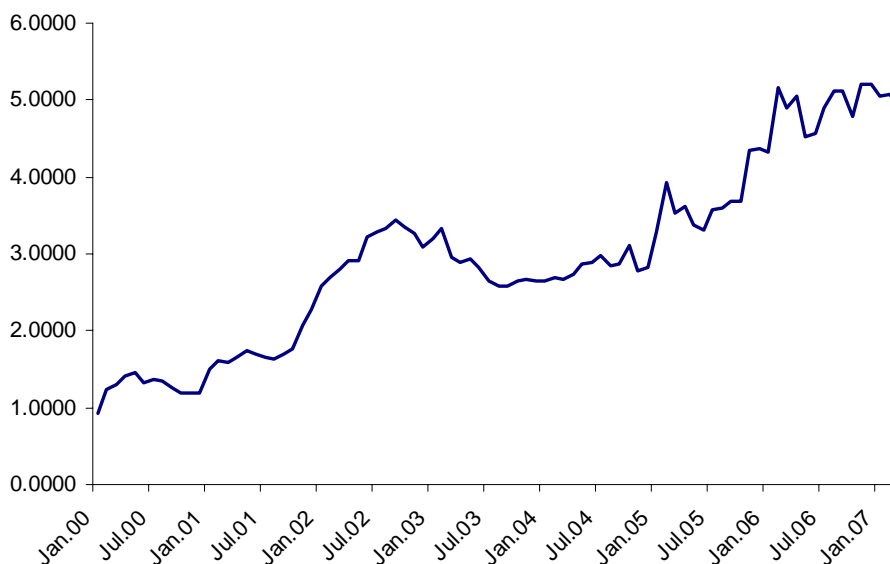
The AB-ICI was down 3% as capital inflows and dedollarization, backed by ruble appreciation,...

...were insufficient to compensate for the uncertainty on the securities market

The AB-ICI was down 3% in March 2007.

- The index's **economic confidence** continued to grow backed by strong capital inflows and ongoing dedollarization. This is largely the effect of ruble appreciation and the increased borrowing by state companies.
- **Foreign confidence** indicators remain unchanged, which reduced the importance of this component for the index calculation.
- **Market confidence** weakened in March due to the stagnated volumes of IPOs coinciding with poor RTS results. The decline in market confidence reflects the uncertainty of investors who barely invest in the RTS, which stagnated around the level of its 2006 close.

Figure 1: The AB-ICI was down 3% last month



Source: Alfa Bank Research, New School of Economics

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Budget Policy Dilemma

The RTS market did not perform well due to uncertainty on economic policy

While in previous years the increase in capital inflows always translated into good RTS performance, this year there has been no such link. Financial markets are not only dominated by uncertainty related to the upcoming electoral campaigns, but also are concerned about the priorities of Russian economic policy in coming years and the relative performance of different equity market segments.

Commodity producers are calling for easing the tax burden

In particular, the consensus seems to be that Russian oil companies need to have their tax burden eased in order to appear attractive to portfolio investors. Commodity producers are increasing pressure on the Cabinet for tax relief after 2008, with their lobbying focused on the need to increase oil production, which requires significant CAPEX. The country's ambitious plans to increase exports to new markets like China call for an increase in oil extraction and higher infrastructural expenditures. While the commodity extraction sector currently shows 4% growth y-o-y, their lobbyist insist that fiscal support is necessary for investment projects. Given that oil companies are important political players, a promise to ease oil taxation could become a part of the presidential campaign.

Local consumers are seeing strong competition from imports

However, the Russian equity market in recent years has gradually become more and more consumer-driven. Food producers, telecoms and the banking sector are increasing their shares in total equity market capitalization, particularly by conducting IPOs. However, while in 2003 local producers were benefitting from the 44% yearly growth in domestic consumption, in 2006 this growth slowed to a mere 8%. Increasing living standards as well as ruble appreciation are both pushing people to increase imports, which are now growing by 30-35% per year. Thus without a decline in the tax burden on local producers, these segments are unlikely to provide strong upside potential in coming years.

Figure 2: Russian main economic indicators, real GDP ppts

	2003	2004	2005	2006
GDP growth	7.3	7.2	6.4	6.7
Increase in exports	3.3	3.5	1.1	1.0
Increase in supply of local production (1)-(2)	2.9	2.8	1.6	0.6
Increase in domestic demand (1)	5.2	6.2	6.4	7.4
Import growth (2)	2.3	3.4	4.9	6.8
Imports, % of local demand growth	44%	55%	77%	92%

Source: Center for Macroeconomic Analysis and Short-Term Forecasting, Alfa Bank Research

Russian banks are the best way to play retail growth in Russia, but their performance is insufficient for supporting the entire RTS

The Russian banking sector appears to be offering a unique opportunity to gain exposure to Russia's strong growth for two reasons. First, banking assets to GDP penetration is still modest at 56% of GDP as of the end of 2006. Additionally, competition with foreign banks is still very limited. While the largest Russian companies are clearly using their access to the international markets to borrow from international banks rather than domestic, SMEs and the retail segment are still dominated by local players. Sberbank's recent placement and VTB's forthcoming IPO are the best way to play this growth story. However, the banking sector represents less than 10% of Russian market capitalization, and its strong fundamentals would need to be even stronger to drive growth on the entire RTS. Forthcoming government policy thus remains the key catalyst for RTS performance.

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