AB-ICI: Good start, but prospects cloudy

Natalia Orlova (+7 495) 795-3677 NOrlova@alfabank.ru

January 31, 2011 www.alfabank.com Moscow

Investment Summary

- The AB-ICI increased 4.7% last month owing to the ongoing rally on Russian financial markets
- Capital outflows from Russia stabilized, preventing economic confidence from plunging further
- Strong CPI acceleration in January confirms high inflationary risks for the AB-ICI this year

AB-ICI added 4.7% thanks to improved market sentiment

AB-ICI growth continued with 4.7% m/m increase entirely due to strong markets

The AB-ICI continued to post strong growth, adding 4.7% last month after increasing 5.8% the previous month thanks to the rally on financial markets and increasing inflows to Russia-dedicated funds. While the capital outflow stabilized in December, the full-year outflow of $38.3bn highlights the low level of economic confidence in Russia.

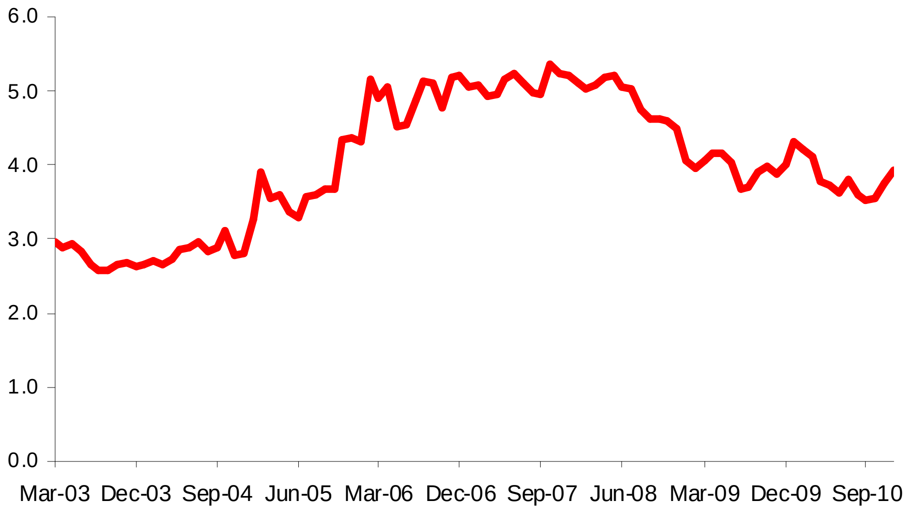
Economic confidence stabilized but remains low

- **Economic confidence** remained stable after falling steeply the month before, as Russia managed to stabilize capital outflows in December. At the same time, the full-year capital outflow from Russia of $38.3bn exceeded official expectations of $29bn, which highlights Russia's poor attractiveness to foreign capital. Moreover, despite the outflow, corporate foreign debt increased by $15bn, indicating that no deleverage took place, which poses a threat to the capital account in 2011;
- **Foreign confidence** remained flat, as no relevant FDI data has been released;

Russian market inspired by high commodity prices

- **Market confidence** continued to grow, as Russia-dedicated funds managed to attract $1bn in the last several weeks beating other emerging market peers. This favorable attitude towards the Russian market is explained by the very high oil price range of $90-100/bbl, which allowed local bond and equity markets' growth to catch up after lagging during 2H10.

Figure 1: AB-ICI increased 5.8% last month



Source: New School of Economics, Alfa Research

Inflation: The key threat to the AB-ICI in 2011

GDP growth of 4.0% mainly explained by restocking

January news flow suggests that 2011 will be a tough year for the AB-ICI. While Rosstat's first estimate of 2010 GDP growth of 4.0% y/y exceeded our and the market's expectations, the composition of this growth does not guarantee the same strong result this year. The key growth driver was the 24.3% increase in gross capital formation, which, however, includes only 3.5% growth in fixed investments (vs. our expectations of 5.0%), suggesting that the remaining contribution to growth was from stockbuilding. The poor investment figure corresponds to the 0.9% decline in construction sector output, which suggests that real investment demand in Russia has yet to recover.

Faster inflation resulted in disappointing 4.3% y/y real income growth

Consumption was also weaker than we expected on faster inflation, which came in at 8.8% in 2010. Retail trade increased 4.4% y/y and real disposable income was up only 4.3% y/y vs. our expectations of 5% y/y growth each. Income growth is particularly weak if we bear in mind that pensions were up 45% y/y in nominal terms in 2010, an increase of around 35% y/y growth in real terms. As pensions will only be indexed 10% y/y and social taxes have been increased effective January 2011, we maintain our real income forecast for 2011 of 3.0% y/y.

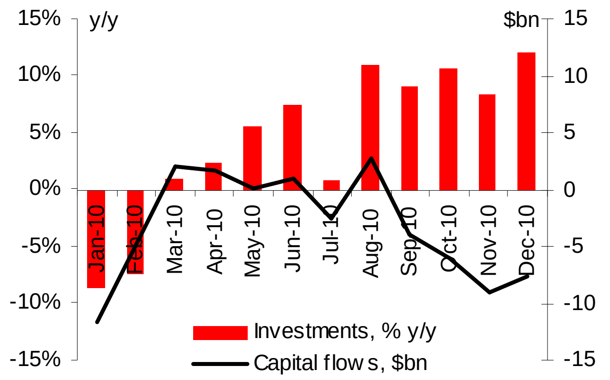
Capital outflow of $38.3 bln and 18% drop in FDI in 9M10 means economy not ready to digest new money

Squeezed final demand on both consumption and investment sides meant the economy was unable to digest the available cheap liquidity. FDI flows to Russia were also down, falling some 18% y/y. Capital outflow in 1H10 was $11.4bn, while the full-year figure totaled $38.3bn, which was substantially worse than the CBR's guidance of $29bn. This capital outflow was particularly bad, as companies' foreign debt declined only $2.8bn in 2010, while banks increased foreign obligations by $17.6bn. This suggests that the corporate sector's foreign debt burden will not be relieved in 2011.

Higher oil prices helped to keep budget breakeven at $109/bbl, but fuel inflationary risks

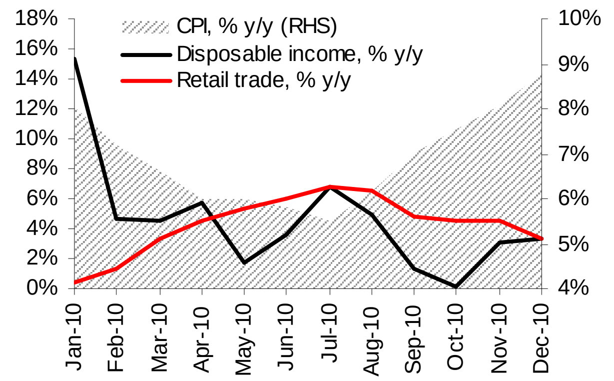
However, increased commodity prices helped the country to maintain a strong financial position. It was only thanks to the high oil price that CBR reserves managed to end the year at $480bn. Higher-than-expected oil prices also allowed the cabinet to keep the budget breakeven oil price at $109/bbl. Also, the reserve fund closed the year with $25bn vs. the expected $10bn. This enabled the ruble to finish the year at RUB30.5/$ and the current account surplus to total $72 bln. The flip side of this, however, is the risk of higher inflation, particularly given the jump in global agricultural prices.

Figure 2: Investments vs. capital outflow



Source: Rosstat, CBR, Alfa Research

Figure 3: RDI and trade vs. CPI



Source: Rosstat, Alfa Research

The environment of slow economic growth combined with almost double-digit inflation and unclear prospects in terms of capital flows highlights the risks faced by Russian economy and AB-ICI for 2011.

Contact Information

Alfa Bank (Moscow)	12 Akad. Sakharov Prospect, Moscow, Russia 107078
Head of Equities	Michael Pijiolis
Telephone	(+7 495) 795-3712
Research Department	
Telephone	(+7 495) 795-3676
Head of Research	Peter Szopo
Oil & Gas	Pavel Sorokin, Alexander Bespalov
Macroeconomics	Natalia Orlova, Ph.D., Dmitry Dolgin
Banking	Jason Hurwitz
Telecommunications, Industrials	Iouli Matevossov, CFA, CPA
Utilities	Alexander Kornilov, CFA, Elina Kulieva, Ph.D., Fedor Kornachev
Metals & Mining	Barry Ehrlich, CFA, Maxim Semenovykh, Sergei Krivokhizhin, Ph.D.
Consumer, Agriculture, Pharmaceuticals	Alexandra Melnikova, Irina Prokopyeva
Chemicals, Logistics, Industrials	Georgy Ivanin, Vladimir Dorogov, CFA
Russian Product	Angelika Henkel, Ph.D., Alan Kaziev
Editorial	David Spencer, Heather Dean
Translation	Anna Sholomitskaya, Elena Elovskaya
Production	Aleksei Balashov
Equity Sales & Trading	
Telephone	(+7 495) 223-5500, 223-5522
Facsimile	(+7 495) 745-7897
International	Roland Glasfors, Victoria Duben, Michael Kotov, Dmitry Ryzhkov
Domestic Institutional	Dmitry Soloviev, Dmitry Demchenko, Mikhail Babaev, Evgeny Tereschenko
Alfa-Direct Sales Team	(+7 495) 795-3680 Sergey Rybakov, Valeriy Kremnev, Evgeniy Batelman
Alfa Capital (Kiev)	77-a Chervonoarmiyska St.(6th floor) Kiev, Ukraine 03150
Research Department	
Telephone	(+380 44) 490-1600
Facsimile	(+380 44) 490-1601
Analysts	Denis Shauruk, Oleh Yuzefovych
Equity Sales & Trading	
Sales & Trading	Sergey Grigorian, Denis Dolmatov, Yulia Grigoryan
Telephone	(+380 44) 490-1600
Alfa Capital Markets (London)	1 Angel Court, 14th Floor, London, EC2R 7HJ
Telephone	(+44 20) 7588-8500
Facsimile	(+44 20) 7382-4170
Telephone (Sales & Sales Trading)	(+44 20) 7382-4175
Sales	Matthew Arnold (+44 20) 7382 4171 Victoria Filimonova (+44 20) 7382-4172 Robert Szucsich (+44 20) 7382-4174
Sales Trading	Douglas Babic (+44 20) 7382-4178
Alforma Capital Markets (New York)	1270 Avenue of the Americas, New York, NY 10020
Telephones	(+1 212) 421-7500
Facsimile	(+1 212) 421-8633
Sales	Isai Pochtar (+1 212) 421-8564 Michael Jordan (+1 212) 421-8560
Sales Trading	Yan Gloukhovsky (+1 212) 421-8567
Fixed Income Sales	Jeffrey Weichsel (+1 212) 421-8563