AB-ICI: Struggling For Growth in 2012

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Investment Summary

- The AB-ICI fell by 4.0% last month, reflecting increased nervousness on financial markets.
- Increased local political risks drove a massive $38bn capital outflow in 4Q11.
- The future performance of AB-ICI depends on the ability to curb capital outflow and continue loan growth.

The AB-ICI fell 4.0% in December

AB-ICI fell due to nervousness of the financial markets

Last month, our index posted a significant 4.0% drop, reflecting significant underperformance of Russian markets versus EM and DM peers mainly due to pre-election nervousness. The increased local political risks continued to weigh on Russia's balance of payments, with capital outflow reaching $38bn in 4Q11 alone and $84bn in 2011. The strong capital outflow was the key reason why our index fell by 1.2% last year despite the 4.3% GDP growth.

Capital outflow accelerated significantly in 4Q11

- **Economic confidence** increased, reflecting a seasonal 7.3% m/m increase in household savings in bank accounts thanks to year-end bonuses. The capital account, on the other hand, brought little support, with a massive $38bn capital outflow in 4Q11 leading to $84bn outflow for the full-year, meeting our pessimistic expectations.

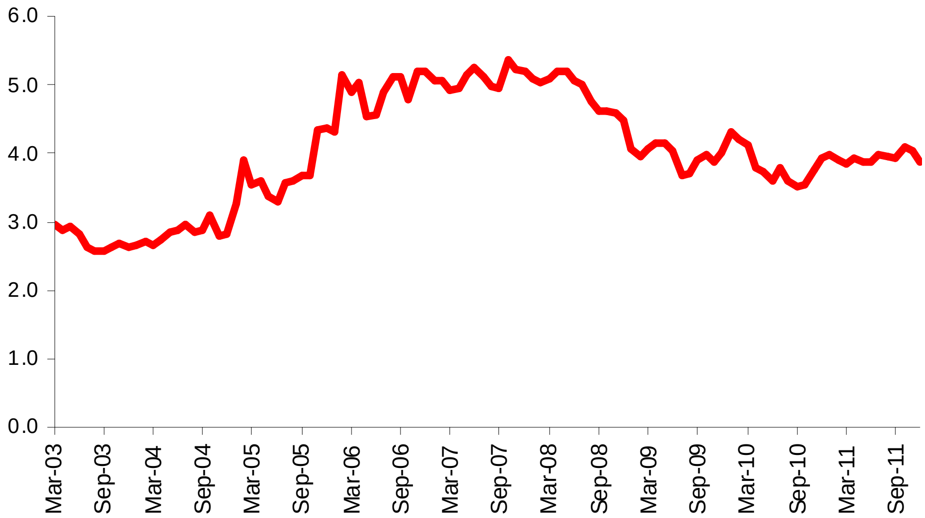
Foreign banks were hit by the European crisis

- **Foreign confidence** declined, as the European interbank crisis has damaged the position of foreign banks operating in Russia. Banks with foreign capital managed to show only half the market growth seen for local players in 2011.

The Russian market reacted to political and economic challenges

- **Market confidence** fell, reflecting the negative reaction of Russia-focused investors to the political uncertainty that arose in December, which is likely to remain an important factor in 1Q12. Another obstacle to an increase in market confidence comes from the risks of economic slowdown in 2012, as 85% of the GDP growth last year is explained by restocking. The immediate concern, however, is the recent Finance Ministry initiative to enforce a tax on Eurobond coupon payments, which could potentially cost Russian companies $4-5bn in 2012.

Figure 1: AB-ICI dropped 4.0%



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Source: New School of Economics, Alfa Research

Data Watch and Current Trends

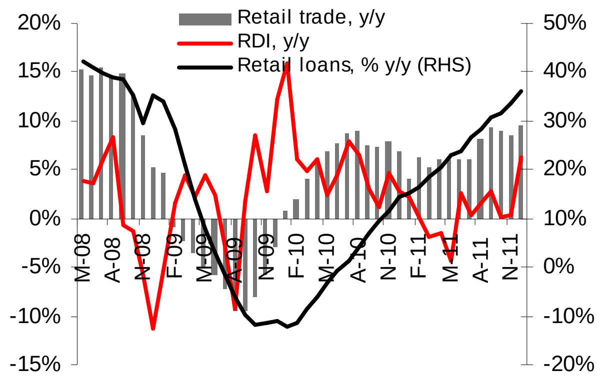
Russian consumers were not affected by political uncertainty and global risks, retail trade jumped 7.2% in 2011

December and 4Q11 came out strong, reducing our concerns regarding Russia's potential economic vulnerability to increasing political uncertainty and global recession. The key positive surprise was the acceleration in retail trade growth, which accounted for 9.5% y/y in December and 9.1% for 4Q11. Some acceleration in disposable income growth to 2.7% y/y in 4Q11 from 0.2% y/y in 9M11 made the population confident in spending. The unemployment rate also stood at 6.0-6.5% from 2Q11 through year-end, also supporting consumer confidence. Both factors allowed for increasing financial leverage, and retail loans grew 36% y/y for full-2011 versus only 14% y/y in 2010. As a result, retail trade accelerated to 7.2% in 2011 from 6.3% in 2010.

Investment growth reported at 6.2% was more sensitive to risk factors

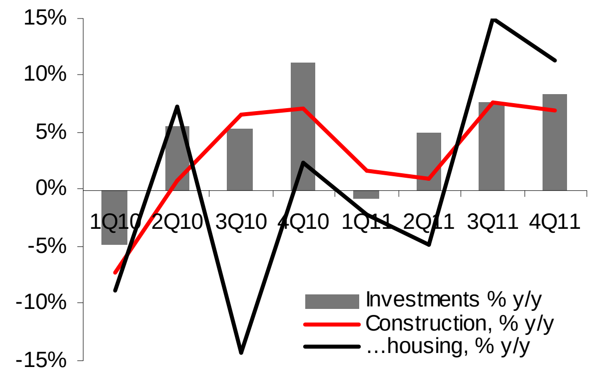
By contrast, companies are definitely more sensitive to global risks. While 2Q11 investment growth was 5.0% y/y, in 3Q11 and 4Q11 it failed to accelerate materially, and as a result annual investment growth totaled 6.2%, very close to our expectations and to the 6.0% reported for 2010. Moreover, both general construction and housing construction reported 4Q11 growth that turned out below the 3Q11 result, implying that the real sector reacted to an increase in risk perception.

Figure 2: Retail trade and retail lending



Source: Rosstat, CBR, Alfa Research

Figure 3: Investments and construction



Source: Rosstat, Alfa Research

Capital outflow accelerated to $84bn, while monetary supply growth was only 10% y/y

The effect on the balance of payments was much more pronounced. According to recent CBR estimates, capital outflow reached $38bn in 4Q11, substantially accelerating from the beginning of 2011 and putting the full-year figure at $84 bn. This created a shock for the local interbank market, propelling overnight rates to a high 6% seen even at the very end of December, while three-month rates exceeded 7%. The strong capital outflow forced monetary supply growth to decelerate from 30% in 2010 to 20% in 2011 even despite the acceleration in loan growth from 13% to 28%.

Inflation decelerated to 6.1%, the lowest since 1990

The increase in local interest rates was especially important as it coincided with a sizeable deceleration in the inflation rate. The CPI went up only 6.1% in 2011, the lowest level since the beginning of the transition. Given that the tariff increase was postponed until summer 2012, we are likely to see inflation decelerating to 4-5% in coming months. This will support consumption optimism but boost the real cost of money.

Capital outflow and loan growth are key potential catalysts for raising our 2012 outlook figures

The strong December and 4Q11 added up to 4.3% GDP in 2011, exceeding our expectations. This also created a window for upgrading our 2012 macroeconomic outlook, but we rather prefer to look for catalysts in coming months before making any revisions. First, we wait to see whether loan growth will remain fast despite the material increase in interest rates. Secondly, we believe that improvement in the capital account is prerequisite for better real sector trends. We agree with the view that a global recession would push some Russian capital back to Russia and create a growth opportunity; however, internal constraints may reduce the efficacy of this trend.

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