

AB-ICI: Further deterioration of economic trends

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Investment Summary

- The AB-ICI fell slightly in December as market confidence weakened towards last year's end
- EM markets sell-off reflects fall of market confidence in the whole developing economies cluster
- Fresh data signals further real economy weakening that increases risks of prolonged ruble instability

AB-ICI fell reflecting disappointing news from December 2013

Economic confidence rose on ForEx savings slight fall that is unlikely to stay with EMs capital flight

Foreign confidence was flat but license-revoking policy puts it under pressure

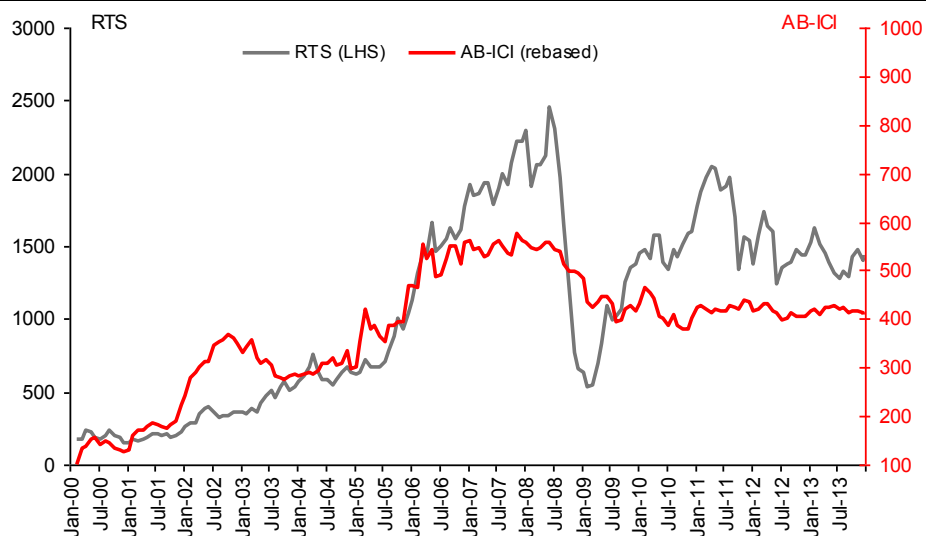
Market confidence fell on downbeat economy as Russia is lagging further behind other EMs' growth

AB-ICI fell in December

The AB-ICI diminished slightly in December losing 0.2%. The end of the year came disappointing with only 1.3% y/y GDP growth posted by Russia in 2013 and Fed decision to start tapering, fuelling the forex markets volatility across EM universe. AB-ICI enters 2014 with considerable pressures and the trends in domestic economy are not favoring its growth.

- **Economic confidence** increased in December as capital flight slowed down towards the end of last year and ForEx savings diminished slightly. However, we take this as very temporal move. Considering current EM markets sell-off we expect economic confidence to remain under pressure until the volatility hike levels out.
- **Foreign confidence** was effectively flat in December. As share of foreign banks' assets have been falling even before the license-revoking policy came into full, foreign confidence is subject to further deterioration in coming months.
- **Market confidence** fell in December. The spread between Russian and LatAm bonds widened as Russian economic data remained downbeat compared to its peers. Poor growth does not allow the CBR to raise interest rate in face of the greater forex market volatility. As fresh data package signals weak real economy is there to stay, risks of market confidence deterioration in 2014 are still elevated.

Figure 1: AB-ICI decreased in December



Source: New School of Economics, RTS, Alfa Research

AB-ICI: Sources of risk multiply

Weak production side of the economy continues to weigh down on AB-ICI...

...but consumer sector now also poses concerns

FX market volatility is also not adding to consumer confidence

Russian monetary policy regime switch is under pressure posing risks of reform back-off

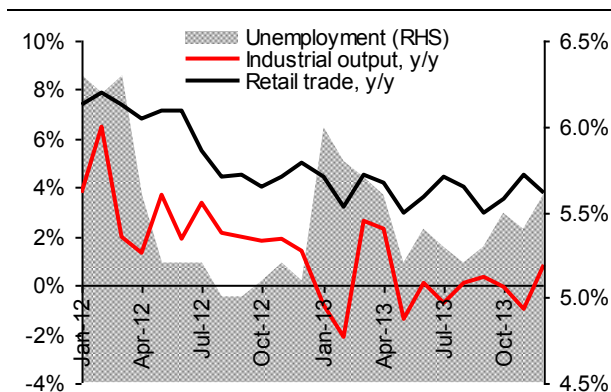
Weak AB-ICI performance that reflects ensuing deterioration of underlying economic fundamentals supports our view that real economy won't allow for strong market performance in 2014. Fresh data on the production side of the economy confirms the pessimistic view. Investment contracted in 2013, -0.3% y/y and is expected to weaken this year as the SOEs cut investment programs due to the government tariff-freeze policy. Industrial output barely grew in 2013 yielding just 0.3% y/y growth with manufacturing standing still, 0.1% y/y.

Less expected are additional concerns that are posed by weak retail trade data calling into question this year's performance of Russian consumption-led growth model. Retail trade grew by considerable 3.9% y/y in 2013 but weak real disposable income growth that decelerated in December down to 1.5% from November's 2.4% y/y reveals fragility of consumption growth. Rise in unemployment, 5.7% in December, adds to the downbeat story. With income and employment deterioration expecting strong consumer confidence this year would be a tough call.

Exacerbation of FX market volatility doesn't add to consumer confidence either. The ruble has been leading the EMs sell-off recently losing 7% YTD. As the imported goods play significant role in Russian consumption basket, considerable ruble weakening amplifies inflation risks. Last year's inflation rate overshooted CBR's target of 6% y/y considerably with 6.5% y/y price growth for 2013. This year's early depreciation casts doubt upon CBR being able to hold inflation in its 5-6% y/y range that is set for 2014.

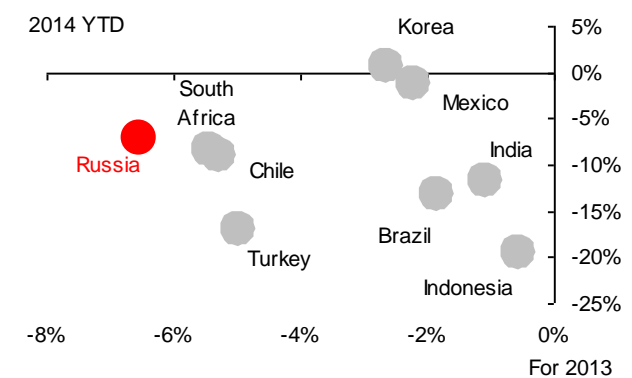
FX market instability comes at particularly wrong time as CBR's still in process of merging from active interventions in FX market towards more standard inflation-targeting regime. This coincides with developed economies preparing to enter the tightening cycle. EMs attempt to prevent capital flight by raising rates aggressively relying on signaling effect of monetary tightening but Russia is lagging in this area. As peers' rate hikes proved to be of mixed efficiency in immediately relieving the pressure, fear of float is rising putting under pressure switch to the inflation-targeting regime.

Figure 2: Producer and consumer trends



Source: Rosstat, Alfa Research

Figure 3: EM currencies to USD performance in 2013 and YTD



Source: Bloomberg, Alfa-Bank

With risks coming from vast variety of economic issues, AB-ICI is subject to sever pressure in 2014

Structural problems that have been accumulating for years and resulted in poor production side dynamics remain a major concern. But as markets enter 2014, Russian economy is caught between deterioration of its consumption-oriented growth model and inflation rate that is well above CBR's. These issues are aggravated with currency depreciation and lack of inflation-targeting policy credibility. With risks from different sides of Russian economy accumulating, AB-ICI is subject to severe pressure in 2014 making market optimism towards Russia hard to grow.

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