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AB-ICI: Mixed picture behind index growth

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Investment Summary

- The AB-ICI increased 1.4% last month as higher oil prices are supporting Russian investment case
- Weak GDP growth structure in 2010 and poor January macro indicators will constraint AB-ICI performance

AB-ICI added 1.4% last month

The main supporting factor for AB-ICI growth was improved economic confidence

The AB-ICI continued to grow but the rate of growth decreased from 4,7 % to 1,4 % last month. Despite the slight improvement in market and foreign confidence, the main supporting factor for AB-ICI was the reduction of capital outflows in January and the strong growth of savings rate

Economic index was supported by decline in capital outflow but is still fragile

- **Economic confidence** significantly increased in January due to continuing increase in oil prices. Better current account prospects suggests that Russia will still be attractive to foreign capital inflows, at least in the nearest future. The gradual ruble appreciation influenced the share of foreign currency deposits that has started to decrease. However, we take the improvement of this indicator as fragile: the fact that under $100/bbl Russia is still experiencing the net capital outflow is obviously negative;

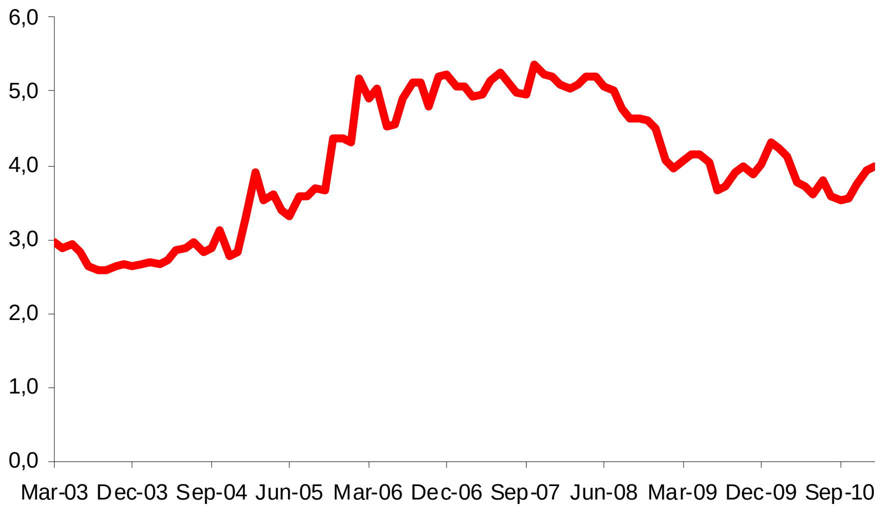
FDI improved, but foreign banks not active

- **Foreign confidence** increased as the 2010 FDI inflows to Russia reported only 13% y/y decline after a 41% y/y drop in 2009. The improved FDI trend is however counterbalanced with the modest activity of foreign banks, some of which have recently announced the cut of their local retail lending presence;

RTS index was supported by high crude oil prices

- **Market confidence** remained stable. The RTS index in January increased by 8% supported by high crude oil prices. Even if the widening spread between Russian and Latin America government bonds caused the negative influence on the market confidence, we see this component to perform well.

Figure 1: AB-ICI increased 1.4% last month



Source: New School of Economics, Alfa Research

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Poor January macro stats is a risk for AB-ICI

January consumption and investment figures were below expectations

We believe that the mixed picture behind AB-ICI performance is related to poor macro fundamentals on both cosumption and investment area. The key market consensus forecasts for January – 3.3% y/y retail sales growth (Alfa 3.1% y/y), 9.6% y/y investment growth (Alfa 10.5% y/y) and a 7.4% unemployment rate (Alfa 7.2%) – were missed. Retail sales expanded, albeit by a mere 0.5% y/y, while investments dropped 4.7% y/y. The unemployment rate reached 7.6%, above December's 7.2% level.

Weak income growth resulted from higher inflation and increase in payroll tax

Even though January retail sales were below our forecast, we were not entirely surprised. The drop in disposable income reflects inflation, which in January exceeded our expectation and accelerated to 9.6% y/y vs. our forecast of 9.2% y/y. Moreover, we have been saying that the increase in the payroll tax from 26% to 34% this year entails a huge cost to the real sector. Weak income growth and higher-than-expected unemployment (see Figure 10) are predictable results of the higher tax burden.

Large 4.7% y/y drop in investments reflected poor construction

The weak investment figure reflected the negative construction trend. After surging 11.6% in December, construction output shrank by 1.1% y/y in January. Housing construction dropped a huge 16.3% y/y, a rate not seen since mid-2010. Rosstat has also revised the 2010 construction trend downward: while previously, October-November construction growth had been reported at 5-6% y/y, it was later downgraded to 2-3% y/y. As a result, December's 11.6% y/y rise in construction now looks to be a one-off stemming from seasonal year-end factors, substantially damaging the outlook for the investment recovery.

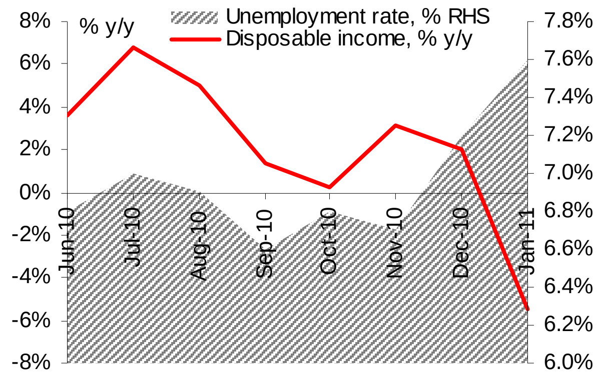
State sees risks to 9.0% y/y investment growth forecast, but our 6.0% target is safe

Responding to the January weakness, deputy economics minister Andrei Klepach commented that full-year investment growth may turn out below the government's 9.0% y/y forecast. However, we are comfortable with our 6.0% forecast. The strong recovery in construction materials observed since mid-2010 is a good sign that construction will start to expand again, though it may not do so as rapidly as the market expects.

The CBR rate hike reflects intention to curb inflationary expectations

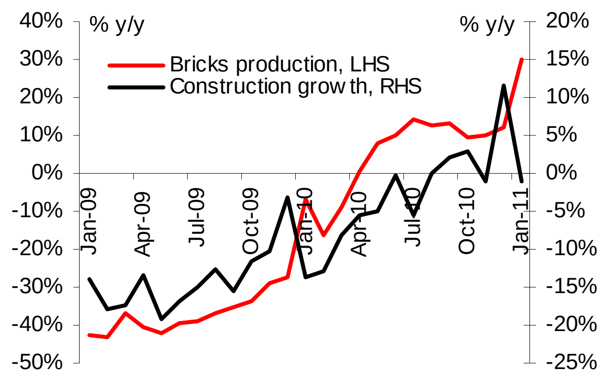
The weak January statistics did not prevent the CBR from raising the refinancing rate from 7.75% to 8.0% and increasing the deposit rate and reserve requirements. We take this as a clear sign that the CBR is concerned about rising inflationary expectations and their social impact. This factor may limit AB-ICI growth going forward.

Figure 2: Income growth and unemployment



Source: Rosstat, CBR, Alfa Research

Figure 3: Construction trends



Source: Rosstat, Alfa Research

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