AB-ICI: Expecting a Better Tomorrow

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Investment Summary

- The decline in local political nervousness allowed AB-ICI to recover 1.0% last month.
- We expect the capital account to improve in coming months on strong macro statistics…
- …and on strong returns assured by high interest rates and a stable ruble exchange rate

The AB-ICI increased 1.0% in January

The market's mood toward Russia improved

The AB-ICI started the year with modest growth following a sharp 4% drop a month earlier. The key positive change was the growth of Vladimir Putin's political ratings ahead of the March election, which calmed the nervousness on the Russian market. Positive signals are also coming from the real sector, which is supporting investor confidence.

Capital outflow continued in January

- **Economic confidence** declined, as capital outflow in January remained high at $11bn, close to the average $13bn monthly outflow seen in 4Q11. Companies and individuals contributed to the outflow with a strong increase in foreign-currency deposits, which totaled $8bn and $2bn, respectively. That said, this strong outflow did not hurt real sector trends, highlighted by the 15.6% y/y jump in fixed investments in January and 3.9% y/y GDP growth.

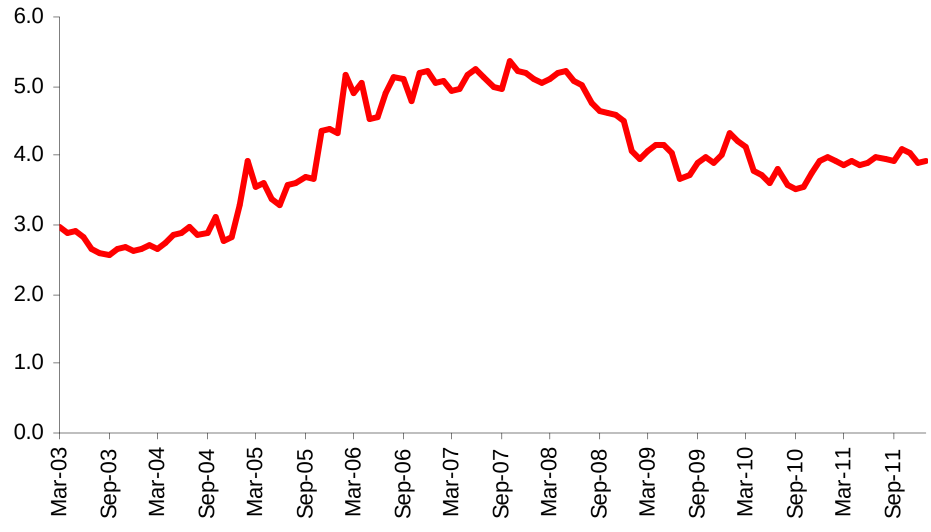
FDI inflows into construction sector support investment recovery

- **Foreign confidence** increased, reflecting 33% y/y growth of FDI in Russia in 2011. Although the role of FDI remains a modest 1% of GDP, the strong inflows into the construction sector in 4Q11 suggest more trust in Russian macro success.

Russian interest rates are attractive for global investors

- **Market confidence** increased, as the local political fears calmed and allowed Russia to benefit from the improved global sentiment. While the expectations of liquidity injections in the Eurozone, UK and Japan resulted in lower global interest rates, Russian market continues to have relatively high interest rates. The strong oil prices of $120-125/bbl provide another argument in favor of investing in ruble instruments, supporting an upbeat mood on the market.

Figure 1: AB-ICI increased 1.0% last month



Source: New School of Economics, Alfa Research

Expecting improvement of capital flows

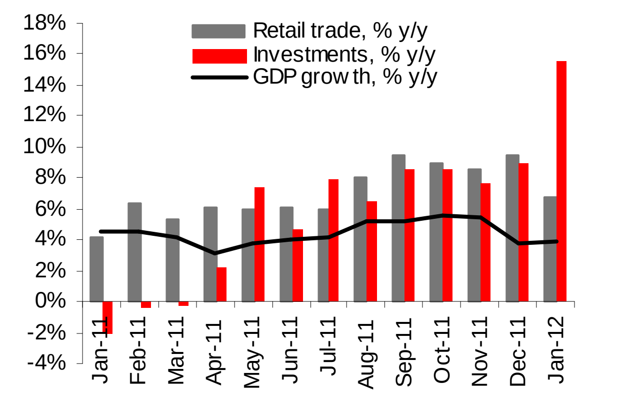
Capital account may improve on strong retail trade growth…

While the recent recovery of the AB-ICI is mainly being driven by the better market sentiment, we expect that in the coming months it will be supported by the improvement of the capital account. Macro statistics seems to favor this view. Even though in January GDP growth slowed down to 3.9% y/y from 4.3% y/y in 2011, this figure is still strong on a relative basis. Even if this slowdown was brought by the deceleration of retail trade growth from 9.5% y/y in December to just 6.8% y/y in January, the pre-election focus of budget spending, highlighted by the 2-2.5x increase in military salaries starting this year, should help. Furthermore, retail lending growth continued to accelerate to 37% y/y in January, confirming the potential for continued consumer demand in the coming months.

…and accelerated investment growth

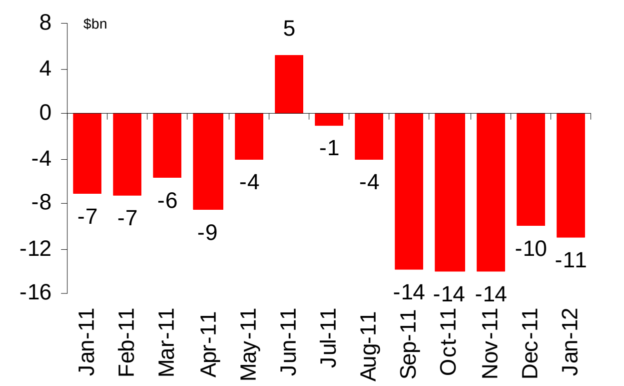
January saw a very significant acceleration in investment growth to 15.6% y/y vs. 8.9% y/y in December, which was contrary to the seasonal trend. At the same time, this surge was in line with strong acceleration in budget spending to 63% y/y, also contrary to the slow season, indicating that state-related capex projects saw a boost in financing ahead of the elections. The investment trend is reflecting acceleration in construction growth of 11.7% y/y and in housing construction by 21.5% y/y, which we believe is enjoying a pickup in activity, highlighted by 31% growth in corporate lending to construction and real estate companies in 2011. This growth is driven by increased demand, reflected in the strong 23% rise in mortgages in 2011. Combined with the upgrade of 2011 investment growth from 6.2% to 8.3%, the 2012 investment trend appears to be well supported.

Figure 2: GDP, investments, retail



Source: Rosstat, Alfa Research

Figure 3: Capital outflow



Source: CBR, Alfa Research

Russian ruble rates are high by global standards and help attract foreign capital

We also believe that there are a number of catalysts favoring Russia as a target for foreign capital. First, compared with other emerging market countries, Russia has experienced a significant increase in local interest rates while other emerging markets were cutting rates on increasing deflationary fears. Secondly, strong oil prices are supporting the ruble exchange rate and provide support for investments in ruble instruments. Finally, Russian sovereign bonds are expected to become Euroclearable, which has supported their attractiveness. We are also under the impression that Russian companies are likely to reach out to global borrowing in order to use this window of opportunity. Local markets are still very much short-term focused, and access to global capital markets is still crucial to attract money for the long term.

AB-ICI is expected to receive support from capital flows in coming months

The potential improvement in capital flows could also find strong support from the upcoming presidential election. Even though we doubt that the capital account will turn positive for a long period of time, net capital inflows should not be completely excluded in the post-election period. We thus believe that the AB-ICI has a chance to increase in the coming months.

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