Alfa-Bank

AB-ICI: Decline Predicted by Fundamentals

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Investment Summary

- The AB-ICI declined 1.8% last month in response to capital outflow and poor macro statistics
- We have a positive outlook on 2Q11, as improved consumption and investment should support the AB-ICI

AB-ICI lost 1.8% last month

The AB-ICI's 1.8% decline last month put an end to the growth that began last September

Capital outflow lowered economic confidence

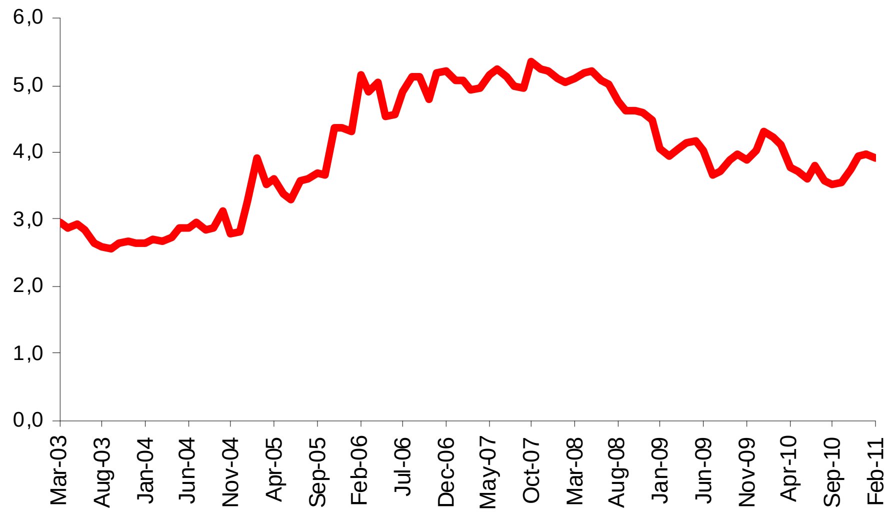
Last year, FDI shrank by 13% y/y

Market growth was limited by negative news from Japan

The AB-ICI lost 1.8% last month, putting an end to the recovery that began in September of last year. We view this reversal as a predictable reaction to weak fundamentals.

- **Economic confidence** sank to the level of December 2010. We believe capital outflow is the primary explanation for the weak trend: the net outflow was $8bn in December, $11bn in January and $6bn in February. The CBR expects the outflow to persist in March, putting the 1Q11 figure at $20 bln;
- **Foreign confidence** also declined, reflecting the lack of a recovery in FDI flows in 4Q10. For the full year, FDI declined by 13% y/y despite Russia's 4% GDP growth;
- **Market confidence** was virtually flat. Despite higher oil prices, the negative news from Japan had a significant effect on market sentiment. The country's decision to raise taxes in 2012 to rebuild after the earthquake will likely have a negative impact on the global economy, limiting capital inflows to emerging economies like Russia.

Figure 1: AB-ICI declined 1.8% last month



Source: New School of Economics, Alfa Research

Weak growth trend should reverse in 2Q11

Disposable incomes shrank in February

February brought little relief from January's relatively weak economic statistics. Real disposable income shrank by 1.5% y/y in February, and Rosstat downgraded its January estimate from -5.5% to -5.8% y/y. Combined with the unemployment rate of 7.4%, above the 7.2% posted in December last year, this suggests that final demand may remain depressed in the near term and the 3.3% y/y jump in retail trade in February lacks fundamental support.

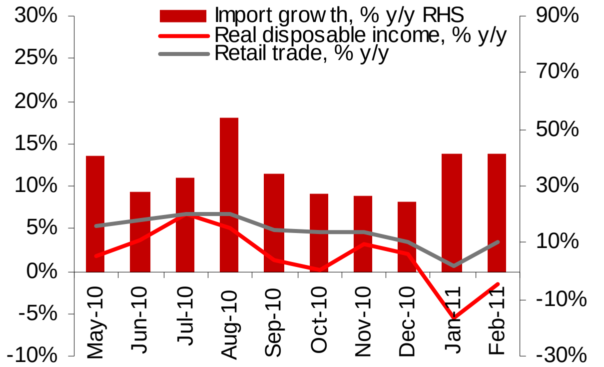
Investment recovery is still constrained by construction

Investment growth recovered somewhat from -4.7% y/y in January to -0.4% y/y in February, but it is still under pressure from depressed construction activity. Housing segment growth was -6.4% y/y in February, keeping overall construction growth at only 0.4% y/y.

The 10% increase in pensions in April is good for consumption; construction activity is also set to accelerate

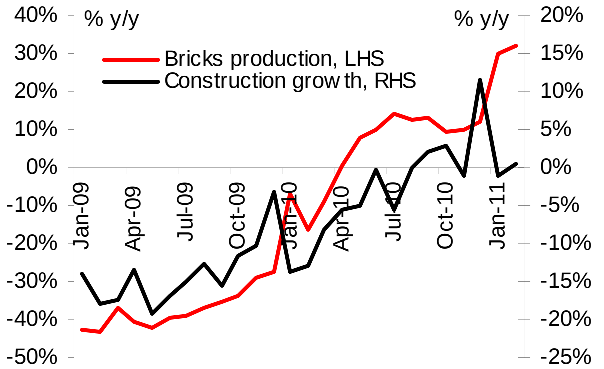
In spite of the negative indicators, we believe 2Q11 is very likely to bring good news. First, President Medvedev recently decided to raise pensions by 10% in April instead of carrying out the increase in two steps in April and October. We believe this will give a boost to retail trade in May-June. Second, the Moscow city government recently finalized the revision of its construction plans and is now ready to resume providing financing. The increase in the production of construction materials leads us to believe the building sector will recover soon.

Figure 2: Retail trade, income and imports



Source: Rosstat, CBR, Alfa Research

Figure 3: Construction and bricks production



Source: Rosstat, Alfa Research

Capital account should improve starting in March after $17bn outflow in 2M11

We also anticipate that the recent heavy capital outflow, estimated at $17bn in January-February, will slow in the coming months. We attribute this outflow to the increased tax burden: according to the government, some 400 companies have relocated their business to other CIS countries, mainly Kazakhstan, in order to avoid paying the 34% payroll tax. In our view, this is the main reason why Russia continues to lose capital even after the $8bn outflow in December and in spite of high oil prices.

Refinancing rate left unchanged, reserve requirements raised

The CBR's decision to increase reserve requirements from 4.5% to 5.5% for international borrowing and from 3.5% to 4.0% for domestic funding is a sign that the capital account is about to improve. However, the regulator left the refinancing rate unchanged, as inflation slowed in March. Full-year inflation is expected to be 9.5%, February's level.

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