

AB-ICI: Risks of CBR Easing Loom Larger

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Investment Summary

- The AB-ICI was down 2.1% in February, reflecting flight from risk due to Eurozone turmoil.
- Weak local economic growth and Cyprus worries may force the CBR to cut rates as early as April.
- Monetary easing would be a bad sign for capital outflow and thus economic confidence.

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AB-ICI was down last month

January's flat AB-ICI performance was followed by a sharp 2.1% drop last month, as the Russian market suffered from global flight from risk. The results of elections in Italy showed the fragility of Eurozone cooperation and triggered outflows from emerging markets. The subsequent Cyprus crisis heightened market fears and remains a risk factor for the AB-ICI in the near term.

Capital outflow risks remain

- **Economic confidence** increased, reflecting the slowdown of the capital outflow to \$6bn in February from \$8-10bn in January. That said, the sharp deterioration in economic growth to 0.1% y/y in February and negative guidance on March trends may lead the CBR to cut rates, discouraging ruble savings, which poses a risk to the capital account going forward.

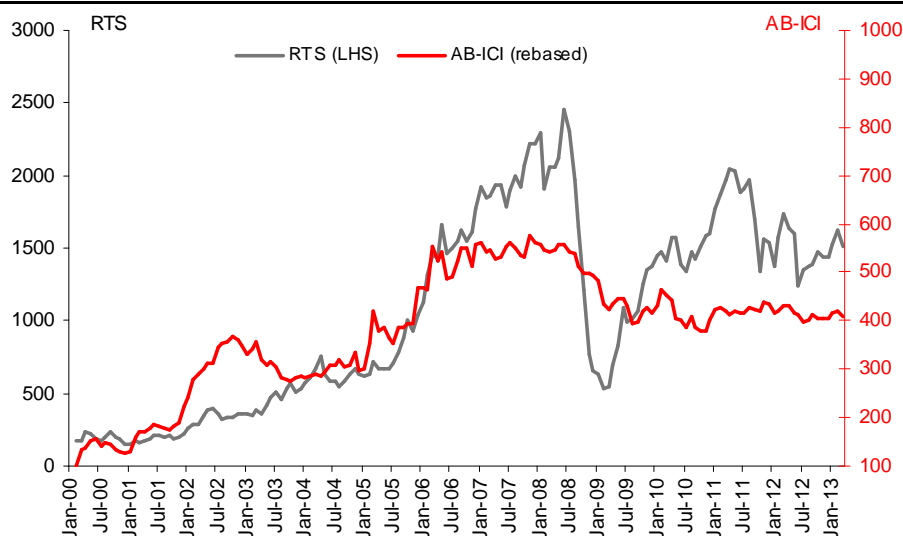
Cyprus banking collapse may negatively affect inward FDI in the near term

- **Foreign confidence** was flat, as no relevant data were released. However, the freezing of the banking system in Cyprus, which accounts for 30% of FDI inflows to Russia, may negatively affect the foreign confidence indicator in the coming months. Even though Cyprus is a transit country for FDI flows, it will take time for Russian business to rearrange the logistics.

Risks of domino effect in Eurozone likely to keep markets under pressure

- **Market confidence** declined in February, reflecting the risk-off mood on global markets. This was initially caused by the lack of support in Italy for fiscal consolidation in the Eurozone. The market's key worry now is the Cyprus saga, which may confirm the domino effect of the crisis in the Eurozone.

Figure 1: AB-ICI dropped 2.1% in February



Source: New School of Economics, RTS, Alfa Research

CBR to cut rates sooner than expected

GDP growth of 0.1% y/y in Feb suggests Russia is in stagnation

Previously, we expected the CBR to ease interest rates in June-July, though the latest macro trends suggest it will cut them earlier than that. While the January figures were bad, the February growth result was a shock. GDP growth dropped from 1.6% y/y in January to a mere 0.1% y/y in February, suggesting stagnation. Deputy Minister of Economic Development Andrei Klepach has twice indicated that the official 3.6% GDP growth forecast for 2013 will not be met, lowering guidance first to 3.0-3.3% and then to below 3%, suggesting the March result will be equally poor.

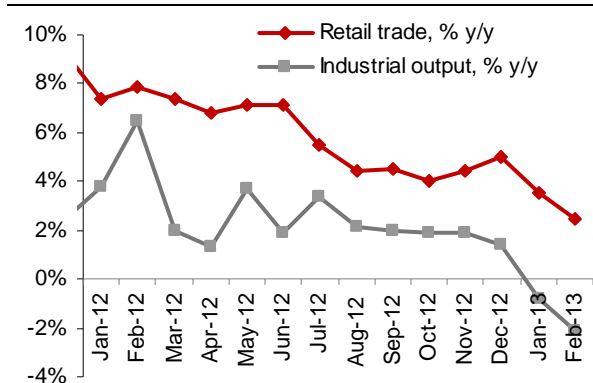
Industrial output fell 2.1% y/y, retail trade growth decelerated to 2.5% y/y

As in January, February's poor growth figures reflected shrinking industrial output, which dropped 2.1% y/y in February after declining 0.8% y/y in January. Investment growth was 0.3% y/y, confirming that it will provide no support to overall growth this year. Consumers sentiment likely also deteriorated, as retail trade growth slowed to 2.5% y/y from 3.5% y/y in January despite strong income growth and a decline in unemployment to 5.8%. It is important that this deceleration is taking place despite strong February retail loan growth of 39% y/y.

Weaker-than-expected consumer trend may have triggered further destocking

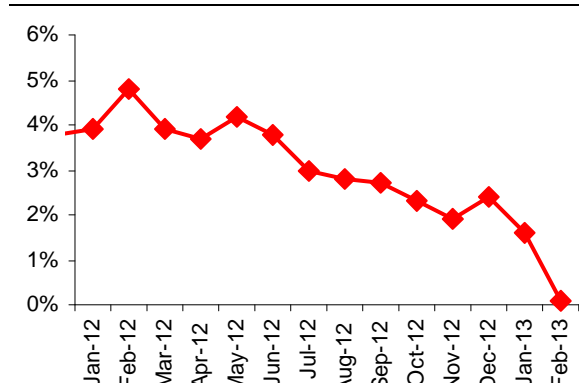
Mr. Klepach mentioned the poor export trend as a reason for the disappointing economic growth figure, hinting that the global environment was partly to blame for the sharp deterioration in growth. In particular, he attributed the slow growth rate to the 6.9% y/y drop in commodity exports. However, we find this inconsistent with the improvement in sentiment on global markets at the beginning of the year and believe there were internal causes of the slowdown. We have previously pointed out that producers' pessimism translates into a deterioration in stockbuilding. This was the case throughout 2012, and we believe there is a high risk that companies started to destock in 1Q13 in response to weaker-than-expected consumption growth.

Figure 2: Retail trade and industrial output



Source: Rosstat, Alfa Research

Figure 3: Russian GDP growth, % y/y



Source: Ministry of Economic Development, Alfa Research

We now expect 25 bpt rate cut in April

The weak growth seems to have reduced inflationary pressure. For March 1-25, inflation was just 0.4% MTD and is very likely to come in at 7.2% y/y for the month versus 7.3% y/y in February. This weakens the argument that the CBR should leave rates flat, while the deceleration in economic growth calls for a rate cut. The regulator's decision to set the next policy rate meeting for April 2 suggests it intends to ease monetary policy in response to the economic challenges. We are thus looking for a 25 bpt rate cut. That said, we do not believe that interest rate policy is an appropriate tool for addressing the economic slowdown. Our concern is that CBR rate cuts will create negative expectations for the ruble exchange rate, posing a risk to the capital account and AB-ICI.

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