

AB-ICI: Economic growth accelerated in March

Natalia Orlova

(+7 495) 795-3677

NORlova@alfabank.ru

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www.alfa-bank.com

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Investment Summary

- The AB-ICI was up 3.2% last month, reflecting strong performance by fixed-income markets
- Economic activity improved in March but is still dependent on consumer sentiment
- The state's active presence on the labor market is positive for consumers but has high economic costs

AB-ICI rose 3.2% in March

AB-ICI was up last month

The AB-ICI increased 3.2% y/y last month, reflecting improvements in both the economic and market indexes. Unsurprisingly, the acceleration in March economic growth contributed to the better economic confidence indicator. In contrast to the poor performance of equity markets, the Russian bond market continued to benefit from global appetite for risk:

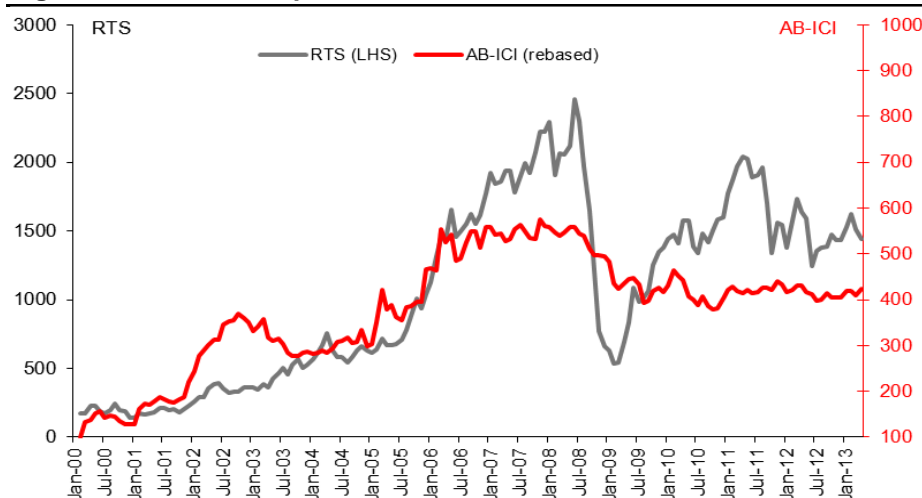
Capital outflow was \$26bn in 1Q13, below \$34bn in 1Q12

Foreign confidence weak on deleveraging by foreign banks

Market confidence supported by active placement of corporate bonds

- **Economic confidence** was up, mainly because its components stopped deteriorating. In particular, net capital outflow was around \$10bn in March and totaled \$26bn in 1Q13. While this is still a sizeable amount, it is an improvement from the \$34bn net capital outflow in 1Q12;
- **Foreign confidence** was unchanged but is unlikely to give a boost to the index anytime soon. Foreign banks continue to deleverage in order to meet Basel requirements, and state banks will likely take their market share. As the Cyprus crisis has shown, a large portion of FDI to Russia is in fact Russian money using other countries as transit economies, and giving slowing local growth, these flows are unlikely to increase;
- **Market confidence** was higher last month thanks to support from the fixed-income market. While the equity market was under pressure, foreign investors are still attracted by the high yield on Russian sovereign bonds. In April, Russian companies have attracted a record-high \$12bn from forex bond placements, which should continue to support the index in the future.

Figure 1: AB-ICI was up 3.2% in March



Source: New School of Economics, RTS, Alfa Research

Growth bottomed in 1Q13 but upside limited

March growth surprised on the upside, supporting the AB-ICI

The AB-ICI found support from the acceleration in GDP growth last month. While the 1Q13 growth figure of 1.1% y/y was a disappointment, the revised monthly GDP data point to an acceleration. After January's weak 1.3% y/y growth and the 0.4% y/y contraction in February, the economy posted a solid 2.3% y/y recovery in March, which we take as a positive sign.

1Q13 slowdown due to base effect in investment; consumer trend still strong

The composition of 1Q13 growth also suggests we may see an acceleration toward year-end. The key factor behind the GDP slowdown in 1Q13 was investment growth of only 0.1% y/y. Retail trade posted a higher-than-expected increase of 3.9% y/y, not markedly down from 7.9% y/y in 1Q12 and 4.9% y/y in 4Q12. Unemployment is near a historical low of 5.7% y/y and disposable income continues to rise, which will likely drive consumption growth in the coming months. As a result, we believe 1Q13 was the low point of the year.

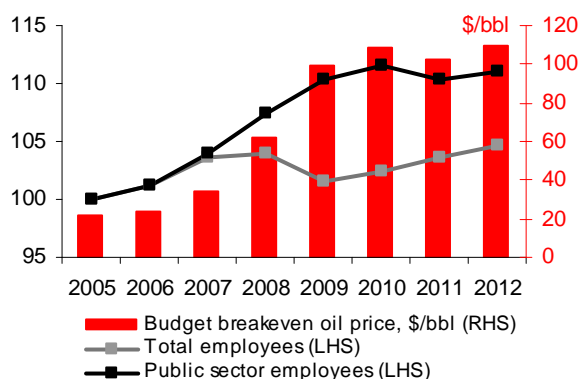
State was the key job-creator after the crisis; public sector now makes up 25% of employment

However, what is positive for consumption may be negative for producers, which suffer from the state's outside presence on the labor market. In 2005, the public sector (law enforcement, military, state administration, education, healthcare) accounted for 23% of total employment, but this share increased during the crisis and is now 25%. In fact, while in 2008-12 the labor force was almost flat, the number of employees increased by 0.8m, reflecting 1.1m jobs created in the public sector and 0.3m jobs lost in the rest of the economy. This was the main reason for the decline in unemployment to a historical low of 5.1% at YE12. Unsurprisingly, the decision to increase public sector salaries by 23% at the beginning of 2012 vs. the 14% average rise in the economy as a whole kept consumers' expectations positive.

Public sector labor productivity fell 5% from 2008 to 2012, contributing to slower productivity growth in the economy overall, limiting AB-ICI and RTS performance

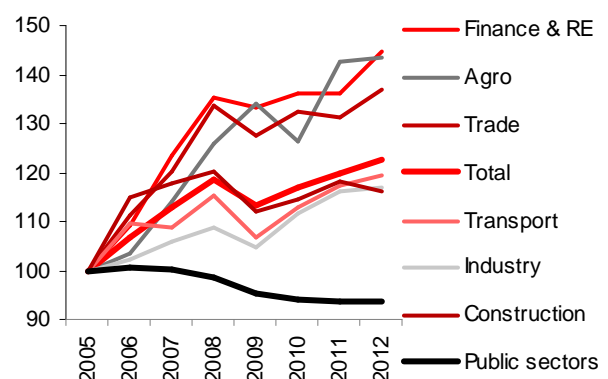
However, the higher share of state employment resulted in a decline in public sector productivity. While productivity growth slowed in all sectors after the 2008 crisis, in the public sector it declined by 5% between 2008 and 2012. The state hired people as actively as the booming trade sector, but the decline in productivity offset much of the increased productivity in the trade and finance sectors. Another important observation from the productivity figures is that growth in the tradable sectors, i.e. industry, slowed significantly in 2012, supporting our view that a stable currency, high inflation and an increase in the competitiveness of foreign goods are hurting the competitiveness of Russian producers. The increase in public sector salaries may not be the only reason for this, but it is certainly the most important, as it put upward pressure on salaries throughout the economy. We therefore expect AB-ICI growth to remain limited, and the RTS will likely converge with its fundamental value as defined by the AB-ICI.

Figure 2: Total and public employment (2005=100) and budget breakeven oil price



Source: Rosstat, Finance Ministry, Alfa Research

Figure 3: Labor productivity index, 2005=100



Source: Rosstat, Alfa Research

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Head of Equities Alfa Bank
 Michael Pijolis 12, Akad. Sakharova Pr-t
 +7 (495) 795-3712 Moscow, Russia 107078

Research Department

+7 (495) 795-3676
research@alfabank.ru

Macroeconomics

Natalia Orlova, Ph.D. norlova@alfabank.ru 795-3677
 Dmitry Dolgin ddolgin@alfabank.ru 780-4724

Financial Services

Jason Hurwitz jhurwitz@alfabank.ru 783-5005
 Marina Karapetyan mkarapetyan@alfabank.ru 795-3740

Oil & Gas

Alexander Kornilov, CFA akornilov@alfabank.ru 788-0334
 Ekaterina Malkova emalkova@alfabank.ru 795-3725

Metals & Mining

Barry Ehrlich, CFA, CMT behrlich@alfabank.ru 785-9568
 Andrey Lobazov alobazov@alfabank.ru 745-5438
 Oleg Iuzefovych, CFA oleg.iuzefovych@alfabank.kiev.ua +380 (44) 239-9135

Utilities, Telecommunications

Elina Kulieva, Ph.D. ekulieva@alfabank.ru 789-8509
 Dmitry Doronin ddoronin@alfabank.ru 795-3612

Transportation, Construction

Andrei Nikitin ainikitin@alfabank.ru 795-3742
 Vladimir Dorogov, CFA vdorogov@alfabank.ru 788-0320

Equity Sales & Sales Trading (Moscow)

+7 (495) 223-5500

International

Victoria Duben vduben@alfabank.ru 228-8880
 Michael Kotov kotov@alfabank.ru 223-5500

Alfa-Direct Sales

+7 (495) 795-3680

Sergey Rybakov srybakov@alfabank.ru ext. 6399
 Valeriy Kremnev vkremnev@alfabank.ru ext. 7083

Alfa Capital Markets (London)

+44 (0) 20 7588-8500

Sales

Robert Szucsich r.szucsich@alfa-cm.com 7382-4174

Alforma Capital Markets (New York)

+1 (212) 421-7500

Sales

Justin Landau jlandau@alformacap.com 421-8564

Retail, Real Estate, Pharmaceuticals

Andrei Nikitin ainikitin@alfabank.ru 795-3742
 Darya Babashkina dbabashkina@alfabank.ru+7-499-681-1706
 Denis Derushkin doderyushkin@alfabank.ru 795-3655

Agriculture & Food, Fertilizers

Maria Bovykina mbovykina@alfabank.ru 795-3713

Russian-Language Product

Geldy Soyunov gsoyunov@alfabank.ru 641-3673
 Alan Kaziev akaziev@alfabank.ru 974-2515
 (ext. 8568)

Editorial & Production

David Spencer dspencer@alfabank.ru 745-7153
 Jeffrey Weiner jweiner@alfabank.ru 745-3714

Data Management

Aleksei Balashov albalashov@alfabank.ru 795-3676

Translation

Anna Martynova amartynova@alfabank.ru 795-3676
 Stanislava Ovcharenko sovcharenko@alfabank.ru 783-5020

223-5522
Domestic Institutional

Ilya Lobanov ialobanov@alfabank.ru 785-7406
 Dmitry Demchenko ddemchenko@alfabank.ru 783-5115
 Alexander Pugovkin apugovkin@alfabank.ru 783-5133
 Dmitry Matyukhin dmatyukhin@alfabank.ru 745-5621

Sales Trading

Yan Gloukhovski y.gloukhovski@alfa-cm.com 7382-4179