Alfa-Bank

AB-ICI: The Market vs. Economics

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Investment Summary

- Last month, the AB-ICI dropped by 8.1% on negative market sentiment and weak FDI statistics
- The global market instability may not yet be over, and the current market recovery could turn out to be unsustainable
- Despite signs of an economic recovery, the growth prospects for 2H10 are still cloudy

AB-ICI posted a sharp 8.1% decline on flight from risk

AB-ICI dropped 8.1% despite some improvement in economic confidence

The AB-ICI declined by 8.1% last month, reflecting market instability and the negative sentiment of foreign investors.

- **The economic confidence** indicator performed very strongly, as Russia's capital outflow declined and the savings rate continued to increase. Though Russian financial markets were dragged down by the crisis in southern Europe, the ruble exchange rate remained relatively stable against the basket;

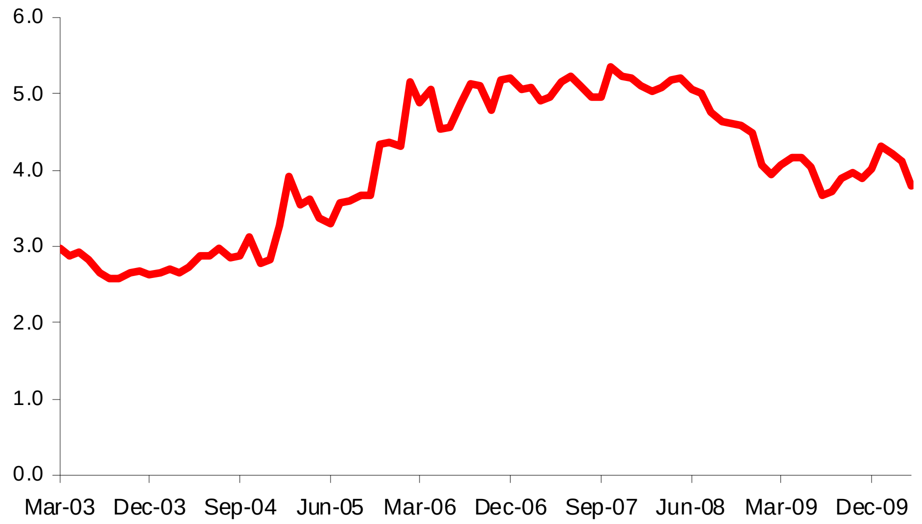
Foreign investors are more cautious about directly investing in Russia

- **The foreign confidence** indicator declined, primarily owing to the continuing decline in foreign direct investment. This indicator dropped by 41% in 2009 and another 18% y-o-y in 1Q10;

Markets are under pressure from the euro debt crisis

- **The market confidence** indicator remained under pressure due to the global flight from risk triggered by the Eurozone debt crisis and the resulting increase in global interest rates. As a number of market participants believe this "second wave" of the crisis is not yet over, the market is unlikely to recover over the next month.

Figure 1: AB-ICI was down 8.1%



Source: New School of Economics, Alfa Research

2H10 outlook to keep AB-ICI depressed

Though the AB-ICI has declined by 12% YTD, we believe the index will remain depressed in the coming months. The prospects of an economic recovery in 2H10 are also unclear because of the cloudy economic outlook.

We expect to see faster GDP growth in coming months…

In the short run, we believe macroeconomic statistics may surprise on the upside. April brought a couple of positive signs, suggesting the economic recovery may accelerate in the coming months. The decline in annual inflation from 8.8% in December to 6.0% in May supports consumption, and budget spending and state programs stimulating demand for cars and mortgages are providing support for the real estate and auto manufacturing sectors. The recovery in final demand is leading companies to build inventories, resulting in accelerated economic growth in 2Q10.

…on better local demand

Our view was confirmed by Ministry of Economic Development statistics indicating that import growth accelerated from 19% y-o-y in 1Q10 to 30% y-o-y in April. This sharp increase is a direct sign of higher local demand. Also, the construction sector is showing some signs of recovery after housing construction jumped by a record 16.2% y-o-y in April. Thus, the May-July period could bring better macro indicators.

Budget deficit is boosting demand for loans

A number of improvements are apparent in the banking sector. Nominal interest rates are now extremely low, making lending attractive, while the turmoil in southern Europe is pushing companies to build up liquidity cushions. In March-April, Russian banks excluding Sberbank saw 1.4-1.7% m-o-m corporate loan growth. Also, the CBR has substantially cut sterilization via its bonds, indirectly confirming better lending prospects: while in 1Q10 it sterilized RUB150 bln a month, in April it placed only RUB100 bln.

In 2H10, growth will likely slow to 3% on lack of internal drivers

Despite these positive indicators, we believe our cautious view on the Russian macro recovery is justified. In spite of the very strong 5.8% y-o-y industrial growth in 1Q10, GDP growth was only 2.9% y-o-y. This means that in the quarter, higher foreign demand did not translate into more local consumption. We believe 2Q10 GDP growth will be stronger and forecast 5-6% y-o-y. In the meantime, due to the base effect, the growth rate is likely to decelerate to 3% y-o-y in 2H10, confirming our annual forecast of 3.6%.

Growth is constrained by high real interest rates

We have two fundamental concerns behind our modest 3% y-o-y growth forecast for 2H10. First, due to the significant decline in inflation, real interest rates are now at their highest level since the beginning of 2000, making money very expensive. This implies that even if final demand recovers temporally, it will still be difficult for the real sector to grow, and it will soon try to pass the cost of growth on to consumers, boosting inflation.

Increase in imports poses threat to ruble; current-account surplus would decline to single digits under $65/bbl in 4Q10

Our second and key concern is that stronger local consumption is increasing imports and making Russia more sensitive to the oil price. Should the price drop to $65/bbl in 2H10, Russia's current account surplus would decline to single digits as early as 4Q10, triggering a deterioration in the capital account and paving the way for ruble depreciation. Russian banks now have around RUB2 trln in short-term liquidity, which can easily be used to finance the deterioration of the capital account. Even the YTD net capital outflow is reported at $13 bln, suggesting the private sector is pricing in such a negative scenario. Should these fears intensify in the coming months, we believe it would be negative for the AB-ICI's outlook.

Figure 2: Current account scenarios, $ bln

Oil prices, Urals	*3Q10*	*4Q10*	*1Q11*	*2Q11*	*3Q11*	*4Q11*
65	8.7	5.1	19.3	0.4	4.6	0.2
70	13.2	9.2	23.7	4.8	7.8	2.9
75	17	14.6	27.6	8.7	9.6	6.3
80	22.5	20.1	33.1	14.3	15.2	11.8

Source: CBR, Alfa Research

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