AB-ICI: Pressured by the Flight from Risks

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Investment Summary

- AB-ICI declined last month as markets were disappointed by a lack of positive signals after the election
- Poor FDI trends underline the lack of producer confidence and weakness of Russia's capital account
- The recent global market turmoil is likely to put pressure on the AB-ICI in the coming months

The AB-ICI rolled back to its 2011 level

AB-ICI fell by 4% in April due to lower foreign and market confidence

Last month, our index fell by almost 4%, undoing all prior YTD gains. The key reason was the poor FDI trend and a lack of progress in the privatization program, both of which underline the lack of triggers for the Russian real sector and investors following the election. We believe the new round of global instability, which started in May, is likely to put additional pressure on the AB-ICI in the coming months.

Capital outflow slowed in April, but the outlook remains gloomy

- **Economic confidence** improved as capital outflow managed to slow down from \$13bn in March to \$8bn in April. Nevertheless, the weak local production data and global flight from risks that emerged in May suggest that the risks for the capital account have not declined. Government officials no longer expect net capital inflows for FY12, and we do not exclude an acceleration of capital outflow in May-June.

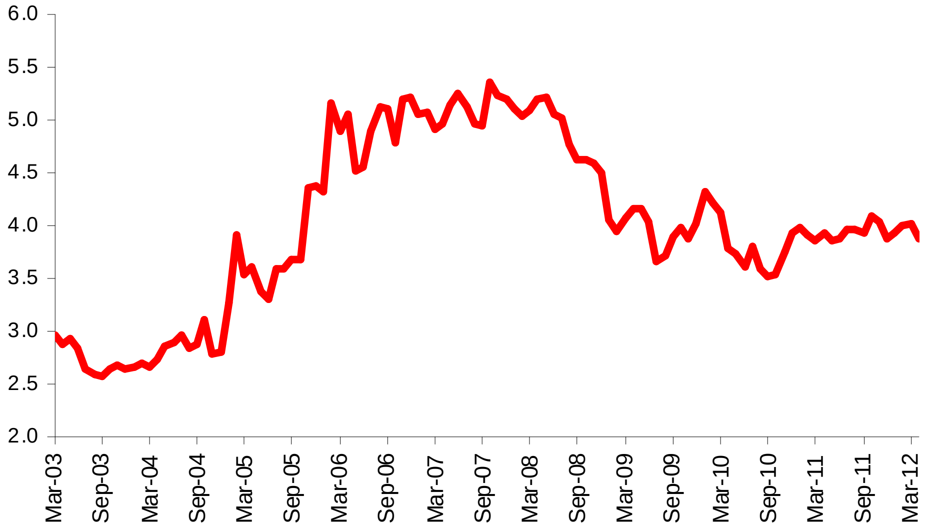
FDI dropped despite better GDP and a favorable global background in 1Q12

- **Foreign confidence** was down, as FDI fell 0.7% y/y in 1Q12 after 13% y/y growth in 2011, reflecting a lack of improvement in Russia's investment attractiveness despite impressive 4.9% GDP growth and a favorable external environment in 1Q12.

A lack of local triggers and global instability will keep Russian markets depressed

- **Market confidence** declined, reflecting Russian markets' underperformance relative to their global peers. While the markets were expecting to see investment triggers in April, including clarity on tax policy and some positive indications regarding the privatization program, this did not take place, which disappointed the markets. Moreover, the global turmoil in May will clearly put additional pressure on the Russian markets in the near future.

Figure 1: AB-ICI fell 4% last month



Source: New School of Economics, Alfa Research

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Strong GDP Growth Does Not Improve Confidence

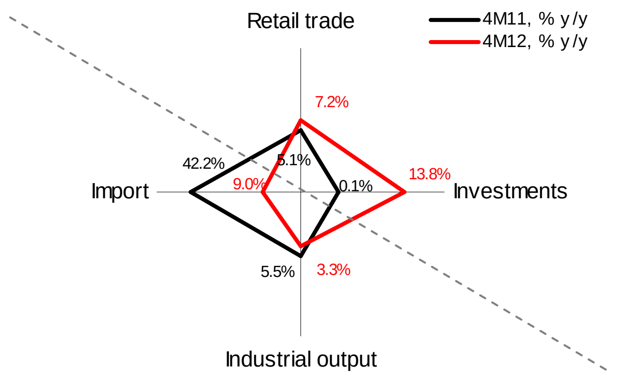
The economy continues to benefit from the fiscal boost…

Surprisingly, the decline of the AB-ICI is taking place despite the seemingly strong macro data. In April, as in previous months, the economy continued to benefit from the budget easing delivered in 1Q12. The electoral cycle, which resulted in a 0.9% of GDP federal budget deficit, supported retail trade and investment growth. Investment growth accelerated to 7.8% y/y in April, easing concerns over the investment trend after a modest 4.9% y/y increase a month earlier. While retail trade growth decelerated somewhat to 6.4% y/y from 7-8% in 1Q12, strength in final demand is still being supported by real salaries growth of 10.4% y/y in April and a substantial decline in unemployment to 5.8%. The comparison of 4M data for 2011 and 2012 (see Figure 2 below) suggests that economic growth this year is receiving more support from final demand.

…but the supply side has been weak for a couple months in a row

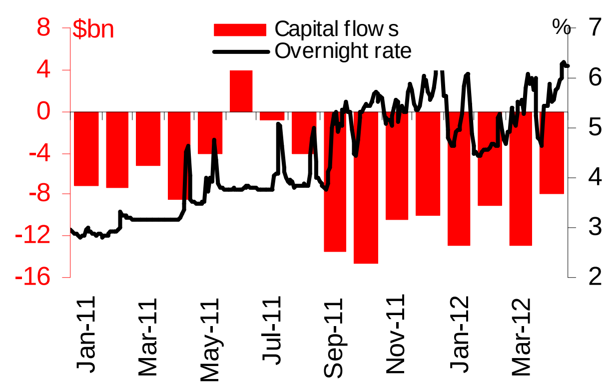
At the same time, the supply side of the Russian economy does not look as strong. First, industrial output growth was extremely low in April, rising only 1.3% y/y and posting a significant deceleration for the second month in a row from around 5% growth in 2M12. Second, according to our estimates, imports increased only 9% y/y in 4M12 and were almost flat in April in annual terms. This suggests a notable slowdown from the 42% y/y increase in 4M11 and 30% growth for the full year. It thus appears that the solid economic growth, which is driven by budget indexation, loan growth and final demand is still being accompanied by poor stockbuilding, indicating a lack of positive expectations among producers. In contrast to 2008, which demonstrated a similar trend due to the severe shock, we do not view this as overly negative news this time. Producers' cautious approach may be linked to the end of the electoral cycle in Russia, which will lead to budget tightening toward year-end. The deterioration of global sentiment is also playing an important role. That said, given the weakness on the supply side, we maintain a cautious outlook for growth and reiterate our 3.2% GDP growth forecast for the full year 2012.

Figure 2: 4M11 vs. 4M12



Source: Rosstat, CBR, Customs Service, Alfa Research

Figure 3: Capital outflow and interbank rate



Source: CBR, Alfa Research

Capital outflow was $8bn in April and will accelerate

The lack of confidence in the real sector, amplified by the current nervousness on the global market, is translating into increasing risks to Russia's capital account. Capital outflow for April was $8bn and is likely to be reported at $10-12bn in May. The ruble exchange rate has come under pressure and traded above RUB37 to the basket in late May. This was a depreciation of 9% since the end of April and forced the CBR to begin interventions on the forex market. With outflow of $42-43bn in 4M12, even government officials are no longer expecting the capital account to be positive this year. With little support from local stories, the coming months are shaping up to be tough for AB-ICI dynamics.

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