AB-ICI: Lack of Fundamental Improvement

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Investment Summary

- The AB-ICI was flat, mainly due to the lack of a fundamental improvement in FDI inflows to Russia
- The public's increased preference for savings is the key positive
- 2H13 will depend on whether domestic growth can offset the likely deterioration in the global mood

AB-ICI stood flat in April

Flat AB-ICI reflects no fundamental improvement in Russia's investment case; 2H13 risks remain

The AB-ICI failed to post any growth last month, as the improved economic indicator was offset by the drop in foreign confidence. The market indicator was sluggish due to increased competition for capital from Russia's EM peers. The prospects for 2H13 sentiment are uncertain, as the potential acceleration in domestic economic growth may be offset by a possible decline in risk appetite on global markets

Faster retail deposit growth and slower capital outflow were positive surprises

- **Economic confidence** was up strongly due to a pick-up in retail deposit growth to 24% y/y in April from 20% y/y in December 2012, reflecting the accumulation of savings. The deceleration in capital outflow to $4bn in May was a positive surprise and will support next month's indicator, though it reflects the reaction to the Cyprus crisis and thus does not signal any long-term improvement in local confidence;

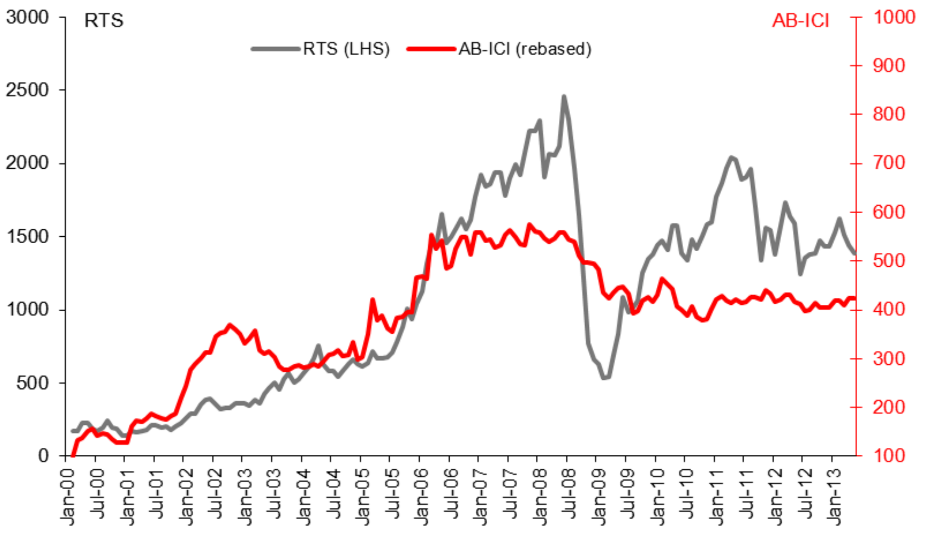
Foreign confidence dropped on foreign banks' withdrawal and weak FDI inflows

- **Foreign confidence** dropped, reflecting foreign banks' continued scaling-back of their presence in Russia and unsatisfactory FDI inflows in 1Q13. Adjusted for the one-off inflows from Cyprus to the Russian trade sector, which reflect panic repatriation, FDI inflows were only $3.9bn, flat y/y, suggesting no fundamental improvement in Russia's investment case;

Fixed income market still provides support, but the potential reduction in US QE is a risk for 2H13

- **Market confidence** was up slightly last month. While the global mood remained risk-on and the local fixed income market was expectedly strong, the bond yield spread suggests that Russia is beginning to lose the competition for capital to its EM peers. Ben Bernanke's comments suggesting the Fed may scale back QE poses additional risk to Russian market confidence for 2H13.

Figure 1: AB-ICI was flat in April



Source: New School of Economics, RTS, Alfa Research

Investments are the key concern

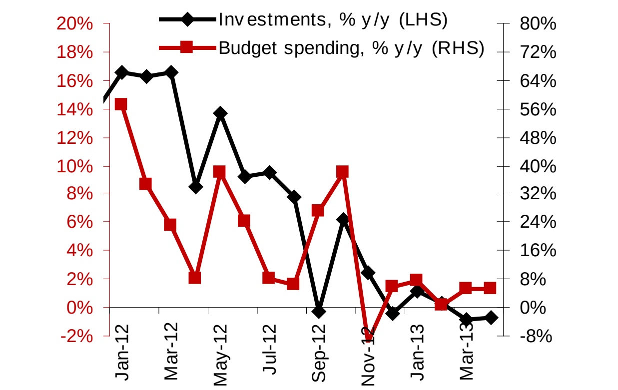
Headline GDP growth for 4M13 turned out better than expected, but headwinds ahead

Recent AB-ICI and RTS dynamics support our view that there is limited upside from current levels, mainly because markets are now more skeptical toward the Russian growth story and the current picture appears contradictory. On the one hand, recently published GDP estimates paint a slightly better picture than we initially expected. First, the estimate for 1Q13 GDP growth was revised upwards from 1.1% to 1.6% y/y, which is a positive development even though this is the slowest pace in the post-crisis period. Second, April growth was initially estimated at 2.6% y/y, higher than the 2.0% y/y posted in March, leading to 1.8% y/y growth in 4M13. On the other hand, we maintain our cautious 1.3% y/y expectation for 2Q13, primarily because the high base and calendar effects will likely result in very weak May figures. Also, April growth may be downgraded, as it looks too high relative to the unspectacular investment and consumption trends.

Investment was very weak in April and is unlikely to find support going forward

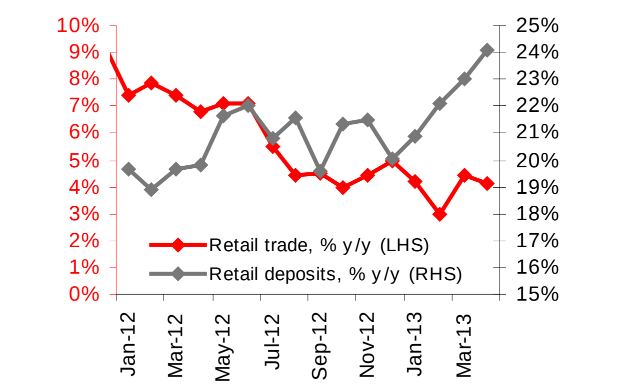
Our key fundamental concern is on the producer side. Despite a very strong low-base effect, investments dropped 0.7% y/y in April after a 0.8% y/y decline in March. This is particularly disappointing compared with the consensus expectation of 2.0% y/y growth in April. The decline was driven by a 3.7% y/y contraction in construction activity. These figures support our concern that the current tightening of budget policy is primarily affecting investment spending. The expected slowdown in budget spending growth to 2-4% this year from 18% y/y last year suggests there will be little support for investments going forward.

Figure 2: Investments vs. budget spending



Source: Rosstat, Finance Ministry, Alfa Research

Figure 3: Consumption and savings



Source: Rosstat, Alfa Research

Consumption also weakened but reflects higher savings

The April slowdown in retail trade growth to 4.1% y/y from 4.4% y/y in March suggests that consumption also weakened, though the outlook for 2H13 is more positive. Strong income growth of 7.3% y/y, very low unemployment of 5.6% and an acceleration in retail deposit growth to 24% y/y in April from 20% y/y in December 2012 suggest the general public is accumulating savings, which may translate into a better consumer trend, though this is unlikely until later in the year.

Near-term sentiment likely to be weak

Thus, the near-term trends do not look supportive for growth and market sentiment. The recent acceleration in inflation to 7.3-7.5% y/y in May – the second monthly increase in a row – was a negative surprise and hampers the CBR's ability to support growth. At the same time, the government acknowledged there was a risk of lower-than-expected budget revenue collection, which could push the breakeven oil price to $110-115/bbl in 2014-15 and limit room for any budgetary stimulus to growth. This puts the government in an uncomfortable position, in which any weakness in macro statistics would likely lead the market to expect a possible reshuffling in the Cabinet. These domestic concerns, combined with the risk of a deterioration in global sentiment in 2H13 due to QE uncertainties, support our view that there is limited upside potential for the AB-ICI.

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