

# AB-ICI: Disregarding Capital Inflow

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## Investment Summary

- The Alfa Bank Investor Confidence Index (AB-ICI) was down 2.8% on market volatility
- Foreign capital inflow and a rating increase failed to support the index
- Since we believe that economic growth will resume in 2H08, the index has the potential to go up

### The AB-ICI was down 2.8% last month on market instability

**AB-ICI was down last month**

**Economic index was up slightly**

**Foreign confidence flat**

**Market confidence still weak**

The AB-ICI index was down last month owing to market instability and despite the capital inflow.

- **The index's economic confidence indicator** was up slightly, mainly in reaction to the increase in foreign borrowing by Russian banks. From mid-May until the end of June, they attracted \$11 bln from foreign markets. However, Russia saw an increase in the share of foreign currency in total deposits from 13.2% to 14.2%, which had a negative impact on the index ;
- **Foreign confidence** was unchanged and thus did not affect the index's performance;
- **Market confidence** was weak, reflecting pressure from the global market as well as large borrowers' increasing share of the debt market. The market mood is sour enough that the index did not even react to Moody's recent increase in Russia's sovereign rating.

**Figure 1: AB-ICI was down 2.8% last month**



Source: Alfa Research, New School of Economics

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## Weak industrial output added pressure

**The AB-ICI's poor showing may reflect the slowdown in economic growth in June**

The dynamics of the AB-ICI are in the long-run a proxy for the fundamental value of the Russian market. They should therefore reflect the trend in the real sector. In particular, the index may have been affected by the slowdown in Russian industrial production growth and economic growth reported in June. We, however, interpret this slowdown as temporary and remain optimistic.

**Manufacturing sector slowed from 10.2% y-o-y in 5M08 to 8.4% y-o-y in 1H08**

Russia's industrial growth was a negative surprise in June 2008. While commodity extraction grew a modest 0.5% y-o-y in 1H08 as expected, and regulated goods maintained their 4.1% y-o-y growth rate, manufacturing sector growth dropped from 10.2% y-o-y in 5M08 to 8.4% y-o-y in 1H08.

**Figure 2: Industrial output growth, y-o-y**

	Commodity extraction	Manufacturing	Regulated goods
2007	1.9%	9.5%	-0.2%
1M08	0.6%	4.0%	12.8%
2M08	1.4%	7.7%	7.4%
3M08	0.7%	8.7%	5.6%
4M08	0.6%	10.2%	4.5%
5M08	0.5%	10.2%	4.1%
6M08	0.5%	8.4%	4.1%

Source: Rosstat

**Output of metal products slowed to 2.0% in 1H08, while machinery production dropped to 10.4%**

Russia's manufacturing production consists of four key areas: food production (16.7%), coke and refineries production (16.2%), machinery and equipment production (19.9%) and the production of metal products (21.4%). June saw a significant slowdown in the latter two sectors: Output growth for metal products dropped to only 2.0% y-o-y in 1H08 from 8.6% y-o-y in 1Q08, while machinery output growth slowed to 10.4% y-o-y from 16.4% y-o-y (see Figure 2).

**Weak investment growth hurt machinery output, but we expect it will bounce back with help from state projects**

We believe that machinery building is the sector most dependent on investment growth. While at the beginning of 2008 investment growth was more than 20% y-o-y, it slowed to 15.3% y-o-y in May and 10.8% y-o-y in June. Unsurprisingly, this weak performance was reflected in manufacturing, mainly in machinery output growth. However, we believe that investment growth in Russia is mainly driven by investments from large companies and state investment projects. We therefore believe that this is a temporary slowdown, since the Russian government has delayed financing for a number of federal projects. We expect investment to increase and machinery output to resume its growth in the coming months.

**Metal product output reflects weak housing construction, which was down 5.2% y-o-y in June**

Metal product output is more closely linked to the construction sector, and here the prospects are less clear. On the one hand, the sector's growth started to slow as far back as 2Q07, and if we do not take into account its acceleration in 1Q08, it delivered 2% y-o-y growth in 1H08 (see Figure 2). However, since it is linked to the construction sector, it may also feel the effects of lower private demand. Before the credit crunch, Russian households saw residential real estate as an attractive financial investment. However, the global market instability appears to have scared them off, leading to a slowdown in housing construction. Between December 2007 and May 2008, housing construction grew in the single digits, and it shrunk by 5.2% y-o-y in June (Figure 3). We therefore do not expect a swift recovery in this sector.

**Figure 3: Construction and housing construction growth, y-o-y**

	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Construction	20.8%	19.4%	14.5%	13.6%	14.1%	12.9%	25.8%	30.3%	30.0%	27.0%	21.8%	17.2%	16.2%
Housing construction	19.4%	44.6%	24.6%	18.2%	19.8%	26.9%	3.1%	7.8%	4.9%	9.6%	2.5%	3.8%	-5.2%

Source: Rosstat

**While 1H08 GDP growth was only 8.0%, we believe that growth in consumption is still strong based on 8.1% disposable income growth**

Poor industrial growth in June evidently affected overall GDP growth, which is estimated at only 8.0% in 1H08 vs. 8.5% in 1Q08. However, we believe that the two key trends of the Russian economy – consumption growth and investment growth – are still very strong. On the consumption side, real disposable income growth slowed from 10.7% y-o-y in 2007 to 8.1% y-o-y in 1H08, which is still strong. High inflation is stimulating consumption; retail trade, usually seen as a proxy for consumption growth, was up 13.8% y-o-y in June.

**Investment growth will resume with state investments**

On the investment side, we believe that investment growth is dictated by state spending. In 1H08, the Russian government delayed financing for its federal investment projects; however, some acceleration is expected in 2H08. We therefore expect investment growth to recover soon, helping to boost machinery output.

**We forecast 7.5% GDP growth for 2008**

All in all, even if housing construction is set to keep declining, we believe that the general economic trend will remain strong in the short term. We expect 7.5% GDP growth for 2008. The price to pay for this high growth will be high inflation, which we project at 13% for this year. If there is any hint of an industrial slowdown in the next two months, we believe the government will act to support growth. Therefore, the risks are still on the side of inflation rather than growth.

**Figure 4: Macro forecasts 2008-2011**

	2007	2008F	2009F	2010F
GDP growth	8.1%	7.5%	7.3%	6.6%
Inflation	11.9%	13.0%	10.5%	10.5%
Exchange rate	24.6	23.5	21.4	21.0

Source: Rosstat, Alfa Research

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