AB-ICI: Falling Markets, Rising Rates

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Investment Summary

- Last month, the AB-ICI declined by 1.5% on sluggish international and domestic markets
- The weakening trade balance suggests that the potential for ruble appreciation is limited
- The CBR's decision to keep the key rates unchanged marks the end of declining interest rates

AB-ICI lost another 1.5% on lack of market confidence

AB-ICI declined 1.5% on investor flight from risky assets

The AB-ICI continued to decline, this time by 1.5%, on the weak performance of financial markets, with investors around the globe remaining cautious toward risky assets.

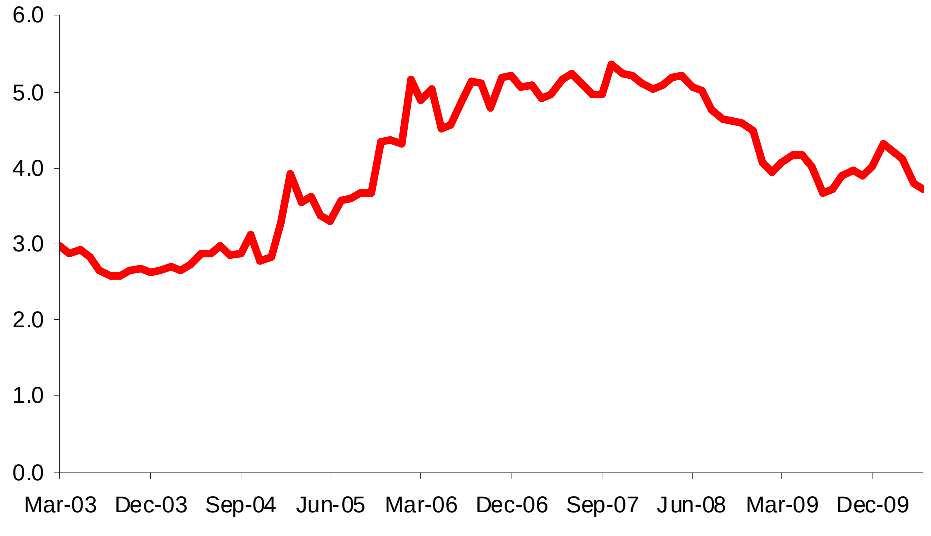
Confidence in the ruble remains strong for now

- **The economic confidence** indicator increased thanks to continuing de-dollarization of Russians' savings: YTD, the share of foreign-currency-denominated deposits has fallen from 26.2% to 21.8%. At the same time, the weakening trade balance due to a strong recovery in imports and capital outflow, the latter of which reemerged in the last month, suggest that the potential for further ruble appreciation is limited. This is underscored by the CBR's decision to stop cutting interest rates;
- **The foreign confidence** indicator remained flat, as no relevant data were released;

European debt and Asian growth concerns weigh on the market

- **The market confidence** indicator, as expected, continued to decline, as last month brought no relief in terms of investor sentiment. The current environment is providing investors with no clear sense of where markets are headed, as fears of a wider European debt crisis have been joined by concern over Asia-Pacific (especially Chinese) economic growth, which had been considered the engine of the world economic recovery. This instability means interest rates around the world will rise, and the Russian market will be no exception.

Figure 1: AB-ICI was down 1.5%



Source: New School of Economics, Alfa Research

Focus on interest rates

The performance of the AB-ICI over the last couple of months mainly reflects instability on global financial markets rather than Russia-specific issues. Over the last two months, rates around the world have begun to rise, sending investors fleeing from risky markets, including Russia. This will eventually lead to upward pressure on local interest rates.

Local interest rates stopped declining in May…

…reflecting banks' increased appetite for lending…

Recent local monetary developments also suggest that interest rates have bottomed. In April and May, average lending rates and annual CPI remained flat at 11.4% and 6.0%, respectively, after a prolonged decline, highlighting the end of the year-long decline in interest rates. This change was brought about by a decrease in liquidity, as banks have started channeling money into new loans: over the last three months, they have increased their corporate and retail portfolios by 2.8% and 2.5%, respectively. These positive figures led to banks' first YTD increase in loan books this year. Moreover, in May banks reduced their securities portfolios, underscoring the better lending environment.

…uneven distribution of liquidity…

At the same time, the upward pressure on interest rates comes against the backdrop of continuing excess liquidity in the banking sector: around RUB2 trln is in correspondent accounts, deposits with the CBR and CBR bonds, the latter of which accounts for around 50% of the total. This indicates that Sberbank is still not participating in the observed lending recovery. The latter is the key player on the market and still holds a considerable amount of liquidity. As a result, the CBR continues to sterilize excess liquidity by placing CBR bonds: in June it placed RUB160 bln, and it plans to place another RUB440 bln.

…and limited potential for ruble appreciation going forward

The ruble exchange rate market provides further evidence that interest rates will soon start rising again. The monetary authorities have indicated that the period of a strong ruble is ending, and there is limited potential for it to appreciate from the current level of RUB30-31/$. Both fundamental and market indicators support this argument. First, Russia's current account faces the risk of a strong pickup in imports: in May, they increased 50% y-o-y, a pace not seen since before the crisis, after rising 29% in April and 22% in 1Q10. Given the close correlation between Russia's current and capital accounts, if strong import growth continues, the ruble could come under pressure towards year-end. The current volatility on the commodities market underscores the CBR's need to support the ruble exchange rate by keeping interest rates high.

Fear of more expensive credit will stimulate demand for loans short-term

All in all, the increased risk of another global reccesion, suggested by decelerating growth even in the Asia-Pacific region, will likely cause interest rates around the world to begin to rise. In the short term, this turnaround may support demand for loans in Russia, as companies will want to borrow now, while rates (predominantly fixed) are still low. However, more expensive money suggests bleaker prospects for the AB-ICI, as without structural support, further economic growth will be unstable.

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