Alfa-Bank

AB-ICI: Capital Outflow Still on the Agenda

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Investment Summary

- The AB-ICI declined 1.4% last month, lacking support from the Russian equity market.
- Recent instability in oil prices hit Russia's trade balance position, which has already suffered from import growth.
- A downward revision of capital outflow forecast for 2011 is a key risk factor for AB-ICI performance.

AB-ICI lost 1.4% last month

AB-ICI declined owing to lower economic and market confidence

Rapidly increasing uncertainty over the dollar/euro rate and commodity prices did not help Russian AB-ICI, which lost 1.4% last month. While the foreign confidence was virtually unchanged, the dynamics of the index dynamic are currently driven by the poor performance of economic and market confidence.

May capital outflow of $5bn was negative news

- **Economic confidence** was depressed by two factors: the continuing capital outflow and the declining saving rate. Even if the $5bn capital outflow in May appears to be positive news after the $7.8bn outflow in April, it is still high, and prospects for coming months remain unclear. Regarding the savings ratio, with very weak growth in income since the beginning of the year, consumption is financed by a reduction in savings, with retail deposits up only 5% y/y in 5M11 vs. 9% y/y in 5M10.

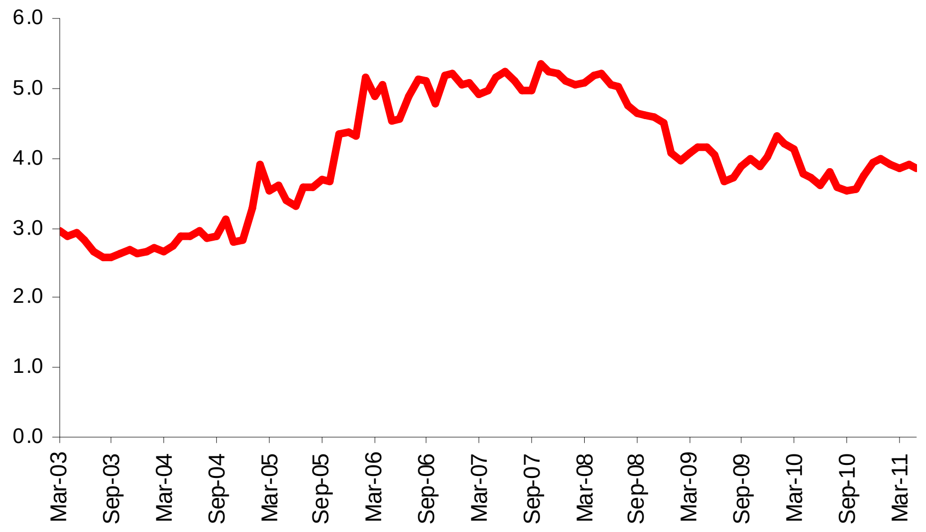
Foreign confidence remained unchanged…

- **Foreign confidence** was unchanged last month in the absence of new data.

…while the stability of the bond market was offset by weak equity market performance

- **Market confidence** stood flat but contained two conflicting trends. On the one hand, the Russian bond market has converged with other emerging market countries, and its duration has increased as a result of recent placements. However, as the RTS was under pressure and the presence of small and medium companies on the market has declined, the positive trends were completely neutralized.

Figure 1: AB-ICI has declined by 1.4%



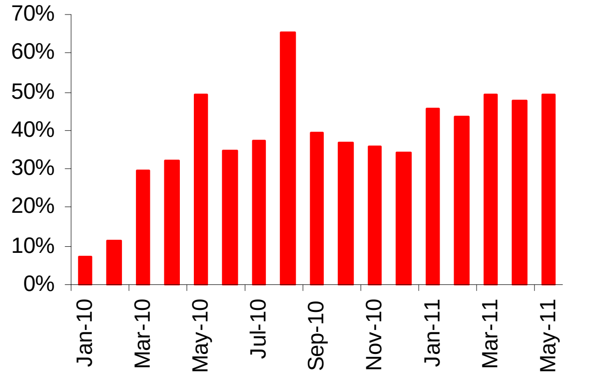
Source: New School of Economics, Alfa Research

Capital outflow forecast hit by poor 5M11 data

49% y/y import growth and capital outflow of $5bn in May came as negative surprises

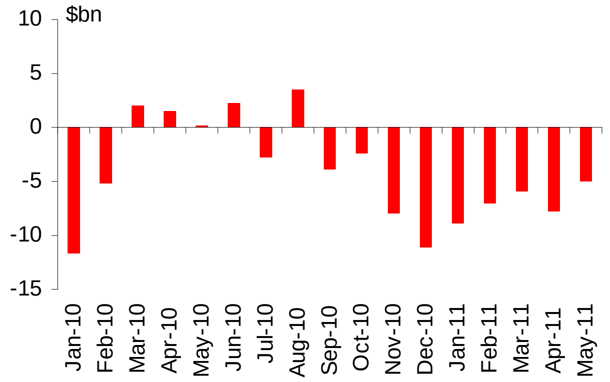
The balance of payments seems to play a very important and negative role in dictating this year's AB-ICI performance. Unfortunately, no relief on this front has been seen, beginning with disappointing and unexpected May balance of payments statistics. First, non-CIS import growth accelerated from 46% y/y in 1Q11 to 49% y/y in May. Secondly, the capital account also disappointed as Russia posted the previously noted $5bn outflow. While at first glance these indicators suggest deceleration, we are concerned that they reflect lower business activity in May owing to the traditional Russian May holidays, which means that the capital outflow may gather pace again in June.

Figure 2: Non-CIS import growth, % y/y



Source: CBR, Alfa Research

Figure 3: Private capital flows, $bn



Source: CBR, Alfa Research

We increase our import growth forecast to 40% y/y, current account breakeven to $80/bbl

The May figures therefore lead us to adjust our balance of payment forecasts. Our full-year import growth forecast of 35% y/y is looking increasingly optimistic, and we therefore upgrade our forecast to 40% y/y for 2011. In nominal terms, we cut our $90bn current account surplus forecast to $75bn. Faster import growth implies that the current account breakeven level under our $105/bbl assumption will increase from $75/bbl to $80/bbl, the highest ever level for Russia.

We forecast 2011 capital outflow of $50bn

We also revise our capital account expectations. We previously forecast $15bn for 2Q11; however, given the outflow of $12.8bn in April-May, we now believe $20bn is a more appropriate level. Even though the CBR recently guided for a FY11 capital outflow of $30-35bn, we believe a zero-balanced capital account for 2H11 is an overly positive scenario. We therefore forecast the capital outflow to total $50bn this year. We also believe that the increase in current account risks per se is a strong negative factor, affecting the capital account trend.

Given the continuing real ruble appreciation and lack of clarity regarding the future of the tax regime, we expect the AB-ICI to remain depressed

The above-mentioned risks seem to have been priced in by the exchange rate market. After appreciating to the basket from 36.5 in December 2010 to 33.5 in March 2011 (which compelled the CBR to widen the RUB1 currency band to 32.45-37.45), the ruble has remained flat despite the increase in oil prices. We also believe that these risks are the key factors preventing recovery in AB-ICI economic component. Unfortunately, with the relatively high expected inflation of 7-8% at best for this year, the appreciation of the ruble's effective exchange rate does not provide a competitive advantage for local producers. The recently announced change in the tax regime with the cut of the social tax from 34% to 30% is also failing to invoke enough positive sentiment to reverse the capital account. Thus, we anticipate that AB-ICI performance will be significantly squeezed in the coming months.

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