

AB-ICI: Fearing the Worst, Hoping for the Best

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Investment Summary

- As expected, Russia was not immune to the May market turmoil, but the AB-ICI decline was modest.
- Despite sharp 15% RUB/\$ depreciation last month, capital outflow slowed to \$6bn.
- Low market and real sector expectations suggest limited downside to the AB-ICI going forward.

AB-ICI declined ~1% in May despite a very negative global market

The economy's reaction to ruble volatility is now much calmer than in 2008

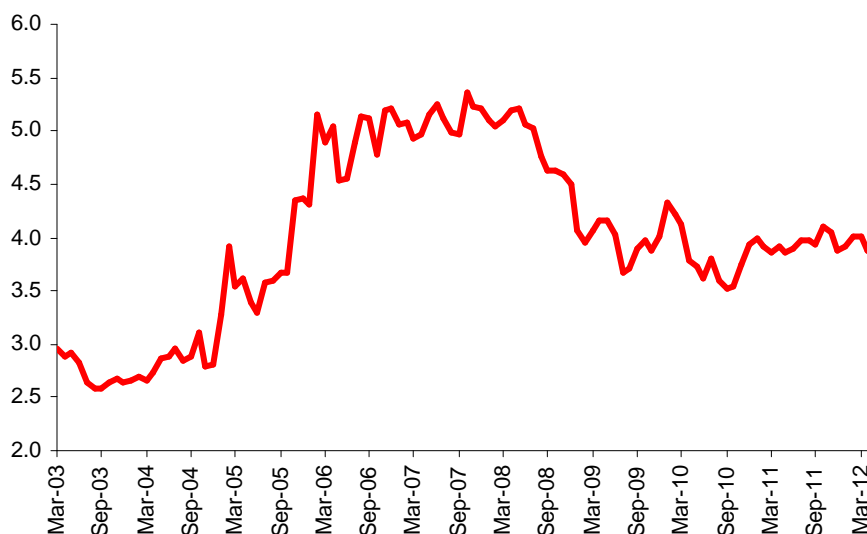
Markets are focused on global fears, while local themes are overlooked

The AB-ICI decline has decelerated

While the severe global market downturn in May resulted in ~1% decline of the AB-ICI, this was modest compared to the 4% in the previous month. Unlike 2007-2008, growth expectations in the Russian real sector and financial market are not overheated, suggesting limited downside to investor confidence and even potential for a positive surprise if the global situation stabilizes.

- **Economic confidence** declined slightly, as the population increased the share of foreign currency deposits to 19% in May from 18% in April. That said, given the very sharp 15% ruble depreciation to the dollar last month, this modest reaction suggests households are now more used to ruble volatility than in 2008. Overall capital outflow of \$6bn also came in significantly below expectations, reflecting a much lower role for speculative flows thanks to the CBR's more flexible approach to exchange rate management.
- **Foreign confidence** remained unchanged, as no relevant data was released.
- **Market confidence** dropped, reflecting global flight from risk due to acute Eurozone debt and Chinese growth concerns. Obviously, global trends remain a significant risk factor for the Russian market; however, surprisingly and persistently strong local economic trends, such as buoyant consumption supported by strong loan growth, may come in to market focus when the external situation stabilizes.

Figure 1: AB-ICI decreased 1% in May



Source: New School of Economics, Alfa Research

Cautious Producer Meets Strong Consumer

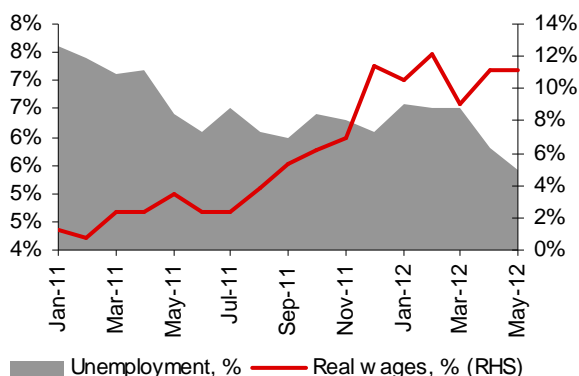
The 5M11 consumer trend was surprisingly strong...

... supported by high income growth expectations and a readiness to increase leverage

The recent drop of the market confidence indicator suggests that market participants are focusing on global concerns and are not optimistic regarding the Russian economy's ability to resist global volatility. However, May statistics have shown that Russia's economic trends are better than the market feared. The key positive was on the consumer side. Unemployment dropped to 5.4% in May, a historical low previously only reported in May 2008. This drove the 2.5% y/y growth in real disposable income growth in 5M12, including the 10-11% y/y growth in real salaries. As a result, retail trade exceeded expectations by growing 6.8% y/y in May, or 7.2% y/y in 5M12 vs. 7.0% in 2011.

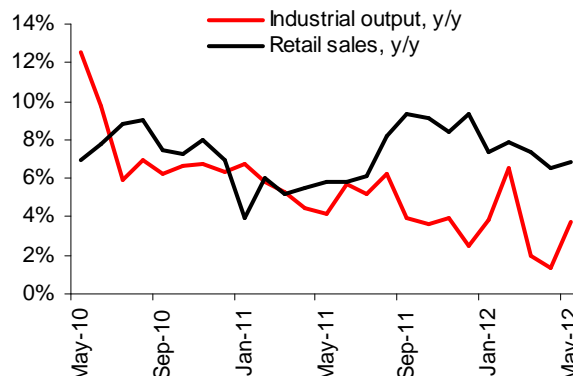
We take the data as a strong confirmation that the Russian economy is driven by consumerism despite the global economic backdrop. The key driver is the social focus of the Russian budget. Our take is that facilitating consumption is the Cabinet's way to face the crisis, including the pension indexation in 2007-2010, public salary indexation this year and President Vladimir Putin's promise to spend 1.5% of GDP per annum on an additional social program, thus maintaining households' high expectations. The confidence in future income is fuelling strong retail loan growth, reaching 43% y/y and strengthening the consumption trend.

Figure 2: Unemployment and income growth



Source: Rosstat, Alfa Research

Figure 3: Retail trade vs. industrial output



Source: Rosstat, Alfa Research

Industrial production is not overheated, offers upside potential

One interesting observation is that, unlike in 2008, positive consumer expectations have not been fully shared by producers. In 4Q11, Russian industry was destocking, while in March and April industrial output growth has substantially decelerated to 1-2% y/y. This implies that Russia is unlikely to face a deep shock like in 2008 under a worst-case global scenario as producers are adopting a more prudent approach. In a way, this is confirmed by a recovery of industrial output growth to 3.7% y/y in May and even suggests an upside surprise from the real sector in the event the global situation stabilizes.

GDP growth expectations upgraded to 3.8% y/y in 2012

Still, we remind that last year's 3Q results were quite strong, which implies a negative base effect this year, and the passage of the presidential election in March suggests that budget policy may stay tight through the end of the year, unlike in 2011. Combined with the risks of further deterioration in the global environment, this suggests that in 2H12 Russian GDP growth is unlikely to exceed 3% y/y. That said, surprisingly strong 1H12, which is likely to bring close to 5% y/y growth thanks to buoyant consumer demand, makes our previous 3.2% GDP forecast for 2012 too conservative, and we upgrade it to 3.8% y/y. While even this would not be able to prevent a decline of the AB-ICI in the case of aggravated global turmoil, stronger than expected local economic trends may at least provide some support to investor confidence if the market situation stabilizes.

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