

# AB-ICI: Market support may only be temporary

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June 28, 2013

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Moscow

## Investment Summary

- The AB-ICI increased 1% m/m last month thanks to support from financial markets
- Recent drop in risk appetite is not yet priced in and will negatively affect AB-ICI in the coming months
- Fundamental support for the index remains weak, and capital outflow is the biggest risk

**AB-ICI rose 1% last month thanks to support from financial markets**

**Economic indicator was down last month**

**Foreign confidence neutral, but there are hidden risks**

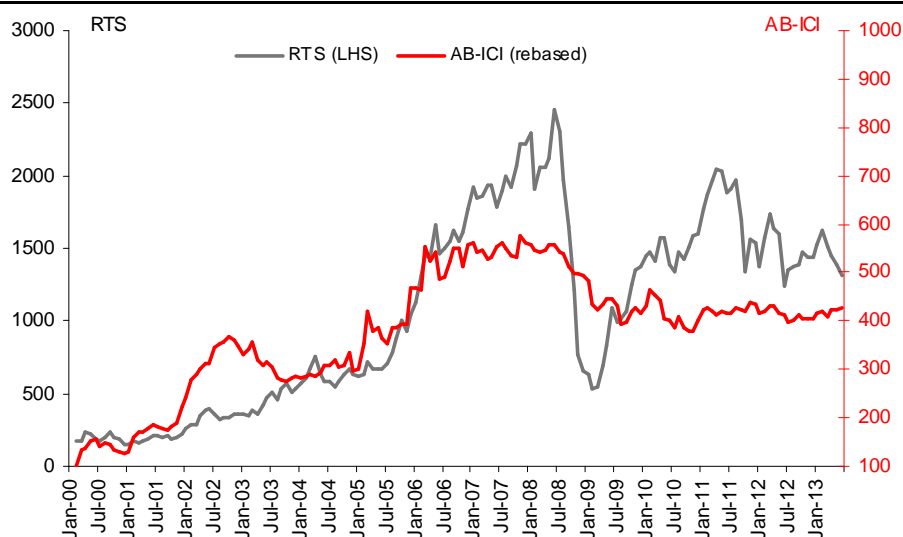
**Financial markets supportive, but outlook is very negative**

### AB-ICI up 1% m/m in May

The AB-ICI was up 1% last month thanks to support from financial markets. However, this does not yet reflect the recent drop in risk appetite across emerging markets, and the index's performance will most likely not be sustainable in the coming months given the weakness of its fundamental components:

- **Economic confidence** was down significantly last month, mainly reflecting poor deposit growth and a preference for capital outflow. We believe capital flight from emerging markets is a good leading indicator for weakness in the AB-ICI;
- **Foreign confidence** was unchanged last month due to a lack of updated figures. However, as suggested by the previous months' results, FDI flows and foreign bank activity are unlikely to surprise on the upside in future;
- **Market confidence** was the main source of support for the AB-ICI. This was a surprise given the recent capital flight from emerging markets and risky assets overall, and we view it as a short-term phenomenon that is likely to disappear in the coming months.

**Figure 1: AB-ICI was up 1% last month**



Source: New School of Economics, RTS, Alfa Research

## Weak fundamentals to lead to weak market

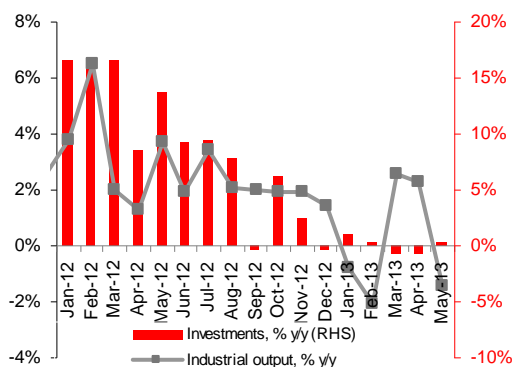
**AB-ICI is up 2% YTD, but weak fundamentals to trigger adjustment of equity market**

**Recent appointments strengthen the economic bloc in the government**

Though the AB-ICI has performed well and is up 2% YTD, we believe the global decline in risk appetite will have a negative effect in the near future. The weak fundamentals of the Russian economy, which are becoming more and more apparent, are poised to trigger an adjustment of the equity market. Even if the actual trigger is a change in global sentiment, the Russian market is not defensive given the country's internal weakness.

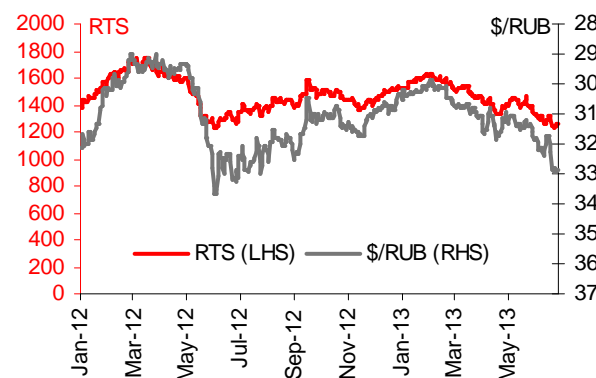
The key consideration is that the government's reaction to the economic deceleration has been mixed. Russian GDP growth for 5M13 was only 1.8% y/y, which is a very disappointing result. On the positive side, the recent restructuring of the economic bloc is very promising. New CBR head Elvira Nabiullina is likely to focus on the regulator's credibility as an inflation-targeter, while the appointment of the former first deputy chairman of the CBR, Alexei Ulyukayev, as Minister of Economic Development opens up an opportunity to improve dialogue between the government and the market. Andrei Belousov's move from the government to the Kremlin suggests that President Putin will continue to benefit from the advice of this talented economist. Overall, the economic bloc now looks stronger and more focused on the market.

**Figure 2: Industrial output and investments**



Source: Rosstat, Alfa Research

**Figure 3: Ruble exchange rate and RTS index**



Source: CBR, RTS, Alfa Research

**Growth is limited by fundamentals, concerns over NPLs in the agenda**

**Markets ignored poor real sector, but risk appetite is down...**

**...which will hit AB-ICI and push down RTS closer to fundamental value**

The bad news is that the deceleration of Russian economic growth looks more and more structural. Industrial output was up only 0.2% y/y in 5M13, and investments shrank 0.4% y/y over the same period. This makes consumption growth look more and more unsustainable in the long run, and the deceleration in loan growth is adding to concerns over loan quality.

Unsurprisingly, sentiment on the exchange rate market is poor. At the moment, the ruble has depreciated 4-5% against major currencies, in line with peers. However, weak fundamentals will make local capital nervous about future exchange rate dynamics for two reasons. First, the capital outflow is \$38bn YTD and is likely to accelerate due to speculative considerations. Second, pressure on the ruble exchange rate will compel the CBR to keep rates high, which will in itself contribute to further deceleration of economic growth. In 5M13, growth was weak, but the market did not react to the deteriorating macro case given the general increase in risk appetite. Now, with Fed Chairman Ben Bernanke announcing his preference for tightening, Russia's poor macro fundamentals will start to affect the exchange rate, complicating the task of the reformist economic bloc to support Russian economic indicators. We thus believe the poor real sector performance means AB-ICI growth is unsustainable and should trigger a justified decline in the RTS closer to its fundamental value.

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