

## AB-ICI: Expecting Interest Rates to Rise

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### Investment Summary

- Last month, the AB-ICI declined by 3.0%, as financial markets did not recover and investors are expecting higher interest rates
- Rising inflationary pressure will be the key factor to watch out for in the coming months

#### AB-ICI lost another 3.0% on lack of market confidence

**AB-ICI declined 3.0% due to lack of recovery in market sentiment**

Last month, the AB-ICI fell by another 3.0%, as financial markets remained weighed down by the Eurozone debt/deficit crisis and concern over economic growth in the US and China. At the same time, investors expect the CBR to raise interest rates, which are very low.

**CBR policy of reducing interventions on the FOREX market boosting confidence in the ruble**

- **The economic confidence** indicator continued to improve moderately, as Russians continued to de-dollarize their savings. In addition, Russia saw a \$4.5 bln inflow of private capital in 2Q10 after a substantial outflow in Q1. Those figures indicate that the CBR's tactic of reducing currency interventions that it adopted starting in April successfully prevented capital outflow;
- **The foreign confidence** indicator remained flat, as no relevant data were released;
- **The market confidence** indicator continued to decline, as last month brought no reassurance to investors. Economic statistics and corporate financials sent mixed signals. Markets remained under pressure from the euro debt crisis, and, since interest rates are currently very low, investors expect them to rise, putting pressure on bond markets.

**Rising expectations of higher interest rates put pressure on bond markets**

**Figure 1: AB-ICI was down 3.0%**



Source: New School of Economics, Alfa Research

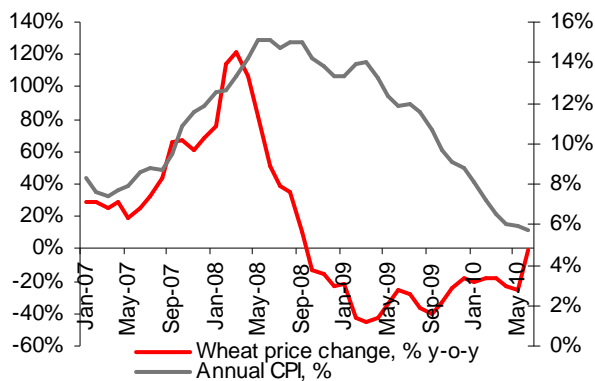
## Inflation to limit AB-ICI recovery in 2H10

Russia's financial markets were supported in 1H10 by the continued decline in domestic interest rates. However, recent news suggests that the cycle of declining inflation may be coming to an end, which could lead to an increase in interest rates. The reversal of the trend will likely weigh on Russia's fixed-income market. For the AB-ICI, this means the 2H10 recovery is fully dependent on an economic recovery and capital inflows, i.e. on the economic confidence component of the index.

**Historically, grain price rallies have led to accelerated food price growth**

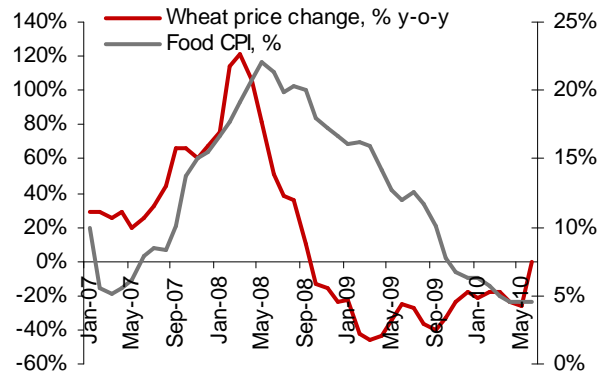
Owing to the abnormally hot summer, grain prices on international markets have risen by 30% since the beginning of July, and they are expected to rise further. In 3Q07-1Q08, which saw a 90% rally on global agricultural markets, Russia's food inflation accelerated from 8.4% y-o-y in August 2007 to 22.1% in March 2008. That translated into a 6.4 ppt increase in total annual CPI over the same period.

**Figure 2: Grain prices and CPI**



Source: USDA, Rosstat, Alfa Research

**Figure 3: Grain prices and food inflation**



Source: USDA, Rosstat, Alfa Research

**We estimate higher grain prices will add 1.7 ppts to Russia's 2010 CPI**

This year's situation looks to be very similar, as the global drought has already led the world's leading grain-producing countries to downgrade their harvest expectations. This includes Russia, which now expects the harvest to shrink by 12% y-o-y. This has led to panic buying, causing global wheat prices to rise by 30% in July. According to our estimates, a 30% y-o-y increase in grain prices could add up to 1.7 ppts to Russia's 2010 inflation.

**Food prices account for almost 40% of Russia's CPI**

This concern is justified, as the share of food consumption in Russia's CPI basket is as high as 38%. This is well above the 15-20% level seen in developed countries and even higher than China's 32%. Increases in global grain prices usually boost domestic prices, eventually affecting the price of meat. The two have a strong combined effect on food prices and, in turn, CPI.

**Figure 4: Structure of CPI by segment**

	USA	China	Russia
<b>Food</b>	<b>15%</b>	<b>32%</b>	<b>38%</b>
Housing	37%	14%	3%
Transport and communications	20%	10%	6%
Clothing	4%	9%	10%
Entertainment, education, healthcare	16%	24%	5%
Communal services	5%	6%	6%
Other (non-food products for Russia)	9%	11%	39%

Source: US BLS, NBSC, Rosstat, Alfa Research

**Apart from grain prices, inflation is boosted by the consumer recovery...**

Until now, inflationary concern has been mitigated by poor consumer sentiment and low lending growth. However, positive macro statistics in 2Q10 suggest that improvements in both areas have brought higher inflationary risk. In June, unemployment declined to 6.8% from 7.3% in May, too much to be explained merely by seasonal adjustment, suggesting better job market

**...and the increase in the money supply**

**We upgrade our annual CPI forecast from 7.0% to 7.5%...**

**...taking into account possible state interventions on the grain market**

**We raise our year-end refinancing rate target by 25 bpts to 8.00%**

conditions. Retail trade in June was up 5.8% y-o-y versus 5.1% in May. Faster consumption growth will encourage retailers to increase margins.

Russia's money supply growth reached 31% y-o-y in May, reflecting strong deposit inflows to Russian banks. The 3.3% q-o-q recovery in lending activity in 2Q10 implies that banks will gradually start passing on inflationary pressure to the real sector. This intensifies inflationary risks and justifies our expectations of higher inflationary pressure in 2H10.

At the moment, Russia's CPI remains at a historical low of 5.8%. While we previously expected improved consumer sentiment and lending activity to boost inflation to 7.0% in December, the increase in global grain prices calls for an upgrade to 7.5%. On a monthly basis, while we previously forecasted flat prices in August and deflation in September, we now expect CPI to reach 0.3% m-o-m in August and 0.2% m-o-m in September.

**Figure 5: Monthly and 12M CPI, %**

	May-10	Jun-10	Jul-10F	Aug-10F	Sep-10F	Oct-10F	Nov-10F	Dec-10F
12M CPI	6.0%	5.8%	5.8%	6.1%	6.3%	6.8%	7.1%	7.5%
Monthly CPI	0.5%	0.4%	0.6%	0.3%	0.2%	0.5%	0.6%	0.7%

Source: Rosstat, Alfa Research

The reason why we increase our annual CPI forecast by a mere 0.5 ppts is that Russia currently enjoys grain reserves of 24 mln tons (compared with annual domestic consumption of 77 mln tons), allowing the government to intervene to dampen upward pressure on domestic prices. We expect part of these excess reserves to be used to curb inflationary pressure this year.

Given the rising inflationary risk, we no longer expect the CBR to cut the refinancing rate. In response to the change in our inflation forecast, we raise our year-end refinancing rate target from 7.75% to 8.00%. However, a decline in the savings ratio is likely to force banks to keep real interest rates in positive territory, and we expect the nominal interest rate to increase gradually. For the AB-ICI, this means much less support will come from the debt market and economic confidence will play a more significant role.

**Figure 6: Refinancing rate and inflation forecast change, YE**

	Old forecast	New forecast
CBR refinancing rate, %	7.75%	8.00%
Consumer price inflation, 12M, %	7.0%	7.5%

Source: Alfa Research

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