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AB-ICI: Inflation Back in Focus

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Investment Summary

- The decline of the AB-ICI deepened to 3% last month due to lower economic and foreign confidence.
- The deteriorating inflationary outlook is a worrying sign for the local savings trend.
- Strong capital outflow at 5% of GDP in 1H12 reflects weak local demand for investments.

The AB-ICI dropped 3% last month

The acceleration of inflation is the key negative surprise to the AB-ICI trend

Contrary to some positive expectations we expressed previously, the decline of the AB-ICI intensified from 1% m/m in May to 3% m/m in June despite some improvement in the market's mood. The key negative surprise was the acceleration of local inflation due to the global grain price shock. While this supports our positive view on consumption trends in the coming months, it is a clear bad sign for local savings and an obstacle to an AB-ICI recovery.

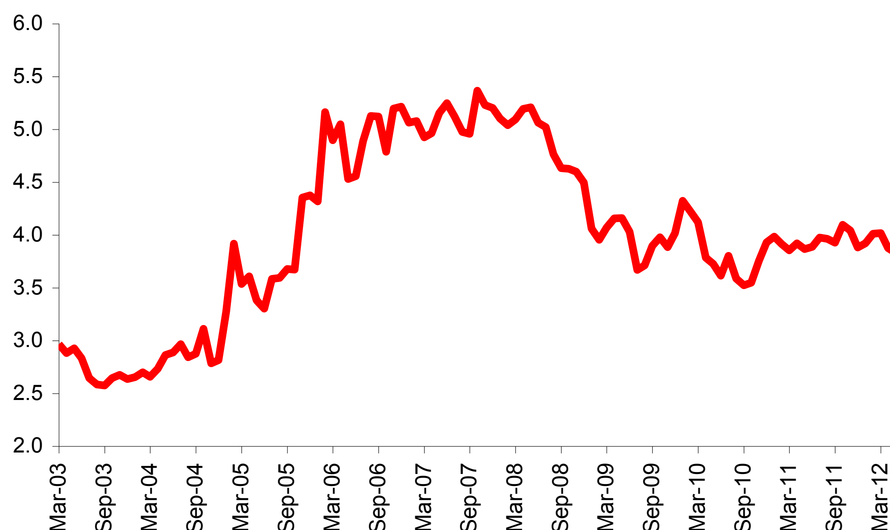
Higher inflation is de-stimulating savings, while capital outflow remains high at 5% of GDP

- **Economic confidence** dropped, primarily due to the decline in the savings rate. Despite the acceleration of real wage growth to 11.3% y/y in 1H12 vs. 2.1% y/y in 1H11, retail deposit growth was only 22% y/y as of June, showing no acceleration compared to 2011. This trend reflects households' preference for spending, which was recently reinforced by an acceleration of inflation to close to 6% y/y currently from 4% y/y in June. In addition, the investment trend appears weak, with capital outflow reaching $43bn, or 5% of GDP in 1H12, representing no improvement compared to 2011.

Foreign banks continue to reduce their presence on the local market

- **Foreign confidence** decreased, reflecting the continuing decline of foreign banks' presence on the Russian market and highlighting the limited interest of foreign players in the local market.
- **Market confidence** increased, reflecting the better performance of the Russian financial market compared to peers last month. That said, a lack of clarity regarding the euro area debt issue combined with the weakness of the local capital account represent a risk factor for the market's mood going forward.

Figure 1: AB-ICI decreased by 3% in June



Source: New School of Economics, Alfa Research

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Inflation Back in Focus

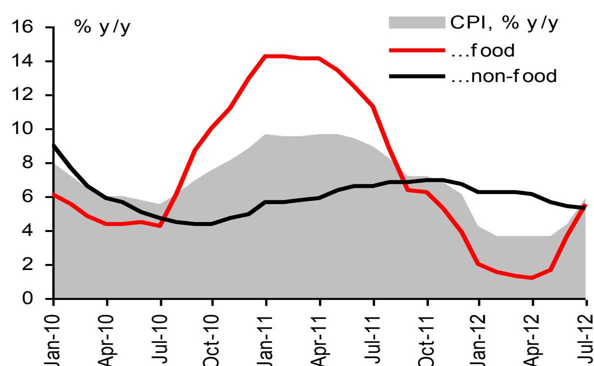
The deteriorating inflationary outlook is damaging for AB-ICI

The sudden acceleration of inflation in Russia is a new challenge for the AB-ICI. Due to poor weather conditions in the US and southern Russia, global wheat prices increased 50% in June-July and reached a three-year high. In June, Russian CPI growth exceeded expectations, and, after July's hike in tariffs, it accelerated to around 6% y/y and almost 5% YTD. The global ag price shock casts doubt on Russia's ability to experience traditional price deflation in August-September and makes it unlikely that last year's 6.1% y/y full-year inflation achievement will be repeated. We recently upgraded our 2012 inflation forecast to 6.7% y/y to reflect the deterioration of inflationary expectations.

The CBR's ability to counter inflation is limited

While the CBR recently reiterated its 6% y/y CPI growth target for the year, we believe this goal will be very challenging to achieve. Most importantly, its freedom to use interest rate policy is limited given the high dependency of the banking sector on CBR refinancing. Banks' current exposure to the CBR equals 5% of banking assets, and any increase in the policy rate could damage the loan growth trend, which is already weak in the key corporate segment. As of June, growth in this segment remained at 24% y/y, which is even below the 26% seen in 2011. Thus, the CBR's calming statements are not a strong tool for lowering inflationary concerns.

Figure 2: CPI growth by components



Source: Rosstat, Alfa Research

Figure 3: Key macro indicators, % y/y

	1H11	1H12	1Q12	2Q12
Retail trade	5.4%	7.1%	7.6%	6.7%
Real wages	2.1%	11.3%	10.3%	12.2%
Disp. income	-0.6%	2.7%	2.4%	3.1%
Unemployment*	6.1%	5.4%	6.5%	5.4%
Investments	2.7%	10.2%	16.3%	6.7%
Construction	1.2%	5.4%	5.2%	5.4%
…housing	-3.7%	1.9%	5.7%	-1.3%
Industrial output	5.3%	3.1%	4.0%	2.3%

*Source: Rosstat, Alfa Research; * as a % of the labor force, EOP*

The inflow of household savings to bank deposits is limited

On the one hand, higher inflation fears are an additional supporting factor for Russia's consumption trends, which so far remain strong. The budget-driven acceleration of real salary growth to 11.3% y/y in 1H12 from just 2.1% y/y in 1H11 has already translated into fast 7.1% y/y growth in retail trade in 1H12. At the same time, the growth of retail savings with banks remained slow at 22% y/y, almost in line with 2011. The recent acceleration of inflation is likely to play further in the favor of households' preference for spending over saving. While this is likely to provide some support for GDP growth rates in the near turn, it also limits the supply of sources to fund investment growth.

Investment demand is vulnerable to negative inflation surprises

On the other hand, the negative inflation surprise is clearly a bad sign for the investment trend, which is already showing signs of weakness. Investment growth decelerated substantially from the skyrocketing 16.3% y/y in 1Q12 to 10.2% y/y for 1H12. While this is still much higher than the 2.7% y/y in 1H11, it also implies a substantial deterioration in 2Q12. Housing construction was particularly weak, showing a 1.3% y/y decline in 2Q12 after the 5.7% y/y growth in 1Q12. Industrial output is even less spectacular, with growth decelerating to 2.3% y/y in 2Q12 and 3.1% y/y in 1H12, below the 5.3% y/y seen in 1H11. The weakness of the investment trends is also highlighted by the fact that capital outflow did not slow down in 1H12 compared to 2011 and stayed at 5% of GDP, or $43bn. Thus, given the vulnerability of savings and capital account trends to inflation, the recent developments represent a challenge for our economic confidence indicator going forward.

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The ratings are:

Overweight (O/W):	Expected total stock return > 15%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
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