AB-ICI: Rebound on Better Capital Flows

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August 31, 2010 www.alfabank.com Moscow

Investment Summary

- Last month, the AB-ICI increased by 5.2%, reflecting improved capital flows on strong 2Q10 GDP growth
- Inflation is back on the agenda, with August CPI at 0.6% m/m, positive for 3Q10 consumption
- Consumption growth is unlikely to offset weak investments, so the AB-ICI will be under pressure again

AB-ICI recovered by 5.2% on capital inflows

AB-ICI increased 5.2% on improvement in economic and market components

Last month, the AB-ICI posted a 5.2% increase after five consecutive monthly declines. This resulted from a substantial improvement in capital inflows and foreign investors' increased confidence in the Russian market. In the meantime, faster-than-expected price growth and higher credit risk caused by the drought mean that interest rates could start to rise as early as October.

Capital inflow continued

- **The economic confidence** indicator improved dramatically, as according to the balance of payment statistics, Russia continued to see capital inflows after the $4.5 bln inflow of private capital in 2Q10. Moreover, the share of dollarized retail deposits continued to decline;

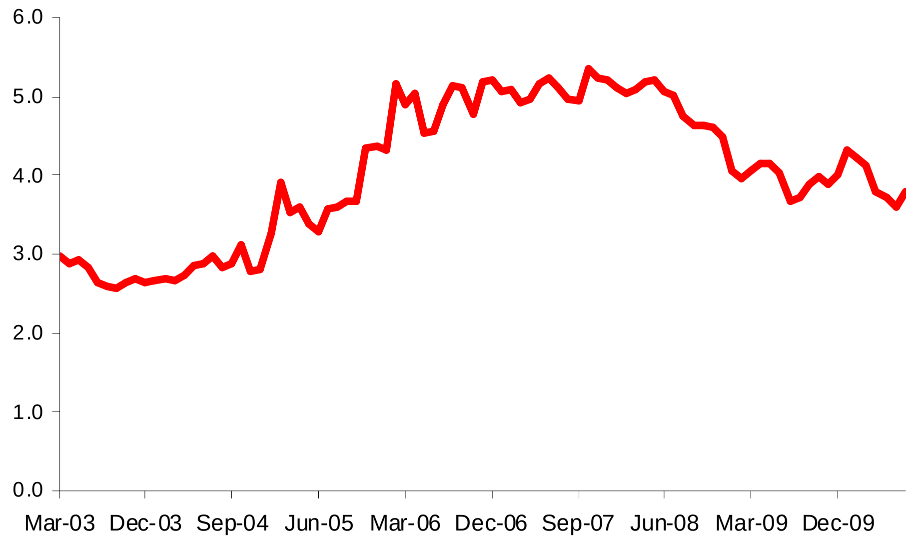
FDI slightly increased

- **The foreign confidence** indicator improved slightly, as in 2Q10, Russia received FDI of $2.8 bln vs. $2.6 bln in 1Q10;

Russian market became more attractive

- **The market confidence** indicator bounced back after a series of declines, reflecting the RTS index's higher monthly average level and the Russian bond market's lower spreads over emerging- and developed-market peers. Current economic indicators, including an acceleration in GDP growth from 2.9% in 1Q10 to 5.2% in 2Q10 driven by consumption trends, improved investor sentiment towards Russia. However, mounting inflationary pressure raises the likelihood of higher interest rates, which will be negative for the market.

Figure 1: AB-ICI increased by 5.2%



Source: New School of Economics, Alfa Research

Weaker Growth to Hit Markets

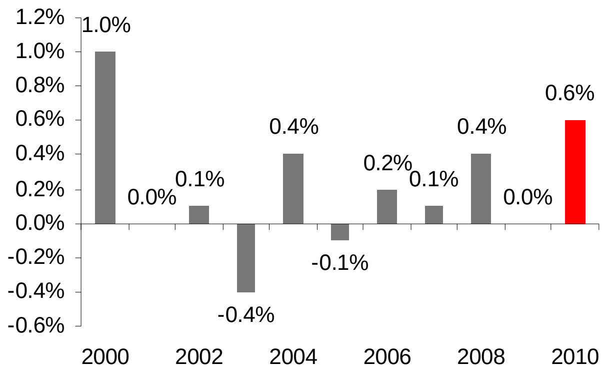
Higher inflation will bring forward the reversal of nominal interest rates

Inflation remains in the spotlight for the second month in a row, as CPI growth in August, driven by food prices, outpaced even the most pessimistic forecasts. While the government did not expect CPI growth to exceed 0.5% in otherwise deflationary August, actual price growth amounted to 0.6% in the first four weeks of the month, the highest August inflation in the past decade. This signals a turnaround in the decline in annual inflation observed since 2Q09 and suggests that interest rates could begin to rise earlier than previously believed. While the current annual CPI rate of 6.2% is still comfortably below the 7.75% refinancing rate, if September price growth exceeds 0.3% m/m, the CBR may need to raise the key rates as early as October.

In the short run, higher inflation boosts consumption, which is already strong

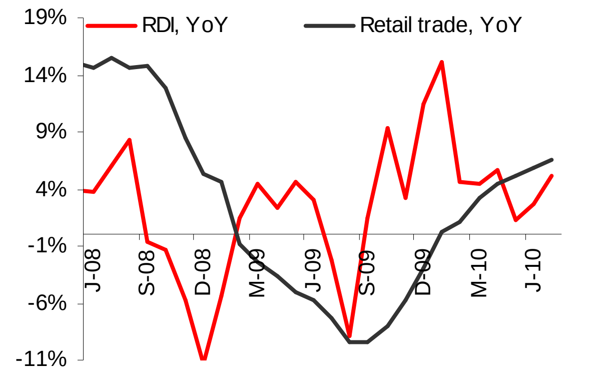
Faster price growth will in the short run support consumption growth, which is already strong. In July, real disposable income went up by 5.2% y/y, supporting a strong 6.6% pick-up in retail trade. The savings rate as of June was 14.4% versus the 15.7% average for 1H10, reflecting greater consumer confidence. We expect this trend to continue into 2H10, as we anticipate that fears of faster price growth will push individuals to save less. As after 1-7M10, some 49% of budget funds had yet to be spent, we anticipate that disposable income growth, driven by social spending, will remain high despite higher inflation.

Figure 2: August inflation, 2000-10, % m/m



Source: Rosstat, Alfa Research

Figure 3: Disposable income and retail trade, % y/y



Source: Rosstat, Alfa Research

Import growth reached 30% in 1-7M10

However, despite strong consumption, economic growth is likely to decelerate, reducing the attractiveness of Russian financial markets. First, rapid import growth continues to be the other side of the coin of the recovery in consumption. In July, imports went up by 36% y/y, bring 1-7M10 import growth to 30%, similar to the pre-crisis level, making our 15-20% forecast for annual import growth very optimistic.

Investment growth decelerated to 0.8% y/y in July, reflecting a 24.6% y/y drop in housing construction

Second, investments continued to disappoint. In July, housing construction dropped by 24.6% y/y, triggering a 2.5% y/y decline in overall construction and reducing investment growth to 0.8% y/y, the lowest since March 2010. This represented a 10.7% m/m decline in investments, and lower investment activity translated into weak industrial output growth: the latter was reported at 5.9% y/y in July after staying above 10% y/y for most of 1H10. The government's bearish 2.5% y/y expectation for investment growth is thus becoming a realistic scenario.

Overall, while at the moment sentiment towards the Russian economy seems to be positive, weak investment and industrial output in an environment of strong consumption will pose a risk in the coming months by shrinking the trade surplus, thereby leading to capital outflows, which will push down the AB-ICI.

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