Alfa-Bank

AB-ICI: Suffering from Weak Ruble

Natalia Orlova (+7 495) 795-3677 NOrlova@alfabank.ru

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Investment Summary

- AB-ICI was up 1% last month, the first increase since March, but it is still down 4% YTD.
- The ruble exchange rate is under pressure because of a likely acceleration in import growth due to WTO.
- The weaker ruble will support capital outflow, which is likely to keep AB-ICI depressed in coming months.

The AB-ICI rose 1% last month

AB-ICI stopped declining last month but is still down 4% YTD

Last month's AB-ICI growth is a positive sign, as it was the first rise since March 2012. The index has lost 4% YTD, but has now found support. Our worry is that this may just be temporary, and a lack of catalysts is our key concern.

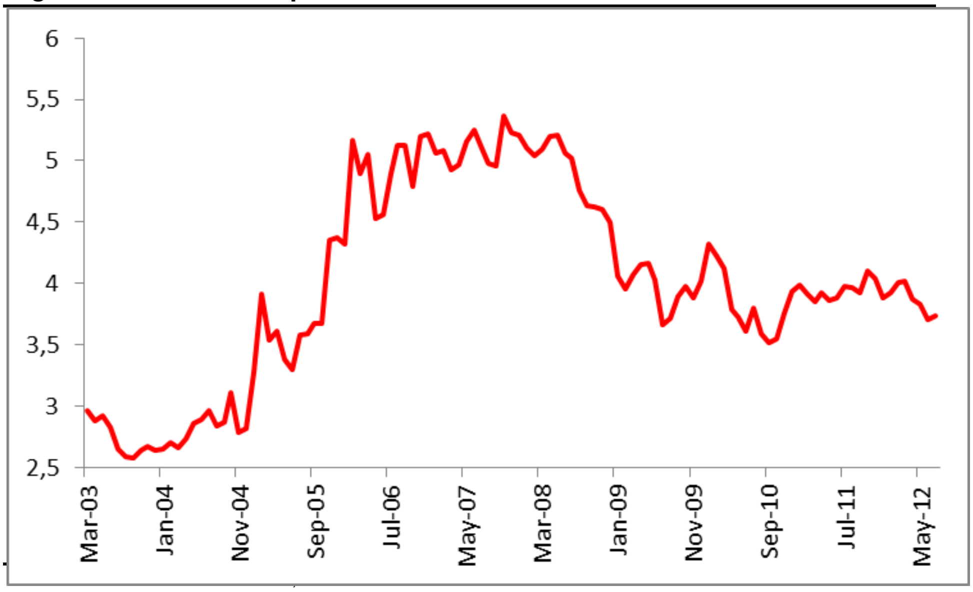
Economic confidence suffered from the capital outflow in July

- **Economic confidence** remained weak, reflecting the deterioration of the capital account. In July, capital outflow totaled $3-5bn, according to the Ministry of Economic Development, suggesting that the capital inflow in June was a one-off event. The deceleration in retail deposit growth in recent months also inhibited a strong economic confidence trend.
- **Foreign confidence** decreased slightly as a reaction to the poor FDI statistics. In 1H12, FDI increased only 8% y/y and has still been unable to reach its level from pre-crisis years, when it was $25-30bn per year. At best, FDI inflow will total $18-20bn this year.

Market was strong, but concerns persists

- **Market confidence** was higher, mirroring the improvement of virtually all indicators. The structure of the market was better with more placements coming due and the RTS Index increased. However, the key concern is that in the absence of fundamental improvement, it is hard to expect that the market dynamic will be strong entering 2H12.

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



Ruble Exchange Rate Will Dictate AB-ICI Trend

The ruble remained flat in August while the 7% MTD oil price increase would suggest appreciation to RUB30-31/$

While oil prices recovered from $105/bbl to $115/bbl in the last three weeks, or by 7% MTD, the ruble exchange rate remained virtually flat. Compared with peers, the currency has seen little movement against the dollar. Rather, it is doing better than other emerging market currencies, showing a 4-9% depreciation YTD, but is lagging behind the performance of oil-dependent peers. The recent spike in oil prices would also suggest that the ruble exchange rate would move to RUB30-31/$, or by 5% MTD, based on the rule that a $10/bbl change in oil prices shifts the exchange rate by RUB1.5-2.0/$. However, the fact that the ruble appreciated by only 1% MTD suggests that the oil factor is driving the currency less than usual. We reiterate our view that by year-end the RUB/$ rate should approach 33 to the dollar under $110/bbl annual average oil prices (current average Brent price is $112/bbl).

Acceleration in import growth following WTO entry is one factor pressuring the ruble exchange rate

We believe this cautious market view on the ruble exchange rate is the result of a couple factors. First, WTO entry will be a litmus test for Russia's ability to continue modest import growth. The 4% y/y growth in 1H12 was much better than expected mainly thanks to global deflation but also due to some delay in signing import contracts due to the expectation of lowered import duties. The recent news about the rise in import growth to 13% y/y in July confirms that our 10% forecast for 2H12 import growth is realistic. This will be in line with our 8% y/y import growth for the full year but will obviously put pressure on the current account surplus.

Capital outflow in July came as a negative surprise for the market

Second, the capital account is also unlikely to be supportive for the ruble exchange rate. According to Cabinet estimates yet to be confirmed by the CBR, in July Russia posted a capital outflow of $3-5bn. This implies that June's capital inflow of $4bn was a one-off improvement, repeating the improvement seen in June 2011. In 2011, June was the only month with a capital account surplus, and we expect the same pattern to be repeated this year.

Dividend payments will contribute to capital outflow in August

It does not appear this indicator improved in August. One of the reasons explaining the ruble's weak reaction to the recent spike in oil prices could be the outflow related to dividend payments by Russian companies. According to estimates, the dividend flows from oil companies alone accounted to $10-12bn. The portion of these revenues received by local shareholders are likely to contribute to capital outflow in August.

The Cabinet's guidance for a weaker ruble in coming years is also negative

Finally, we believe that the official guidance matters a great deal. The Ministry of Economic Development recently published a new macroeconomic forecast, adjusting its ruble exchange rate forecast to an average of RUB31.3/$ this year and RUB33.7/$ in 2015. This represents a significant weakening from the previous official guidance and will also damage market sentiment regarding the exchange rate.

We anticipate the AB-ICI dynamic will be hurt by the weaker ruble and capital outflow

Given all these negative factors, we anticipate the capital account will deteriorate in August. Following the capital outflow in July, we expect at least $5-7bn in capital outflow in August. Combined with the likely $4bn outflow in July, capital outflow is thus likely to approach $54bn in 8M12 versus $32bn in 8M11. This should damage AB-ICI growth directly through the weak economic component and indirectly through the worse than expected market performance.

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The ratings are:

Overweight (O/W):	Expected total stock return > 15%
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IMPORTANT INFORMATION

Equity Market

Head of Equities
Michael Pijiolis
+7 (495) 795-3712

Alfa Bank
12, Akad. Sakharova Pr-t
Moscow, Russia 107078

Research Department +7 (495) 795-3676
research@alfabank.ru

Head of Research

Peter Szopo	pszopo@alfabank.ru	792-5848

Macroeconomics

Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724

Financial Services

Jason Hurwitz	jhurwitz@alfabank.ru	783-5005
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740

Oil & Gas

Maria Yegikyan	myegikyan@alfabank.ru	795-3725

Metals & Mining

Barry Ehrlich, CFA CMT	behrlich@alfabank.ru	785-9568
Andrey Lobazov	alobazov@alfabank.ru	745-5438
Oleh Yuzefovych	oyuzefovych@alfacapital.com.ua	+380 (44) 490-1617

Utilities

Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334
Elina Kulieva, Ph.D.	ekulieva@alfabank.ru	789-8509

Transportation, Construction

Iouli Matevossov, CFA	imatevossov@alfabank.ru	755-5931
Vladimir Dorogov, CFA	vdorogov@alfabank.ru	788-0320

Telecommunications, Media & Internet

Iouli Matevossov, CFA	imatevossov@alfabank.ru	755-5931

Retail, Real Estate, Pharmaceuticals

Andrei Nikitin	ainikitin@alfabank.ru	795-3742
Irina Prokopyeva, CFA	iprokopyeva@alfabank.ru	795-3655
Darya Babashkina	dbabashkina@alfabank.ru	+7-499-681-1706

Agriculture & Food, Fertilizers

Maria Bovykina	mbovykina@alfabank.ru	795-3713
Martin Masar	mmasar@alfabank.ru	795-3612

Russian-Language Product

Angelika Henkel, Ph.D.	agenkel@alfabank.ru	785-9678
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)

Editorial & Production

Cole Akeson	cakeson@alfabank.ru	745-7153
Jeffrey Weiner	jweiner@alfabank.ru	745-3714

Data Management

Aleksei Balashov	albalashov@alfabank.ru	795-3676

Translation

Anna Martynova	amartynova@alfabank.ru	795-3676
Stanislava Ovcharenko	sovcharenko@alfabank.ru	783-5020

Equity Sales & Sales Trading (Moscow) +7 (495) 223-5500, 223-5522

International

Victoria Duben	vduben@alfabank.ru	228-8880
Michael Kotov	kotov@alfabank.ru	223-5500
Dmitry Ryzhkov	dryzhkov@alfabank.ru	783-2836

Domestic Institutional

Ilya Lobanov	ialobanov@alfabank.ru	785-7406
Dmitry Demchenko	ddemchenko@alfabank.ru	783-5115
Alexander Pugovkin	apugovkin@alfabank.ru	783-5133
Dmitry Matyukhin	dmatyukhin@alfabank.ru	745-5621

Alfa-Direct Sales +7 (495) 795-3680

Sergey Rybakov	srybakov@alfabank.ru	ext. 6399
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083

Alfa Capital Markets (London) +44 (0) 20 7588-8500

Sales

Victoria Filimonova	v.filimonova@alfa-cm.com	7382-4172
Robert Szucsich	r.szucsich@alfa-cm.com	7382-4174

Sales Trading

Yan Gloukhovski	y.gloukhovski@alfa-cm.com	7382-4179
Gareth Johnson	g.johnson@alfa-cm.com	7382-4178

Alforma Capital Markets (New York) +1 (212) 421-7500

Sales

Justin Landau	jlandau@alformacap.com	421-8564