

AB-ICI: Market support may prove temporary

Natalia Orlova

(+7 495) 795-3677

NORlova@alfabank.ru

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www.alfa-bank.com

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Investment Summary

- The AB-ICI showed slight recovery last month thanks to the temporary relief on the global markets in July
- Unfavorable capital account trend remained, with little confidence from local and foreign investors
- Weak local GDP growth and lack of downside for interest rates to keep AB-ICI under pressure

AB-ICI recovered 0.4% in July thanks to higher market confidence

Capital outflow continued to disappoint

FDI growth was weak in 2Q13 when cleared from the effect of Cyprus repatriation

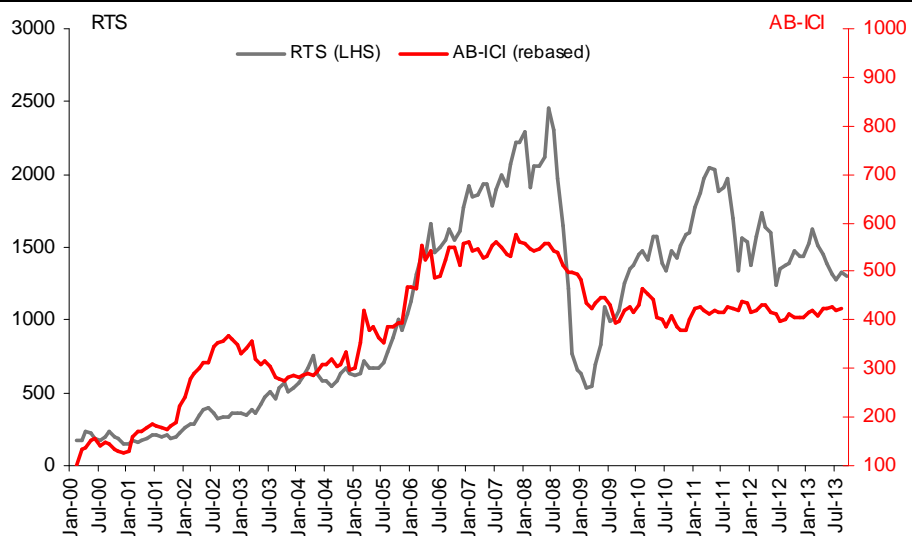
Market took a pause to breath in July, but more nervousness may follow

AB-ICI increased modestly in July

Last month, the AB-ICI managed to increase slightly by 0.4% m/m, partially offsetting the 1.6% m/m in the preceding month. The key reason was the end of the first wave of Fed-tapering-related panic on the global markets, and given the continuing uncertainties regarding the issue, the support from the market confidence may prove temporary. Combined with persisting negative capital account statistics and deteriorating GDP growth expectations, AB-ICI appears vulnerable in the coming months.

- **Economic confidence** continued to drop, reflecting acceleration of capital outflow to \$6-7bn in July after \$10 bn for the entire 2Q13. With 44-45 bn outflow YTD, our recent worsening of the full-year outlook from \$50 bn to \$70 bn appears justified. The falling trust to ruble is highlighted by the further increased in dollarization of retail deposits to 18.3% from 17.9% in June and 17.5% in YE12.
- **Foreign confidence** declined, reflecting weak FDI inflows in Russia in 2Q13. Even though the headline growth was impressive 54% y/y, when cleared from the one-off effect of real estate FDI from Cyprus, the growth is only 22% y/y, in line with average growth seen in the previous 3 years, which is not strong enough to allow the total volume of annual FDI to exceed very modest 1% of GDP.
- **Market confidence** recovered, reflecting the end of first round of panic, which emerged in June as a response to Fed tapering fears. That said, the decision on the tapering is expected to be taken in mid-September, which may bring new round of risk aversion on the market in the coming months, being a threat to AB-ICI

Figure 1: AB-ICI recovered 0.4% last month



Source: New School of Economics, RTS, Alfa Research

Local trends continue to disappoint

Capital outflow this year is likely to exceed 2012 level and reach \$70 bn

As we mentioned previously, capital outflow remains the biggest concern for AB-ICI, and this seems to be materializing in the recent months. The July net capital outflow of \$6-7 bn provided confirmation that the 2H13 is unlikely to see any relief, and this year's outflow is likely to reach \$70 bn or even higher, exceeding the last year's \$54 bn. This suggests that ruble, which already depreciated to RUB33/\$ even despite the massive \$13bn CBR interventions over the last three months, will remain under pressure, and any material appreciation from this level is unlikely, being a drag on all the confidence indicators.

Poor 1H13 GDP growth force us to downgrade full-year forecast from 2.0%

The strong capital outflow is partly a response to the local fundamentals, which are guiding for very poor economic growth rate. With a weak 1.2% y/y GDP growth for 2Q13, which is significantly lower than the Cabinet's initial estimate of 1.9%, Rosstat assessed 1H13 GDP growth at 1.4% versus 4.4% y/y growth in 1H12. While better base effects will still support the 2H13E growth rate, we view our previous annual GDP growth forecast as challenging. Even if we still expect budget expenditure growth to accelerate to 4% for the full year vs. 1% y/y drop in 1H13, the global environment is tighter; thus we anticipate the 2H13E GDP growth to come to 2.0-2.3%. We cut our previous 2.2% y/y GDP growth to 2.0% y/y.

Low unemployment is keeping the income and consumption growth high...

On the bright side, the consumption trends are likely to provide some support. Despite the downgrade, Russia's growth case remains focused on consumption. With an unemployment rate of 5.3% in July being close to the historical minimum of 5.1% seen in the end of 2012, we anticipate a continuing increase in real salaries and income. Thus, we forecast retail trade growth to accelerate from 3.8% y/y in 7M13 to 5.0% in 4Q13E on the back of strong 4.0% y/y real income growth.

.. but is also keeping industrial output growth depressed at only 0.5% y/y this year

The biggest concern however is on the producer side. The tight labor market and upward pressure on salaries will likely keep industrial output growth depressed. Given no growth of this indicator in 7M13, we cut its annual growth forecast to 0.5% y/y. In the coming month, the acceleration in budget expenditures may support investments in spite of poor industrial growth; however, the low competitiveness of local industry is a strong risk for the 2014E growth outlook.

Figure 2: Key macro indicators

	2012A	2013F (old)	2013F (new)
GDP, % y/y	3.4%	2.2%	2.0%
Industrial output, % y/y	2.6%	2.0%	0.5%
Real income growth, % y/y	4.4%	1.5%	4.0%
RUB/\$, e.o.p.	30.4	32.0	33.0

Source: Rosstat, CBR, Alfa Research

CBR is unlikely to provide support through interest rate channels due to fx and inflationary concerns

The weak growth picture and limited potential for budget support for growth is increasing the pressure on the CBR to ease monetary policy, however we believe that such a scenario is not very likely. First, the abovementioned capital account risks and the current pressure on the foreign exchange market are limiting the monetary authorities' room for maneuver. Second, the inflationary pressure is also a factor to consider. According to the recent data, Russia failed to see deflation in August, and the annual rate remains 6.4% y/y, which is above the targeting 5-6% corridor. We believe the unchanged key interest rates will allow to avoid any shocks on the ruble exchange rate market, all else being equal, however, it will also keep the investor's confidence in recovery of Russia's GDP growth low, limiting the upside for AB-ICI in the coming months.

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Head of Equities Alfa Bank
 Michael Pijolis 12, Akad. Sakharova Pr-t
 +7 (495) 795-3712 Moscow, Russia 107078

Research Department		+7 (495) 795-3676	
		research@alfabank.ru	
Macroeconomics			
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677	
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724	
Sergey Egiev	skegiev@alfabank.ru	974-2515 (ext. 6336)	
Financial Services			
Jason Hurwitz	jhurwitz@alfabank.ru	783-5005	
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740	
Oil & Gas			
Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334	
Ekaterina Malkova	emalkova@alfabank.ru	795-3725	
Metals & Mining			
Vladimir Dorogov, CFA	vdorogov@alfabank.ru	788-0320	
Oleg Iuzefovych, CFA	olegiuzefovych@alfabank.kiev.ua	+380 (44) 239-9135	
Utilities, Telecommunications			
Elina Kulieva, Ph.D.	ekulieva@alfabank.ru	789-8509	
Equity Sales & Sales Trading (Moscow)		+7 (495) 223-5500	
International			
Victoria Duben	vduben@alfabank.ru	228-8880	
Michael Kotov	kotov@alfabank.ru	223-5500	
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			
Robert Szucsich	r.szucsich@alfa-cm.com	7382-4174	
Alforma Capital Markets (New York)		+1 (212) 421-7500	
Sales			
Justin Landau	jlandau@alformacap.com	421-8564	
Retail, Real Estate, Pharmaceuticals, Transportation			
Andrei Nikitin	ainikitin@alfabank.ru	795-3742	
Russian-Language Product			
Geldy Soyunov	gsoyunov@alfabank.ru	641-3673	
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)	
Editorial & Production			
David Spencer	dspencer@alfabank.ru	745-7153	
Translation			
Anna Martynova	amartynova@alfabank.ru	795-3676	
Stanislava Ovcharenko	sovcharenko@alfabank.ru	783-5020	
Domestic Institutional			
Ilya Lobanov	ialobanov@alfabank.ru	785-7406	
Dmitry Demchenko	ddemchenko@alfabank.ru	783-5115	
Dmitry Matyukhin	dmatyukhin@alfabank.ru	745-5621	
Sales Trading			
Yan Gloukhovski	y.gloukhovski@alfa-cm.com	7382-4179	