AB-ICI: Capital Outflow is Back on the Agenda

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Investment Summary

- The AB-ICI lost 5.7% last month, reflecting rising capital outflow on strong import growth
- The ruble's recent deviation from the oil price reflects increasing country risk
- Deteriorating ruble fundamentals highlight the risks to market confidence and AB-ICI for 2010-11

AB-ICI decreased by 5.7% reflecting capital outflows

AB-ICI fell 5.7%...

Last month, the AB-ICI dropped 5.7%, wiping out the gains of the previous month. This was mostly due to the weakening of the balance of payments, which reduced market participants' confidence in ruble instruments and put pressure on the ruble exchange rate.

...as imports surged 51% y/y in August…

- **The economic confidence** indicator decreased owing to accelerated imports growth, which skyrocketed to 51% y/y in August, putting substantial pressure on Russia's current account. According to the CBR, the current account surplus now averages less than \$3 bln/month vs. \$11 bln/month in 1Q10. Not surprisingly, this resulted in a capital outflow of \$2 bln in July-August after an inflow of \$4.5 bln in 2Q10;

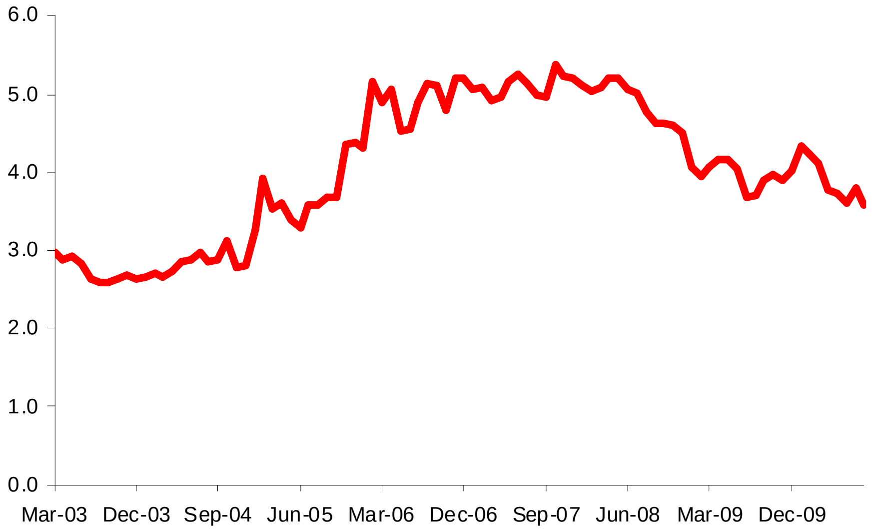
…and accelerating CPI is negative for FDI

- **Foreign confidence** fell as foreign banks decreased their presence on the Russian market. Also, accelerating inflation (to 7.2% y/y in September from 5.5% in July) is bad news for FDI;

Unclear economic perspectives lower market confidence

- **Market confidence** was shaken by the unspectacular performance of Russian GDP, which decelerated to 2.4% y/y in August vs. 5.2% in 2Q10, as strong consumption and a 10.9% y/y surge in investments in August were offset by higher imports. The significantly weaker economic indicators combined with fears of international currency wars are reducing investor preference for ruble assets.

Figure 1: AB-ICI declined 5.7% last month



Source: New School of Economics, Alfa Research

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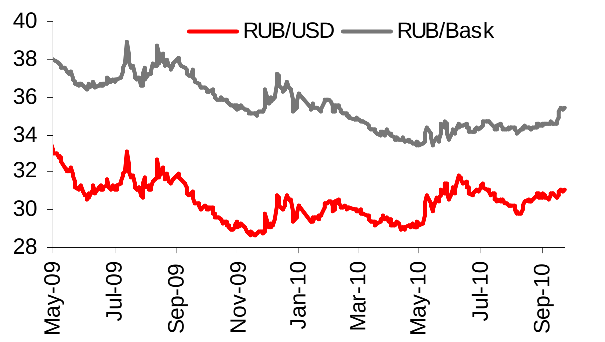
Unstable Ruble Must be Priced In

The ruble declined from 34.7 to 35.8 to the basket on a drop in supply and rising demand

As we noted previously, balance of payment risks are likely to become an important factor for the AB-ICI. The last two weeks offer a confirmation that these risks are materializing quicker than expected.

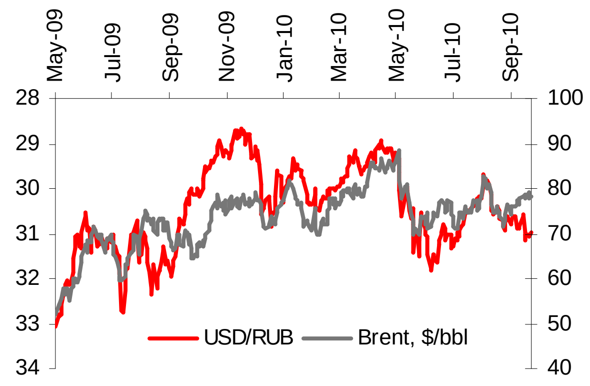
The ruble exchange rate declined recently despite relatively stable oil prices and the stronger euro vs. the dollar. The ruble exchange rate fell 3% to the basket recently on the back of declines in other emerging market currencies after Japan intervened to weaken the yen. The rate is now stabilizing at 35.2, the lowest level since February (see Figure 1). The ruble also edged downward on one-off corporate demand (the LUKoil share buyback) and political factors (beginning with rumors of Yury Luzhkov's resignation). At the same time, the supply of foreign currency is very limited, as export companies have delayed the sale of export revenues and the CBR has said that it will only provide support to the ruble when it reaches RUB36.4/basket.

Figure 2: Ruble vs. basket and dollar



Source: CBR, Alfa Research

Figure 3: $/RUB and oil prices



Source: Bloomberg, Alfa Research

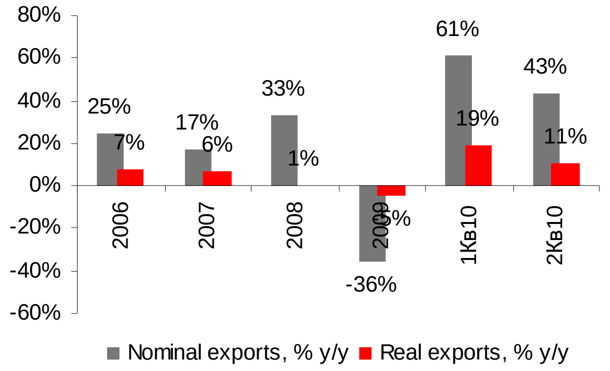
Fundamentals are not supportive of the ruble: export growth is slowing, imports are picking up

The divergence between oil prices and the ruble exchange rate (see Figure 2) may suggest that the market is pricing in country-specific risks, which we believe have increased in recent months.

First, the current account is weak. Export growth decelerated from 19% y/y in 1Q10 to 11% y/y in 2Q10 in real terms, while nominal growth decelerated from 61% to 43% (see Figure 3). Russia's decision to ban grain exports will definitely hurt total export growth in 2H10.

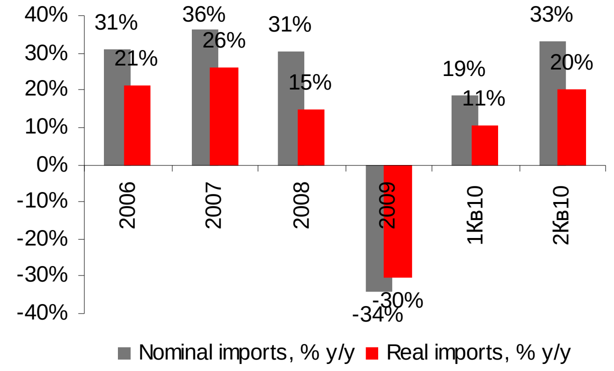
Second, import growth in real terms increased substantially, from 11% y/y in 1Q10 to 20% y/y in 2Q10, or by 19% and 33% in nominal terms, respectively (see Figure 4). Import growth in real terms is once again outperforming export volume growth, as was the case prior to 2009. We are particularly concerned about the recent 62% y/y jump in non-CIS imports in August, equivalent to a hike of 51% y/y in overall imports, stemming from pharmaceutical imports. Rapid import growth has pushed us to upgrade our annual import growth expectation from 20% y/y to 28% y/y in nominal terms.

Figure 4: Export growth, % y/y



Source: Rosstat, Alfa Research

Figure 5: Import growth, % y/y



Source: Rosstat, Alfa Research

Capital account is weak, as FDI is down 11% y/y 1H10

Another indication of mounting country risks is the capital account, which, given a shrinking current account, may bring negative surprises. First, Russia is not successful at attracting long-term capital. Its FDI inflows fell 11% y/y in 1H10, while companies' and banks' foreign debt declined modestly this year. This directly reflects the very weak 1-8M10 investment growth of 2.8% y/y, indicating that demand for long-term money is low.

Preference for dollarization is still a threat

Second, the experience of 2008 indicates that the key trigger of capital account deterioration is internal capital flight, i.e. the dollarization of local savings. At the moment, the excess liquidity accumulated by banks of RUB 2.1 trln is a risk factor that could potentially ruin capital account stability.

Current account of $3 bln in 4Q10 will be negative for the ruble

We believe the pace of the decline in the current account will be a key short-term catalyst for the exchange rate market. We expect the current account surplus will total only $3 bln in 4Q10. We expect that this combined with an expected increase in local interest rates will push the ruble exchange rate down in October-November. In this case, the AB-ICI is likely to come under pressure in 4Q10.

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