AB-ICI: Succumbed to the Market Downturn

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Investment Summary

- Deterioration of global sentiment led to a 0.3% decline in AB-ICI last month
- Ruble remains under pressure despite slowing imports and strong oil prices
- This year's capital outflow may reach $60bn, exceeding initial target and limiting performance of AB-ICI

The AB-ICI fell 0.3% last month

AB-ICI declined due to global market instability

Last month, our AB-ICI retreated by 0.3% m/m after two consecutive months of growth. Global fears of a European interbank crisis and risk of new recession provoked capital outflows from emerging markets, with Russia being no exception.

September capital outflow may surge to $9bn

- **Economic confidence** continued to decline, reflecting negative news regarding capital flows. While August outflow was in line with July's $3bn, the recent indications from the CBR suggest that in September, it could be as high as $9bn due to increased demand for foreign currency by the local corporate sector and non-residents.

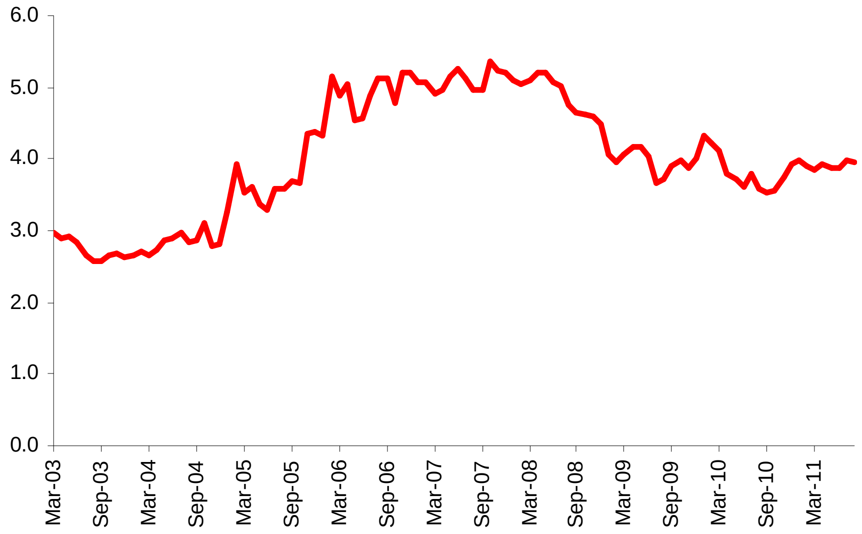
Foreign banks were distracted by problems at home

- **Foreign confidence** remained unchanged, as foreign banks kept their 11.8% share of the total Russian banking market, unchanged compared to the previous data. However, negative sentiment in the European banking sector suggests that the interest of foreign banks and companies in the Russian market may remain limited in the nearest future until their problems at home are resolved.

Global fears negative for Russian market

- **Market confidence** declined last month, as global investors reduced exposure to Russian assets, mainly due to the risks of a liquidity squeeze in the EU. While the selloff stopped recently, global sentiment remains weak, suggesting that market confidence is likely to be AB-ICI's weak spot in the coming months. Also, the markets have yet to price in the recent dismissal of Finance Minister Alexei Kudrin, which may lead to a shift in Russia's budget policy towards higher expenditures, hurting its longer-term investment case.

Figure 1: AB-ICI fell by 0.3%



Source: New School of Economics, Alfa Research

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Capital outflow to reach $60bn this year

The ruble has depreciated 12% to the basket

After being relatively stable since the beginning of this year, the ruble came under strong pressure starting in August. Over the last two months, the ruble has depreciated significantly in response to the fears of global recession. The ruble fell by 15% from 27.5/$ in the beginning of August to 32.5/$ by the beginning of this week, while the basket appreciated accordingly from RUB33.0 to RUB37.5, forcing the CBR to sell $6bn in September, which is its largest intervention since the 2008 crisis. While over the last couple of days we have seen a slight correction, the ruble is still far below its pre-August levels.

We now expect capital outflow to reach $60bn for 2011 vs. our previous $50bn forecast

Given the situation on the foreign exchange market and the volume of CBR interventions, CBR's guidance for a "sizable" increase in capital outflow in September does not come as a surprise. While the regulator did not reveal its exact expectations, we believe the spike in demand for foreign currency could have led to a $9bn outflow this month, much higher than the $3bn in monthly outflow seen in the previous two months. Given that this spike follows the already high $38bn outflow in 8M11, our estimates suggest that our previous $50bn capital outflow forecast for this year appears to be optimistic. We now believe that $60bn in capital outflow is a more realistic scenario for 2011 provided oil prices stay at their current level.

The 15% drop since August after just 6% appreciation since January 2009 suggests overreaction; persisting capital outflows prevent the ruble from being overvalued

That said, there are several arguments suggesting that the ruble has the chance to stabilize or appreciate modestly from current levels. First, while the current 15% drop in the ruble exchange rate starting in August comes in line with the slide in emerging markets and commodity currency peers, we believe the ruble has more fundamental support going forward, as it had not been overvalued. After the 2008 crisis, most of Russia's peers experienced strong capital inflows, and as a result their currencies posted 20-50% appreciation, meeting the recent downturn highly overvalued. Russia, on the other hand, faced a continued capital outflow of 2-4% of GDP in 2009-1H11, which prevented strong appreciation. As a result, despite the significant increase in the oil price, the ruble's appreciation to the dollar from the beginning of 2009 to August 2011 was only 6%. Thus, Russia's currency downside risks are now much more limited than in other countries.

The ruble is pricing in $85-90/bbl oil prices

Another argument in favor of the ruble is that the ruble has decoupled from the oil price trend as a result of the sharp drop. With the ruble currently trades at RUB37 to the basket, the currency is pricing in $85-90/bbl oil price, which is substantially below the current level. This implies that the ruble has a chance to stabilize or even show slight appreciation from current levels in the event that global sentiment stops deteriorating. That said, oil staying above the psychologically important level of $100/bbl is crucial for that scenario to materialize.

The deceleration in import growth to 28-30% in July-August is supportive for the ruble

Finally, we have recently heard from the Federal Customs Service and the CBR that import growth has decelerated from the skyrocketing 40% y/y in 1H11 to a less dramatic 28-30% level in July-August. This deceleration in import growth is very positive given the recent decline in oil prices and may help to offset the negative impact of the ruble's decline on the current account this year.

Deterioration of capital outflow outlook to put additional pressure on AB-ICI this year

Nevertheless, while these arguments set the framework for some improvement in the medium turn, we believe the deterioration of the capital account outlook for this year makes it very unlikely that AB-ICI will be able to show a strong performance in the coming months, especially if global markets continue to show significant volatility.

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