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AB-ICI: Lifted by Global Market Optimism

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September 28, 2012 www.alfa-bank.com Moscow

Investment Summary

- The improved mood on the global market dimmed local caution and propelled AB-ICI up 3% last month.
- The increase in the CBR refinancing rate is unlikely to prevent an acceleration of inflation in the near term.
- Capital outflow, an obstacle to AB-ICI growth, will likely gain importance in coming months.

AB-ICI growth accelerated

AB-ICI growth accelerated to 3% last month from 1% the previous month

Contrary to our concerns, AB-ICI growth not only continued but even accelerated to 3% in August vs. 1% in July. The key source of Russia's increased attractiveness was the global market, which has been expecting supportive measures from central banks in the Eurozone and US. Meanwhile, the risks to AB-ICI, such as accelerating inflation and persisting capital outflow remain in place, which may become more visible after the wave of global market optimism calms.

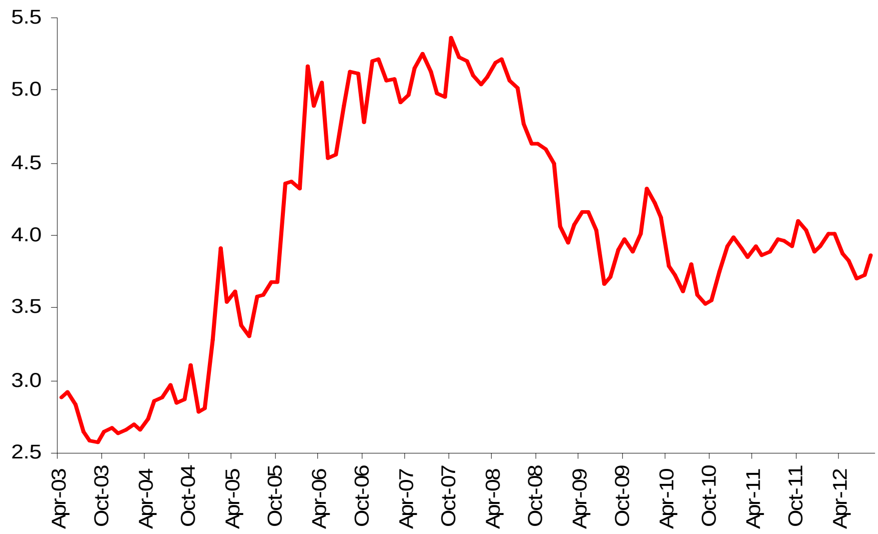
August capital outflow is estimated at $5bn, roughly in line with the July figure

- **Economic confidence** remained under pressure from continuing capital outflow. The Ministry of Economic Development estimated 8M12 capital outflow at $52bn, putting August outflow at $5bn after $4bn in July. At the same time, the CBR recently worsened its full-year capital outflow outlook to $65bn, suggesting further outflow will follow.
- **Foreign confidence** remained unchanged, as no relevant data were released. However, preliminary banking statistics indicate that foreign banks' corporate loan portfolios are flat YTD, suggesting that the presence of foreign players on the Russian market is continuing to decline.

How long will the global rally last

- **Market confidence** increased on the back of the improved mood on the global markets. With the ECB and Fed justifying positive market expectations of monetary easing, the Russian market is benefitting from the weaker dollar. That said, the still negative yields on German bonds suggest that the preference for quality remains, making Russia vulnerable to a likely cooling of global optimism in the near term.

Figure 1: AB-ICI was up 3% last month



Source: New School of Economics, Alfa Research

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Slowing GDP Growth – a Test for AB-ICI

Deceleration of retail trade in August came as a negative surprise

With the prospects of a global rally under question, AB-ICI will soon become more focused on local themes, which unfortunately have provided little support thus far. August macroeconomic statistics came as a negative surprise and hit our positive expectations with regards to the consumption growth trend. Retail trade growth posted only a 4.3% y/y increase, even below the poor 5.4% y/y increase in July. In the coming months the strong base effect reflecting the pre-election spike in consumption in 4Q11 will allow retail trade to show growth of 5.5% in the best case. While a month ago we mentioned that our retail trade forecast for FY2012E of 6.3% y/y can be exceeded, we now assume that this is the best level that can be reached. The only hope is that the recent deceleration was a result of the vacation period, thus September macro statistics are a crucial litmus test for the annual forecast.

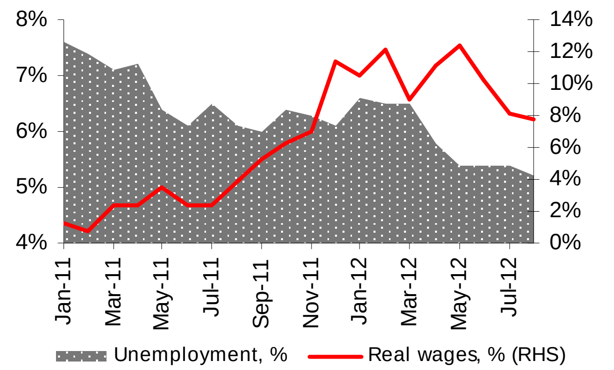
Increase in interest rates and downward revision of wage growth cooled our expectations

Fundamentally, there are two reasons why we are taking a more cautious approach toward Russia's ability to keep a strong consumption growth rate. First, the recent CBR decision to increase interest rates obviously was a hit on loan growth, even if 25bp is a small move. We still expect that due to the psychological reaction, this will limit the retail loan growth in future. Second, Rosstat recently revised downward the real wage growth figure in July from 10.2% to only 8.1%. Even if we consider the income trend and low level of unemployment as being supportive for consumption, they are not as strong as we initially thought.

Consumption converged to modest industrial output growth, not vice versa

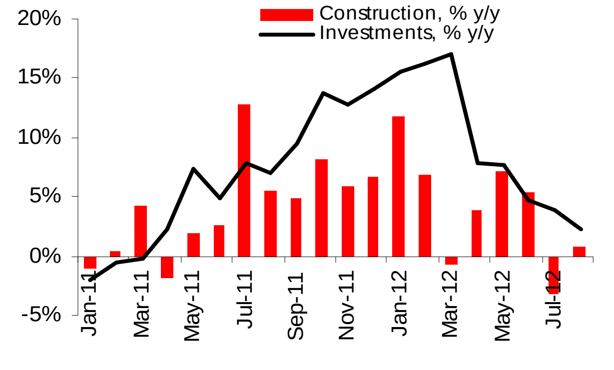
Investment growth of only 2.3% y/y in August came also as a negative surprise. The last two months were particularly negative for construction, which failed to deliver growth and is stagnant. The worrying sign is that these poor investment figures coincide with the low industrial output growth, which pointed to only a 2.1% y/y increase in August. While we previously expected industrial output to receive support from the strong consumption trend, it appears to be the opposite – the retail trade trend is converging to the more pessimistic production dynamic.

Figure 2: Unemployment and wage growth



Source: Rosstat, Alfa Bank

Figure 3: Investment and construction growth



Source: Rosstat, Alfa Research

Higher inflation may play in favor of consumption, but lower savings are definitely an obstacle to the growth of economic confidence

Still, a factor which may support consumption in the coming months is the recent acceleration in inflation. Even the CBR has recently indicated that the 6% inflation target may be missed, which is likely to increase incentives for spending. That said, the obvious consequence of the higher inflationary expectations is further pressure on the savings rate, which was already at 8% of household income in 1H12, the lowest figure since 2000. This will definitely pose a challenge to economic confidence and thus be a risk to the AB-ICI going forward.

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