

AB-ICI: Down on Weak Economic Growth

Natalia Orlova

(+7 495) 795-3677

NOrlova@alfabank.ru

October 29, 2010

www.alfabank.com

Moscow

Investment Summary

- The AB-ICI declined by 1.8% last month on continuing capital outflow and unstable markets
- Weak growth prospects and risk of higher taxation pushing Russian companies to seek investment opportunities abroad
- Ruble decoupling from other commodity currencies highlights the risks facing the AB-ICI

AB-ICI decreased by 1.8% on continuing capital outflows

Last month, the AB-ICI declined by 1.8%, as Russia failed to stop the capital outflow in 3Q10. Deteriorating net exports resulted in a deceleration of GDP growth from 5.2% y/y in 2Q10 to 2.0-2.5% y/y in 3Q10. Weak fundamentals resulted in the ruble decoupling from other commodity currencies, creating negative sentiment on the market and forcing the CBR to take action to stabilize capital flows. The resulting decline in ruble liquidity pushed money rates up for the first time in several months.

- **Economic confidence** decreased on the back of the continuing decline in net exports owing to strong import growth and deceleration in exports. Despite the increase in oil prices, the ruble has decoupled from other commodity currencies, forcing the CBR to intervene with around \$5bn in recent weeks to stop the capital outflow;
- **Foreign confidence** remained flat as no relevant FDI statistics have been released; however, accelerating inflation as well as mounting risks of higher taxation are not supporting FDI inflows;
- **Market confidence** declined despite strong support from global markets on QE2 expectations. Russia's negative growth statistics were a powerful factor affecting market sentiment on bond and equity markets. At the very end of October, banking sector liquidity showed signs of declining, boosting interbank interest rates to higher levels.

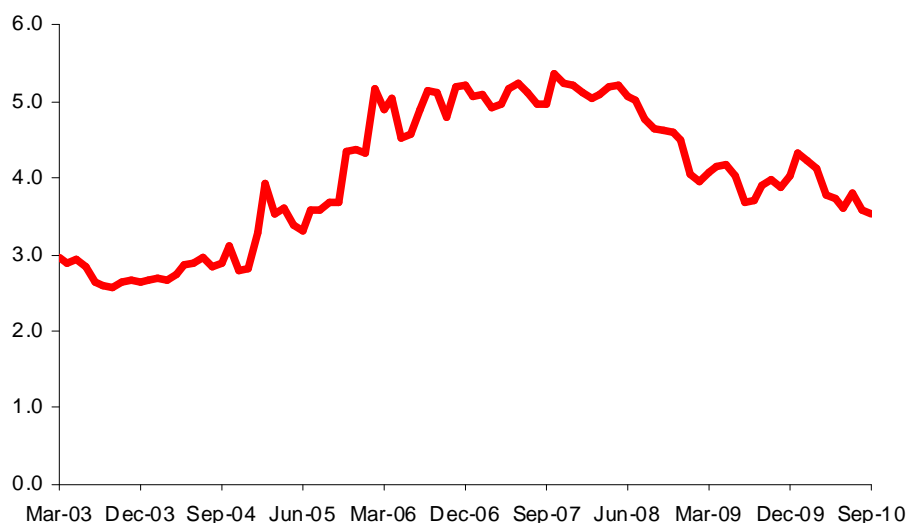
AB-ICI fell 1.8% last month

CBR intervened in order to fight capital outflow

Prospects for FDI uncertain

Russian market underperformed EM peers on unclear economic prospects

Figure 1: AB-ICI declined 1.8% last month



Source: New School of Economics, Alfa Research

RESEARCH DEPARTMENT research@alfabank.ru

The contents of this document have been prepared by Natalia Orlova of OJSC Alfa Bank ("Alfa Bank") as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive (2004/39/EC). Please refer to the further important information in relation to this Document located on the last page.

Poor Net Exports Undermine Growth

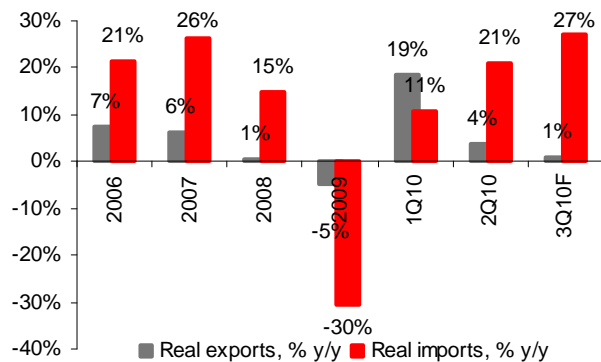
GDP growth slowed to 2.3% y/y in 3Q10 despite strong investments and consumption

Real imports rose 27% y/y in 3Q10; export growth decelerated

The AB-ICI remained under pressure last month, reflecting the continued deceleration of Russian economic growth. Preliminary estimates for 3Q10 GDP growth suggest the rate was as low as 2.3% y/y, well below the 3.2% y/y we expected. This is particularly surprising given that investment growth surged to 9.1-10.9% y/y in August-September after coming in at just 1.3% y/y in 1H10, and retail sales grew 5.9% y/y in 3Q10 versus 5.3% y/y in 2Q10.

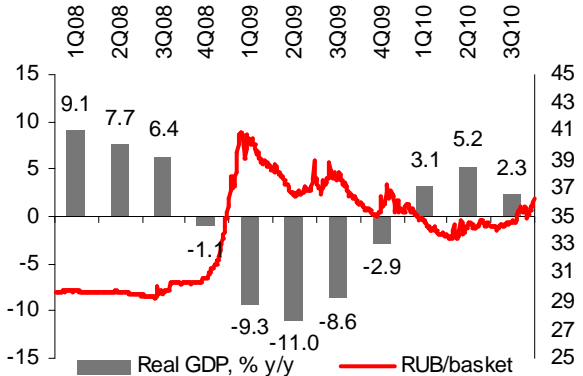
The key reason for this unspectacular result was poor net exports. Real import growth was 27% y/y in 3Q10, up from 11% y/y in 1Q10 and 21% y/y in 2Q10. Lost production in the agricultural sector and related industries boosted substitution-driven demand for imports. At the same time, the slowdown in global growth reduced export growth from 4% y/y in 2Q10 to 1% y/y in 3Q10. This demand shock has been felt by local industries, with industrial output growth falling to 6.5% y/y in 3Q10 versus 10.2% in 1H10.

Figure 2: Exports vs. imports, % y/y



Source: Rosstat, CBR, Alfa Research

Figure 3: GDP growth and ruble exchange rate



Source: Bloomberg, Alfa Research

Budget spending only way to accelerate GDP growth in 4Q10 to the 3.5-4.0% required to reach our 3.6% annual forecast

Weaker ruble unlikely to support strong growth, as it simply offsets faster inflation

Now, GDP growth must accelerate to 3.5-4.0% y/y in 4Q10 in order to achieve our 2010 forecast of 3.6%. Should 4Q10 growth be a mere 2.5% y/y, the full-year figure would drop to around 3.0% y/y. Fiscal stimulus is the only way to give the necessary boost to economic activity. The 9M10 budget deficit was reported at only 2.2% of GDP, well below the government's annual guidance of 5.0% of GDP. If the remaining one-third of the budget for the year is spent in 4Q10, it could support retail sales, as long as the spending is not delayed until December.

The weaker ruble might provide some, though not a lot, of additional support to the economy. Despite the falling dollar and higher commodity prices, the Russian currency has weakened from 34.6 to the basket to above 36. This instability appears to reflect a deterioration in the capital account, a premise supported by the 30% decline in ruble liquidity in the last week of October. Unfortunately, the ruble's nominal weakness is unlikely to improve net exports, as it is only serving to partly offset the 11.6% appreciation of the real effective exchange rate in 9M10 caused by the increase in the CPI from 5.5% y/y in mid-summer to 7.6% in mid-October. The resulting pressure on Russia's balance of payments is likely to affect the AB-ICI in the coming months.

Contact Information

Alfa Bank (Moscow)

Head of Equities
Telephone

12 Akad. Sakharov Prospect, Moscow, Russia 107078
Michael Pijiolis
(+7 495) 795-3712

Research Department

Telephone
Head of Research
Oil & Gas
Macroeconomics
Banking
Telecoms, Technology, Internet, Media
Utilities
Metals & Mining
Consumer Goods, Retail, Real Estate
Agriculture, Industrials, Logistics
Russian Product
Editorial
Translation
Production

(+7 495) 795-3676
Peter Szopo
Pavel Sorokin, Alexander Bespalov
Natalia Orlova, Ph.D., Dmitry Dolgin
Leyla Sharifullina
Elena Mills
Alexander Kornilov, CFA, Elina Kulieva, Ph.D., Fedor Kornachev
Barry Ehrlich, CFA, Maxim Semenovych, Sergei Krivokhizhin, Ph.D.
Elena Mills
Georgiy Ivanin
Angelika Henkel, Ph.D., Vladimir Dorogov, CFA
David Spencer, Heather Dean
Anna Sholomitskaya, Elena Elovskaya
Aleksei Balashov

Equity Sales & Trading

Telephone
Facsimile
International
Domestic Institutional
Alfa-Direct Sales Team

(+7 495) 223-5500, 223-5522
(+7 495) 745-7897
Roland Glasfors, Victoria Duben, Michael Kotov, Dmitry Ryzhkov
Dmitry Soloviev, Dmitry Demchenko, Mikhail Babaev
(+7 495) 795-3680
Sergey Rybakov, Valeriy Kremnev, Evgeniy Batelman

Alfa Capital (Kiev)

Research Department

Telephone
Facsimile
Analysts

77-a Chervonoarmiyska St. (6th floor) Kiev, Ukraine 03150
(+380 44) 490-1600
(+380 44) 490-1601
Denis Shauruk, Oleh Yuzefovych

Equity Sales & Trading

Sales & Trading
Telephone

Sergey Grigorian, Denis Dolmatov, Yulia Grigoryan
(+380 44) 490-1600

Alfa Capital Markets (London)

Telephone
Facsimile
Telephone (Sales & Sales Trading)
Sales

1 Angel Court, 14th Floor, London, EC2R 7HJ
(+44 20) 7588-8500
(+44 20) 7382-4170
(+44 20) 7382-4175
Matthew Arnold (+44 20) 7382 4171
Victoria Filimonova (+44 20) 7382-4172
Robert Szucsich (+44 20) 7382-4174
Douglas Babic (+44 20) 7382-4178

Sales Trading

Alforma Capital Markets (New York)

Telephones
Facsimile
Sales

Sales Trading
Fixed Income Sales

1270 Avenue of the Americas, New York, NY 10020
(+1 212) 421-7500
(+1 212) 421-8633
Isai Pochtar (+1 212) 421-8564
Michael Jordan (+1 212) 421-8560
Yan Gloukhovsky (+1 212) 421-8567
Jeffrey Weichsel (+1 212) 421-8563

Copyright Alfa Bank, 2010. All rights reserved.

IMPORTANT INFORMATION

The contents of this document have been prepared by Natalia Orlova, Chief Economist at Open Joint Stock Company Alfa Bank ("Alfa Bank"), as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive 2004/39/EC ("MiFID"). Alfa Capital Markets ("ACM") is distributing this document to its clients in the EEA and accepts no responsibility towards any other classes of recipient. Alfa Bank and ACM have in place appropriate conflicts of interest policies and procedures aimed at ensuring the objectivity of the information contained in this document. The information contained in this document is provided for information purposes only and is not a marketing communication, investment advice or personal recommendation within the meaning of MiFID. The information must not be used or considered as an offer or solicitation of an offer to sell or to buy or subscribe for any securities or financial instruments. In the UK, this document does not constitute a Financial Promotion within the meaning of section 21 of the Financial Services and Markets Act 2000 (as amended). ACM is regulated by the Financial Services Authority ("FSA") with FSA registration number 416251, for the conduct of UK investment business and is the trading name of the UK branch of Alfa Capital Holdings (Cyprus) Limited ("ACC"), which is authorized by the Cyprus Securities and Exchange Commission under license number CIF 025/04. This document is not for distribution to retail clients as defined by MiFID and may not be communicated to such persons. This document is not for distribution or use by any person or entity in any jurisdiction where such distribution or use would be contrary to local law or regulation or which would subject Alfa Bank, ACC, ACM or any other group entity to authorization, licensing or other registration requirements under applicable laws. The information contained in this document is the exclusive property of Alfa Bank. Unauthorized duplication, replication or dissemination of this document, in whole or in part, without the express written consent of Alfa Bank is strictly prohibited. Although the information in this document has been obtained from, and is based on, sources Alfa Bank believes to be reliable, no representation or warranty, express or implied, is made by Alfa Bank, ACM or the authors. ACM and its officers and employees do not accept any responsibility as to the accurateness or completeness of any information herein or as to whether any material facts have been omitted. All information stated herein is subject to change without notice. ACM makes no warranty or representation that any securities referred to herein are suitable for all recipients and any recipients considering investment decisions should seek appropriate independent advice. Nothing in this document constitutes tax, legal or accounting advice. Alfa Bank, ACC and their associated companies, officers, directors or employees (excluding any financial analysts or other personnel involved in the production of research), from time to time, may deal in, hold or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to the securities, financial instruments and companies mentioned in this email, or may have been, or may be represented on the board of such companies. If such circumstances arise, ACC, Alfa Bank, ACC and their associated companies have in place appropriate conflicts of interest policies and procedures to ensure that investment research remains independent and objective. A summary of ACC's conflicts of interests policy (which also covers ACM), containing details relevant to investment research, is available upon request from ACC or ACM. ACC and ACM have arranged for Alfa Bank and other relevant group entities involved in the production of research to implement equivalent policies. **Alfa Bank is incorporated, focused and based in the Russian Federation and is not affiliated with US-based Alfa Insurance.**