AB-ICI: Risks of Further Capital Outflow Remain

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Investment Summary

- The AB-ICI fell by 0.9% last month, reflecting the sharp $13bn outflow in September.
- Despite the recent improvement of global sentiment, risks of further capital outflow remain.
- September destocking creates concerns over the GDP growth rate in 4Q11.

The AB-ICI declined 0.9% last month

The AB-ICI continued to decline in September on the market drop and capital outflow.

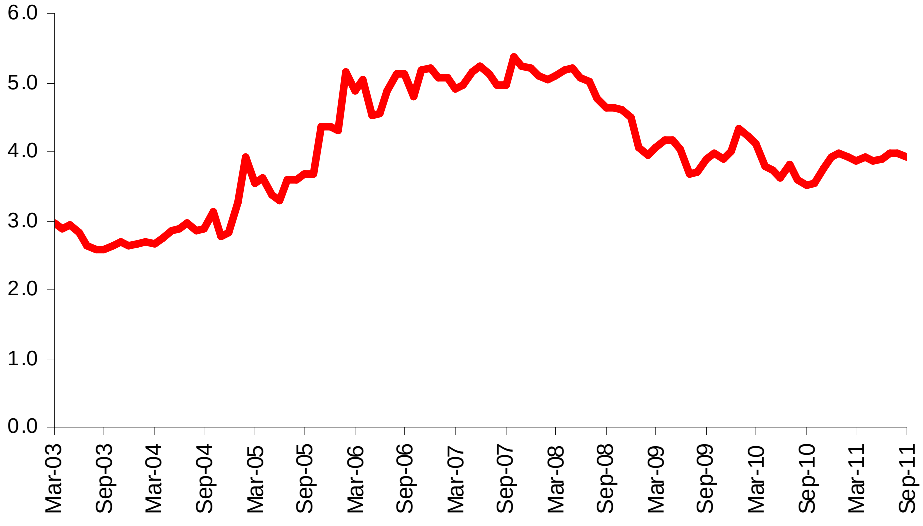
Last month the fall of the AB-ICI index intensified to 0.9% m/m after declining by 0.3% in August, reflecting a further deterioration in both market and economic confidence. While currently we see some improvement in global sentiment, the weakness of Russia's capital account and lackluster economic growth rates are likely to prevent a strong increase of the AB-ICI in coming months.

Having reached $13bn in September, capital outflow continued in October despite improvement of global sentiment.

- **Economic confidence** fell sharply, reflecting the very strong $13bn capital outflow recorded in September. The primary source of the outflow was the corporate sector, which apparently responded to the global turmoil by accumulating foreign currency in order to buy back foreign debt. The poor CBR reserve statistics in October suggest that outflow continued despite the recent improvement of global market sentiment, creating a risk of capital outflow exceeding our recently upgraded $60bn forecast for the full year.
- **Foreign confidence** remained flat as no relevant data was released.
- **Market confidence** declined, as the global sell-off of risk assets has resulted in a significant 20% drop in the Russian equity market and caused nervousness on the bond markets as well. As the recent EU decision on Greek debt restructuring and EFSF expansion helped stabilize the markets, investors will be focused on Russian GDP growth, which is likely to fall from 5.1% y/y in 3Q11 to below 4% in 4Q11 due to destocking, which apparently started in September.

Stabilization of global markets is likely to shift investor focus towards local risks.

Figure 1: AB-ICI declined by 0.9%



Source: New School of Economics, Alfa Research

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4Q11 GDP growth to fall below 4% y/y

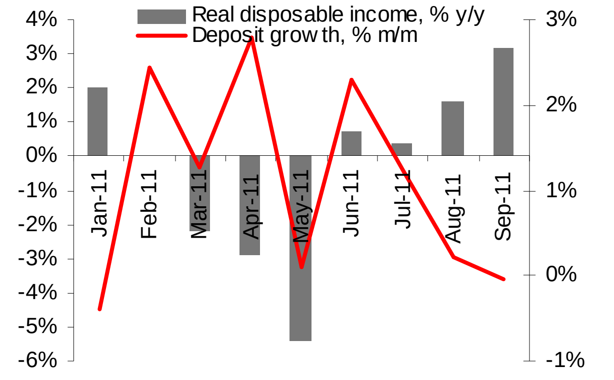
While the government's 5.1% y/y GDP growth is strong, Rosstat's figure may be more conservative.

According to the government's preliminary estimates, in September Russian GDP accelerated to 5.7% y/y from 5.2% y/y in August and 4.2% in July, which translates into 5.1% y/y growth in 3Q11. While these figures found support from both retail trade and investment trends, we are concerned that the sharp reduction of industrial output volume by 0.3% m/m in September accompanied with a significant slowdown of imports growth to 18% y/y suggest destocking, and thus Rosstat's assessment of the 3Q GDP growth rate may turn out more conservative.

August-September consumption was boosted by income growth and a lower savings rate.

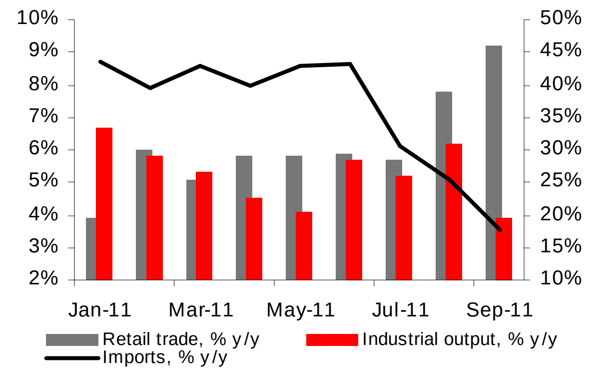
The latest consumption trends were more than favorable, as retail trade posted a very strong acceleration to 9.2% in September from the already high 7.8% y/y in August, bringing the 3Q11 growth to 7.6% y/y after 5.4% y/y in 1H11. This trend was supported by the continued improvement in disposable income, which accelerated to 3.2% in September, and a further decline of unemployment to the pre-crisis level of 6.0%. In addition, ruble exchange rate instability has apparently boosted the preference for consumption at the expense of the savings rate, which translated into a sudden halt in retail deposit growth (see Figure 2).

Figure 2: Retail deposits* and disposable income



*Source: Rosstat, CBR, Alfa Research; * - adjusted for the forex revaluation effect*

Figure 3: Industrial output, imports and trade



Source: CBR, Alfa Research

Investment growth has started to accelerate towards the end of the year.

Good news also came from the investment side, as Russia lifted fixed investment growth to 7.6% y/y in 3Q11 from just 2.7% y/y in 1H11. This trend was supported by the impressive 15.5% y/y growth in construction volumes, which were also weak in 1H11. As a result, 9M11 investment growth was reported at 4.8% y/y, and we expect 4Q11 to be seasonally strong thanks to the traditional end-of-year completion of construction and other corporate capex projects. Our full-year expectations of 6.0% investment growth are now not at risk.

Given destocking, we keep our 3.8% 2011 GDP growth forecast.

Based on 9M11 results, we also upgrade our consumption forecast from 4% to 6% and cut import growth from 35% to 30%. However, destocking will prevent these forecasts from affecting full-year GDP growth. Given the 2.0-2.5pp base effect incorporated into the 3Q11 GDP growth data, we anticipate that in 4Q11 GDP growth will be back to below 4% level. As a result, we maintain our full-year GDP growth target of 3.8% for 2011. Russia's inability to boost economic growth rates, combined with persisting risks of capital outflow, are likely to prevent the AB-ICI from posting a substantial improvement despite the apparent stabilization of global markets.

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