

AB-ICI: Foreign Confidence Hit Again

Natalia Orlova

(+7 495) 795-3677

NOrlova@alfabank.ru

November 6, 2012

www.alfa-bank.com

Moscow

Investment Summary

- AB-ICI dropped 2% in September, reflecting a reduction of foreign presence in the Russian economy.
- Risks of global flight to safety are high in November-December, a risk to market confidence.
- Economic slowdown in 4Q12 and 1H13 is the key challenge to AB-ICI in the medium term.

AB-ICI dropped 2% in September, reflecting further decline in the foreign confidence

Confidence in the ruble may weaken soon

Foreign presence in the Russian economy continues to decline

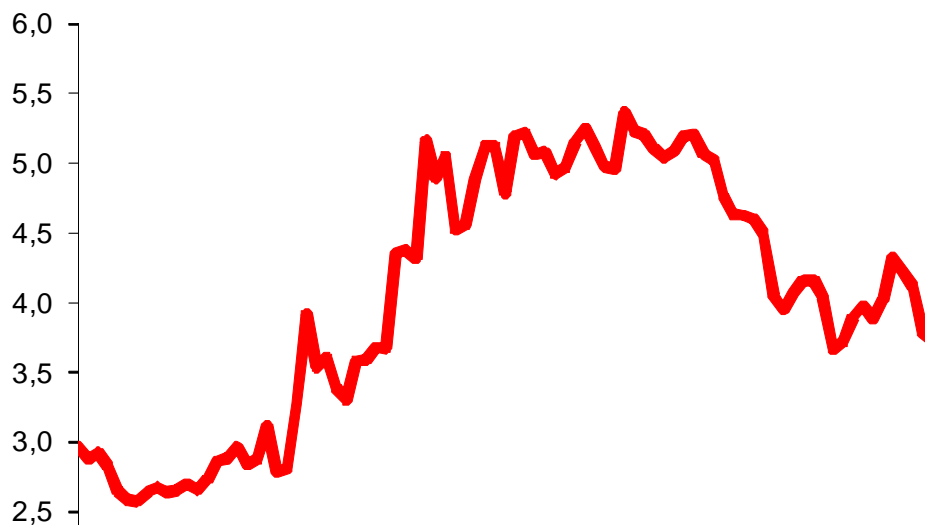
Markets remain nervous, awaiting budget discussion in the US

The AB-ICI declined 2% in September

In September, the AB-ICI showed a significant 2% drop after two consecutive months of growth, mainly due to further reduction of foreign investor presence in the Russian economy. The AB-ICI's further prospects appear fragile due to the high risk of global market turmoil in the end of the year. Moreover, weakening local growth drivers are likely to limit Russia's attractiveness next year.

- **Economic confidence** increased thanks to continued de-dollarization of retail deposits with Russian banks, following the ruble's 3% appreciation to the dollar since mid-year. That said, the strong growth of corporate forex deposits YTD and in September suggests that the population's confidence in ruble is not shared by the corporate sector and thus may turn out to be a fragile trend.
- **Foreign confidence** dropped, reflecting a further decline in foreign banks' share on the Russian market below 10%, which is a 5-year low. Combined with Rosneft's buying-out of BP's strategic investment in the Russian oil industry, foreign confidence is unlikely to support AB-ICI anytime soon.
- **Market confidence** stayed flat as global markets remained reluctant to take a clear choice regarding the directions of portfolio flows. The post-election budget discussion in USA is the key risk for the EMs in November-December. The US is facing a tough choice between tightening budget discipline and facing a rating downgrade. Both options may provoke flight to safety in the coming months, keeping us cautious on Russia's near-term market performance.

Figure 1: AB-ICI dropped 2% in September



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.

Economic slowdown in 2013E to hit AB-ICI

GDP growth to decelerate to 3.5% in 2012E and 2.8% in 2013E

The recent economic trends suggest an uneasy environment for our investor confidence indicator for the coming year. First, the deterioration of the global outlook is translating into worsening producer sentiment, which was reflected in the deceleration of industrial output growth from 4.0% y/y in 1Q12 to 2.5% y/y in 3Q12. Second, the surprising deceleration of retail trade growth to 4.6% y/y in 3Q12 was another blow to expectations. The very positive fundamentals, such as the decline of the unemployment rate to a historical low of 5.2% and rather strong disposable income growth of 4.3% y/y were not enough to support retail trade growth in 3Q12. As a result, we cut our 2012E GDP growth expectations and expect further deceleration of investment and consumer trends in 2013 (see table below). 1H13 will be the most difficult period due to the high base effect of 1H12. While not being a direct input to the AB-ICI, this sets a negative backdrop for Russia's attractiveness.

Budget support for growth to remain limited

The key issue for 2013 is that the state's ability to support growth appears to be limited. The introduction of the budget rule, necessary to keep Russia's macro stability, will effectively keep the budget in surplus next year. According to the Finance Ministry's latest projections, federal budget expenditure growth will decelerate from 18% y/y in 2012 to just 4% y/y in 2013, while consolidated budget expenditures will increase by 9% y/y versus 13% y/y this year. Thus, the budget contribution to GDP growth is unlikely to be strong enough to offset the weakness of the private sector.

Banking sector will be the key growth driver, but this entails risks of higher inflation and strong capital outflow

The lack of budget support will make the banking sector the key source of growth. However, this year's trend implies that corporate and retail deposit growth will underperform the expansion of loan books, resulting in the expansion of the banks' funding gap. This suggests that in order to maintain the banking sector stability the CBR will have to inject up to RUB1.5tr next year to avoid an increase in market interest rates, all else being equal. In this case, the CBR would fund up to 8% of total banking assets by the end of 2013E and the ultimate outcome would be faster inflation and continuing capital outflow, which is another major concern for next year.

Ruble depreciation is a necessary tool to support economic growth, but is a hit to AB-ICI

The combination of weaker growth and a lack of structural changes will support expectations for ruble depreciation, in our view. We anticipate capital outflow to remain firm at \$50bn next year. Faster inflation combined with an increase in the CBR's position in total banking assets to 8% from an already high 6% this year will also put pressure on the currency. While a favorable change to the commodity market environment may temporarily overcome this trend, in the base case we expect the ruble to depreciate to RUB33/\$ by YE12E and RUB34.5/\$ at YE13E, both under an oil price assumption of \$110/bbl. This depreciation is necessary to secure our GDP growth forecast, however, it also represents an obstacle to the growth of the AB-ICI overall and its economic confidence indicator in particular.

Figure 2: Key forecasts

	2011	2012E	2013E
GDP, % y/y	4.3%	3.5%	2.8%
Retail trade, % y/y	7.0%	5.8%	4.5%
Investments, % y/y	8.3%	6.0%	3.5%
Industrial output, % y/y	4.7%	3.0%	2.8%
Current account, \$ bn	99	90	60
Capital outflow, \$ bn	80	70	50
R/\$, eop	32.2	33.0	34.5
CPI, % y/y	6.1	6.8	7.0
Oil price	110	110	110

Source: Rosstat, CBR, Alfa Research

RATING DEFINITIONS

Alfa Bank applies a three-tier rating system for stocks under coverage. These ratings are based on the expected total stock return, which is the sum of the return to the target price and the expected dividend yield.

The ratings are:

Overweight (O/W):	Expected total stock return > 15%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
Underweight (U/W):	Expected total stock return < 0%

Owing to price volatility and our policy of not changing our ratings in response to frequent, short-term misalignments with expected returns, our ratings may sometimes not conform with the ranges indicated above.

In addition to the ratings above, we may occasionally assign the following classifications to stocks covered:

Restricted (R):	A rating, target price or financial forecasts are not disclosed owing to compliance or other regulatory considerations.
Under Review (U/R):	In response to recent or pending news flow requiring a significant overhaul or amendment of a company's financial model, the previous rating and/or target price is temporarily not disclosed.
Coverage in Transition (I/T)	Due to changes in the research team, the disclosure of a stock's rating and/or any other stock-specific information is temporarily suspended. The stock stays in Alfa Bank's coverage universe and usual disclosures will be resumed in due course.
Not Rated (N/R)	The stock is not in Alfa Bank's coverage universe at the time the research product referring to it is published.

IMPORTANT INFORMATION

The contents of this document have been prepared by 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, ACM, 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. This document is distributed in the United States by Alforma Capital Markets, Inc., a subsidiary of Alfa Bank, which accepts responsibility for its contents. Alforma Capital Markets, Inc. did not contribute to the preparation of this report and the authors are neither employed by, nor are associated persons of, Alforma Capital Markets, Inc. The issuing entity and authors may not be subject to all of the disclosures and other US regulatory requirements to which Alforma Capital Markets, Inc. and its employees are subject. Any US person receiving this report who wishes to effect transactions in any securities referred to herein should contact Alforma Capital Markets, Inc., not its affiliates. **Alfa Bank is incorporated, focused and based in the Russian Federation and is not affiliated with US-based Alfa Insurance.**

Head of Equities Alfa Bank
 Michael Pijolis 12, Akad. Sakharova Pr-t
 +7 (495) 795-3712 Moscow, Russia 107078

Research Department		+7 (495) 795-3676	
		research@alfabank.ru	
Head of Research			
Peter Szopo	pszopo@alfabank.ru	792-5848	
Macroeconomics			
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677	
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724	
Financial Services			
Jason Hurwitz	jhurwitz@alfabank.ru	783-5005	
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740	
Oil & Gas		792-5848	
Metals & Mining			
Barry Ehrlich, CFA, CMT	behrlich@alfabank.ru	785-9568	
Andrey Lobazov	alobazov@alfabank.ru	745-5438	
Oleg Iuzefovych, CFA	olegiuzefovych@alfabank.kiev.ua	+380 (44) 239-9135	
Utilities, Telecommunications			
Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334	
Elina Kulieva, Ph.D.	ekulieva@alfabank.ru	789-8509	
Transportation, Construction			
Andrei Nikitin	ainikitin@alfabank.ru	795-3742	
Vladimir Dorogov, CFA	vdorogov@alfabank.ru	788-0320	
Equity Sales & Sales Trading (Moscow)		+7 (495) 223-5500	
International			
Victoria Duben	vduben@alfabank.ru	228-8880	
Michael Kotov	kotov@alfabank.ru	223-5500	
Dmitry Ryzhkov	dryzhkov@alfabank.ru	783-2836	
Alfa-Direct Sales		+7 (495) 795-3680	
Sergey Rybakov	srybakov@alfabank.ru	ext. 6399	
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083	
Alfa Capital Markets (London)		+44 (0) 20 7588-8500	
Sales			
Robert Szucsich	r.szucsich@alfa-cm.com	7382-4174	
Alforma Capital Markets (New York)		+1 (212) 421-7500	
Sales			
Justin Landau	jlandau@alformacap.com	421-8564	
Retail, Real Estate, Pharmaceuticals			
Andrei Nikitin	ainikitin@alfabank.ru	795-3742	
Darya Babashkina	dbabashkina@alfabank.ru	+7-499-681-1706	
Denis Derushkin	doderyushkin@alfabank.ru	795-3655	
Agriculture & Food, Fertilizers			
Maria Bovykina	mbovykina@alfabank.ru	795-3713	
Russian-Language Product			
Angelika Henkel, Ph.D.	agenkel@alfabank.ru	785-9678	
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)	
Editorial & Production			
Stephen Collins	scollins@alfabank.ru	745-7153	
Jeffrey Weiner	jweiner@alfabank.ru	745-3714	
Data Management			
Aleksei Balashov	albalashov@alfabank.ru	795-3676	
Translation			
Anna Martynova	amartynova@alfabank.ru	795-3676	
Stanislava Ovcharenko	sovcharenko@alfabank.ru	783-5020	
Domestic Institutional			
Ilya Lobanov	ialobanov@alfabank.ru	785-7406	
Dmitry Demchenko	ddemchenko@alfabank.ru	783-5115	
Alexander Pugovkin	apugovkin@alfabank.ru	783-5133	
Dmitry Matyukhin	dmatyukhin@alfabank.ru	745-5621	
Sales Trading			
Yan Gloukhovski	y.gloukhovski@alfa-cm.com	7382-4179	