AB-ICI: A temporary recovery

Natalia Orlova (+7 495) 795-3677 NOrlova@alfabank.ru

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Investment Summary

- The AB-ICI increased by 4.3% last month, as October GDP growth exceeded expectations
- Foreign confidence improved on the back of strong growth of FDI inflows in 3Q11
- Expected slowdown of economic growth in 2012 to limit upside of AB-ICI performance going forward

The AB-ICI increased 4.3% in October

AB-ICI recovered in October, as Russian economy did not decelerate despite global turmoil

Despite the poor global market conditions, the AB-ICI managed to post a 4.3% increase last month, mainly reflecting stronger than expected economic growth in October. Additional support came from improvement of FDI inflows in Russia. Nevertheless, negative signals from the capital account and risks of post-election destocking make us cautious regarding future AB-ICI movements.

Economic confidence increased on 5.6% GDP growth in October

- **Economic confidence** increased thanks to the fact that, contrary to negative expectations, Russian GDP managed to post an acceleration from already strong 5.2% y/y growth in September to 5.6% y/y in October, supported by both consumption and production trends. Nevertheless, the persisting capital outflow, which totaled $13bn last month and $64bn for 10M11, limits the upside to this indicator.

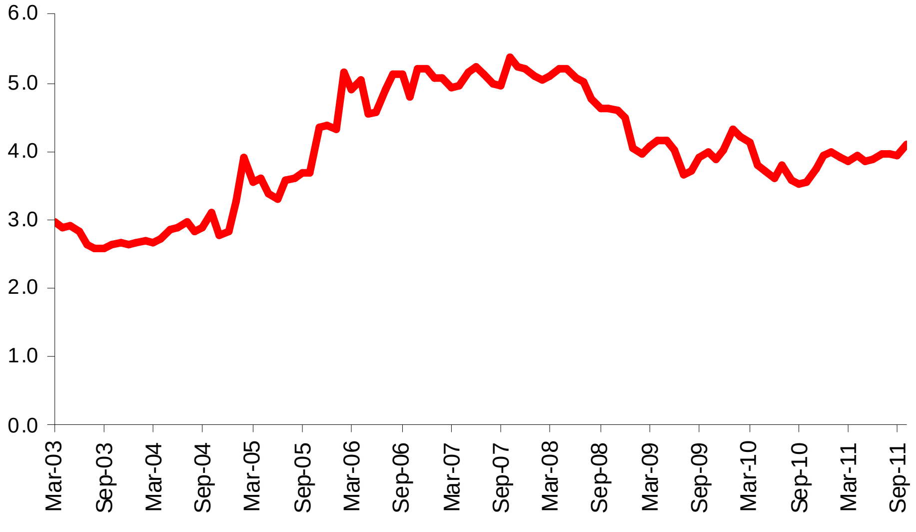
FDI inflows jumped 69% y/y in 3Q11, structure improved

- **Foreign confidence** increased, reflecting 69% y/y growth in FDI inflows in 3Q11. Strong inflows to the manufacturing sector diversified FDI structure away from the commodity extraction sector, lowering its contribution from 54% in 1Q11 to just 32% in 9M11.

Global markets are closed for emerging market companies

- **Market confidence** declined as despite some improvement in global sentiment in October, Russian markets saw outflows, mainly reflecting concerns over Russia's growth in a longer-term perspective. Global financial markets are closed for Russian companies as international banks are unwilling to take on emerging market risks at this time.

Figure 1: AB-ICI increased by 4.3%



Source: New School of Economics, Alfa Research

October trends exceed expectations

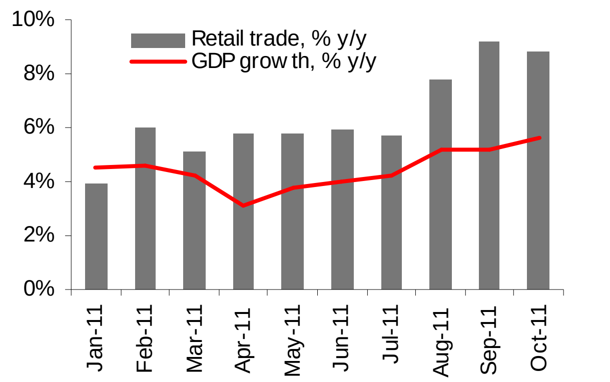
GDP growth rate was strong in September and October…

Recent months have brought a couple of surprises at the macro statistic level, which in our view highlights an accumulation of risks entering 2012. First, despite the fact that sentiment became more cautious starting in August 2011, the recent statistics do not suggest a deterioration of the growth trend. Although the September GDP growth estimate was expectedly downgraded from 5.7% y/y to 5.2% y/y, October GDP growth was reported at 5.6% y/y. Even if revised later, this figure already suggests that our 3% GDP growth target for 4Q11 is too pessimistic.

…backed by retail growth and slower than expected destocking

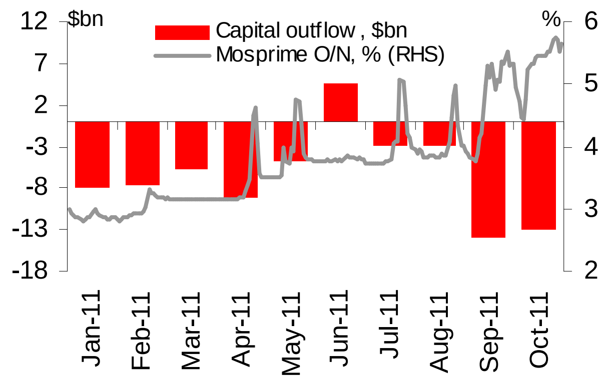
The key explanation for the better than expected growth seems to be stronger than expected consumer activity. First, exchange rate instability fueled a spike in consumption spending and retail trade growth accelerated to 9.2% y/y in September and 8.8% y/y in October, the highest monthly growth rates in 2011. Second, the 0.8% m/m growth in industrial output in October indicates that contrary to our previous assessment, companies still prefer to keep inventories high due to pre-election considerations. That said, the end of the electoral period may cause a change in sentiment, representing a serious risk to 2012 growth.

Figure 2: GDP growth, retail trade



Source: Rosstat, Alfa Research

Figure 3: Capital outflow and interest rates



Source: CBR, Alfa Research

Government continues to accumulate budget surplus

The paradox, however, it that this acceleration in retail activity was not combined with a respective change in the budget policy. Despite upcoming elections, the government continues to accumulate a budget surplus. As a result of the RUB300bn surplus in October, the 10M11 federal surplus reached RUB1.4tr, and in November, the budget spending seems to have remained conservative, as the interbank liquidity situation remains tight. An increase in budget spending will come only in the very end of December and have no impact on macro trends in 2011.

Capital outflow does not improve and may reach $80-90bn in 2011

Another paradox is the jump in consumption is taking place together with the continuing deterioration of the capital account. In October, capital outflow reached $13bn, which suggests no improvement compared to the $14bn outflow in September. Moreover, the CBR continued to intervene on the exchange rate market in November. The annual capital outflow is likely to reach 5% of GDP, or $80-90bn this year, the largest since 1994, excluding 2008.

CBR no longer able to consider rate cut, increase possible from 2Q12

Conflicting macro signals forced the CBR to keep the refinancing rate unchanged last week. We anticipate this wait-and-see approach will persist until the end of 1Q12. However, as inflation is unlikely to decelerate materially below the 6-7% level, we believe that the window of opportunity for a rate cut is over, while a decision to increase rates could be taken starting in April 2012.

Contact Information

Alfa Bank (Moscow)	12 Akad. Sakharov Prospect, Moscow, Russia 107078
Head of Equities	Michael Pijiolis
Telephone	(+7 495) 795-3712
Research Department	
Telephone	(+7 495) 795-3676
Head of Research	Peter Szopo
Oil & Gas	Pavel Sorokin, Maria Yegikyan
Macroeconomics	Natalia Orlova, Ph.D., Dmitry Dolgin
Financial Sector, Real Estate	Jason Hurwitz, Eldar Vagabov
Telecoms & Media, Transport, Industrials	Iouli Matevossov, CFA, CPA, Vladimir Dorogov, CFA
Utilities	Alexander Kornilov, CFA, Elina Kulieva, Ph.D.
Metals & Mining	Barry Ehrlich, CFA, Andrey Lobazov
Consumer Goods, Retail, Pharmaceuticals	Alexandra Melnikova, Irina Prokopyeva, CFA
Agriculture, Fertilizers	Alexandra Melnikova, Maria Bovykina
Russian Product	Angelika Henkel, Ph.D., Alan Kaziev
Editorial	Cole Akeson, Jeffrey Weiner
Translation	Elena Elovskaya, Stanislava Ovcharenko
Production	Aleksei Balashov
Equity Sales & Trading	
Telephone	(+7 495) 223-5500, 223-5522
Facsimile	(+7 495) 745-7897
International	Roland Glasfors, Victoria Duben, Michael Kotov, Dmitry Ryzhkov
Domestic Institutional	Dmitry Soloviev, Dmitry Demchenko, Evgeny Tereschenko
Alfa-Direct Sales Team	(+7 495) 795-3680
	Sergey Rybakov, Valeriy Kremnev, Evgeniy Batelman
Alfa Capital (Kiev)	77-a Chervonoarmiyska St.(6th floor) Kiev, Ukraine 03150
Research Department	
Telephone	(+380 44) 490-1600
Facsimile	(+380 44) 490-1601
Analysts	Martin Masar, Oleh Yuzefovych
Equity Sales & Trading	
Sales & Trading	Sergey Grigorian, Denis Dolmatov
Telephone	(+380 44) 490-1600
Alfa Capital Markets (London)	1 Angel Court, 14th Floor, London, EC2R 7HJ
Telephone (office)	(+44 20) 7588-8500
Facsimile (office)	(+44 20) 7382-4170
Telephone (Sales & Sales Trading)	(+44 20) 7382-4175
Sales	Matthew Arnold (+44 20) 7382-4171
	Victoria Filimonova (+44 20) 7382-4172
	Robert Szucsich (+44 20) 7382-4174
Sales Trading	Douglas Babic (+44 20) 7382-4178
	Yan Gloukhovski (+44 20) 7382-4179
Alforma Capital Markets (New York)	1270 Avenue of the Americas, New York, NY 10020
Telephones	(+1 212) 421-7500
Facsimile	(+1 212) 421-8633
Sales	Isai Pochtar (+1 212) 421-8564