AB-ICI: Year-End Uncertainties Exert Pressure

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Investment Summary

- AB-ICI remained flat, reflecting global and local market nervousness.
- Despite a slight deceleration, capital outflow continues to signal weakness in Russia's investment case.
- Weak local economic fundamentals represent an obstacle to AB-ICI recovery.

The AB-ICI was flat in October

Market weakness offset some improvement of economic and foreign indicators

As we had expected, market confidence remained under pressure last month, reflecting concerns over Russia's growth trend and uncertainties regarding global growth. While economic and foreign indicators showed some improvement, it was only enough to offset the market weakness, leaving the AB-ICI flat last month.

Confidence in the ruble still appears fragile

- **Economic confidence** somewhat improved, reflecting some slowdown of capital outflow to $3bn, according to the most recent CBR estimates (earlier EcoMin's estimate was higher at $5bn), and ruble appreciation continued. That said, ruble strength has been used by the real sector's FX position: in October banks saw $8bn inflow of FX corporate and retail deposits, making it $50bn YTD. Lack of preference for ruble savings suggests capital outflow is likely to continue.

FDI increased q/q, but remained flat y/y

- **Foreign confidence** slightly increased thanks to 25% q/q increase in FDI in 3Q12 to $4.7bn. That said, on y/y terms FDI was flat, and the full-year inflow is unlikely to exceed 1% GDP, providing little support to Russia's capital account and the AB-ICI.

Pre-New Year tension over US "fiscal cliff" issue remains

- **Market confidence** dropped, in line with our expectations, and remains our biggest concern. Deceleration of local economic growth is causing continuous portfolio outflows from the Russian market, while substantial risks to global sentiment remain. Currently the global market is pricing in a very favorable resolution of "fiscal cliff" debate, causing risks of flight to safety in the event of any deviation from this scenario.

Figure 1: AB-ICI remained flat in October

Source: New School of Economics, Alfa Research

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Local growth fundamentals remain weak

GDP growth decelerated to 2.3% y/y in October despite strong investment growth

October economic trends continued to show that Russia's investment attractiveness remains an issue. October macro statistics continued to disappoint, with weaker-than-expected 3.8% y/y retail trade and only 1.8% y/y production growth. Even though investment growth brought a positive surprise, delivering a 4.9% y/y increase, this recovery failed to affect the overall growth figure. According to the Ministry of Economic Development, GDP growth decelerated to 2.3% y/y from 2.7% in September and 2.9% y/y for 3Q12.

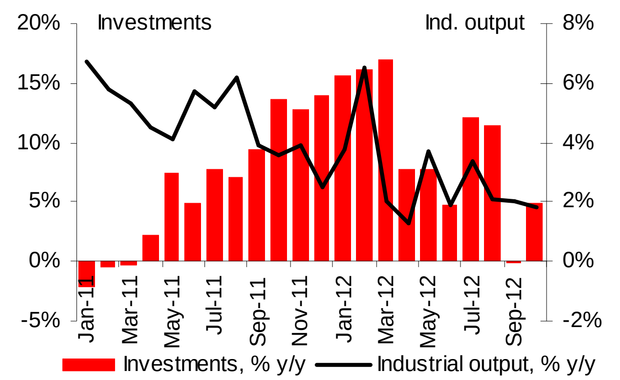
The slowdown in growth is due to the jump in inflation, budget seasonality and the base effect; we expect growth to stabilize soon

We do not take the slowdown in the growth rate as an overly negative sign, as we previously expected it to decelerate to 3% because of increased inflationary pressure, a different seasonality of budget expenditures this year due to the presidential election in March and the base effect in the agricultural sector. In other words, we believe that economic growth will reach its bottom in 2H12E and stay at this level in 2013E in the context of a global slowdown and lack of local reforms.

A concern is that investment growth is not strong enough to compensate for the weakness in consumption growth

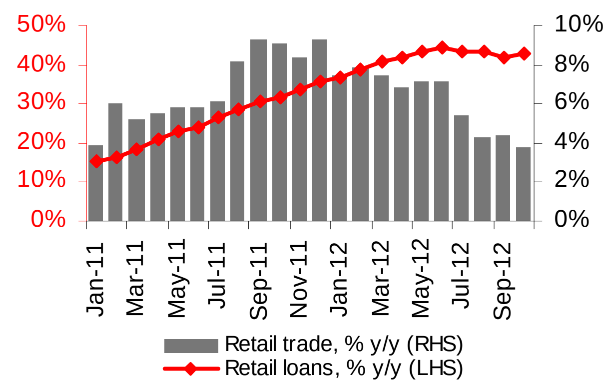
Still, a couple observations add risks to this view. First, in contrast to our previous expectations, investment growth proved unable to provide any boost to economic growth. Although Rosstat revised the 3Q12 investment growth figure from 1.4% y/y to 7.3% y/y, it was still unable to compensate for the weakness in retail trade growth. As a result, 10M12 GDP grew by 3.7% y/y, very close to our 3.5% y/y GDP growth projection.

Figure 2: Investment and production growth



Source: Rosstat, Alfa Research

Figure 3: Retail trade and retail lending



Source: Rosstat, Alfa Research

As weaker consumption growth coincides with the acceleration in retail loans, we expect banks will become more cautious regarding retail loan growth despite the CBR's loose monetary policy

Second, we are concerned by the fact that in May 2012 real salary growth started to decelerate significantly and is now around only 5% y/y vs. 10.7% y/y in 1Q12. It appears that the ability of the public sector to drive income growth under tight budget discipline will be limited and that the population will have to adjust its expectations to the new reality. We are thus surprised to see that Russian households continued to accelerate their borrowing in October, with retail loans rising 43% y/y in the month. Given that around 80% of the total increase in the non-mortgage retail loan book is used to finance interest payments on accumulated debt, we believe that the marginal impact of loan growth on consumption will become weaker and weaker. In this environment banks are likely to continue to increase interest rates despite the CBR's attempt to support loan growth. Given the deceleration of income growth, loan growth will soon become a concern for the majority of the banking sector.

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