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AB-ICI: End-of-the-year Market Rally

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Investment Summary

- The AB-ICI jumped by 5.8% last month thanks to strong financial markets in Russia
- Economic confidence is low, as capital outflow increased markedly
- We anticipate the slow growth environment to persist in 2011, limiting performance of AB-ICI

AB-ICI increased by 5.8% on market rally

AB-ICI growth accelerated markedly to 5.8% m/m

Last month, the AB-ICI posted a strong 5.8% growth, largely reflecting the end-of-the year rally on the global markets. However, while the oil price is near $90/bbl, Russia continues to see strong capital outflows, and the December 2% appreciation of ruble to the basket reflects CBR's interventions on the foreign exchange market.

November capital outflow accelerated to $9bn compared to $8bn in the previous two months

- **Economic confidence** dropped even though the GDP growth accelerated to 4.2% y/y compared to 3.9% y/y in October. The decline was brought by the fact that despite strong oil prices capital outflow from Russia accelerated to $9bn in November compared to $8bn in the previous months, and can total as high as $7bn in the first two weeks of December. The recent appreciation of ruble is thus a result of CBR interventions, while the population's confidence is declining, which is reflected in increased dollarization of retail deposits;

Foreign banks gained share

- **Foreign confidence** increased slightly as foreign banks managed to increase presence on the Russian market in the segments of retail and corporate lending. However, their share in total banking assets still remains low at just above 12%;

Russian market plays catch-up

- **Market confidence** increased substantially, as the global market optimism finally reached the Russian market, which allowed to hold several large IPOs and resulted in the increase in RTS index. On the bond market, the spread between Russia and EM peers however widened, reflecting the former's lagging behind in terms of portfolio investments flows.

Figure 1: AB-ICI increased 5.8% last month

Source: New School of Economics, Alfa Research

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AB-ICI in 2011: Getting used to slow growth

GDP growth accelerated towards the end of 2010

Last month AB-ICI managed to post a substantial hike, it was driven by a very volatile market component, while the economic component, which largely dependent on the capital flows, remained weak. We note that the accelerating outflow is taking place in the environment of slight improvement in the economic growth. According to the Ministry of economic development, in November GDP accelerated to 4.2% y/y vs. 3.9% y/y in October. In November, investments continued to show almost double-digit growth of 8.4% y/y resulting in acceleration from 4.7% y/y in 10M10 to 5.1% y/y in 11M10. Retail trade also managed to pick up from 4.5% y/y in October to 4.6% y/y in November. The support coming from both consumption and investments is a positive sign indicating that the full-year growth may slightly outperform our forecast of 3.6% y/y.

GDP to grow 3.0% in 2011; consumption will be offset by decline in net exports

The next year, however, is unlikely to bring acceleration compared to 2010 due to the slowdown in consumption. The government's plan to limit budget spending growth to 4% y/y in nominal terms suggest that in real terms there will be a decline, implying that the key public sectors will not contribute to growth. The only item of budget spending that could turn out higher than planned is pensions; however, any boost to private consumption is very likely to lead to faster-than-expected import growth and thus be largely neutral for GDP growth. We expect 3% y/y GDP growth in 2011, with only possible positive surprise coming from the investments side.

Figure 2: Real GDP growth by component

	2007	2008	2009	1H10	2010F	2011F
GDP	8.5%	5.2%	-7.9%	4.2%	3.6%	3.0%
Consumption	11.2%	8.6%	-5.1%	2.1%	3.5%	3.0%
Investments	21.0%	10.4%	-15.7%	2.2%	5.0%	6.0%
Net exports	-26.6%	-34.9%	56.6%	8.3%	-8.5%	-17.3%

Source: Rosstat, Alfa Research

Import growth expected at 15% y/y in 2011, current account surplus at $30bn, half the 2010 figure

Owing to slower consumption, we forecast import growth of 15% y/y in 2011 vs. 30% this year. With oil at $75/bbl, this would create a current account deficit starting in 2H11. As a result, the full-year current account surplus would drop to $30bn vs. $60bn this year, including the 1Q11 surplus of $35bn.

Capital inflows expected at $5 bln for full 2011, but outflow expected for 1H11

We reiterate our view that the net capital inflow will likely be around $5bn in 2011. We expect this inflow to be caused by: 1) the government's increasing appetite for domestic borrowing, which will boost interest rates; and 2) the CBR's decision to stop preventing ruble depreciation in line with fundamentals, reducing the financing of capital outflow. However, this inflow is unlikely to materialize before 2H11, and we expect the outflow to continue in 1H11. We continue to see the environment of low economic growth as the key obstacle to strong capital inflows into Russia.

Ruble expected at 33/$ by the end of next year

We stick to our view that the ruble exchange rate will reach 33/$ and 38.2 to the basket by the end of 2011. This is in line with the CBR's indication that it prefers to widen the range in which the currency trades. We also believe the CBR will maintain its presence on the market and will buy up any capital inflow.

Figure 3: Current account with oil at $75/bbl, $ bln

	4Q10F	1Q11F	2Q11F	3Q11F	4Q11F
Current account	3	35	6	-1	-10
Trade balance	22	47	27	17	14
Exports	97	100	95	95	100
Imports	-75	-53	-67	-78	-86

Source: Alfa Research

Ruble depreciation will add to inflationary pressure

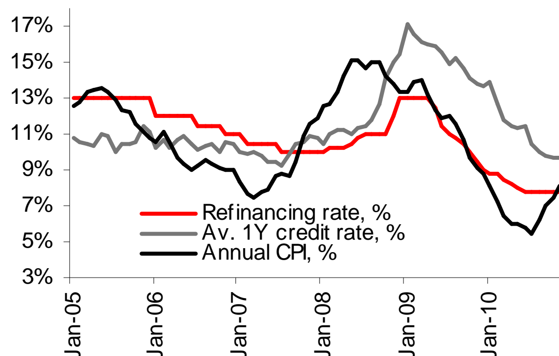
The depreciation of ruble has already added to the acceleration in CPI growth this year, when price growth accelerated from 5.5% y/y in mid-year to 8.6% y/y in the year-end. While originally this hike started as a cost surge due to

global grain price rally, towards the end of the year the ruble devaluation factor came to the forefront. We expect this to continue to affect price growth in the first half of 2011.

Refinancing rate expected at 8.75% by mid-year, 8.25% YE

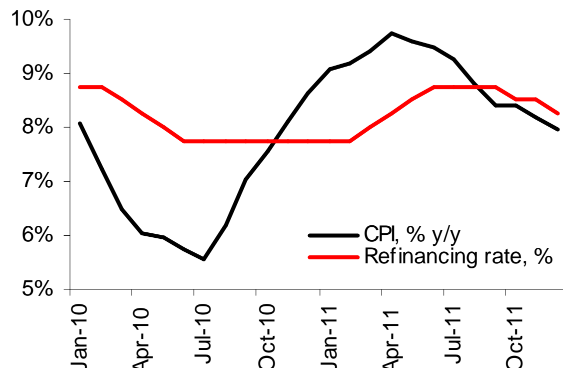
In order to respond to rising inflationary pressure and improve the capital account, the CBR is expected to increase the refinancing rate starting at the beginning of next year, which is already confirmed by the fact that in the end of December CBR raised the deposit rate by 25 bpts. We expect the refinancing rate to rise to 8.75% by mid-2011 and then decline to 8.25% at year-end. We believe this move will happen following the increase in domestic market rates expected in February-March.

Figure 4: Historical key interest rates



Source: CBR, Alfa Research

Figure 5: CPI and refinancing rate forecast



Source: CBR, Rosstat Alfa Research

Our scenario assumes $75/bbl: each $10/bbl increase adds 0.5 ppts of GDP growth

Our scenario assumes an average oil price for the year of $75/bbl, which looks conservative given the recent increase in oil prices to $90/bbl. However, higher prices will not dramatically change the growth outlook: each $10/bbl increase adds 0.5 ppts to GDP growth. The implication for financial flows (i.e. export and fiscal revenues) is more significant. However, as the government sterilizes a significant portion of oil revenues, the net impact on the economy is very modest.

$100/bbl required to keep current account surplus at $60bn

Oil prices would have to rise to $100/bbl to keep Russia's current account surplus in 2011 at $60bn, the level of the 2010 surplus. This is because any additional increase in budget revenues would (1) directly affect household consumption; and (2) reduce the savings rate by boosting inflation. Under this scenario we can expect ruble to stay at 30/$.

Higher oil prices will help keep macro risks low, but will not easily accelerate growth

Higher oil prices will bring the cabinet additional resources, which will support Russia's low-risk macroeconomic profile. However, in order to accelerate economic growth the cabinet needs to form an investment agenda aimed at addressing the low investment-to-GDP ratio and increasing the competitiveness of local producers. If this happens, Russia will not only retain low macro risks, but will also be able to bring positive surprises in terms of economic growth. Otherwise, the current slow growth environment is likely to limit AB-ICI performance in 2011.

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