AB-ICI: Political Risks in Focus

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Investment Summary

- The AB-ICI fell by 1.3% last month, reflecting weakness of Russia's capital account
- Continued growth in local rates created nervousness on the bond market
- Political risks, which arose in December, are likely to weigh on the AB-ICI at least for 1Q12

The AB-ICI fell 1.3% in November

AB-ICI declined last month, reflecting negative signals in terms of capital outflow

Last month, our index posted a 1.3% decline despite a relatively strong 5.4% y/y GDP growth in November, suggesting that upbeat mood in the real sector, is not shared by the investment community. The key concern was the strong capital outflow in November, which put ruble under pressure and drained ruble liquidity, causing pressure on the interbank market. Given that December brought political uncertainties on the map, the upcoming months will be tough for the real sector and the financial markets.

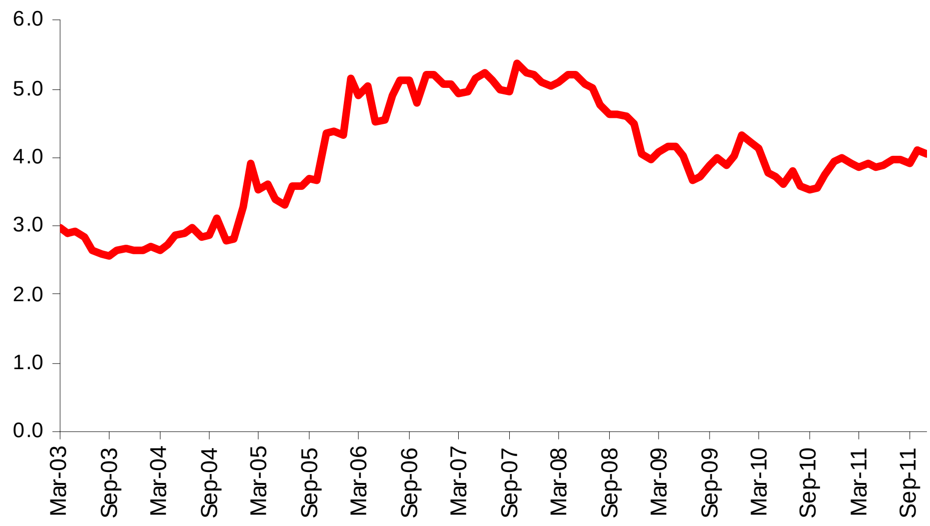
Relatively strong 5.4% y/y GDP growth in November did not result in improvement of the capital account

- **Economic confidence** remained relatively unchanged, as positive GDP growth of 5.4% y/y in November did not prevent capital account from posting $10bn capital outflow. With 11M11 outflow of $74bn, and increased nervousness following the December 4 parliamentary elections, the full-year outflow is now likely to reach $90bn, or 5% GDP, almost entirely offsetting the current account surplus. Negative signals for capital account confirm our expectations of investment and economic slowdown in 2012.
- **Foreign confidence** remained flat, as no relevant data was released.

Russia's bond market under pressure of global recession fears and local political mood swings

- **Market confidence** was down, as the capital outflow and the resulting liquidity crunch provoked a sell-off on the Russian bond markets. Noteworthy, if in November this reflected a global trend, this month the nervousness of the market was Russia-specific, as the series of mass protests occurred in December has reminded the markets of political risks ahead of March 2012 presidential elections, putting foreign exchange and local interbank markets under pressure.

Figure 1: AB-ICI declined by 1.3%



Source: New School of Economics, Alfa Research

1Q12: All Eyes on Politics

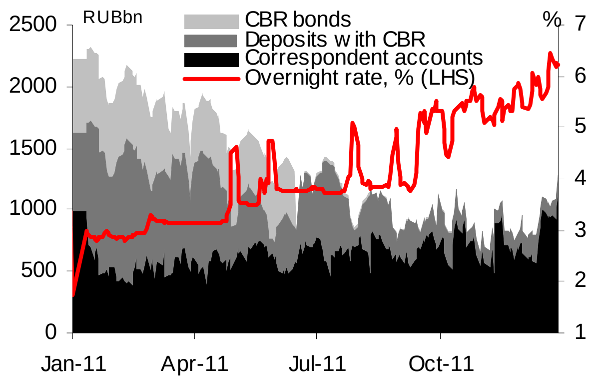
Investment growth posted a surprising slowdown in November

The end of the 2011 has been rich for surprises, which will determine Russian real sector and market performance in the coming months. The first surprise came from the real sector, which showed a slowdown in investment activity. According to the macro statistics, investment growth decelerated from 8.6% y/y in October to 7.7% y/y in November while the year-end factor suggested further acceleration. This surprising setback showed that the recent market instability has reduced corporate sector's capex activity, rather increasing the preference for capital outflow. Even though the still strong consumption supported strong 5.4% y/y GDP growth in November and secured at least 4% GDP increase for the full year, zero income growth and high reliance on retail lending make the high consumption figures as unsustainable, and we continue to expect economic growth to slow down to 2.6% y/y in 2012.

New political risks have appeared on the agenda in December and will persist at least until the presidential elections in March

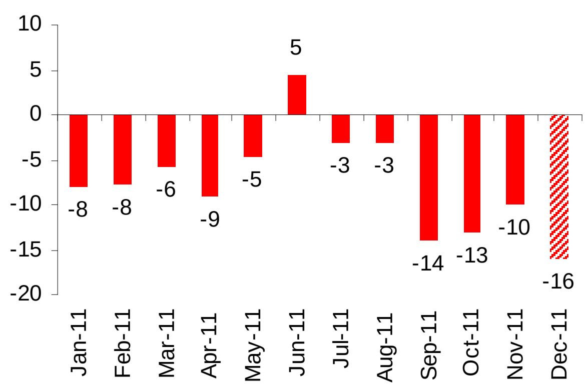
However, the key event for the markets were the results of the December 4 State Duma elections. First, the elections revealed the surprisingly weak 49% result for United Russia, the pro-governmental party, vs. 64% in the 2007 elections, indicating a declining support for the Cabinet economic policy. Second, the numerous allegations that even this weak result was achieved with the aide of massive vote rigging have provoked series of mass protests in Russia, including 60ths and 100ths people events in Moscow, the largest since early 90s. As the authorities did not indicate willingness to satisfy the demands of the protesters, which included revision of election results and ousting the head of the election committee, the risk of further growth in protest mood increases the likelihood of second round of presidential elections, causing nervousness on the markets, reflected in 3% ruble drop to dollar.

Figure 2: Liquidity and overnight rate



Source: CBR, Alfa Research

Figure 3: Monthly capital account



Source: CBR, Alfa Research

End of the year did not bring relief to the local interbank market

Another surprise was the mounting pressure on the interbank market, reflected in steady growth in overnight interest rate to above 6% as of now vs. 5% in November and considerable demand for CBR repo instruments. While we partially attribute this phenomenon to increased politics-related capital outflow, which may reach $90bn, or 5% GDP this year, the tight interbank liquidity suggest no material acceleration in the budget inflows despite the expectations of traditional end-of-year spending splurge. As the lack of liquidity support from the budget is combined with tightening in CBR approach to repo provision, the interest rates are unlikely to show any softening in the coming months.

2012 will be a tough year for AB-ICI

The abovementioned considerations suggest that the next year will bring significant challenges to the AB-ICI. The immediate risks include mounting capital outflow on the back of increasing political instability and further pressure on the interbank market. Also the evident tightening in the budget policy is a negative signal for GDP growth expectations.

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