AB-ICI: Wait and See Approach Prevails

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Investment Summary

- AB-ICI remained flat for the second month in a row, reflecting a lack of new global and local drivers.
- Weak economic fundamentals are preventing the Russian market from benefitting from the upbeat global mood.
- The Russian economy found its bottom in 4Q12, and the growth rate will remain weak in 2013E.

The AB-ICI remained flat in November

AB-ICI is under pressure from global uncertainties and a lack of local growth drivers

November did not bring any material change from October, as AB-ICI remained flat because some technical improvement in economic confidence was offset by market weakness. A lack of clarity regarding the fiscal cliff and decelerating local economic growth has forced markets to maintain a wait and see approach.

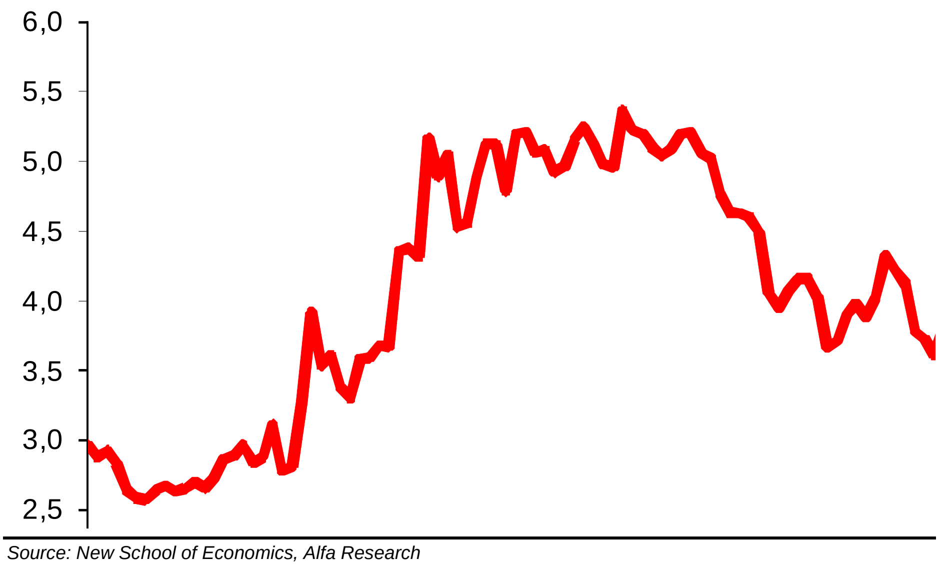
Contradictory capital outflow data have created doubts regarding actual improvement of the capital account by year-end

- **Economic confidence** increased, reflecting some backdated improvement in the CBR's capital outflow statistics. According to the CBR, 11M12 capital outflow was $59bn, lower than the $61bn reported for 10M12. However, the Cabinet's estimates for 11M12 are much higher at $68bn, suggesting a lack of clarity regarding the capital outflow picture.
- **Foreign confidence** remained flat, as no new data were released. However, the exit of a foreign investor from Absolut Bank in December indicates that the foreign presence in the Russian economy continues to shrink.

Portfolio investors maintain a cautious attitude toward Russia

- **Market confidence** continued to decline, reflecting the underperformance of the Russian market vs. peers. While global appetites for risk improved due to positive expectations regarding the resolution of the fiscal cliff, Russian equity and forex markets did not see inflows. The cautious attitude toward Russia is explained by decelerating economic growth rates and risks to the ruble, which is approaching levels that make the accumulation of a foreign currency position attractive.

Figure 1: AB-ICI remained flat in November



Source: New School of Economics, Alfa Research

2013: Another challenging year for AB-ICI

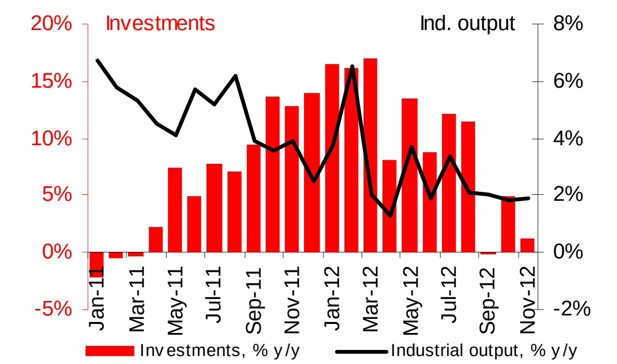
The tight budget and a lack of external stimuli are dragging down Russian GDP growth

The sluggish performance of the AB-ICI this year reflects the very cautious attitude of markets toward Russia's growth story, and the deceleration of GDP growth toward year-end justifies these concerns. In November GDP growth slowed to a post-crisis low of 1.9% y/y, resulting in 3.5% y/y growth for 11M12, down from 4.3% y/y in 2011 and 4.0% y/y in 1H12. This deceleration reflects the downbeat mood in the real sector. Industrial output growth was reported at 1.9% y/y in November and 2.7% y/y in 11M12, down from 4.7% y/y in 2011. The lack of producer confidence stems from global growth concerns and the tightening of Russian fiscal policy – after 37% y/y growth in pre-election 1Q12, federal expenditure growth decelerated to 21% y/y in 11M12. The planned tightening of fiscal spending growth to 2-4% y/y next year supports expectations of a further slowdown of GDP growth in 2013.

Loose monetary policy is preventing interest rates from increasing to levels supportive of the ruble

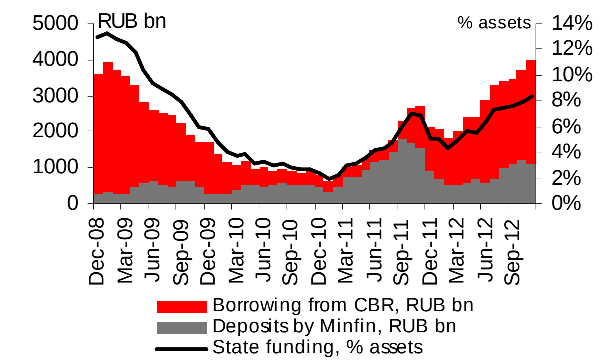
The CBR is attempting to support economic growth. In order to offset the weak funding base growth resulting from tight budget policy, the regulator has already increased its support to banks by RUB1.6tr. Combined with Finance Ministry deposits, the state funds almost RUB4tr, higher than the crisis peak of January 2009. This level of support, amounting to over 8% of banking assets, is softening the growth of interest rates in the economy. This approach, however, is de-stimulating investments in ruble instruments: Russian companies and households placed $51bn in forex deposits with Russian banks YTD vs. only $9bn in 2011, thus contributing to ongoing capital outflow. Loose monetary policy is expected to continue into 2013, limiting the performance of the ruble on global markets.

Figure 2: Investment and production growth



Source: Rosstat, Alfa Research

Figure 3: State funding of banking sector



Source: CBR, Alfa Research

The high dependency of consumption growth on retail lending is a risk factor

Given producers' cautious mood, the key growth driver is continuing consumer spending. Retail trade increased 6.0% y/y in 11M12, only slightly below the 7.0% y/y increase in 2011, and this growth was supported by 8.8% y/y real wage growth and a low 5.4% unemployment rate. That said, almost 50% of consumption growth this year was funded by retail lending growth (vs. 30% in 2011), which accelerated from an already high 36% y/y in 2011 to 41-43% y/y in 2H12. The CBR's expected regulatory tightening of retail lending in 2013 implies less support for consumer trends next year, all else being equal.

2013 will be challenging for AB-ICI

As a result of the weak economic fundamentals, the prospects for capital flows and thus AB-ICI in 2013 appear challenging. The current ruble appreciation is opening attractive opportunities for accumulating foreign currency positions. Even if the ruble exchange rate stays at the current level in the short term, weak GDP growth and continuing inflation on the back of no structural shifts in the economy likely mean the ruble will depreciate in the longer term.

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