

AB-ICI: A Modest Recovery

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Investment Summary

- The AB-ICI increased by a modest 0.6% last month on the improved capital account.
- The squeeze out of foreign banks from the Russian market highlights deterioration of the business environment.
- Investment growth is crucial for 2H11 AB-ICI performance.

AB-ICI increased only slightly

The capital account turned positive in June

Foreign banks reduced their presence on the Russian banking market

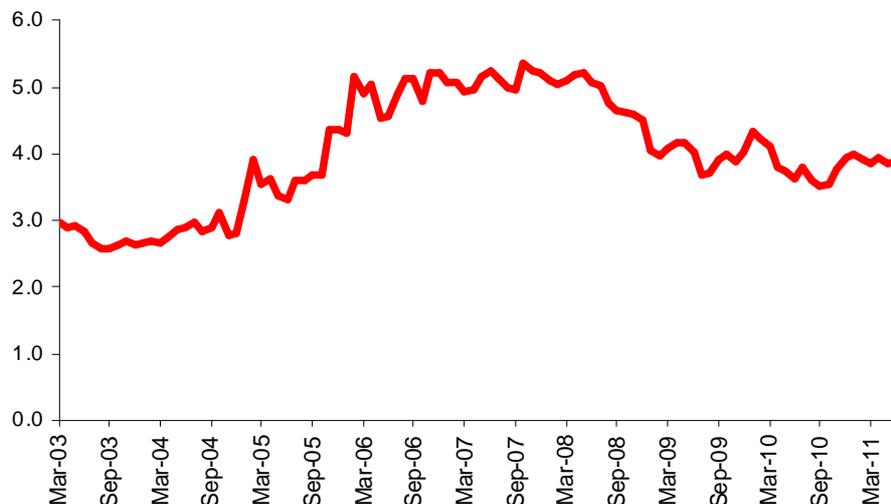
The Russian stock market is pressured by risks of global instability

The AB-ICI gained 0.6% last month.

After a 1.4% decline in May, the AB-ICI managed to post only a 0.6% recovery last month. While economic sentiment improved on a reversal in the capital account in June, negative foreign confidence statistics and a nearly flat performance from the Russian market prevented more solid results. Given the risk of a new round of global instability, Russia's ability to show investment growth will be key for AB-IC performance in 2H11.

- **Economic confidence** improved thanks to the \$2.9bn capital inflow Russia managed to post in June after nine consecutive months of outflow totaling \$55bn. The strong ruble also allowed the population to continue de-dollarization of their savings, as the share of foreign currency-denominated deposits fell to 18%, heading towards the pre-crisis level of 13%.
- **Foreign confidence** fell, as foreign banks reduced their share to 11.8% of total assets vs. the 12.0% seen in 1Q11. The news on VTB purchasing Home Credit Finance Bank highlights the squeeze out of foreign players from the Russian banking market.
- **Market confidence** increased only slightly last month, as the effect of high oil prices has been almost entirely offset by the mounting risks of US and EU debt crises, which are forcing global investors to remain cautious towards risky markets, including Russian assets. As Russia is facing difficulties finding internal sources of growth, the key risk for the market is potential oil price volatility.

Figure 1: AB-ICI increased by 0.6%



Source: New School of Economics, Alfa Research

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Investment growth crucial for 2H11

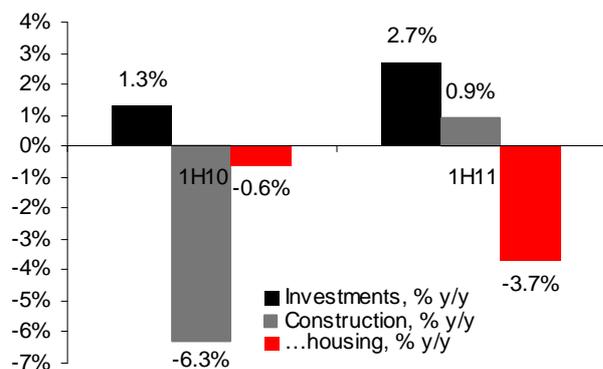
GDP growth at 3.9% in 1H11

Investment growth at only 2.7% y/y in 1H11; housing construction dropped 3.7% y/y after declining 0.6% y/y in 1H10

The sluggish performance of the AB-ICI – down 1.1% YTD – reflects Russia's continuous inability to meet expectations of investment growth. As a result of rather poor investment and construction trends, our initially positive expectations of a 5% y/y GDP growth rate in 2Q11 failed to come to pass. With only 3.7% y/y growth reported in 2Q11, 1H11 GDP grew by 3.9%, still close to our 3.8% y/y full-year expectations. This confirms our view that GDP growth in Russia is unlikely to exceed 3.8% y/y for FY11.

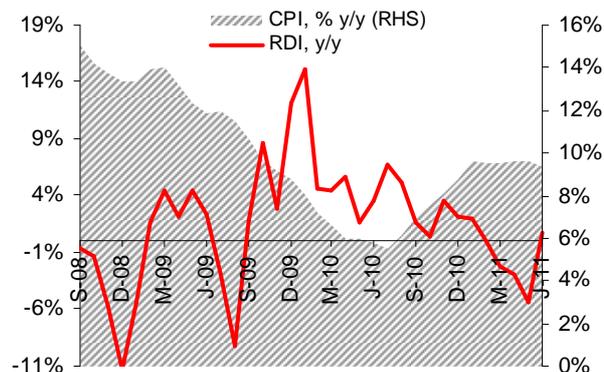
The weak investment trends are the key reason our 2Q11 GDP growth target was missed. The 4.7% y/y growth in June was below expectations, putting overall investment growth at only 2.7% y/y. As opposed to our initial view, the construction trend is still disappointing, as housing construction dropped 3.7% y/y in 1H11, which is particularly negative given the 0.6% y/y decline observed in 1H10. This causes huge concerns as housing construction does not appear to have caught up since the crisis, which explains the modest construction growth of only 0.9% y/y in 1H11. The weak trend contradicts the recently improved capital account and makes the \$2.9bn capital inflow in June fragile going forward.

Figure 2: Investments and construction



Source: Rosstat, Alfa Research

Figure 3: Annual inflation and income growth



Source: Rosstat, Alfa Research

Retail trade grew strongly at 5.3% y/y, while disposable income growth rose

At the same time, the consumption trends were generally in line with our expectations. Retail trade growth stood at 5.6% y/y in 2Q11, or 5.3% y/y for 1H11, confirming that the weak disposable income trend is more likely to be a statistical issue. As we predicted, Rosstat has substantially revised upward its real disposable income trend, initially expected at -3.7% y/y in 5M11 but now reported at -1.4% y/y for 1H11. The revision incorporates estimates for additional revenues based on the amount Russians are spending on credit cards. Given our view that the share of grey salaries has increased and that this also has to be taken into account, we thus believe that disposable income growth should in actuality be slightly positive this year.

Expecting 4.5% y/y GDP growth in 3Q11, with slower inflation to support consumption

Due to the base effect of weak 3Q10 GDP growth, we anticipate 4.5% y/y GDP growth will be reported in 3Q11. We expect consumption to stay well supported by the inflation trend, as the inflation rate has recently decelerated to 9.4% y/y on annual terms from 9.6-9.7% in the beginning of the year. Considering this, we are revising our annual 8.0% forecast to 7.0%. Budget spending should also help, as the current federal budget surplus of 2.7% of GDP is expected to decline to a 1.4% of GDP deficit by year-end, implying accelerated spending growth. Investments, and construction in particular, are the key uncertainty going forward. Should the 2H11 bring the long-awaited acceleration in investment growth, it could justify our 3.8% full-year GDP growth forecast for this year, providing support for AB-ICI.

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