Alfa-Bank Macro Insights

AB-ICI: Recovery Postponed, Not Cancelled

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February 1, 2015 **www.alfa-bank.com** **Moscow**

Investment Summary

- AB-ICI down 7% in December on deterioration of the market mood
- Net capital outflow moderated to $57bn and its quality improved in 2015
- Confidence might recover in 2H16, but long-term prospects are under pressure from isolationist BoP

AB-ICI dropped 7% in December

AB-ICI lost 7% in December due to the very weak market performance

AB-ICI dropped by a noticeable 7% in December, following the sharp deterioration in market sentiment, driven the decline in oil prices at YE15. The near-term guidance for AB-ICI remains negative, as January 2016 saw new lows in oil prices and Russian market indices. However, the improvement in the capital account, which became evident in 2015, is likely to support a recovery in AB-ICI once the global financial and commodity markets stabilize.

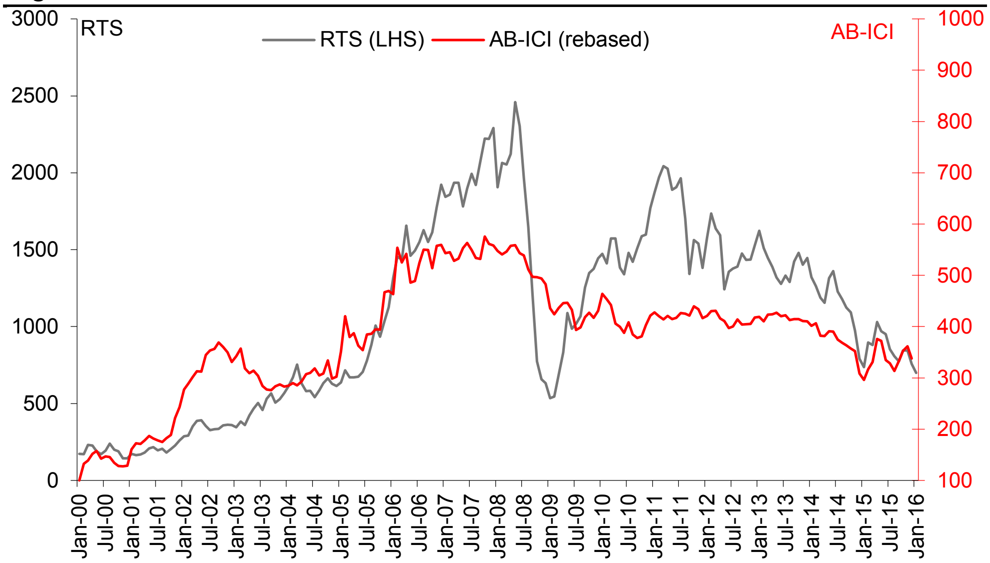
Net capital outflow was only $57bn in 2015 (vs. $153bn in 2014), and 80% of it was foreign debt redemption

- **Economic confidence** increased thanks to a better than expected slowdown in the net capital outflow to $57bn and the improvement of its structure. Unlike 2014, when only $31bn out of the total $153bn net outflow was related to the foreign debt redemption, in 2015, it accounted for $47bn – or 80% of the total – signifying a decline in the speculative outflows following the introduction of the ruble free float.
- **Foreign confidence** dropped, reflecting the continued decline in FDI inflows: according to the CBR data, they shrank 62% y/y in 3Q15 and 15% y/y in 9M15, confirming the weakness in the foreign investment trend.

Market confidence dropped in December and remains under pressure of uncertainties of the commodities prices in the beginning of 2016

- **Market confidence** suffered a sharp decline in December 2015, as the 17% drop in the oil prices to $38/bbl triggered a broad-spectrum adjustment on the Russian equity and bond markets. Moreover, the further drop to $27/bbl in mid-January and the continued pressure on the Russian financial market offer poor guidance for the near-term AB-ICI performance until the global markets plateau.

Figure 1: AB-ICI down 7% in December



Source: New Economic School, RTS, Alfa Bank

AB-ICI: Recovery Postponed, Not Cancelled

Recovery in the oil prices to $35/bbl is based on speculation and might prove temporary

The recent performance of the AB-ICI, which is now tightly linked to market dynamics, confirm that risks we identified on the eve of 2016 are materializing, especially on the commodities market front. Oil prices have so far rebounded from multi-year lows to $35/bbl, but the move is based on speculation that oil producing countries are willing to discuss a coordinated cut in supply. The facts, on the contrary, indicate an increase in supply so far, and the signals are that the demand side remains under pressure from slowdown in China. As a result, unless the cut in oil production materializes, a drop in oil prices to new lows around $15-20/bbl cannot be excluded, which raises the question of Russia's vulnerability.

With the government focused on limiting budget risks, the economic trend is under pressure, with investments, already down 8.4% y/y in 2015, at risk in 2016 as well

The negative news is that unlike the 2008, Russia has no budget cushion to soften the blow coming from the low oil price environment. The collapse in the oil prices to $53/bbl average in 2015 pushed the deficit to 2.6% GDP and will expand to 4% GDP under $30/bbl. While the response to the 2008-09 low oil price environment was 6% GDP stimulus, the current budget discussion is focused on limiting budget risks, with a sequester of 3% of the spending plan for 2016, higher oil tax and even payroll tax (which is an indirect tax on households) are on the agenda. This discussion is limiting confidence in the real sector, which is already under pressure, as suggested by the surprisingly sharp 8.4% drop in investment in 2015.

Light foreign debt redemption of $30bn in 2016 and minimal speculative outflow limit the downside risks for ruble

The positive news, however, is that Russia's external balance is now well positioned to weather the low oil price environment. First, the current account surplus expanded in 2015 to $66bn thanks to a strong drop in imports, by 37% y/y in merchandise and 28% y/y in services, mainly foreign travel. Second, as aforementioned, the net capital outflow shrank to $57bn, on below-expected foreign debt redemption, which was only 40% of the planned amount, and the 2016 guidance suggest that the actual net foreign debt redemption will be only $30bn. At the same time, the CBR's commitment to a free floating ruble combined with the recent hawkish comments on the monetary policy are likely to put the non-debt related capital outflow under control. As a result, even in a $30/bbl average oil price environment, Russia is not facing a strong risk of ruble depreciation beyond the RUB80/$ level, which limits downside risks for sentiment.

Confidence might recover in 2H16, but long-term prospects are under pressure of isolationist BoP

As a result, we still believe that the recovery in the AB-ICI is still possible in 2016, once the global commodities markets stabilize and the local mood improves in the Parliamentary-election-driven 2H16, when, as we still believe, some financing inflows from the budget are still possible. That said, the longer-term trend is still under question. We note that while the most part of the BoP improvement is happening thanks to the ruble free float regime, it is also partially a result of administrative involvement, including sanctions limiting merchandise imports and foreign travel, and also some administrative measures to curb channels of the capital flows. Such an approach helps to maintain the stability of the balance of payments; however, it highlights the preference for limiting Russia's integration into international trade and capital flows, which is not supportive of an improvement of Russia's potential growth rate and investor confidence.

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