AB-ICI: Adjustment Nears Completion

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Investment Summary

- AB-ICI decline slowed to 0.7% in March after 1% in January and nearly 7% in December 2015
- Macro data was mixed in 1Q16 with diverging dynamics among key real economy indicators
- Budget expenditure seasonality is likely to support Russian fundamentals in coming months

AB-ICI declined 0.7% in March

AB-ICI decline slowed to 0.7%, mostly due to economic confidence dynamics

AB-ICI's decline slowed in March, with a 0.7% decrease after the 1% drop in January. Economic confidence was the main supporting factor, with the net capital outflow in 1Q16 contracting to just $7bn. Foreign confidence continued to stagnate, while market confidence was nearly flat, despite higher oil prices and growing global risk appetite. This reflects the widening gap between Russia and its EM peers, as recovery has not yet strengthened fundamentals.

Capital flight of just $7bn drove economic confidence in March

- **Economic confidence** increased significantly in March, mostly due to a slowdown in capital outflow dynamics and a decreasing share of FX-denominated deposits. Capital outflow was just $7bn in 1Q16 compared with $33bn a year earlier. That said, the deteriorating savings rate continued to pressure the indicator, posing risks for its future dynamics.

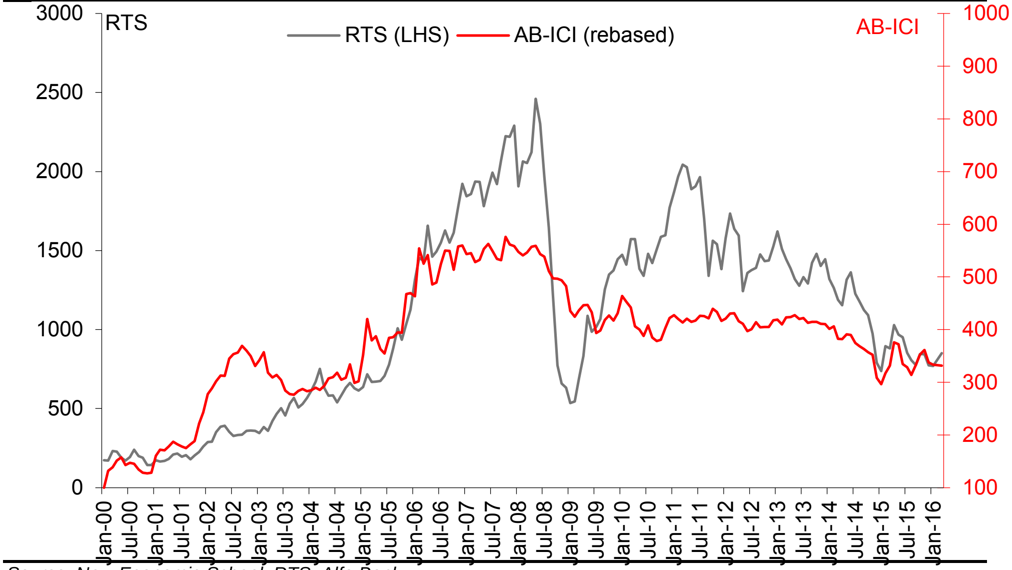
Foreign confidence continued to stagnate

- **Foreign confidence** decreased slightly in March. The presence of foreign banks in Russia continues to stagnate, creating additional pressure for the foreign confidence component.

Market confidence was nearly flat despite rising oil prices reflecting widening gap between Russia and its peers

- **Market confidence** was nearly flat in March, with underlying fundamentals demonstrating diverging dynamics. On the one hand, oil price increases and the Fed's postponement of interest rate increases supported risk appetite. On the other hand, weak fundamentals continue to widen the gap between Russia and its EM peers, with the spread between Russian and LatAm bonds significantly increasing. The trajectory of economic recovery will determine these dynamics in the coming months, we believe.

Figure 1: AB-ICI down 0.7% in March



Source: New Economic School, RTS, Alfa Bank

AB-ICI: Data points to support from fundamentals in future

AB-ICI fundamentals might improve in coming months....

The AB-ICI index decline has been slowing since December 2015. Indeed, this movement was accompanied by relatively upbeat data, released at the time, which pointed to these dynamics being rooted in better-than-expected fundamentals.

…as real economy indicators signal that adjustment has already gone a long way…

First, despite experiencing a commodity shock in January, Russian 1Q16 real economy macro results were solid. Retail trade decreased by only 5.4% y/y in 1Q16, while the 6.1% y/y nominal salary growth in 1Q16 was positive. GDP contracted 1.6% y/y in 2M16. Additionally, while the market expected industrial production to return to sizable negative growth rates in March, interpreting February's positive, 1.0% growth rate as a purely seasonal phenomenon, it in fact was only -0.5% y/y, which is upbeat news. Thus, adjustment of the real economy to the new economic environment seems to have already gone a long way, which might provide points to some support for the AB-ICI in future.

…while the slowdown in capital flight reflects more stable environment.

Second, the 1Q16 balance of payments suggested that the sharp ruble depreciation is over. Despite the Russian current account surplus being a relatively weak $11bn, the recent recovery in commodity prices is likely to help this in future. The main positive was the sharp deceleration of the net capital outflow, to $7bn, from $32bn in 1Q15. Russian corporate debt (banks and companies) stopped declining in 1Q16, staying at $475bn, signaling that pressure on the Russian capital account is falling. The AB-ICI is also likely to benefit from this partial stabilization.

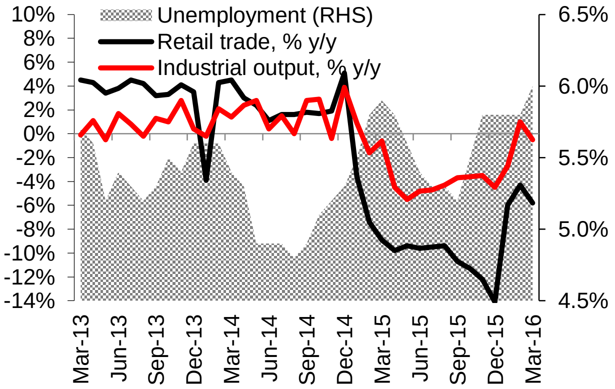
Fiscal policy might support the economy in coming months…

Therefore, the 1Q16 economic result, while still mostly in the negative zone, turned out to be better than had been previously expected. An additional source of support is likely to come from the fiscal side: while in January-February, federal budget spending contracted 36% y/y in nominal terms, already in March it had increased 54% y/y (33% m/m). Based on the cabinet's total federal expenditures projection for FY16, the 1Q16 budget execution implies that April-December expenditures would deliver 9% y/y growth.

…pointing to support for the AB-ICI index in future.

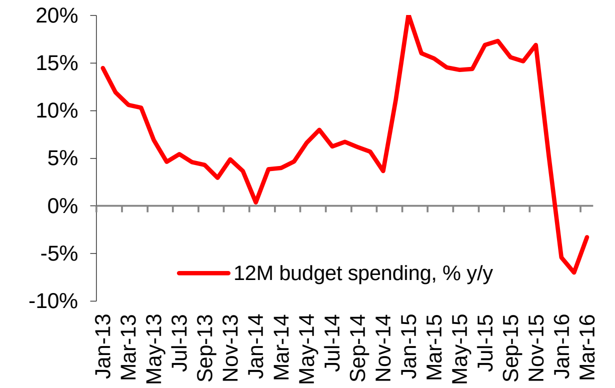
This suggests that for the rest of this year, budget policy is set to stimulate the economy, offering reason to be more positive on AB-ICI fundamentals. Fiscal policy, accompanied by better-than-expected data for the 1Q16, is likely to provide some support for the AB-ICI index dynamics in the coming months.

Figure 2: Key Russian indicators, % and % y/y



Source: Rosstat, Alfa Bank

Figure 3: Budget spending, 12-M y/y



Source: Finance Ministry, Alfa Bank

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