AB-ICI: 12% collapse, historical record

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Investment Summary

- AB-ICI marked a 12% decline in December, a historical record
- December's slump reflected both deterioration in fundamentals and highly negative market sentiment
- Restoring communication between the CBR, the Cabinet and the market is the call of 2015

AB-ICI collapsed by 12% in December

AB-ICI collapsed by 12% in December and 19% since March due to highly negative dynamics in both economic and market confidence

AB-ICI marked a historically record fall declining by 12% m/m in December. The overall loss since March has now amounted for 19% vis-à-vis 25% loss during 2008-09 episode. Economic confidence was in freefall with monetary policy failing to counteract the sizable capital outflow shock. As exchange rate volatility remains elevated demand for ruble savings is expected to decline further. Foreign confidence was effectively flat in December and lost less since March as the sanctions' effect feeds in slower. Given this lag, foreign confidence is subject for additional pressure in 2015. Market confidence declined considerably in 2014 and particularly in December as loss of communication on the CBR's side contributed to negative market sentiment. Recent decision to slash policy rate by 200bps has created additional policy uncertainty for the 2015.

Economic confidence fell on capital outflow acceleration and rising demand for FX savings

- **Economic confidence** was in freefall as capital outflow accelerated on negative newsflow and exchange rate instability. Recent bold rate hike of 650bps failed to immediately alleviate the pressure but contributed to overall market disarray. While demand for FX savings also rose in December, the CBR has now lowered the rate damaging efficiency of the original hike.

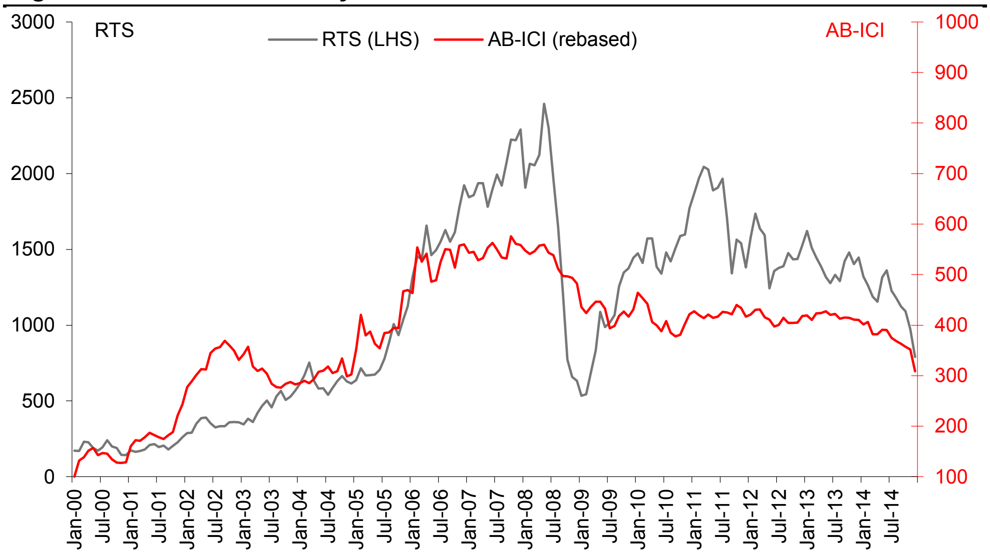
Foreign confidence is yet to reflect negative impact of sanctions

- **Foreign confidence** was flat in December and relatively stable in 2014. As the sanctions' effect feeds in with lag, major negative impact is yet to come in 2015.

Market confidence declined with confidence shocks pressuring market sentiment towards Russia

- **Market confidence** declined considerably with pressure from (1) panic sentiment in the banking sector, (2) absence of efficient communication on the CBR's side and (3) expectations of S&P downgrade. RTS lost almost 20% of its value in December and Eurobond market was sell-off mode. As S&P downgrade has already materialized, the focus now is on how the CBR deals with deterioration in the banking sector's balance sheet.

Figure 1: AB-ICI is down by 12% in December



Source: New Economic School, RTS, Alfa Bank

Focus on monetary policy coherency

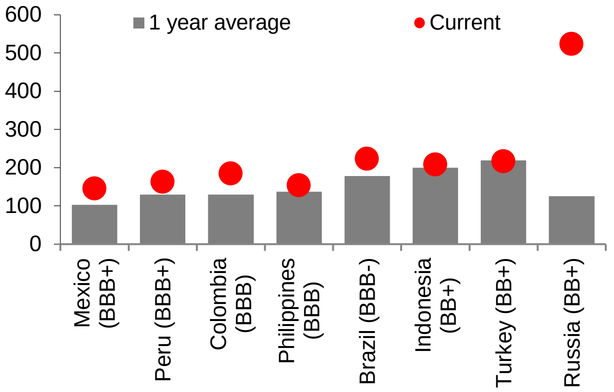
AB-ICI was hit by major confidence shock…

Sharp fall of AB-ICI in December reflected both deterioration in market sentiment towards Russia and in real economic environment. The CBR attempted to tackle the former issue, but results are mixed at best. 650bp rate hike that CBR conducted in December could be justified from the macroeconomic standpoint but it resulted in market disarray as the CBR failed to communicate to the market its main policy goals and concerns. Indeed, 2014 marked declining trust of Russian households towards stability of monetary system. Increase in their demand for FX cash surpassed that of 2008 as net purchasing amounted for $34bn in 2014 vs $25bn in 2008. Overall net capital outflow jumped from $61bn in 2013 to $152bn in 2014. Recent decision to slash rate by 200bps further entagled communication leaving this issue the major concern for the 2015.

…as well by deterioration in stability of Russian financial system

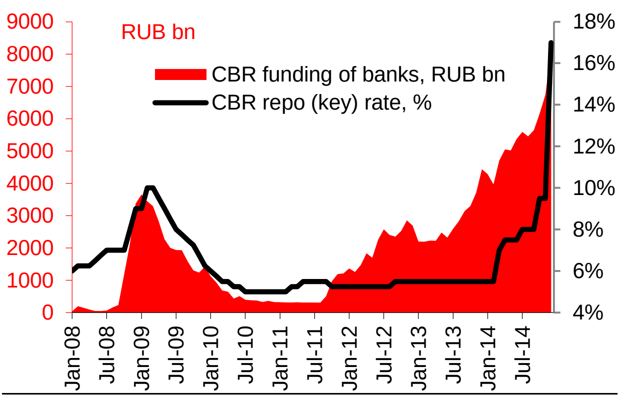
Deterioration in general banking sector environment exacerbates negative capital account dynamics. Indeed, its stability is at risk as banks have faced severe pressure on both sides of balance sheet recently. Since December 2014 there has been a sharp decline of 10-30% in the Russian bonds market; it is a major shock as bonds accounted for 80% of banks' securities portfolio. Thus the totall loss just from this market might reach ~RUB1tr. Furthermore, liabilities were repriced upwards as the CBR's rate hike severly increased the cost of funding. This would not have been such major issue in 2008 when banks had exposure to the CBR's funding of only 1% of assets magnitude. Now that their exposure stands at 11% of assets, monetary policy tighetning resulted in a major hit. As S&P downgrade has already occurred and remaining agencies report negative outlook it is hard to expect quick rebound in banks' balance sheet quality. The risks for the 2015 are intensified by the fact that effects of sanctions have not fed in economic evironment completely yet. As foreign presence in economy lags market dynamics, Russian economy is yet to digest deterioration in foreign investment later this year.

Figure 2: EM 10Yr bond spreads to 10-yr UST: Russia and peers (similar ratings)



Source: Bloomberg, Alfa Bank

Figure 3: Banks' total exposure to CBR



Source: CBR, Alfa Bank

As shocks feed into real economy, AB-ICI is likely to stay under sizable pressure in 2015

Thus the Russian economic environment was subject to both severe confidence and economic shocks. They already start to feed into real economy dynamics posing concerns on the GDP trend this year. Retail lending growth haulted in December and stood at 14% y/y in 2014 while it was 29% y/y in 2013. Thus overoptimism of pre-crisis period is now likely to be corrected by below trend consumption growth. Recent inflation spike makes this schenario for 2015 highly probable. The state sector is likely to support investments as it did in 2014 when military expenditures were up by 18% y/y. Yet the overall growth is likely to stay in the negative zone as the private sector sentiment remains negative. With major shocks incoming from different sectors of the economy and policy uncertainty remaining high AB-ICI is likely to stay under additional pressure in early 2015 already.

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