Alfa-Bank

Equity Market

AB-ICI: Ruble instability is the key risk

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Investment Summary

- AB-ICI index increased in February with foreign confidence pulling the index up
- Ruble instability aggravates negative trend on forex savings, net capital outflow to reach $70 bn in 1Q14
- Lack of new and clear guidance from the CBR is likely to add to confidence deterioration in coming months

AB-ICI grew in February

AB-ICI increased in February by 1.2% solely due to positive one-off in foreign confidence

The AB-ICI increased in February by 1.2%, first time since October 2013. Still, positive dynamics of AB-ICI was provided for only by foreign confidence which increased due to seasonality in FDI dynamics. Economic confidence continued to fall on acceleration of capital outflow while market confidence signals that Russian economy lags farther from peers. With weak real economy and risky developments in geopolitics uncertainty is likely to stay elevated adding to pressure on AB-ICI index.

Forex savings continue to accumulate and capital outflow is expected to post $70 bn in 1Q14

- **Economic confidence** continued its fall in February. Exacerbation of forex market instability added to the capital outflow and preference for forex deposits. Fx savings of corporates increased by another $5 bn in February as firms accumulate a safety cushions. We expect capital outflow to post $70 bn for the whole 1Q14 vs. $63 bn for 2013 adding to March's pressure on economic confidence.

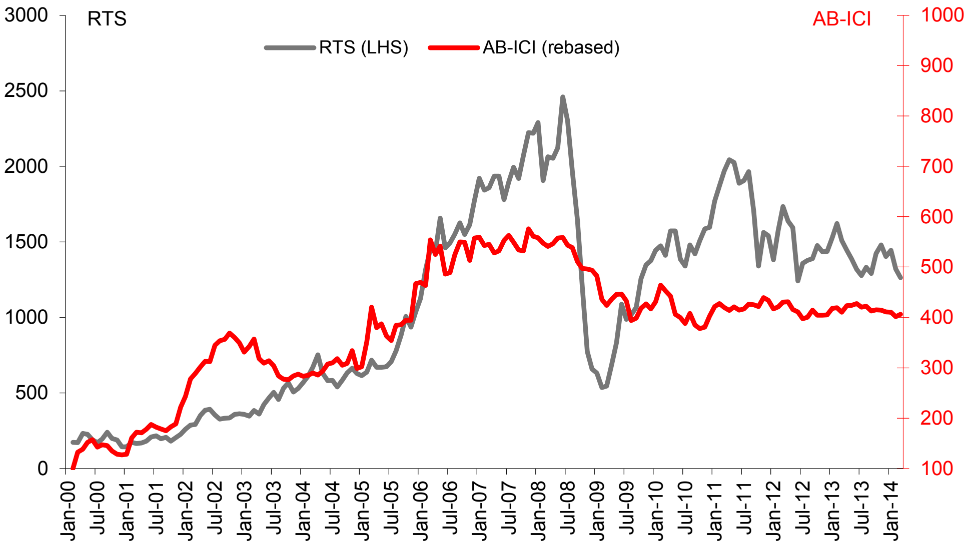
FDI seasonality increased foreign confidence but instability still pressures foreign banks presence

- **Foreign confidence** increased in February being the sole driver of the whole index. FDI increased mostly due to seasonal factors. That said, financial instability adds to decrease in foreign banks' presence making last month's increase likely to be a one-off.

Real economy remains weak and lagging behind peers'

- **Market confidence** was effectively flat in February. RTS was down while spread between Russian and LatAm bonds increased. The latter reflects poor dynamics in real economy that pulls Russian economy farther from peers. With recent data package on real economy signaling continuing deterioration in investment trend, market confidence is likely to remain subdued in coming months.

Figure 1: AB-ICI grew in February



Source: New School of Economics, RTS, Alfa Research

Uncertainty over free-float to hit AB-ICI

AB-ICI demonstrated a one-off growth in February, but ruble is still under pressure signaling continuing capital outflow

Despite one-off growth of AB-ICI index in February, it still remains under considerable pressure. As we have mentioned earlier, ruble instability accompanied by poor dynamics of Russian real economy have been among key factors that drag down the AB-ICI index. This negative trend continued in February. Indeed, ruble lost 8.0% of its value relative to USD in 2M14. Recently released data on conditions in the production side of the economy has confirmed subdued activity. Although industrial output posted decent 2.1% y/y growth, investment continued to fall with 3.5% slump in February's investments after even sharper slump of 7.0% in January.

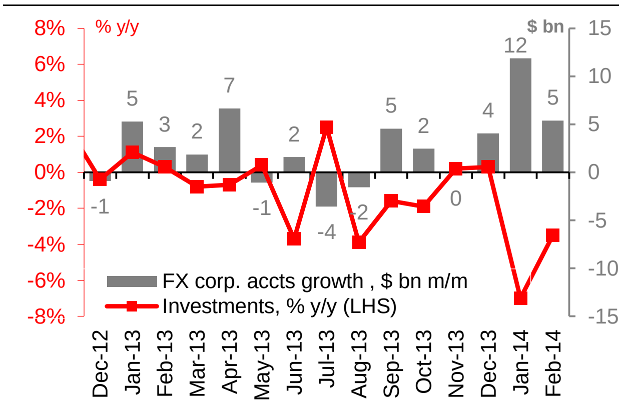
CBR's policy mix broke previous guidance of moving towards free-float…

More importantly, early March changes in the CBR's policy agenda create risks of monetary policy joining the negative factors. Reacting to abnormally high pressure on ruble related to peaking Crimea panic, CBR conducted quite controversial policy mix. First, it has tightened its monetary policy aggressively, increasing the key rate from 5.5% to 7.0% level. This move was in line with previous hawkish guidance of the CBR and followed market expectations. Second, it has tightened its exchange rate regime by making ruble crawling band less flexible. This latter move broke CBR's guidance of smooth introduction of free-float and left markets disoriented.

…while new and clear guidance is yet to come

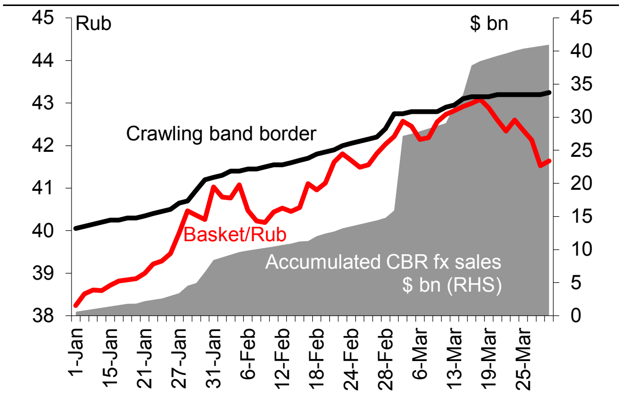
In practice, CBR's decision to make ruble less flexible realized into sharp acceleration of selling of international reserves conducted by the CBR. First, such dynamics only added to forex market instability. Second, it posed concerns on sustainability of such policy in the long-run which, combined with absence of new and clear guidance from the CBR, only aggravates ruble instability. On the one hand, CBR still has opportunity to explain this deviation in exchange rate policy by one-time panic and restore previous guidance. On the other hand, strengthening of ruble control might be a first step in the new guidance of retaining fx operations in the CBR's toolbox.

Figure 2: Investments % y/y vs. FX corporate accounts $ bn m/m



Source: Rosstat, CBR, Alfa-Bank

Figure 3: CBR's crawling band border, Basket/RUB rate and CBR FX sales, $ bn



Source: CBR, Alfa-Bank

Markets are on their own in search of new equilibrium with volatility rising and adding pressure to AB-ICI index

As CBR remains effectively silent on the future of this exchange regime tightening, it is likely that final decision has not been made yet even at the CBR's level. Still, while markets are left disoriented it is hard to expect that confidence in Russian economy will grow. With monetary policy uncertainty joining weak real economy trend, it is hard to expect any considerable rebound in AB-ICI going forward.

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