Alfa-Bank

Macro Insights

AB-ICI: Some Recovery in Sentiment

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Investment Summary

- AB-ICI recovered by 7% in February on recovery in the market sentiment following year-end collapse
- 2M15 GDP drop of 1.9% y/y was a positive surprise, full-year decline might be limited to 3%
- CBR easing and budget policy do not help limiting the capital outflow, which remains a concern

AB-ICI recovered by 7% in February

AB-ICI was up 7% in February on strong recovery in market sentiment

After 16% drop in December-January, AB-ICI recovered by 7% m/m in February, reflecting the recovery in the market sentiment following the year-end collapse. The return of the financial market to the peer trend after the year-end shock is positive news, and it is supported by the smaller than expected 1.9% y/y GDP drop in 2M15. However, net capital outflow remains an ongoing concern.

Economic confidence recovered slightly on better deposit trends; capital outflow remains a concern

- **Economic confidence** recovered after two months of free-fall, reflecting some improvement in the household savings: the higher level of interest rates has stopped the outflow in ruble deposits, which have shown 3% m/m growth in February. However, the net capital outflow data suggest that after some deceleration in outflow to $9bn in January, the February outflow was $15bn, which suggests little deceleration compared to last year's outflow.

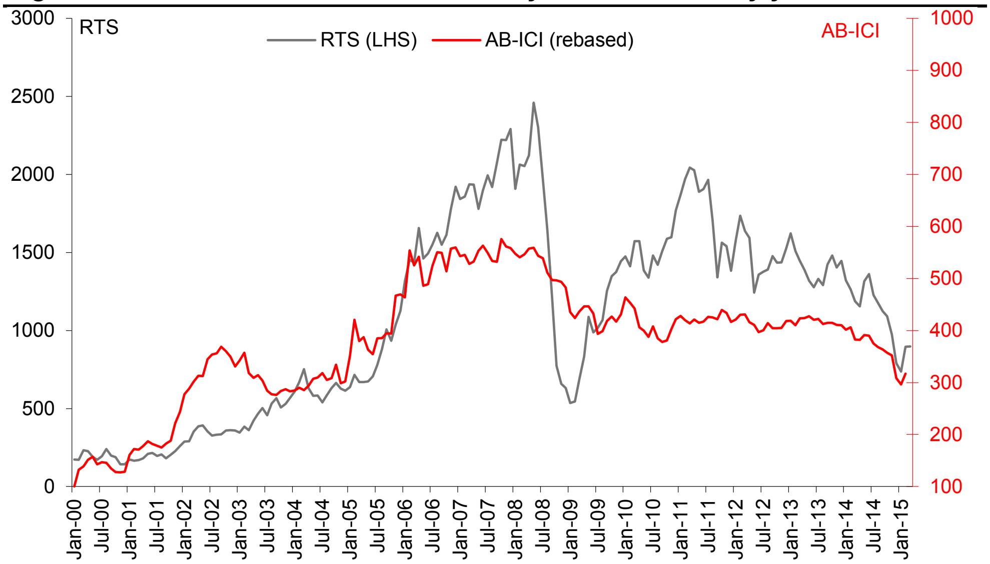
Preliminary data is guiding for 50% reduction of FDI inflows 2014

- **Foreign confidence** declined accounting for the negative trend in FDI inflows. Based on the CBR data, Russia saw a 50% y/y drop in the FDI inflows in 9M14, which is the worst performance since 2009. The recent news on GM willing to divest from Russia and a number of foreign banks reducing presence is a negative guidance for the near term. At the same time, the sharp ruble depreciation may still make Russia attractive for direct investments once the growth trend normalizes.

The market sentiment towards Russian bonds and ruble recovered after December's collapse

- **Market confidence** increased sharply in February after stable performance in January, reflecting recovery in the bond markets. In February, ruble appreciated 12% and continues to recover, returning to the trajectory seen in EM and petro-currencies after December collapse. The decline in global EM interest rates played role in boosting Russia's attractiveness.

Figure 1: AB-ICI recovered 7% in February, still down 22% y/y



Source: New Economic School, RTS, Alfa Bank

AB-ICI Recovery: Sentiment or Fundamentals?

Some recovery in AB-ICI is in line with improvement in the near-term GDP growth prospects

Even if the 7% spike in the AB-ICI in February does not indicate a reversal in the overall trend, it is definitely in line with the recent improvement in the sentiment regarding the economic performance. In particular, while following the collapse of the financial markets we and the market started to fear 5% GDP drop for 2015, the recent macro figures indicate that the scale of the decline can be more modest. In 2M15, the decline was 1.9% y/y, and even if it reflects some deepening in the drop from 1.4% y/y in January and 2.3% y/y in February, it still appears modest compared to our initial fears. While we expect the decline in the GDP growth to continue further into the year, now a 3% full-year GDP contraction appears to be a more plausible scenario.

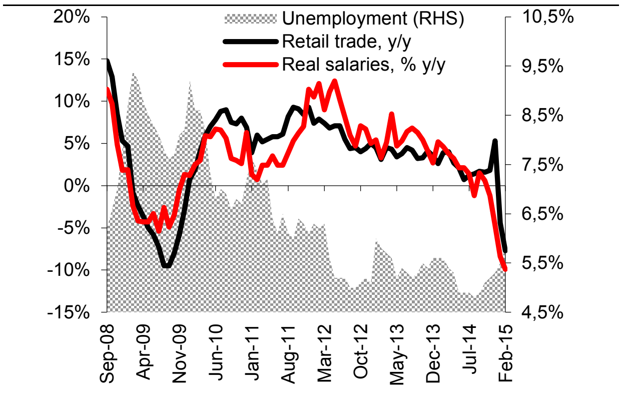
Consumption is supported by structurally low unemployment…

The main reason why the deterioration of the economic trend is very limited is that the consumption remains stronger than expected, with retail trade down 6.1% y/y in 2M15. The first explanation is the structurally tight labor market, keeping unemployment at 5.8%, still much lower than the 9.4% unemployment peak reached in 2009. As a result, the decline in real salaries, even if approaching 10% y/y, is mainly driven by the inflation, which seems to be stabilizing at the moment, while the nominal salary growth remains positive at 5% y/y.

…and a looser than expected CBR and budget policies

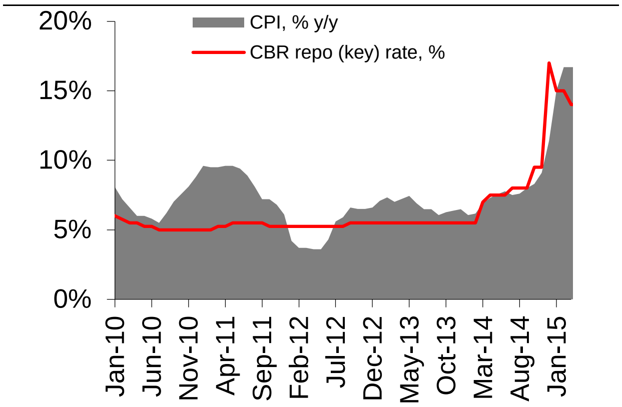
The economic policy considerations also play a role in maintaining Russia's consumer focused model. First, the ahead of schedule decline in the CBR interest rates keep the real deposit rates negative, discouraging savings. Second, the budget policy appear supportive. The pension indexation will total 11% y/y this year, and the overall spending plan for 2015E has not been cut contrary to the previous expectations, as the Cabinet decided to spend the extra RUB1.5tr proceeds coming from the ruble depreciation in the current 2014-15 spending cycle.

Figure 2: Consumer trend fundamentals



Source: Rosstat, CBR, Alfa Bank

Figure 3: CBR key rate and inflation



Source: CBR, Rosstat, Alfa Bank

Risks to ruble remain significant

At the same time, the CBR move towards interest rate easing and the budget preference for maintaining expenditure growth pose persistent inflationary risk and offer bad long-term signs for ruble, which should limit the preference for corporate investments and prevent FDI inflows from recovering even after the last round of ruble depreciation. The February net outflow, which according to VEB estimates was as high as $15bn, is an illustration of this view. As a result, we continue to see risks to ruble stability, being a factor preventing strong recovery in the AB-ICI.

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