Alfa-Bank

Macro Insights

AB-ICI: Risk-Off Mode

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Investment Summary

- AB-ICI index collapsed 6% m/m in March to a four-year low due to risk-off drop in all indicators
- March drop in retail deposits and FX cash purchases reflect falling trust in the ruble and banking sector
- We expect net capital outflow to persist on geopolitical and structural factors, putting pressure on AB-ICI

AB-ICI fell 6% in March, 7% YTD

AB-ICI dropped 6% last month, reflecting a fall in all indicators

AB-ICI collapsed 6% in March, confirming our take on the one-off nature of the February recovery. All index components took a 2009-style synchronized dive, reflecting a material decline in confidence in all sectors of the economy and putting pressure on RTS fundamental value. We expect the downward trend in AB-ICI to persist in 2014, reflecting geopolitics-induced nervousness in the short term and structurally predetermined weak economic growth environment in the long-term.

Households withdrew rubles from banks in March to buy FX cash, $20bn in 1Q14, fearing exchange rate, price and banking sector instability

- **Economic confidence** dropped on the material acceleration of net capital outflow, which was not a surprise, given the financial market turmoil; however, in March it reflected not just the dollarization of household savings in banks, as in the previous months, but also a material 2% m/m net withdrawal of retail deposits from banks. This was used to purchase durable goods and FX cash, $20bn in 1Q14, the highest since 4Q08, reflecting lower confidence in the banking system in addition to the lack of trust in the ruble and high inflationary expectations.

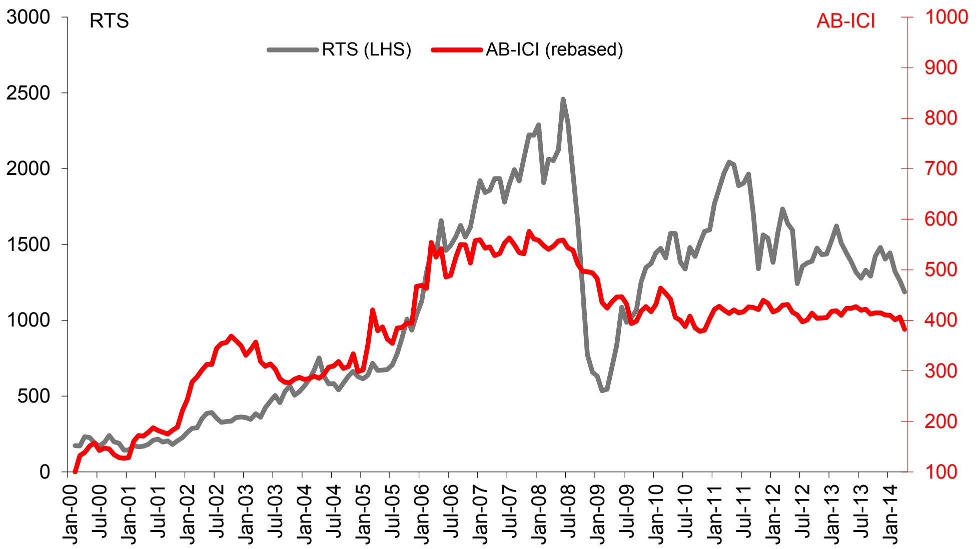
Foreign banks continued to reduce their presence in Russia

- **Foreign confidence** declined, reflecting a continuing decline in foreign bank presence on the Russian market. With the mounting risk of international sanctions, this trend is unlikely to reverse anytime soon.

Markets also in risk-off mode due to geopolitics combined with weak growth prospects

- **Market confidence** decreased, reflecting a risk-off mode on Russian equity and bond markets in response to higher geopolitical tensions. Even after the March sell-off, the market remains under pressure of a sovereign rating cut, CBR key rate tightening, further political instability in Ukraine and expectations of new sanctions against Russia, in addition to the negative sentiment on local growth prospects.

Figure 1: AB-ICI collapsed by 6% in March



Source: New Economic School, RTS, Alfa Bank

Net Capital Outflow: Here to Stay

Despite some relief in April, the prospects of the Russian capital account remain poor

The sharp drop in AB-ICI last month was not a surprise, given the strong turmoil on the markets and negative capital outflow data. In recent weeks, however, the mood on the financial markets has improved somewhat compared to March, the ruble has appraciated to RUB35.5-36.0/$, and the CBR has managed to reduce the volume of interventions to just $200m per day vs. a $1.3bn per day average in March – all of this points to a likely deceleration of the net capital outflow in 2Q14 compared to $64bn reported for 1Q14. An additional factor supporting the market mood at the moment is that the list of international sanctions against Russia appears to be less severe than expected, allowing a number of experts, market participants and state officials to give optimistic guidance regarding capital flows going forward. While we acknowledge the improvement, we find it rather short-term, and see fundamental reasons for persisting net capital outflows

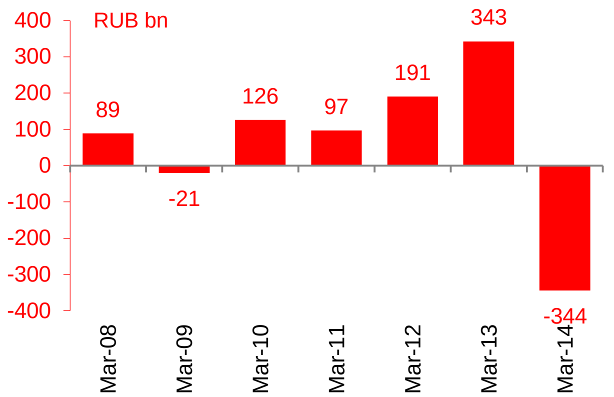
Companies are contributing to net capital outflow by ceasing to accumulate foreign debt

First, with continuing political instability in Ukraine and the risk of further geopolitical tensions, Russian companies are continuing to price in the risk of closure of foreign capital markets. The Russian corporate sector in 1Q14 managed to attract only $4bn of new foreign debt vs. $20bn average quarterly growth in 2012-13. Russian compnies are due to redeem up to $100bn of foreign debt until YE14, and with unclear prospects regarding the ability to refinance, they are accumulating a forex cushion. In 1Q14, corporate FX accounts with Russian banks jumped by $23bn (the same amount as for FY13), while fixed investments slumped by 4.8% y/y. With a high likelihood of negative newsflow keeping the foreign capital markets closed, corporate net capital outflow is likely to remain high.

Households continue to prefer saving in FX due to expectations of high inflation and further RUB depreciation

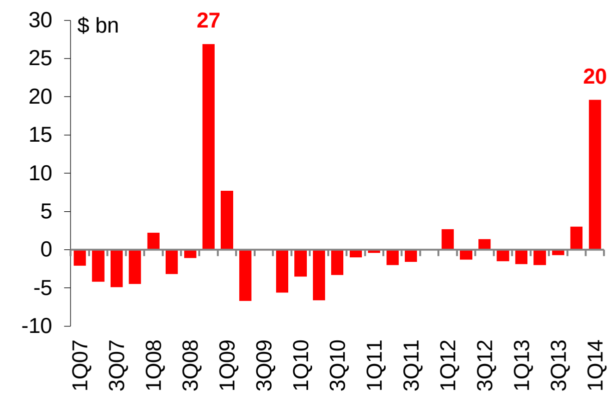
Second, the deterioration of inflationary expectations – which are caused by the recent 10% ruble depreciation and disruptions in Russia-Ukraine trade – households' trust in the ruble as a savings currency continues to diminish. While the purchase of $20bn in forex cash in 1Q14 was partially driven by one-off factors and is unlikely to repeat on the same scale, low ruble interest rates, the acceleration of inflation to above the 7% level and the low likelihood of a slowdown will keep the preference high for FX savings among the population.

Figure 2: Retail deposit growth RUB bn m/m



Source: CBR, Alfa Bank

Figure 3: Cash FX net purchase, $ bn



Source: CBR, Alfa Bank

Ruble depreciation is seen as beneficial for the state budget

Finally, the overall expectations of ruble depreciation are indirectly supported by the budget discussion. As each RUB1/$ depreciation boosts annual budget revenues by RUB200-300bn, a weaker ruble is a means to finance additional Crimea-related and social spending without weakening the overall budget balance. This creates expectations that the Cabinet is favoring ruble weakening as a tool to rebalance the bugdet position. All in all, we take the corporate, household and state view on the ruble as supporting our new $120bn net capital outflow forecast for 2014, which should keep AB-ICI under pressure in the coming months.

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