Alfa-Bank

Macro Insights

AB-ICI: Recovery with Side-Effects

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Investment Summary

- AB-ICI continued its recovery with an additional 4.6% m/m in March after the 7% bounce in February.
- Active budget spending, big state investments and policy rate cuts limited the slowdown in 1Q15.
- Proactive state policies create additional risks to longer-term price stability.

AB-ICI increases 4.6% in March

AB-ICI continued its recovery in March: 4.6% m/m after 7.0% m/m In February

AB-ICI continued its recovery in March, climbing 4.6% m/m after the 7.0% m/m increase in February. This trend reflects improvement in market sentiment after the risk-off regimen of December and January. The better market mood was supported by pro-growth fiscal and monetary policies that limited the slowdown in the real economy; however, these policies create risks for longer-term inflation dynamics and pose questions about future macroeconomic stability, in our view.

Share of FX deposits declined but exchange rate and price instability are likely to constrain this effect

- **Economic confidence** increased slightly, generally due to the decline in the share of FX deposits; the sharp ruble appreciation of March and April contributed to this change in saver preference. However, we believe that both exchange rate and price instability are likely to limit the upside of ruble deposits. We do not expect inflation to decelerate to pre-2014 (6.0-7.5% y/y) levels in 2015-16.

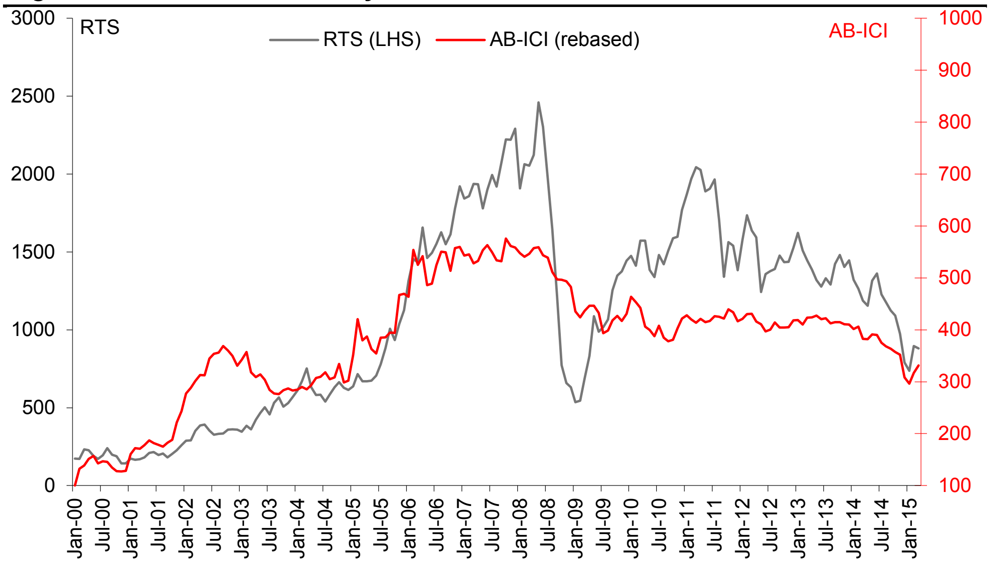
Foreign confidence was flat but negative FDI trend of 2014 (inflow -70% y/y) is likely to continue

- **Foreign confidence** was effectively flat last month, given the lack of relevant fresh data. However, we expect the negative trend of 2014 (FDI inflow slumped by a huge 70% y/y) to remain, as negative real economic growth and the sharp ruble appreciation of recent months reduced the attractiveness of direct investment in Russia.

Market confidence improved as Russia returned to the EM trend but CBR cuts are likely to hamper convergence

- **Market confidence** was slightly up in March as spreads between Russian and LatAm bonds narrowed. This signaled gradual Russian movement toward the global EM trend. However, the CBR's sharp rate cuts in 2015 decrease the relative attractiveness of Russia and will in our view limit the upside to market confidence in the coming months.

Figure 1: AB-ICI increased by 4.6% in March



Source: New Economic School, RTS, Alfa Bank

AB-ICI: Recovery with Side-Effects

AB-ICI continued its recovery, in line with stronger than expected real economy data

AB-ICI continued its recovery in March, with 4.6% m/m growth after the 7.0% m/m increase in February. This trend was in line with the better-than-expected dynamics of the real economy in 1Q15. Both production and consumption data were relatively strong; however, this result was achieved mainly through loose fiscal policy, with military expenditures up 51% in 1Q15. CBR cuts to the key rate (from 17% to 14% in 1Q15) also contributed.

But inflation (now at 16.9% y/y) is at the heart of macro instability

Nevertheless, while anti-crisis policies are concentrated on pro-growth issues, inflation – now at 16.9% y/y – is at the heart of macroeconomic instability. Prior to the 2014 shock, price growth had been decelerating (inflation had held in the 6.0-7.5% range since 2H12) and had fallen as low as 6.1% y/y in January 2014; however, since then, the measure has surged near threefold. While we expect price growth to decelerate toward the end of 2015, as transitory shocks (exchange rates and import bans) vanish, in the longer term, we believe that it is still a risk.

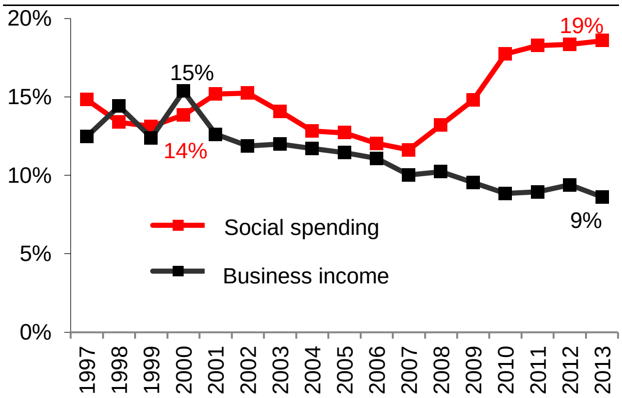
State accounts for 29% of employment, salary indexation strongly affects income trend

First, demand-pull inflation pressures are not to be underestimated. In preparation for the 2018 elections, we believe the government might implement a program of public sector wage indexation and increased social spending in 2016-2017. The effect of this would be especially large, given that in Russia the state accounts for almost 29% of employment, and social payments generate some 20% of household income. With a low unemployment rate (5.9% in March), reflecting demographic constraints, public sector salary growth would be immediately shared by the private sector – even in a recessionary environment, in our view.

Monetary policy is also easing while preference for savings remains low

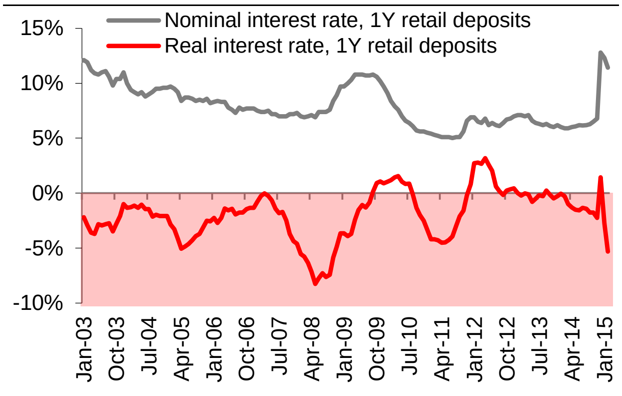
Monetary policy also contributes to the inflationary trend. The present weakness in the retail credit market (7% y/y in March vs. 28% in early 2014) mainly reflects the CBR's continuous tightening throughout 2014. Now that the regulator has entered an easing cycle, credit resources are likely to be more available toward the end of this year. This would support a pro-inflationary trend. It would also hurt preference for savings, which is already low – as are real rates on deposits. In fact, deposit rates have not been significantly positive for more than a decade. The real rate on the 1Y deposit rate in rubles has slumped to almost -5.3%. Only 41% of Russian adults saved in the previous 12 months compared with the global average of 56%.

Figure 2: Income sources: social spending of the state and business income, %



Source: Rosstat, Alfa Bank

Figure 3: Nominal and real deposit interest rates, %



Source: CBR, Rosstat, Alfa Bank

State monopolies are to return to their indexation practices; MED proposed 7.5% for 2016

Second, cost-push risks are also unfavorable. State monopolies' tariffs are likely to return to their previous practice of price increases; the MED has already proposed a 7.5% hike in 2016. Accounting for the low base that the tariff freeze has created, the contribution from this source of inflation will be higher. The low competitive environment in the Russian economy also amplifies inflationary pressures.

Price instability is likely to be prolonged and hurt AB-ICI prospects

Thus, while current policies attempt to limit recession, they are also inflationary, which is risky in the current – already high – inflationary environment. As rapid price growth is likely to remain and hurt savings and investment, we do not expect strong development of the real economy, limiting AB-ICI index improvement.

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