AB-ICI: CBR to Kill the Mood?

Natalia Orlova **(+7 495) 795-3677** NOrlova@alfabank.ru
Dmitry Dolgin (+7 495) 780-4724 DDolgin@alfabank.ru

June 1, 2015 www.alfa-bank.com Moscow

Investment Summary

- AB-ICI spiked 13% m/m in April thanks to the improvement in all three key components.
- Better sentiment toward Russia was observed among financial markets and households.
- The CBR's return to the FX market is a negative sign for the ruble, which is a risk to further AB-ICI recovery.

AB-ICI up 13% in April, 22% YTD

AB-ICI jumped 13% in April thanks to improvement in sentiment towards Russia

AB-ICI posted a sharp and positive 13% m/m increase in April, after climbing 5-7% in February-March. The good news is that confidence increased among all economic agents, mainly reflecting the return of interest from local households, businesses and foreign investors in ruble assets. Our concern however, is that the resulting 35% ruble appreciation since February has triggered reinstatement of the CBR's FX interventions, which might be a strong drag on further ABI-ICI recovery.

Households started to return their savings to rubles

- **Economic confidence** increased materially, reflecting a return of savings from under mattresses to banks, with ruble retail deposits increasing 3% m/m in April and 6% YTD, and dollarization dropping to 24% from the 27-30% peak near the beginning of the year. The higher preference for rubles among households is also confirmed by the anecdotal evidence of increased FX cash conversion to the national currency.

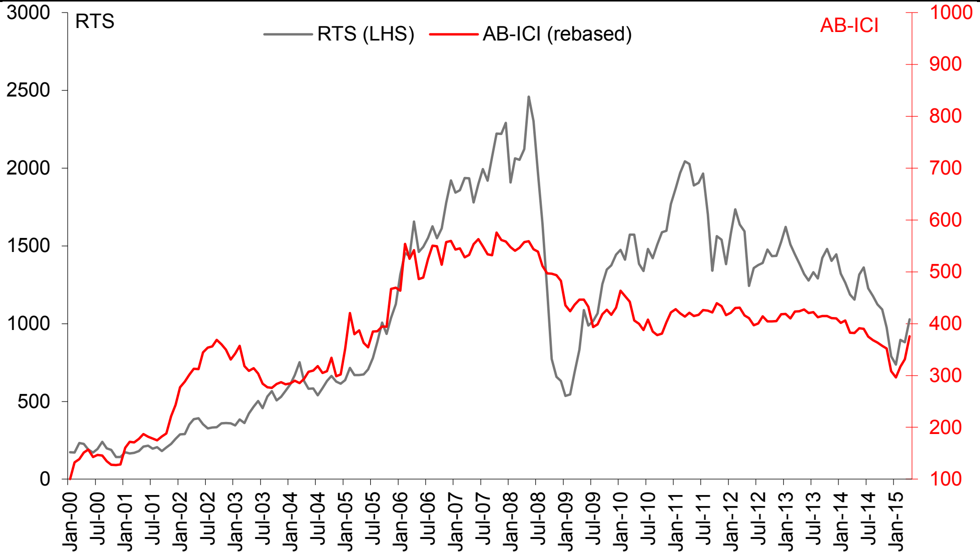
FDI inflows improved – possibly thanks to sanctions

- **Foreign confidence** increased, reflecting some improvement in FDI inflows in 4Q14, and suggesting that the sanction environment may have stimulated repatriation of the Russian capital. Another positive is that the share of foreign banks' assets in Russia also increased; however, this partially reflects the revaluation effect.

Russian FX, equity and bond markets rallied in March-April, after being extremely oversold in YE14

- **Market confidence** continued to rally in April, further narrowing the lag to other EMs that had emerged at YE14. The drop in yields on Russian local and foreign bonds, as well as the continuing increase in the RTS index reflected a return of foreign capital to the Russian markets and supporting ruble appreciation. The recent CBR decision to purchase FX on the market raises questions over the longevity of this rally.

Figure 1: AB-ICI jumped 13% in April



Source: New Economic School, RTS, Alfa Bank

AB-ICI: CBR to Kill the Mood?

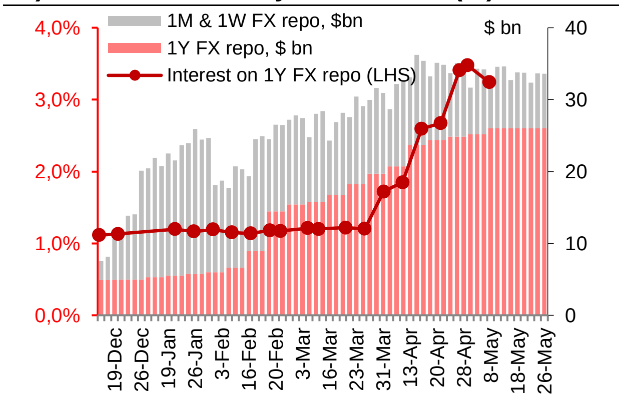
AB-ICI is up 22% YTD on better sentiment towards Russia; stronger ruble was the key component

The growth in the AB-ICI by 13% in April was a positive surprise. As a result of this growth, the index is now up 22% YTD, indicating that in the four months of 2015, Russia has managed to restore most of the confidence lost in 2014, when the AB-ICI collapsed 25%. We welcome the most recent developments, which, in addition to a very shallow 1.9% y/y GDP drop in 1Q15, included a rapid recovery in the financial markets in March-April after being oversold in YE14. The return of oil prices from the low of $55/bbl to $65-70/bbl and the easing of geopolitical tension resulted in a material drop in the yields on Russian Eurobonds to 3.8% and the growth of the RTS index by 25% to 1000 points in two months. The most visible sign of better sentiment toward Russia was the ruble appreciation to 50/$ by the end of April, after touching RUB70/$ only two months prior. However, in May, the ruble's attempts to enter the much expected RUB45-50/$ range failed, raising questions about the prospects for investor sentiment.

CBR blocks further ruble appreciation through higher FX repo rates, lower key rate and FX interventions

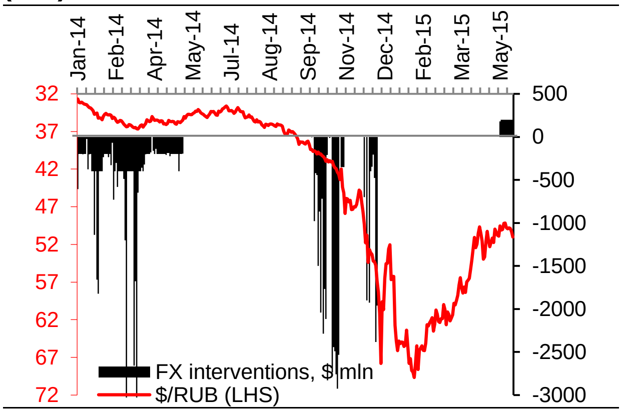
The reason the rally hit the wall was the CBR, which, despite the nominal shift to a free-float, has recently been sending strong signals to the FX market that it is still targeting the ruble exchange rate. First, since April, the bank has raised interest rates on FX repo instruments and ceased offering 1-year repo (in May), lowering the supply of FX to the markets. Second, it lowered the key rate 150bp (450bp YTD) despite still high inflation, reducing the attractiveness of ruble assets to foreign capital. Finally, and the most importantly, since May 13, it has reinstated FX interventions, so far buying $100-200m daily but not excluding higher volumes in future.

Figure 2: CBR FX repo operations structure ($ bn) and interest on 1-year auctions (%)



Source: CBR, Alfa-Bank

Figure 3: $/RUB and daily CBR FX interventions ($ m)



Source: CBR, Alfa-Bank

CBR's shift back to exchange rate targeting is damaging for its credibility, can create expectations of a weaker ruble, and depress the investor sentiment

While the CBR might well reason that its explicit attempts to influence the FX market are excused by fears of higher capital outflows following a too sharp ruble appreciation, our concern is that those actions contradict the commitments the CBR undertook late last year, when it announced a transition to a ruble free-float. First, shifting back to FX management before bringing down inflation (which is still high, at 16-17% y/y) to the 4% target appears premature. Second, FX interventions do not appear justified to us when the ruble is trading at 50-55/$, in line with the fair value and representing no apparent risk to financial stability. Comparing this behavior with allowing the ruble to free-fall to RUB80/$ last year, the market might draw the conclusion that the asymmetric approach to ruble management signifies reduced CBR independence and a need to satisfy budgetary needs with a weaker ruble. This environment damages sentiment by making the economy more focused on playing exchange rate fluctuations rather than on ruble savings and investments. We consider the CBR's recent actions as a strong factor limiting the further recovery in the AB-ICI.

RATING DEFINITIONS

Alfa Bank applies a three-tier rating system for stocks under coverage. These ratings are based on the expected total stock return, which is the sum of the return to the target price and the expected dividend yield.

The ratings are:

Overweight (O/W):	Expected total stock return > 15%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
Underweight (U/W):	Expected total stock return < 0%

Owing to price volatility and our policy of not changing our ratings in response to frequent, short-term misalignments with expected returns, our ratings may sometimes not conform with the ranges indicated above.

In addition to the ratings above, we may occasionally assign the following classifications to stocks covered:

Restricted (R):	A rating, target price or financial forecasts are not disclosed owing to compliance or other regulatory considerations.
Under Review (U/R):	In response to recent or pending news flow requiring a significant overhaul or amendment of a company's financial model, the previous rating and/or target price is temporarily not disclosed.
Coverage in Transition (I/T)	Due to changes in the research team, the disclosure of a stock's rating and/or any other stock-specific information is temporarily suspended. The stock stays in Alfa Bank's coverage universe and usual disclosures will be resumed in due course.
Not Rated (N/R)	The stock is not in Alfa Bank's coverage universe at the time the research product referring to it is published.

IMPORTANT INFORMATION

Equity Market

Head of Equities
Michael Pijiolis
+7 (495) 795-3712

Alfa Bank
12, Akad. Sakharova Pr-t
Moscow, Russia 107078

Research Department +7 (495) 795-3676
research@alfabank.ru

Macroeconomics		
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724
Financial Sector, Internet		
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740
Oil & Gas		
Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334
Metals & Mining		
Dmitry Glushakov, CFA	dglushakov@alfabank.ru	+7 (499) 681-2918
Oleg Iuzefovych, CFA	oleg.iuzefovych@alfabank.kiev.ua	+380 (44) 239-9135
Retail, Real Estate		
Andrei Nikitin	ainikitin@alfabank.ru	795-3742
Alfa-Direct Research		
Geldy Soyunov	gsoyunov@alfabank.ru	641-3673
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)
Editorial & Production		
Christopher Rose	crose@alfabank.ru	745-7153 (ext. 8238)
Translation		
Anna Martynova	amartynova@alfabank.ru	795-3676
Stanislava Ovcharenko	sovcharenko@alfabank.ru	783-5020

Equity Sales & Sales Trading (Moscow) +7 (495) 223-5500 223-5522

International		
Dmitry Matyukhin	dmatyukhin@alfabank.ru	745-5621
Domestic Institutional		
Dmitry Demchenko	ddemchenko@alfabank.ru	783-5115
Vladimir Aleksandrov	vkaleksandrov@alfabank.ru	783-5120

Alfa-Direct Sales +7 (495) 795-3680

Sergey Rybakov	srybakov@alfabank.ru	ext. 6399
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083

Alfa Capital Markets (London) +44 (0) 20 7588-8500

Sales		
Robert Szucsich	r.szucsich@alfa-cm.com	7382-4174
Sales Trading		
Yan Gloukhovski	y.gloukhovski@alfa-cm.com	7382-4179

Alforma Capital Markets (New York) +1 (212) 421-7500

Sales		
Justin Landau	jlandau@alformacap.com	421-8564