Alfa·Bank

Macro Insights

AB-ICI: Fresh Round of Sanctions

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Investment Summary

- AB-ICI stagnated in June, reflecting lack of positive drivers
- Tightening of sanction rhetoric in July supports our negative view on ruble and inflation for 2H14
- The CBR is likely to expand its support to the banking sector, but will also have to increase its cost

AB-ICI stagnated in June, 2H14 outlook under pressure

The AB-ICI index showed a very modest 0.3% decline last month

After impressive growth in May, AB-ICI declined by 0.3% in June, which we view as stagnation, caused by no improvement in the index' main components. Our cautious take on 2H14 prospects is finding new confirmation due to the deterioration of the sanction agenda against Russia. While the real sector trends could be supported by likely budget easing, the lower availability of the foreign debt market for Russian corporates combined with the risk of foreign trade restrictions represents a bad sign in terms of capital flows and inflation.

Economic confidence showed a modest increase, but savings rate is a concern

- **Economic confidence** continued to grow in June, reflecting deceleration of the net capital outflow. According to CBR data, it slowed from $62bn in 1Q14 to $12bn in 2Q14 on the back of calmer sentiment on financial markets. That said, the local savings trend remains a concern – retail deposit growth decelerated to 8% y/y by mid-year vs. 19-20% y/y in 2013, reflecting persisting fears regarding stability of the banking system and ruble exchange rate, both factors supporting capital outflow in 2H14

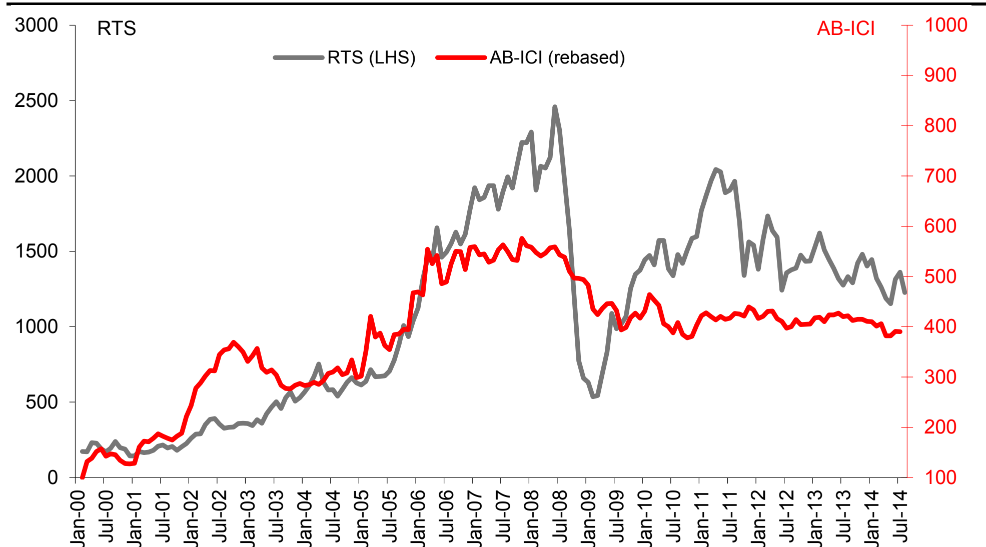
Foreign confidence flat, likely to drop soon

- **Foreign confidence** was flat last month, as no relevant data were released. However, given the tightening of the foreign sanction rhetoric against Russia, we expect foreign confidence to come under strong pressure soon.

Market confidence down, we see downside

- **Market confidence** declined in June, reflecting a cautious mood on the Russian equity and debt markets, given the concerns regarding Russia's local economic growth trend and geopolitical tensions. The new round of sanction pressure initiated against Russia in July combined with a pronounced US dollar appreciation on global markets suggest that the rest of the year will be challenging for RTS's fundamental value.

Figure 1: AB-ICI stagnated in June



Source: New Economic School, RTS, Alfa Bank

Fresh Round of Sanctions: A New Challenge

The sanction situation has deteriorated recently, with restrictions on new foreign borrowing, the EU taking a more active position, and increasing chances of a trade war escalating

Even though the discussion on sanctions started already on March, it became an important factor to consider only in July. First, on July 17, the US introduced limitations on Russian corporate access to global markets. Secondly, the EU has recently followed the US' lead by announcing the closure of EUR-denominated debt markets to Russian state banks. Finally, the risk of trade restrictions, which looked extremely unlikely a couple of months ago, is becoming more apparent with the EU's recent decision to ban European technology supplies to the Russian O&G sector, and Russia reacting by announcing restrictions on food imports from Europe. Beside the obvious psycological pressure on the market, the tightening of the sanction rhetoric has fundamental implications for Russian economy.

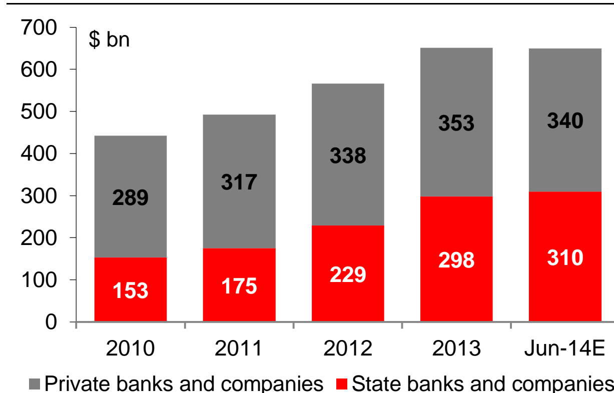
"Soft sanctions" are a concern – will Russian private companies be able to borrow; and will Asian markets be open to Russia?

While the list of entities sanctioned explicitly and directly is still very limited (so far the access the international debt market is limited to Rosneft, Novatek, Gazprombank, VEB, VTB, Bank of Moscow, Rosselkhozbank), the question remains whether the global markets will differentiate between sanctioned and non-sanctioned entities, or they will put all Russian corporates into the "avoid" basket. One litmus test here would be the ability of private banks and companies to keep using global markets as a financing tool. A related issue is the ability of Russian borrowing, which is currently focused on the EU, to switch to Asian markets.

State companies and banks have around $310bn in foreign debt exposure, with $60bn due for redemption in next 12 months

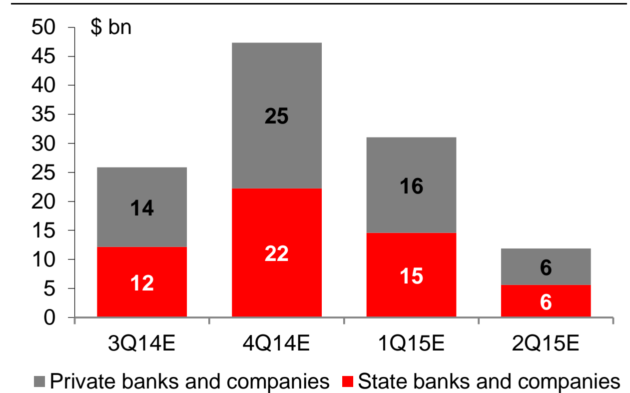
The most obvious implication of the new sanction reality is the increased risk of forced reduction in foreign debt that is especially pronounced in the state-owned entities segment. State-owned entities' exposure to foreign debt is $140bn for banks and around $170bn for companies. All in all, the exposure of state-owned banks and companies to global markets is around $310bn, or some 50% of the total corporate foreign debt. By mid-2015, Russian corporates are scheduled to redeem around $120bn of foreign debt principal, and, according to our estimates, around $60bn out of that sum is owed by state-owned entities.

Figure 2: Russian corporate foreign debt, $ bn



Source: CBR, Alfa Bank

Figure 3: Corporate foreign debt redemption schedule, $ bn



Source: CBR, Alfa Bank

Demand for CBR support should increase by RUB1tr, all else being equal

The likely local response to the forced redemption scenario is that the CBR will have to increase liquidity support in the banking sector by around RUB 1tr in order to facilitate these payments, but liquidity is likely to become more expensive, with another 50bpt key rate hike likely. We maintain our RUB37/$ year-end ruble exchange rate target that already prices in the high $120bn net capital outflow. We also do not see any dramatic impact on this year's GDP growth, however in the longer run, restrictions on technology imports may negatively affect the growth rate. This scenario indicates, that the AB-ICI will be facing pressure in 2H14 from the financial side, while in the long term, it will be challenged by the slow economic growth rates.

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