

AB-ICI: New Risk to Ruble

Natalia Orlova
Dmitry Dolgin

(+7 495) 795-3677
(+7 495) 780-4724

NOrlova@alfabank.ru
DDolgin@alfabank.ru

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www.alfa-bank.com

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Investment Summary

- AB-ICI surprisingly fell 10% in June, reflecting noticeable weakening of the FDI inflows YTD
- Local economic growth close to bottoming out, recovery to be slow
- Turmoil on the Chinese stock market is a new challenge for 2H15

AB-ICI down 10% in June

AB-ICI down 10% in June due to a sharp drop in FDI inflows

Last month brought a negative surprise, with AB-ICI dropping 10% m/m (down 9% YTD). While the economic confidence indicator justified our expectations of a recovery, the foreign confidence indicator dropped significantly, reflecting a sharp deterioration in FDI dynamics YTD after a brief recovery in 4Q14. In addition, market confidence has been under pressure from China woes, which remain an ongoing risk for the Russian market and AB-ICI performance.

Net capital outflow slowed to \$20bn in 2Q15; however, deposit dollarization and foreign debt redemptions are risk factors for 2H15

- **Economic confidence** has increased, reflecting a slowdown in the net capital outflow to \$20bn in 2Q15, vs. \$33bn in 1Q15, and some recovery in the household savings rate seen through inflows to retail deposits – both developments indicating that the turmoil on local financial markets is passing. That said, continuing dollarization remains an issue that, combined with the busy foreign debt redemption schedule for 2H15, suggests possible pressure on the economic confidence indicator in the coming months.

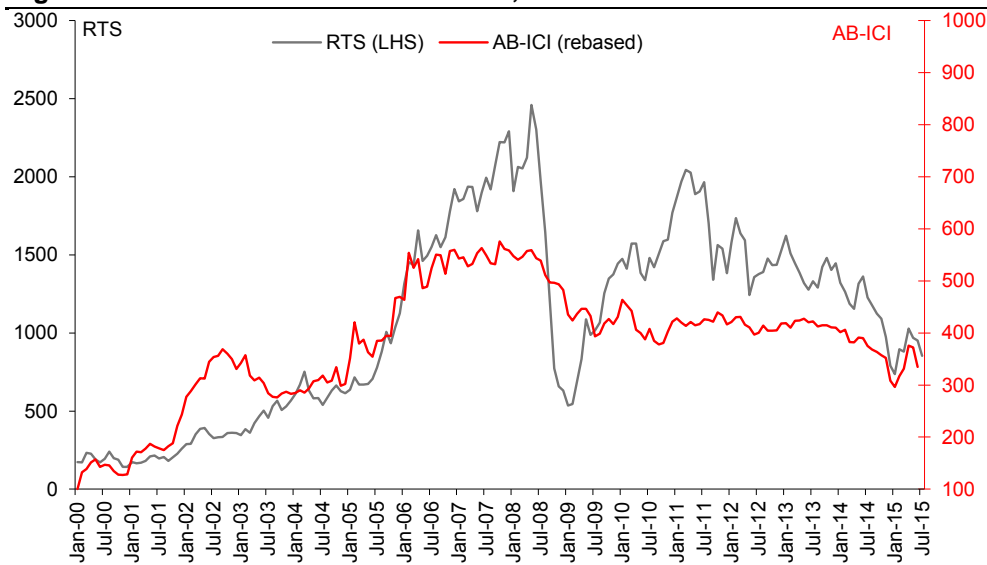
FDI inflows are down 40% y/y in 1Q15, state de-offshorisation efforts did not help

- **Foreign confidence** dropped materially, reflecting the recent CBR data point of a 40% y/y drop in FDI inflows in 1Q15 from an already low base. The figure suggests that despite some de-offshorization efforts, which might have led to recovery in 4Q14, Russia's overall investment attractiveness remains questionable, keeping FDI dynamics volatile.

Mounting risks coming from China are putting pressure on the confidence in Russian market

- **Market confidence** continued to decline in June – although this did not come as a surprise. Despite an easing of pressure on EMs from Greece, markets are now focused on the new threats to global growth and oil prices coming from the turmoil on the Chinese financial market.

Figure 1: AB-ICI down 10% m/m in June, -9% YTD



Source: New Economic School, RTS, Alfa Bank

AB-ICI: New Risks to Ruble

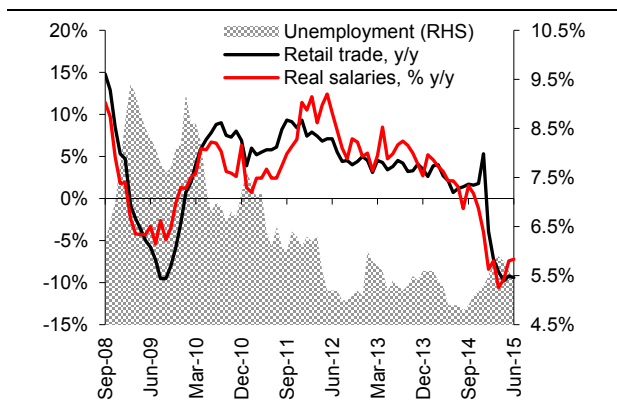
Households and corporates show signs of low trust in the ruble through higher dollarization despite the possible bottoming out of the GDP growth trend

\$20bn net capital outflow in 2Q15 wiped out the current account surplus, FDI inflows weak, future foreign debt redemptions high

The surprisingly negative AB-ICI performance in June highlights the new risks Russia is facing for 2H15. Even the dynamic of the economic confidence indicator, which measures the trust of local households and corporates in the ruble, and which was in fact positive last month, is also painting a mixed picture. On the one hand, the macro statistics for June and 2Q15 suggest that the deterioration in household sentiment has likely reached bottom, with unemployment down to new lows of 5.4%, the retail trade drop of 9.4% y/y in June being close to the May decline, real wage contraction narrowing to 7.2% y/y vs. 7.4% y/y a month earlier and acceleration in the inflow of retail deposits to 2.6% m/m in June from 1.0-1.5% m/m in the previous months. On the other hand, household trust in the ruble still appears low, with the share of FX deposits increasing for the third month in a row to 25.5%, and corporate deposit dollarization also standing high, at 45%.

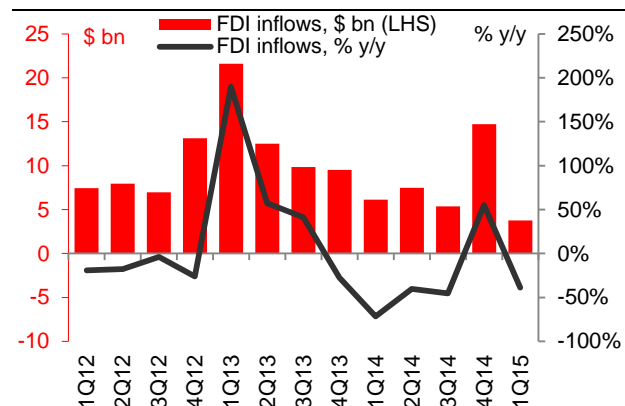
The concerns regarding the ruble find support in the balance of payment data for 2H15. Though the 2Q15 current account surplus of \$19bn might appear high, it remained structurally weak (given the 14% y/y drop in the non-oil exports) and was completely wiped out by the \$20bn net capital outflow. With \$30-40bn of net foreign debt redemptions still due in 2H15, the current account surplus might not be enough to cover net capital outflow in coming months. An additional negative is the fact that the de-offshorisation efforts by the government are failing to make the FDI trend more predictable. After spiking 55% y/y in 4Q15, FDI inflows dropped 40% y/y in 1Q15, not helping to limit the capital outflow risks. The weak balance of payments was the reason we downgraded our YE15 ruble forecast to 58/\$.

Figure 2: Key consumer trends



Source: Rosstat, Alfa-Bank

Figure 3: FDI inflows, \$ bn and % y/y



Source: CBR, Alfa-Bank

New risks are limiting the CBR's scope for interest rate easing in 2H15;

2H15 will be more challenging for AB-ICI than we thought initially

The additional risks to market confidence and the ruble from the lower oil prices (pressured by the lifting of sanctions from Iran and the turmoil on the Chinese financial markets) and the tightening of US sanctions against Russia suggest that even our recently worsened currency outlook might prove too optimistic. The recent ruble depreciation to RUB60/\$ has prompted the CBR to suspend its FX purchases (\$10bn has been bought since mid-May, when ruble exchange rate was RUB50/\$) and forced the regulator to mention global uncertainties as a risk factor to the monetary policy decisions in its commentary to the most recent 50bp key rate cut. Given all the abovementioned, we believe 2H15 will likely be more challenging for AB-ICI in terms of economic, foreign and market confidence, that we had previously thought.

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Head of Equities Alfa Bank
 Michael Pijiolis 12, Akad. Sakharova Pr-t
 +7 (495) 795-3712 Moscow, Russia 107078

Research Department		+7 (495) 795-3676	
		research@alfabank.ru	
Macroeconomics			Retail, Real Estate
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677	Andrei Nikitin
Dmitry Dolgin	ddolgin@alfabank.ru	780-4724	ainikitin@alfabank.ru
Sergey Egiev	segiev@alfabank.ru	795-3612	795-3742
Financial Sector, Internet			Alfa-Direct Research
Marina Karapetyan	mkarapetyan@alfabank.ru	795-3740	Geldy Soyunov
			gsoyunov@alfabank.ru
			Alan Kaziev
			akaziev@alfabank.ru
			641-3673
			974-2515
			(ext. 8568)
Oil & Gas			Translation
Alexander Kornilov, CFA	akornilov@alfabank.ru	788-0334	Anna Martynova
			amartynova@alfabank.ru
			795-3676
Metals & Mining			
Dmitry Glushakov, CFA	dglushakov@alfabank.ru	+7 (499) 681-2918	
Equity Sales & Sales Trading (Moscow)		+7 (495) 223-5500	
International		223-5522	
Dmitry Matyukhin	dmatyukhin@alfabank.ru	745-5621	Domestic Institutional
			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	