AB-ICI: New Global Challenges

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Investment Summary

- AB-ICI declined 2% last month, reflecting an absence of improvement in capital flows, both internal and global
- Sharp deterioration of global markets in August provides negative near-term guidance for AB-ICI
- CBR has little tools or will to support ruble exchange rate

AB-ICI down 2% in July

AB-ICI down 2%; all components under pressure; August market turmoil is negative short term guidance

The AB-ICI continued its dive last month, declining 2% m/m in July. Although this represents a slowdown from the 10% m/m fall a month earlier, we still take it negatively. All the confidence indicators had already come under pressure in July, while the August oil price drop and the EM FX volatility is a negative signal for the AB-ICI, at least in the near term. The ruble, which, at its weakest point, was 20% lower than the July average, has little chance of support from the CBR, as a rate increase could damage the banking sector.

Dollarization continues in banks; decline in savings rate ahead

- **Economic confidence** dropped on continuing net capital outflows, with households remaining key. In July, households continued to boost FX savings in banks, partially returning the funds cashed out at YE14, but also reflecting some flight from ruble savings as well. With the ruble's sharp drop in August, the conversion process might be reversed; however, this would represent the spending of savings, rather than rising economic confidence.

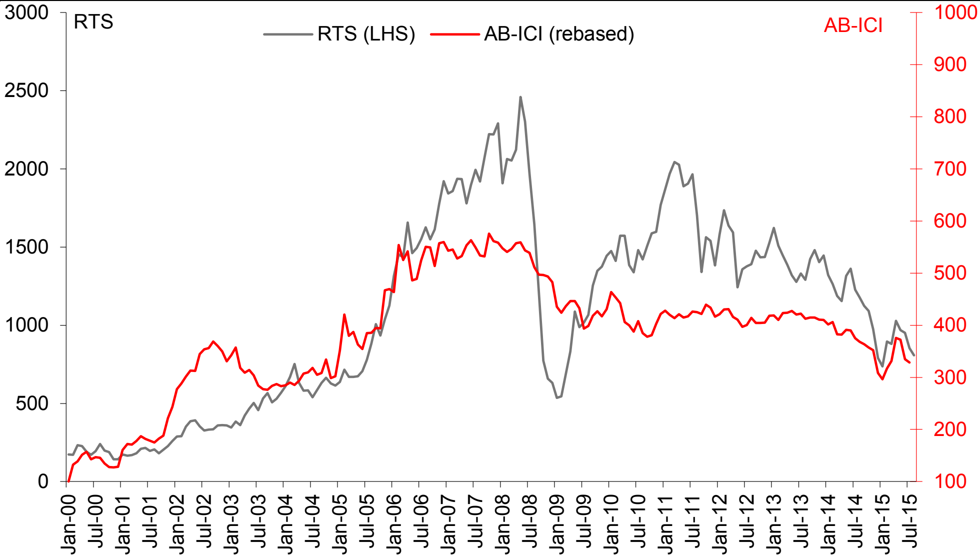
Foreign banks continue to reduce presence in Russia

- **Foreign confidence** decreased, reflecting the continued reduction of foreign banks' presence in Russia. In recent months, this has been due to the weak retail lending segment; however, the discussion on banning state companies from keeping corporate accounts with foreign banks is poses a risk to the foreign confidence indicator.

Low oil prices and yuan depreciation give rise to risk-aversion on all EMs and commodity currencies

- **Market confidence** continued to decline in July, and the fall most likely accelerated in August, when the yuan devaluation and pressure on the oil price provoked sharp volatility on all financial markets and led to a series of depreciations in commodity and EM currencies, with the ruble reaching 71/$. At oil prices of $45/bbl, this level does not look oversold to us.

Figure 1: AB-ICI down 2% m/m in July



Source: New Economic School, RTS, Alfa Bank

AB-ICI: New Global Challenges

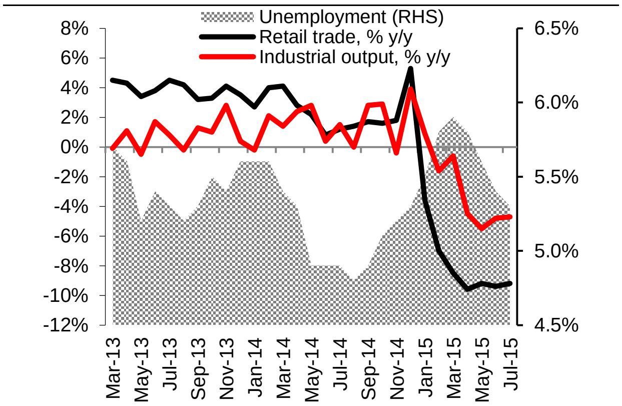
AB-ICI remains under pressure despite the relatively solid trends in the real sector

Last month justified our expectations that 2H15 is likely to be challenging for the Russian economy generally, and the AB-ICI in particular, regardless of the local economic trend. For example, the retail trade performance in July was close to our expectations and slightly better than the market had expected, falling 9.2% y/y, vs. the 9.0% y/y we had forecast and the 9.8% y/y consensus expectation. Given that inflation in July surprised on the upside, the retail data can be seen as positive. Unemployment was supportive: 5.3% vs. 5.4% in June, pointing to a recovery in demand from employers. In addition, the retail loan portfolio of Russian banks added 0.1% m/m after six months of consistent contraction. Finally, federal budget expenditure growth in July was 34% y/y after a 23% y/y increase in 1Q15 and a lackluster 8% y/y growth in 2Q15.

Each $1/bbl decline now triggers a RUB1/$ depreciation; the ruble might go to 75/$ with oil at $40/bbl

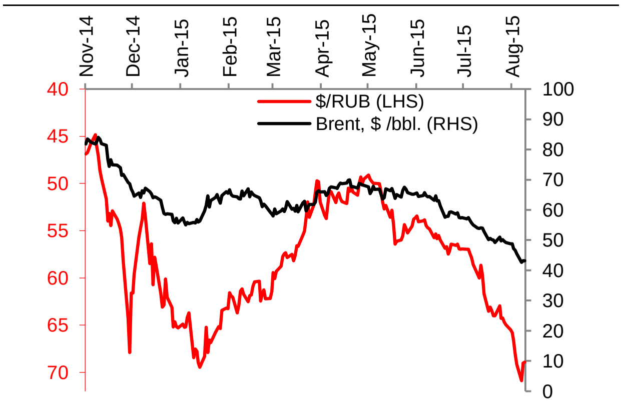
The key reason confidence is not recovering is the continuing deterioration of global and local market sentiment, which started in July, when the oil price declined from $65/bbl to $50/bbl, pushing the ruble from 50-55/$ to 60-65/$, and continued into August, when further pressure on oil prices and a wave of deliberate and surprising devaluations across the EM and Comex universe pushed risk off globally and forced the ruble to new lows of RUB71-72/$. The key issue here is that despite the sharp drop, the ruble does not appear to be oversold, and under a $40/bbl scenario, a further depreciation to 75/$ is likely, as due to low liquidity and the ruble free floating, the market is now following a 1:1 ratio between $/bbl and RUB/$ declines. Given the uncertainties surrounding oil prices and the Fed's schedule for tightening, trust in ruble vehicles is unlikely to return easily.

Figure 2: Key consumer and producer trends



Source: Rosstat, Alfa-Bank

Figure 3: Oil price and ruble exchange rate



Source: Bloomberg, Alfa-Bank

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

We do not believe the authorities are likely to take aggressive steps to prevent further ruble depreciation in the event of a further global downturn. First, some minor steps have already been taken: the CBR has stopped purchasing foreign currency from the market and unveiled a new foreign debt payment schedule for September-December 2015 that implies that only $35bn is to be paid, instead of the $61bn the central bank had initially expected. Second, there is no point in actively preventing ruble depreciation in an environment of falling oil prices and competitive devaluations globally. Third, indirect measures to support the currency (i.e. a hike in the key rate, as expected by some market participants) seems unlikely, as the similar expericence in December 2014 showed that an increase in interest rates damaged banks more than it helped stabilize the markets. As a result, unless the commodities trend offers some positive surprise, the ruble appears undefended, which in itself might be a risk to the capital account and AB-ICI.

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