Alfa-Bank

Macro Insights

AB-ICI: Ruble Weakness In Focus

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Investment Summary

- AB-ICI down 2% in August, posting a decline for the third month in a row; down 10% YTD
- Global USD rally and corporate foreign debt redemptions are putting pressure on ruble
- Weak ruble and fast inflation requires another CBR key rate hike soon

AB-ICI down 2% in August, 10% YTD

AB-ICI down 2% in August

In August, our index continued to experience significant pressure. It was down 2% after a 4% decline in July. As we previously warned, reduced access to the external debt market is taking its toll, with companies accumulating demand for FX instead of expanding production and investment. The key focus is now on the ruble, which depreciated 15% vs. USD in 3Q14, providing negative guidance at least for next month's AB-ICI.

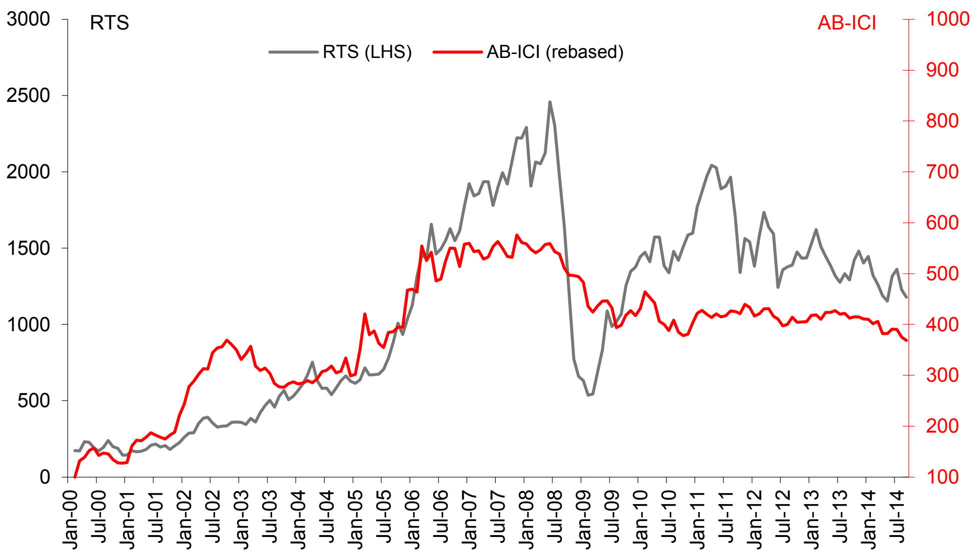
Foreign debt redemption fueling net capital outflow; ruble weakness limiting ruble deposit inflows

- **Economic confidence** continued to decline, reflecting the persisting effect of sanctions. Due to the reduced ability to refinance foreign debt, companies and banks continued to accumulate FX position, fueling net capital outflow and pushing the ruble to new lows. The new round of ruble instability is a factor limiting savings growth, with retail deposit growth still at a multi-year low of 8% y/y. With accelerating inflation dampening real interest rates, the outlook for the economic confidence indicator is grim for the near term.
- **Foreign confidence** remained unchanged on the lack of new relevant statistics; however, with no progress in Russia's international relations, we do not see any support for this indicator coming anytime soon;

Russian market suffering from global outflows from EM, but also facing local challenges

- **Market confidence** is under the dual pressure of (1) Fed-induced global capital outflows from EMs to USD (which also hit the oil price); and (2) the Russia-specific sanctions story that is very negative for sentiment. The market in Sept was further hit by the prosecution of Sistema owner Vladimir Yevtushenkov, being negative guidance for near-term market confidence.

Figure 1: AB-ICI down 2% in August



Source: New Economic School, RTS, Alfa Bank

Macro Insights

AB-ICI: Rebound in 4Q14?

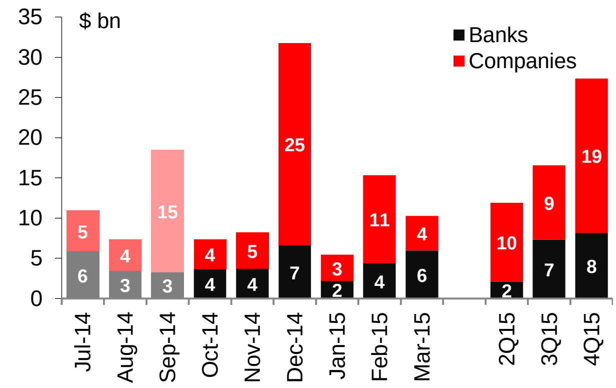
15% ruble depreciation in 3Q14 damaged AB-ICI and raised questions regarding 4Q14 prospects

3Q14 was quite a negative quarter for the ruble, which depreciated 15% (more than the 10% seen in 1Q14) vs. USD at the peak of geopolitical tensions between Russia and the West over the Ukraine conflict. As the ruble exchange rate remains an important anchor of expectations, the sharp movement is damaging confidence, which is confirmed by the negative dynamics of the AB-ICI. We believe that the September index, which will be available next month, is very likely to post another drop; however, the prospects for the year-end remain uncertain. It appears to us that market sentiment is now so negative that it would be easy for economic reality to deliver a positive surprise.

Upcoming foreign debt redemption of $50bn in 4Q14 is key reason for negative expectations

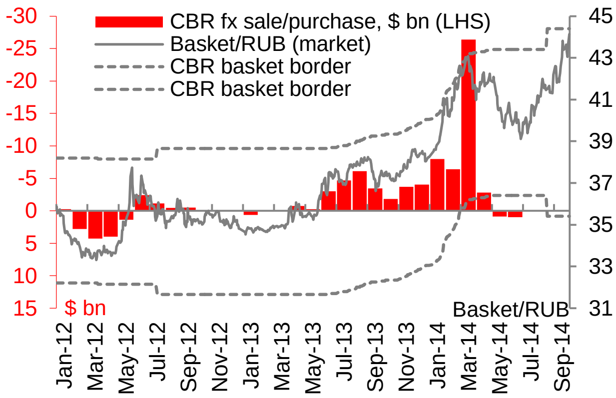
It appears that the fundamental basis for negative expectations on the ruble is the fact that the tightening of the foreign sanctions, restricting access to financial markets for some Russian corporates, will force a decline of foreign debt. In fact, the short supply of FX on the local market in August-September was indeed related to the accumulation of currency for foreign debt redemption. Macro and banking statistics confirm this trend, as companies have boosted their FX accounts with banks by around $30bn in the last six months, while the fixed investment dynamic entered negative territory. The tight foreign debt redemption schedule – $50bn for 4Q14 and another $90bn for 2015 – is causing concern for the real sector, financial markets and expert community, with fears of a drop in CBR reserves and the introduction of capital controls circulating.

Figure 2: Russian foreign debt redemption schedule, $ bn



Source: CBR, Alfa Bank

Figure 3: Basket/RUB market, CBR band and FX interventions, $ bn



Source: CBR, Alfa Bank

Net capital outflow likely to be financed through current account surplus

We do not see tightening of FX management regime and capital controls as realistic policy option

Key rate hike likely to come soon

On the other hand, we do not share market fears. First, while we agree that quasi-sovereign foreign debt redemption (we estimate it at ~$60bn until mid-2015) is a pressure factor on the capital account, we also believe that recent ruble depreciation, combined with the food import ban, will allow financing the extra net capital outflow with the current account surplus. Second, given the new CBR team's recent efforts to boost its monetary-policy credibility, including aggressive interest hikes and easing of the FX management regime, we find it hard to believe that the CBR will fail to implement ruble free-float in 2015, as it promises at the moment. Additionally, the capital control option is completely incompatible with the current CBR management team. We are thus waiting for positive 3Q14 BoP data and a possible key rate hike to confirm this view soon. In that case, economic and market confidence may improve somewhat by year-end.

US monetary policy, Russia-West relations and local legal pressure are risks to AB-ICI rebound

There are, however, two major risk factors that may continue pressuring AB-ICI going forward. The first one is that US Fed tightening may keep Russia subject to global capital outflow from EMs. The second risk is that the lack of a resolution to the Ukraine conflict, combined with legal pressure on Sistema, will keep confidence in Russia low regardless of positive CBR-related news.

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