

**AB-ICI: Capital Outflow Darkens 4Q14 Outlook**

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**Investment Summary**

- AB-ICI down 1% in September reflecting a decline of all the three components
- CBR spent ~\$30bn on FX market in October, suggesting sharp acceleration of net capital outflow
- The aggressive 150bp rate hike came too late to stabilize the local market

**AB-ICI down 1% in September, October capital outflow darkens 4Q14 outlook**

**Ruble instability hampers ruble deposit inflows, boost dollarization**

**Foreign banks continue to pull out**

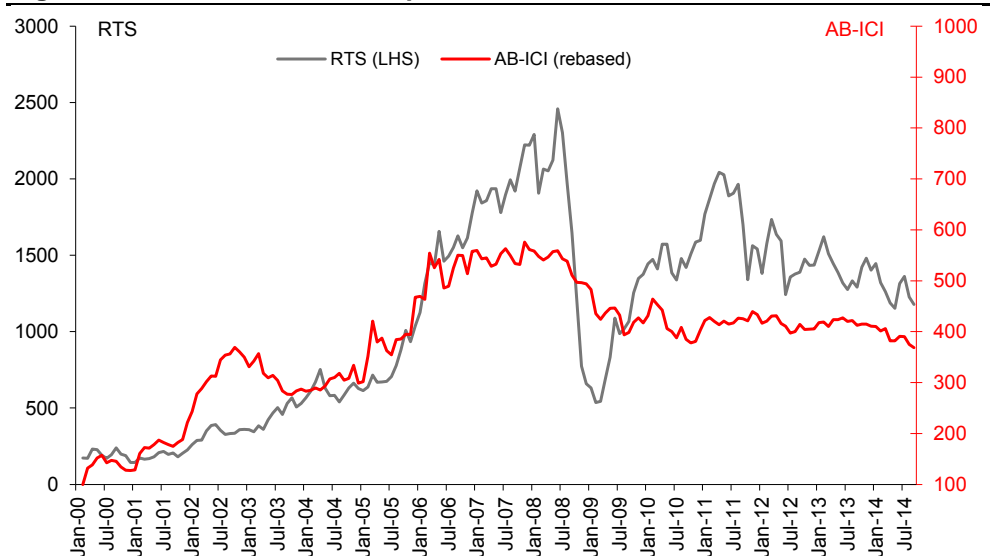
**Russian market suffering from global outflows from EM, but also facing local challenges**

**AB-ICI down 1% in September, more to come in 4Q14**

As expected, September AB-ICI signaled continuing pressure on investor confidence. The 1% index decline was driven mainly by the drop in the market component, which was down on fears around Sistema’s legal woes. That said, if previously we remained optimistic regarding the 4Q14 prospects, now this view is challenged by October’s sharp acceleration of the net capital outflow, which was at least \$30bn, the sum the CBR had to spend on the FX market last month. The capital control rumors, which arose early October and were not properly addressed, provoked an extremely sharp ruble depreciation, which will now weigh on all the index components at least for the next couple of months.

- **Economic confidence** declined on persistently low household preference for savings, exacerbated by the ruble depreciation. The FX rate instability kept the retail deposit growth at a low 8% y/y in September, while the share of FX savings increased to a 6-month high of 19.8%. The even sharper ruble drop in October has likely led to further decline of the household preference for ruble savings, being a very negative guidance for the economic confidence indicator until this year-end at least.
- **Foreign confidence** dropped reflecting the continuing and largely expected reduction of the foreign presence from the Russian banking system. Foreign players currently control 8.4% of Russian bank assets, a 7,5 year low;
- **Market confidence** was down reflecting geopolitics and Sistema case pressuring Russia’s bond and equity markets. October’s capital control fears, combined with the end of Fed’s QE and rate hikes in EM suggest that the effect of CBR’s 150bp hike, which came in the very end of last month, is unlikely help much to restore the market sentiment anytime soon.

**Figure 1: AB-ICI down 1% in September**



Source: New Economic School, RTS, Alfa Bank

### Net Capital Outflow Outlook Darkens

**Capital control rumors destabilized the local markets, 10M14 net capital outflow already exceeds our FY14 target of \$120bn**

**150bp rate hike came too late: capital control fears already drove out some FX deposits abroad...**

**...while dollarization of local deposits increased**

**Net capital outflow from the corporate sector to continue on foreign debt redemptions**

**Global capitals are avoiding Russia for reasons, which are beyond CBR's interest rate policy**

**Net capital outflow may reach \$150bn in 2014, exceed \$100bn next year, ruble to remain in RUB40-45/\$ range in the coming 12-15 months, keeping AB-ICI under pressure**

The September decline in the AB-ICI was in line with expectations, however our concern now that our previous hopes for a rebound in 4Q14 have been slashed by October's obvious downturn of events. In the very beginning of last month the markets were destabilized by the rumor that following the sharp ruble depreciation in 3Q14 the CBR was discussing re-introduction of capital controls. As a result, the pressure on the FX market, which was already high due to low oil prices and the foreign debt redemptions, increased, pushing ruble exchange rate from RUB39-40/\$ to RUB42-43/\$ in just one month. The CBR had to spend around \$30bn on the FX market in the environment of positive current account surplus, which means that October's net capital outflow was at least \$30bn after \$85bn in 9M14. As a result, the 10M14 net outflow figure already exceeds \$120bn, our full-year target.

Unfortunately, even the CBR's 150bp key rate hike, which took place on October 31<sup>st</sup> during the scheduled BoD meeting, does not create expectations of a net capital flow reversal anytime soon. First, we believe it came too late to stabilize the market. Only an immediate response to capital control rumors – with an ahead of schedule rate hike – would have removed the ground from the capital control fears. There is anecdotal evidence suggesting that in October high net worth retail depositors made cross-border transfers of their FX savings, lowering the FX supply in the interbank market, and no rate hike is a powerful tool to assure the return of this FX onshore.

Second, the sharp 7% ruble depreciation which took place in October has apparently lowered the confidence of the ruble depositors, which, judging by the media accounts, started to accumulate the FX position. Even if the end-October rate hike will translate into more attractive ruble deposit rates, we do not expect this positive effect to manifest itself immediately.

Third, the increase in the key rate cannot prevent the net capital outflow from the corporate sector, which remains under pressure of the foreign debt redemptions. Even though the scale of the problem in our view is much less than the market fears, failure to attract new foreign debt is a strong argument in favor of higher net capital outflow. To remind, in the last 5 years the capital account was supported by the \$40 bn p.a. corporate foreign debt accumulation, including \$83bn increase in 2013.

Finally, the CBR rate hike is not impressive enough to make Russia more attractive for global capitals. In the environment of the expected tightening of the Fed monetary policy, acceleration of the GDP growth in the developed markets, and the increase of interest rates in the EM (including Brazil's most recent rate hike), Russia's rate increase at best prevents further deterioration of portfolio investors' confidence. The latter will increase in case of improvement of Russian GDP growth story, removal of geopolitical tensions and improvement of the investor protection, neither of the three being within CBR's domain.

As a result, we have to worsen our net capital outflow expectations. Even accounting for the slowdown of the net outflow following the October spike, the full-year outflow will now definitely exceed the all-time high of \$133bn seen in 2008 and may reach \$150bn. Incorporating this downgrade and accounting for the below expected oil price environment we have to downgrade our YE14 ruble exchange rate expectations to RUB41/\$. Moreover, unless there is any improvement in the foreign policy front, next year's net capital outflow will also exceed \$100bn, keeping ruble exchange rate in the weak RUB40-45/\$ range. This sets a very negative background for all the AB-ICI components for the foreseeable future.

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