

AB-ICI: Ruble is the Key Risk Now

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Investment Summary

- The AB-ICI was flat, as some recovery of FDI inflows was offset by a drop of market confidence
- Russia is punished by the markets due to its growth lagging other EMs
- Deterioration of global and local view on GDP growth poses risk to AB-ICI in 2014

AB-ICI remained flat last month as positive FDI data were offset by the deterioration of the market mood towards Russia

Economic confidence did not increase

Strong FDI inflows in 2013 reflect one-off capital repatriation from Cyprus

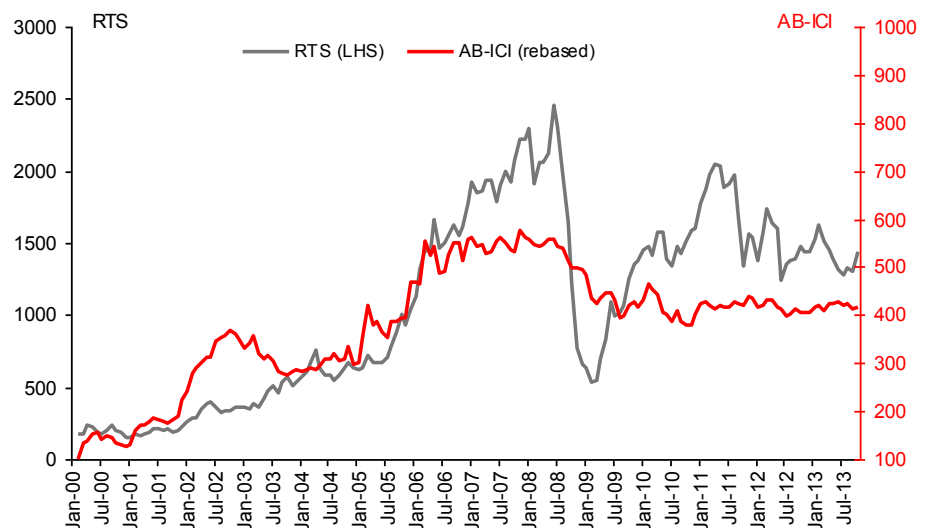
Russian market performance is lagging behind EM peers due to lagging economic growth

AB-ICI was flat in October

The AB-ICI stayed unchanged in October as underlying components demonstrated mixed dynamics. Domestic pressure eased only slightly, while foreign confidence was strong, though mostly due to one-off FDI inflow jump. In contrast, market confidence fell in response to Russia's GDP growth underperformance compared to peers. With high risk of further disappointments for the market, the AB-ICI index is likely to remain subdued in 2014.

- **Economic confidence** was slightly up in October due to insignificant improvement in several factors. Share of forex deposits decreased, while savings rate was up slightly. We consider such halt in economic confidence deterioration to be of short-term nature as the recent pressure on ruble is not supportive of preference for ruble savings.
- **Foreign confidence** was the main support factor of AB-ICI in October, preventing the index drop. It increased mainly due to considerable FDI inflow, 52% y/y in 9M13. However, corrected for the one-off repatriation of Russian capital due to Cyprus crisis, FDI grew by 19% y/y, just in line with previous years. This suggests that strong foreign confidence is likely to be a one-off event for 2013.
- **Market confidence** decreased considerably last month. The spread between Russian and LatAm bonds widened, confirming our expectations of country-specific concerns. Russian GDP slowdown was sharper than peers' causing portfolio outflows. That said, the market consensus for next year's growth is still high, suggesting that the downside for market sentiment towards Russia remains high in 2014.

Figure 1: AB-ICI remained flat in October



Source: New School of Economics, RTS, Alfa Research

AB-ICI: Under Pressure of Weak Ruble

The recent weak ruble performance puts exchange rate market back into investors' focus

In the short term, ruble is under pressure of nervousness in the banking system

Deterioration of the local GDP growth trend is the key risk for ruble in 2014

CBR commitment to inflation targeting and weak balance of payments will put pressure on ruble in 2014

Even though AB-ICI seems to have stabilized in the recent months, the deterioration of the mood on the ruble exchange rate market is causing increased concern. Indeed, ruble has come under considerable pressure recently, with the currency basket returning to its mid-2009 level of RUB38.5. \$/RUB rate has also recently exceeded the psychological threshold of RUB33. Continuous weakening of ruble, observed since the beginning of the year, is a potential threat to investor confidence, calling us to take a closer look at the further forex prospects.

The immediate trigger for the recent turbulence on the forex market was the overall nervousness, caused by the tightening of the CBR approach to the banking sector supervision. In the last couple of months, the authority revoked licenses from a number of banks, including a relatively large Masterbank, and announced intention to proceed with the cleanup going forward. Fundamentally, this move seems healthy and reflects the CBR's desire to address mounting risks in the retail lending segment and to reduce the number of banks from the overly high 800+ level. However, in the short-run, this creates fears of repetition of the 2004 banking crisis, and ability to overcome those fears will largely depend on the CBR's ability to properly convey its actions to the market.

At the same time, we believe the pressure on ruble has a more fundamental ground and reflects adjustment of expectations on the forex market to the economic reality. The lack of acceleration of the Russian GDP growth in 3Q13 and very poor 1.3% y/y growth in 9M13 came as a shock to the market and triggered downgrade in expectations for this year towards our below-consensus view for this year, however we believe that 2014 expectations still have a downside.

There are several reasons why disappointing GDP growth is making the market more bearish on ruble. First, the CBR's commitment to gradual enforcement of inflation-targeting framework, suggest more focus on price stability and less support to the forex market. Second, competitive depreciation is widely seen as a tool of boosting economic growth. Third, the seasonality of Russia's current account may be amplified by the end of Sochi Olympics, exacerbating expectations of faster depreciation in the 2H14.

Figure 2: Basket/Ruble rate and CBR forex operations

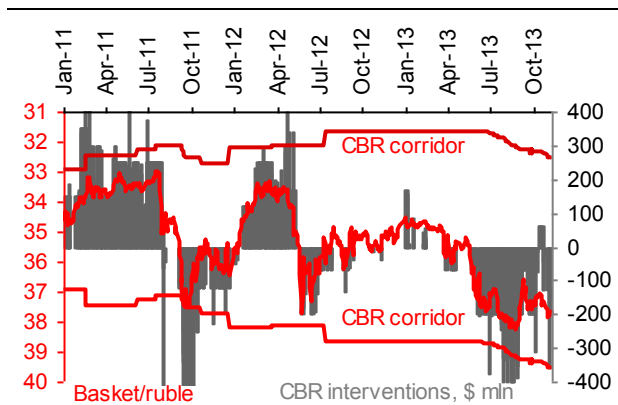
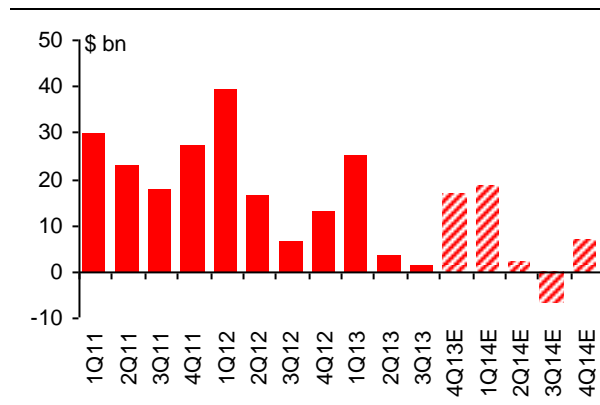


Figure 3: Russian current account surplus, \$ bn



Mounting expectations of ruble depreciation will limit the performance of all AB-ICI components in 2014

Finally, the global environment is gradually becoming more negative towards emerging markets. American economy again sends signals of increasing health and brings tapering option back on the table. As EMs has already experienced considerable attack onto their currencies during June tapering-talk episode, the US growth acceleration is adding to the pressure on ruble expectations. Being a major drag on all the AB-ICI components, ruble depreciation – to RUB35/\$ by YE2014 – is a major risk to the index in the next year, especially in the 2H.

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