Alfa-Bank

Macro Insights

AB-ICI: It's All About Ruble Now

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Investment Summary

- AB-ICI dropped by 2% in October on sharp acceleration of net capital outflow that was largely expected
- Further prospects are cloudy, as the initial market reaction to the rate hike and ruble free float was negative
- CBR might have to tighten the ruble liquidity in order to stabilize the FX market

AB-ICI down 2% in October

AB-ICI collapsed by 2% in October on a very strong net capital outflow

AB-ICI's October 2% drop was in line with our gloomy expectations and reflected the sharp acceleration of net capital outflow and poor performance of Russia's financial markets. We believe October outflow was at least $30bn after $85bn in 9M14. While the CBR's November decision to introduce ruble free float should eventually help to improve the capital account, it will take time before the markets will adjust to the new reality.

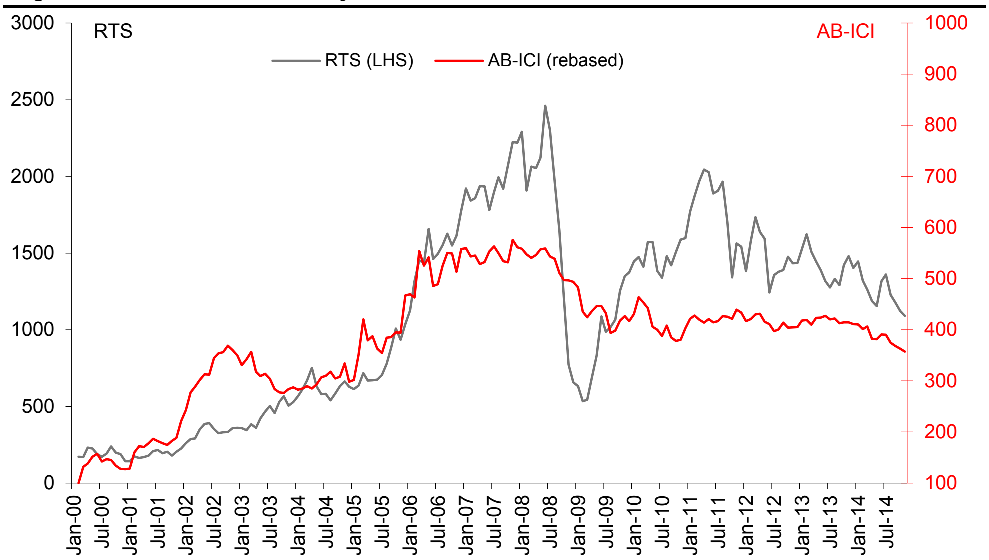
Economic confidence expectedly down on accumulation of FX by all economic agents, households joined the trend in October

- **Economic confidence** collapsed reflecting huge net capital outflow, which forced the CBR to spend almost $30bn of its international reserves in October. The outflow reflected panic accumulation of FX, which was especially pronounced in the corporate sector, which increased its FX position by $7bn in October and $24bn YTD. Surprisingly, the households' FX deposits increased by $2bn, and even if it is still flat YTD, the dollarization spiked to 22% vs. 19% 12M ago, representing a decline in trust to ruble as savings currency;
- **Foreign confidence** remained flat given the lack of new relevant statistics, though the outlook is not positive;

CBR policy decisions are appropriate for the long-term stability, but do not help Russian equities, bonds and FX in the short-term

- **Market confidence** was down reflecting the fact that the Russian market was one of the worst performers in the world in equity, bond, and FX segments in October. The CBR's decision to make a sharp 150bp rate hike, while being positive fundamentally, was an unexpected blow to the bond market. The November decision to introduce ruble free float, also positive for the long-term financial stability, was taken in the environment of strong pressure on FX market (related to sanctions and other non-monetary challenges), resulting in ruble entering RUB45-50/$ range and hitting the key equity indices as well.

Figure 1: AB-ICI is down by 2% in October



Source: New Economic School, RTS, Alfa Bank

New CBR Policy vs. Old Economic Reality

Collapse of AB-ICI in October was expected, but future dynamics will be affected by innovations of the CBR

Collapse of the AB-ICI index in October was largely expected as it mainly reflected sharp acceleration of capital outflow. But bold moves on the CBR's side call for carefull investigation of how Russian capital account will be affected. In November CBR finally decided to introduce the free float regime for ruble. On the positive side this move signalled CBR's desire to no longer finance net capital outflow which is positive for the macro stability. But now the CBR faces another challenge: in order to stabilize exchange rate it will have to tighten its monetary stance sufficiently.

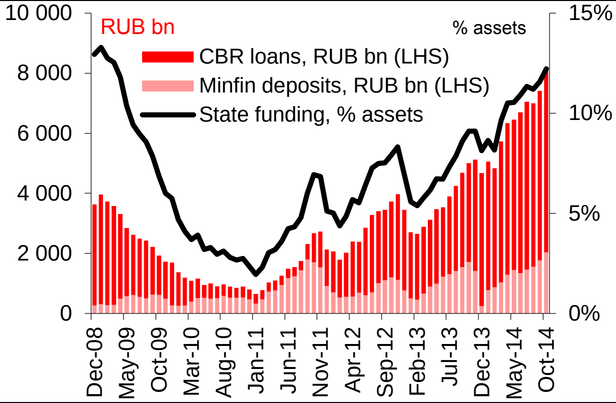
Banks used CBR's liquidity provisions as a way to substitute for expensive retail funding

This task is compicated by the market being accustomed to abundant liquidty provisions that the CBR has previously practiced. The exposure to CBR funds has expanded from 0.8% of total banking assets in mid-2011 to 9.2% in October this year. In part, the CBR intended these liquidity injections to compensate for withdrawals caused by FX interventions. Yet the banks considered this liquidity exposure that increased from RUB300bn to RUB6.2tr currently as a way to substitute expensive retail deposits.

CBR signals that the tightening cycle is far from being over…

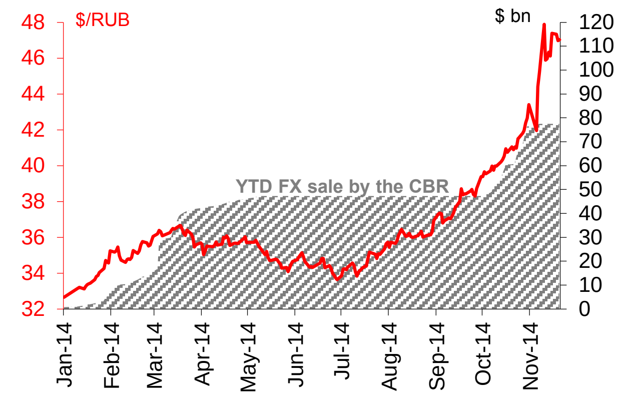
It appears that the monetary stance is now changing so that the banking sector and financial markets will need to readjust. First, the volume of liquidity injections is subject for revision. The CBR's exposure still has some room to grow as Financial Ministry is seasonnaly withdrawing its liquidity towards the end of the year. Yet the RUB7.0-7.5tr level that CBR will reach appears to be a ceiling. For one thing, now that the FX intereventions are cancelled there is less rationale behind abundant liquidity provisions. Furthermore, RUB7.0-7.5 tr reflects the sum of FX reserves stored in the CBR. Aggressive growth of ruble liquidity above this figure will erode fundamental value of ruble and pose threat both to exchange rate and financial stability. Second, sharp Ruble depreciation of 2H14 creates substantial inflationary risks for 2015. Given CBR's attempt to establish *renommée* of an inflation-targeter, additional rate hikes in 2015 are still on the table. Higher price of liquidity is also the new reality that financial markets will need to deal with.

Figure 2: CBR loans and Minfin deposit, RUB bn, and state funding, % assets



Source: CBR, Alfa Bank

Figure 3: Cumulative FX sale by the CBR, $bn, and $/Rub exchange rate



Source: CBR, Alfa Bank

…but the market has not priced it in yet creating risks for AB-ICI in coming months

Yet although the need for aggressive tightening is present, its effect upon market is questionable. The market is not used to the hawkish stance of the CBR. So while introduction of the ruble free float was a major and positive step, the need to accompany it by restrictive monetary policy might be a negative surprise. With the market heading for not yet priced in tightening in 2015, AB-ICI is subject to additional pressure in coming months.

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