Alfa-Bank

Macro Insights

AB-ICI: More Risks to Inflation Inbound

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Investment Summary

- AB-ICI grew another 6% in October on temporary improvement in the market sentiment
- Economic confidence continued to decline on resumed capital outflow and low preference for local savings
- Russia's sanctions against Turkey, Egypt, introduction of freight truck levy to add up 3-4pp to 2016 CPI

AB-ICI up another 6% in October

AB-ICI adds another 6% m/m in October on recovery in the market sentiment

AB-ICI recorded positive growth for the second month in a row. In October, the latest reporting month, it added another 6% m/m – this time thanks to some recovery on the financial markets. That said, the October portfolio inflows to Russia proved temporary, which, combined with the continued weakness in the local economic confidence indicators, forces us to remain cautious on AB-ICI.

Net capital outflow back to $5bn a month, preference for savings low

- **Economic confidence** dropped materially, reflecting two negative trends. First, the capital account, which had shown a $5bn surplus in 3Q15 thanks to the one-off $16bn payment to Rosneft by China, has returned $5bn monthly net outflows in 4Q15. Second, households continue to show a low preference for savings, with retail deposits posting a 0.1% m/m decline in October, reflecting high inflationary expectations and low trust in the ruble.

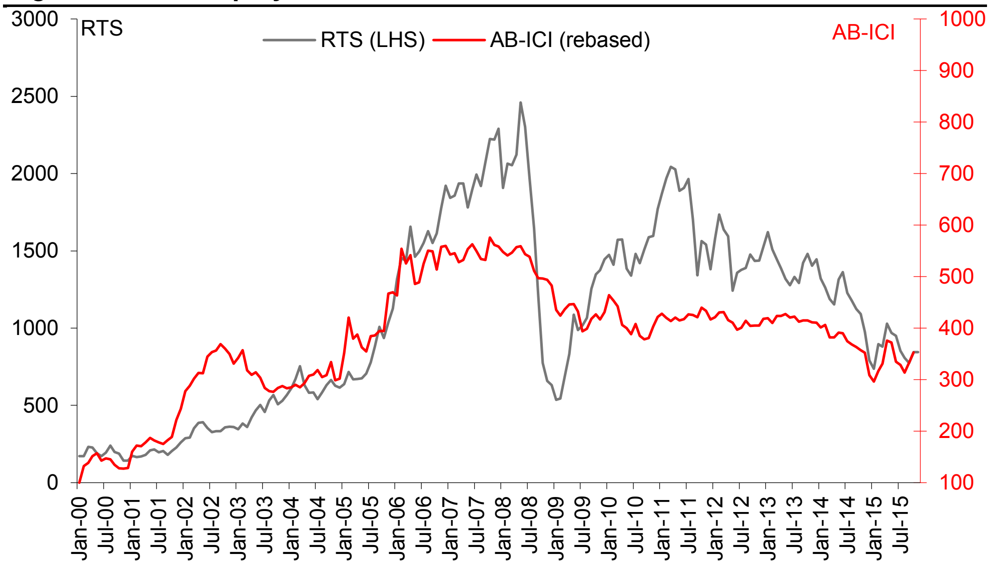
Foreign banks slightly increase presence on paper due to revaluation effect

- **Foreign confidence** increased, reflecting the higher share of foreign banks in total assets in 3Q15 from 2Q15. However, given the 16% ruble depreciation in 3Q15, this increase was most likely the result of the revaluation of the FX-heavy balance sheets of these banks rather than an expansion of their businesses.

The market found temporary support in October, but is back under pressure from the Fed and Russo-Turkey tensions

- **Market confidence** continued to grow, being the main reason of the overall positive AB-ICI performance in October. Apparently, following an investment forum that was attended by the key members of Russia's political establishment, Russia saw increased portfolio investment inflows, which, given the low market liquidity, boosted equity and bond market indicators. This inflow, however, proved temporary, and the preparation for the Fed rate hike and Russia-Turkey tensions are the main focus of the market at the moment.

Figure 1: AB-ICI up by another 6% in October



Source: New Economic School, RTS, Alfa Bank

AB-ICI: More Risks to Inflation Inbound

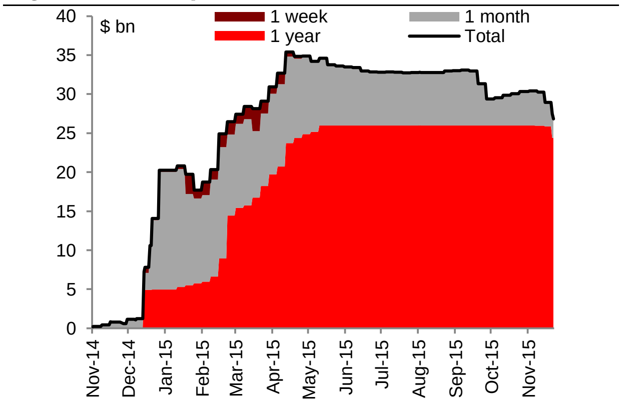
Fed tightening and foreign policy tensions make AB-ICI increasingly dependent on a recovery in local confidence

As it is becoming increasing likely that the Fed will soon tighten monetary policy, given the recent positive US economic data (the recent payroll numbers showed an above-expected 271,000 new jobs created in October, while 3Q15 GDP also beat expectations, growing 2.1%), China remains cause for concern for the entire EM universe and Russia continues to suffer from strained foreign relations, AB-ICI is unlikely to sustainably strengthen on the foreign or market confidence sides any time soon. This leaves AB-ICI increasingly dependent on a recovery in local confidence, which is a function of net capital outflow and the household preference for ruble savings. We believe both areas are facing challenges.

Net capital outflow back to $5bn a month; net foreign debt redemption to reach $60 bn by YE16

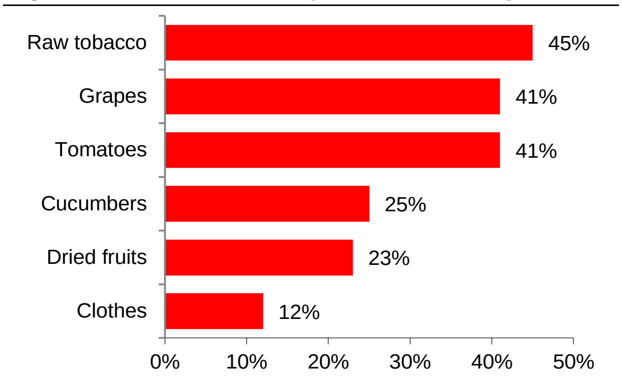
First, Russia's overall capital account trend has recently been shown to be very fragile. While the $5bn net capital inflow in 3Q15 was a positive surprise, it has become known recently that this inflow was due only by Rosneft receiving a $16bn prepayment China. Those payments a part of a long-term contract, but do not have a transparent schedule, normally taking place no more frequently than once a year, putting pressure on the capital account outlook for the coming quarters. This view has already been confirmed, first, by the fact October saw net capital outflow of $5bn, in line with initial expectations, and second, by the CBR decision to extend the FX repo operations for another year. Without this move, banks would have faced the need to redeem $21bn between December 2015 and May 2016, and the CBR's decision to ease this pressure, though positive for the exchange rate, confirms its concerns regarding the overall fragility of the capital account, which is facing pressure of foreign debt redemption of $60bn before YE16.

Figure 2: FX repo with CBR, $ bn



Source: Rosstat, Ministry of Economic Development, Alfa-Bank

Figure 3: Share of Turkey in Russian imports, %



Source: Higher School of Economics, Gazprombank, Vedomosti, Federal Customs Office, Alfa-Bank

Sanctions against Turkey can add up to 2pp to 2016 CPI; freight truck levy might add another 1.5pp

Second, the household preference for ruble savings is facing pressure as well. In addition to low trust in the ruble, local inflationary expectations are mounting. Russia's recent decision to ban tourism to Turkey and Egypt affects 50% of foreign resort travel and might potentially redirect $10bn domestically, which could add 0.5-0.8pp to local inflation next year. Russia's ban on imports from Turkey, which account for 10% of Russian consumption of fruit and vegetables, could add another 1.5pp. Finally, the recent controversial decision to introduce a freight truck levy, if not reversed under pressure of truck driver protests, might add another 1.5pp to CPI growth next year. With strong inflationary expectations and high ruble volatility, the savings rate is likely to remain under pressure, being a challenge to overall AB-ICI recovery.

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