AB-ICI: Long-run trends remain negative

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December 31, 2013 www.alfa-bank.com Moscow

Investment Summary

- The AB-ICI decreased in November as foreign confidence is back on the deterioration track
- Weakening economy and Ruble instability poses concerns
- Long-run nature of negative trends casts doubts on solid recovery of AB-ICI in 2014

AB-ICI fell in November

AB-ICI decreased: foreign confidence deteriorates with slight increase in savings rate preventing index from the free fall

The AB-ICI fell in November loosing 0.9%. As we expected foreign confidence is falling again as foreign banks' share decreases. Market confidence was practically flat with economic confidence preventing AB-ICI's free fall. This is mostly due to savings rate increase that is unlikely to continue in the coming months. As domestic economy remains weak and Fed's strategy exacerbates capital flight from EMs, Ruble market volatility is likely to remain elevated deteriorating investors' sentiment upon Russia and putting pressure upon AB-ICI index in 2014.

Savings rate climbed up last month but currency market instability makes sustainable growth unlikely

- **Economic confidence** increased in November as underlying factors demonstrated mixed dynamics. Savings rate climbed up further as retail deposits rose. But as we expected share of forex deposits is also rising again as Ruble continues to weaken despite considerable interventions of Central Bank. Both weak domestic conditions and Fed's tapering strategy provide basis for exacerbation of currency market volatility that will put additional pressure upon savings in 2014.

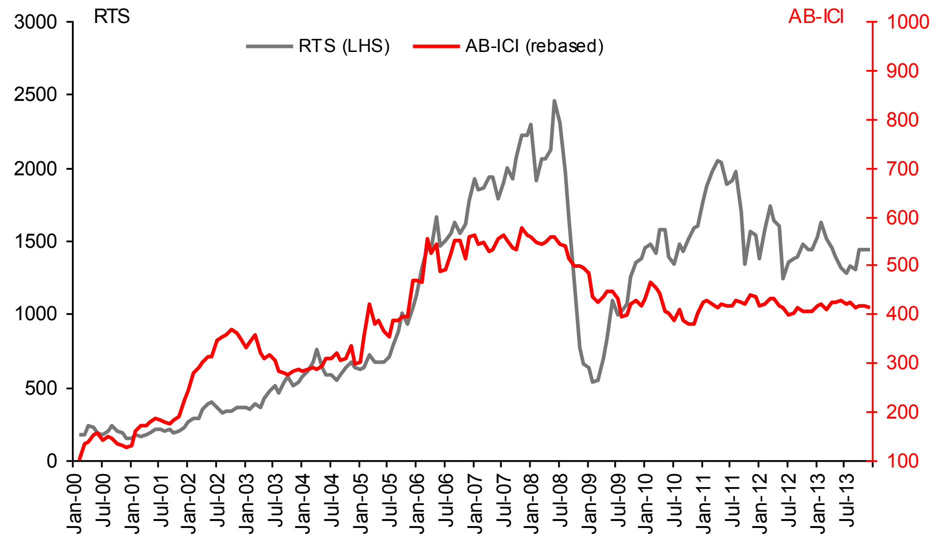
Foreign confidence falls again as foreign banks presence decreases

- **Foreign confidence** is back on the deterioration track with last month being a positive one-off caused by repatriation of Cyprus capital. Share of foreign banks' assets fell signaling continued foreign confidence deterioration is yet to come.

Market confidence stood still but low growth is likely to deteriorate positive sentiment in the coming months

- **Market confidence** was unchanged in November. The spread between Russian and LatAm bonds narrowed due to regional factors. That said investors' sentiment upon Russian economy is still optimistic considering current performance. As we do not expect growth to pick up next year, risks of market confidence deterioration will rise in 2014.

Figure 1: AB-ICI decreased in November



Source: New School of Economics, RTS, Alfa Research

AB-ICI: Risks continue to accumulate

Nature of slowdown is of key interest in determining fundamental value of Russian market

Recent gradual but distinct deterioration in AB-ICI reflect negative trends in fundamental underlying factors that have been accumulating last years. Sharp catch-up story immediately after the crisis allowed to neglect those long-run obstacles, but now that growth has been slow for entire 2013 additional concern arise. To put it differently, is the slowdown cyclical and economy will rebound in 2014 or mediocre growth rates are there to stay?

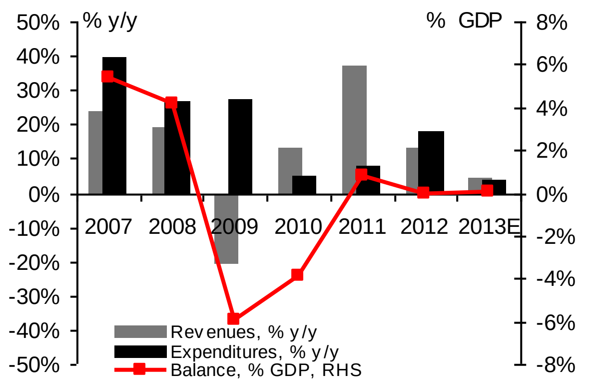
Officials and market observes treat slowdown as cyclical

Both officials and market observers tend to treat 1.2% y/y growth during last 2 quarters as a slowdown of temporary nature, mostly caused by weak external economic conditions. Such assessment leaves plenty of space for optimistic view on 2014: as Eurozone has recently left the recession phase and US economy is accelerating, favorable external factors are to support growth in the next year.

Demand-stimulating policies remain in place despite fall in growth rate

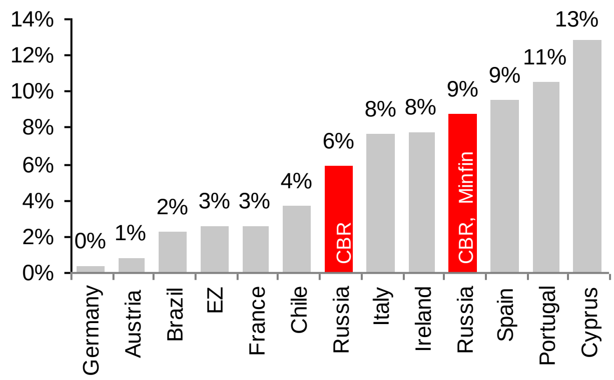
We believe that the slowdown that Russia's experienced in 2013 is of long-run nature and is not related to weak demand issues, particularly external demand. Russia's slowdown is much sharper than peers' while economic policy is not materially different. Expenditures continue to rise with fiscal policy remaining accommodative. CBR is also increasing exposure to the banking sector acting as many developed economies recently did. Combined government and CBR account for 9% of baking assets, considerable figure even comparing to weak European countries.

Figure 2: Budget expenditures, revenue growth, % y/y, and balance, % GDP



Source: Finance Ministry, Alfa Bank

Figure 3: Central banks' exposure to the banking system, % assets



Source: CBR, Eurostat, National Central Banks, Alfa Bank

Instead long-run supply side factors have been deteriorating for years now

Instead as output gap is practically zero we consider slowdown to be caused by structural supply-side constraints. First, demographic factors play against acceleration with labor force expected to drop 3% by 2016. Second, economy failed to renovate its capital stock during favorable 00-s decade with average age of capital stock remaining at 15 years level. Third, productivity remains low, at 39% of US and 45% of EU level. These issues have not been paid substantial attention for years making quick reversal of structural trends unlikely.

Underlying trends are likely to stay negative creating additional pressure upon AB-ICI index

In this sense, the slowdown of 2013 is a long-run phenomenon that is likely to stay in place. Potential GDP growth estimates suggest 1.5-2.0% growth rate in years coming unless measures of capital renovation and productivity increase are brought out. As political agenda remains more socially-oriented these are unlikely to occur in the short-run. Negative trends exacerbation tends to drag fundamental value of Russian market down. To put it differently, real economy factors are likely to put considerable pressure upon AB-ICI in 2014 that poses concerns on market dynamics in coming years.

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