Alfa-Bank

Macro Insights

AB-ICI: RTS Meets Its Fair Value

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Investment Summary

- AB-ICI continued to decline, down 1.4% in November and 14% YTD
- November result was dragged by a sharp deterioration in the local equity and bond markets
- Exchange rate remains the key anchor for the economy – its stabilization in 2015 is key

AB-ICI down 1.4% in November

AB-ICI declined 1.4% in November on deteriorating financial markets

Last month, AB-ICI continued to decline, being down 1.4% in November and 14% in 11M14, which is in line with the magnitude of the 2008 drop. Last month's dynamic was caused by the continuing underperformance of local financial markets, which were negatively surprised by the introduction of the ruble free-float and the tightening of the interest rate policy. Interestingly, economic confidence didn't suffer, confirming our positive take on the CBR's decisions of late vs. the fundamental standpoint. That being said, failure to avoid the FX crisis in December will definitely drag on investor confidence in 2015.

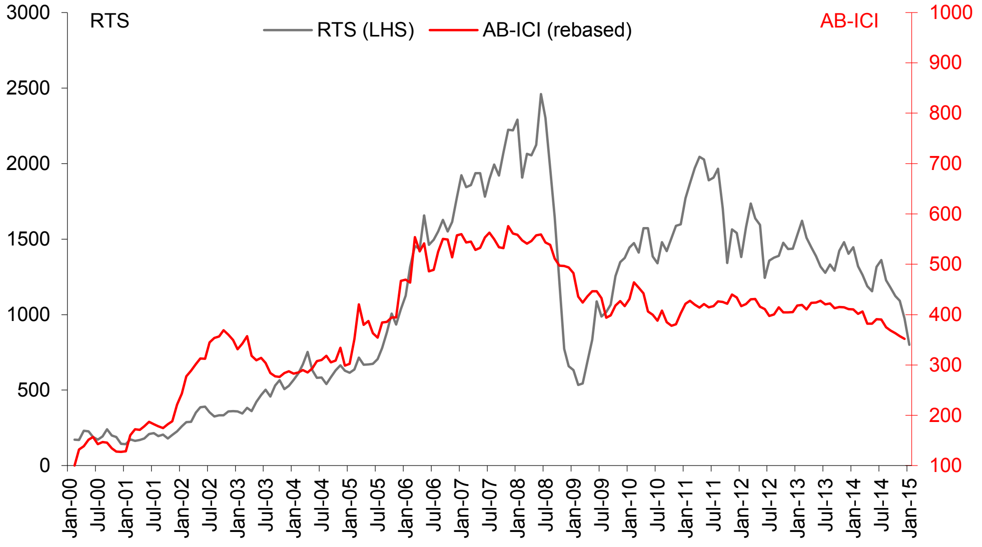
Economic confidence increased in November, reflecting slowdown of capital outflow

- **Economic confidence** increased reflecting the substantial improvement in the capital account following the CBR's withdrawal from the FX market and the increase in interest rates at the beginning of November following the $30bn intervention a month earlier. Meanwhile, households' preference to keep ruble savings continued to decline, being an ongoing concern.
- **Foreign confidence** remained flat given the lack of new relevant data.

Market confidence expectedly down on negative reaction to CBR rate hike

- **Market confidence** dropped sharply, which, in addition to the usual risk-off and Russia-off mode on global markets this year, reflected the local market's very negative reaction to the CBR's 150bp rate hike, which triggered a sharp re-pricing of local bonds. The CBR's 100bp and additional 650bp hikes in December, though justifiable from an economic standpoint, were a new shock to the local markets. The RTS index is now below the values justified by our AB-ICI for the first time since 2009. However the recovery of the market and our index in 2015 will largely depend on the CBR and the government's ability to restore communication with the market, which will now be in anti-crisis mode.

Figure 1: AB-ICI down 2% in October



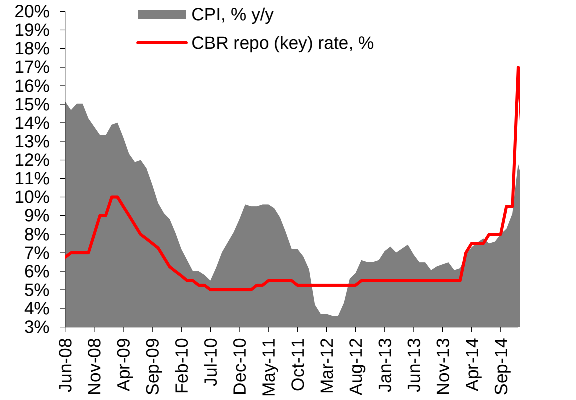
Source: New Economic School, RTS, Alfa Bank

Restoring Communication Is Key In 2015

The CBR rate hike to 17%, though logical to target inflation, caught the market off-guard

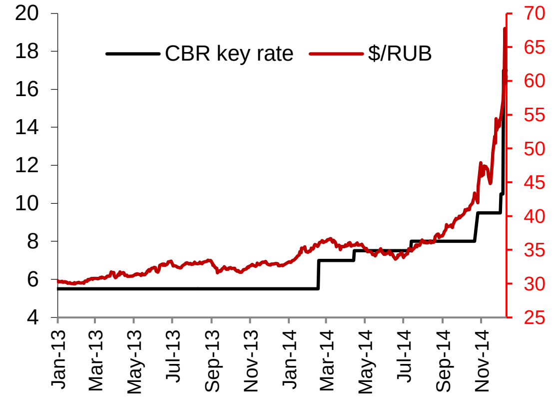
Last month, we mentioned that the local market was not prepared for the ruble free-float and further monetary tightening, and December's panic on the Russian financial markets confirmed this take. Responding to the increased inflationary risks coming from ruble depreciation, which totaled almost 40% in January-November, the CBR hiked the rate 100bp during its scheduled meeting on December 4; however, later, seeing no positive response from the markets (which were under pressure from rumors of exporters' speculative play against ruble), the CBR made an additional sharp 650bp hike to 17% on December 16. Surprisingly, this further destabilized the markets, which, despite the presence the clear economic logic behind the CBR's decision (see our previous issue of AB-ICI for further details), became convinced of the incompetence of the current CBR team and started to price in their resignation. At the peak of the panic in mid-December, the $/RUB approached RUB80/$ (60% depreciation YTD). Alhough these fears later proved to be unfounded and the exchange rate returned to the pre-hike RUB60/$ level, the outlook for 2015 is now damaged.

Figure 2: CBR key rate and inflation



Source: Rosstat, CBR, Alfa Bank

Figure 3: CBR key rate and exchange rate



Source: CBR, Alfa Bank

Inflation to spike to 15% y/y in 1Q15, consumption to fall 10% in 2015, GDP to fall 5%

The immediate economic consequence of the December FX crisis is inflationary shock: the recent weekly CPI statistics alredy indicate a likely acceleration of inflation to 11-12% by YE14, and to 15% y/y in 1Q15, with a subsequent deceleration to 10% y/y by YE15 being the best-case scenario. In December, the population reacted by boosting durable goods consumption, which likely has supported economic growth. That being said, this consumption represents a burning of savings, and with no apparent source of household income growth and the pressure of debt servicing equivalent to 5% in annual consumption and the lack of ability to attract new retail loans, consumption is likely to collapse 10% in real terms next year, dragging GDP down by 5%.

Banking sector will be under pressure in 2015

Another negative outcome of December is the increased concerns regarding the quality of the banking sector balance sheet. The interest rate increase should cause a jump in hidden NPLs, and the drop in financial markets is causing losses in securities portfolios. A number of large Russian banks have started showing capital adequacy dropping below 11% in recent months, and a number institutions are experiencing a run on deposits and require extra support. Next year, banks are unlikely to boost lending and will struggle with a more expensive funding base, which will be a painful adjustment compared to the previous period of easy monetary policy.

Clear communication is required to restore investor confidence

The consequences of the deteriorating 2015 picture for AB-ICI include the further decline in the households' confidence in ruble savings, damagining the economic confidence, and the nervousness on the financial markets being a drag on the market confidence indicator. With the exchange rate remaining the anchor of expectations for economic agents in Russia, the stabilization of the currency is a priority for 2015, and comunication between the CBR/govenrment and the market is the key prerequisite.

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