AB-ICI: Questions For 2016

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Investment Summary

- AB-ICI up 2% in November on moderation of the net capital outflow
- The key risk for 2016 is that the Fed is going to further tighten the policy beyond market expectations…
- …while the key opportunity is that the Russian Cabinet will have to support households in electoral 2H16

AB-ICI up 2% in November

AB-ICI added 2% m/m thanks to the slowdown in the net capital outflow

AB-ICI continued to grow for the third month in a row, adding 2% m/m in November. The key reason was some improvement in the net capital flows thanks to a light foreign debt redemption schedule and some improvement on the global markets. That said the key question now is about 2016: with external risks including tightening in the Fed policy beyond the market expectations and further decline in the oil prices. Should those risks materialize, even the lighter foreign debt redemption schedule will not prevent further pressure on the AB-ICI next year.

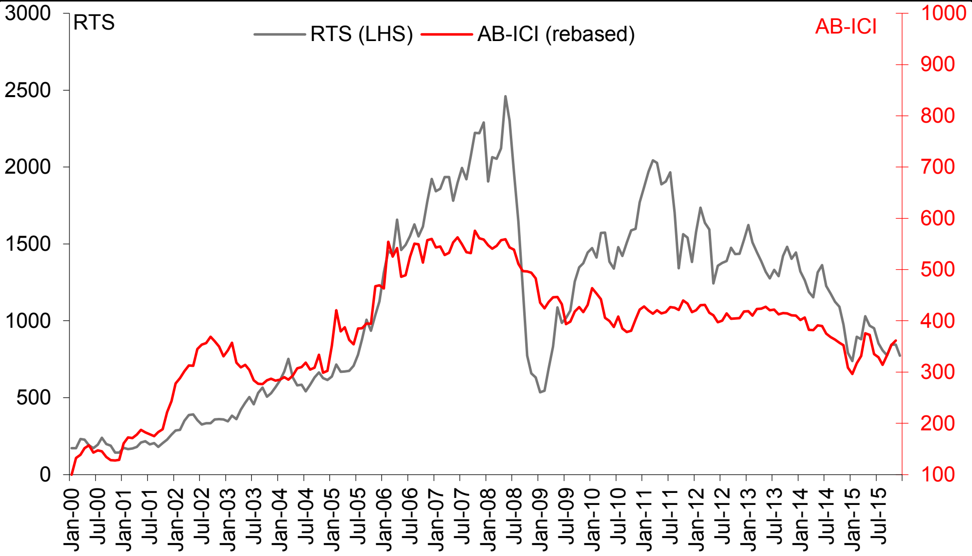
Net capital outflow slowed to $3bn, however preference for FX remains high

- **Economic confidence** increased reflecting slowdown in the net capital outflow to $3bn in November from $5bn in October, which was apparently thanks to a light foreign debt redemption of $3-4bn. For 2016, we expect $40bn net foreign debt redemption vs. $70bn this year, which suggests lower pressure on the capital account. That said the economy maintains high preference for FX, with almost 50% of corporate and almost 30% of retail deposits dollarized.
- **Foreign confidence** remained flat as no relevant data were released.

The market has stabilized with Fed justifying expectations at YE15, however the intrigue about 2016 remains

- **Market confidence** improved in November thanks to expectations of a very moderate increase in the Fed rates, which was subsequently justified, and a temporary stabilization in the oil prices. However now the oil prices are back under pressure of oversupply, while the intrigue about further Fed action remains: the market is pricing in a very smooth one-step increase in the rates next year, hover the consensus among economists and Fed directors assumes 3-4 more hikes based on labor market improvement and possible acceleration in CPI growth.

Figure 1: AB-ICI up by 2% in November



Source: New Economic School, RTS, Alfa Bank

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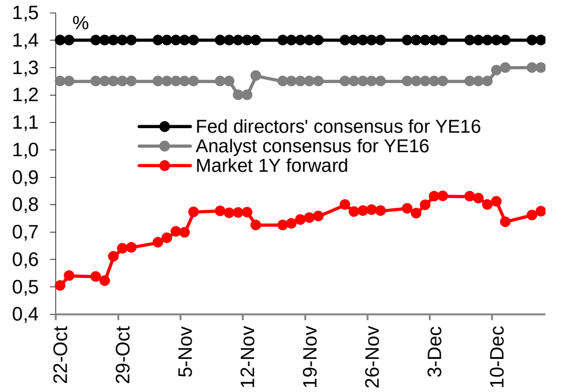
Questions for 2016: how steep the Fed rate increase will be, where oil price will bottom out?

Russia is entering 2016 in a state of high uncertainty, both external and domestic. On the external side, the two key questions are the global rates dynamic and the oil price performance. On the global rates, the Fed policy will be key: though expectedly raising the rate on December 16, US monetary authorities did not give any definitive guidance for 2016, and we believe the US inflationary trend will be the key factor to watch. The prerequisite for a succession of 3-4 rate hikes is inflation accelerating from the current 1.3% to the Fed's target of 1.7% at YE16. However, should US inflation to be weaker the current market expectations of just one more rate hike in 2016 may prove to be true. On the oil, the uncertainty now is where the oil price may bottom out. The lifting of the ban on US oil exports, the expected emergence of extra 0.5-1.0 mln bpd supply from Iran and lack of will from OPEC to cut oil production are all negative signs for the oil prices, with experts forecasting $15-35/bbl as a possible price range for the near term.

When the Russian households will start feeling the recovery?

Local uncertainties are both in the real sector trends and on the financial flows. In the real sector the key question is when will the consumption trend bottom out. Rosstat's November macro statistics confirmed further deterioration of the consumption trend, with retail trade drop deepening from -11.7% y/y in October to -13.1% y/y in November and unemployment rate increasing from 5.5% in October to 5.8% in November. This trend is a sign that under the pressure of government guidance for the tight budget policy in 2016 and the CBR's inability to cut policy rate in the nearest future local businesses are taking steps to reduce costs, including labor costs. It is clear that the 1H16 income trend will be weak, meaning that in order to support consumption the households will have to burn through savings, putting further pressure on the economic confidence. The 2H16, however may bring some improvement thanks to additional election-driven social indexations, which is the main hope for 2016.

Figure 2: YE16 Fed rate expectations, %



Source: Bloomberg, Alfa-Bank

Figure 3: Key Russian macro indicators

	Aug-15	Sep-15	Oct-15
GDP, % y/y	-5.5%	-3.7%	-3.7%
Industrial output, % y/y	-4.3%	-3.7%	-3.6%
Fixed investments, % y/y	-6.8%	-5.6%	-5.2%
Retail trade, % y/y	-9.1%	-10.4%	-11.7%
Real salary, % y/y	-9,0%	-10.4%	-10.9%
Unemployment, %	5.3%	5.2%	5.5%
CPI, % y/y	15.8%	15.7%	15.6%

Source: Rosstat, MED, Alfa-Bank

Will the lighter debt redemption schedule ensure smaller net capital outflows from Russia?

The second hope for AB-ICI in 2016 is the possible lower pressure on the capital account next year. The labor cost optimization, while being negative for consumers, is an overall positive process, confirmed by a relatively strong industrial output and investment figures in 2015. Stable local investment demand combined with a more light foreign debt redemption schedule suggests that under $45/bbl oil price the current account surplus of $50bn should be enough to cover the net capital outflow next year. However, the abovementioned risks to oil price and global rate hikes are not yet priced in this scenario, so we remain cautious on the AB-ICI prospects for the next year. The next couple of months will show whether the Russian economy and AB-ICI have bottomed out in 2H15, or this point has shifted to 1H16.

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