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Russian macro and FI: relying on inner strengths

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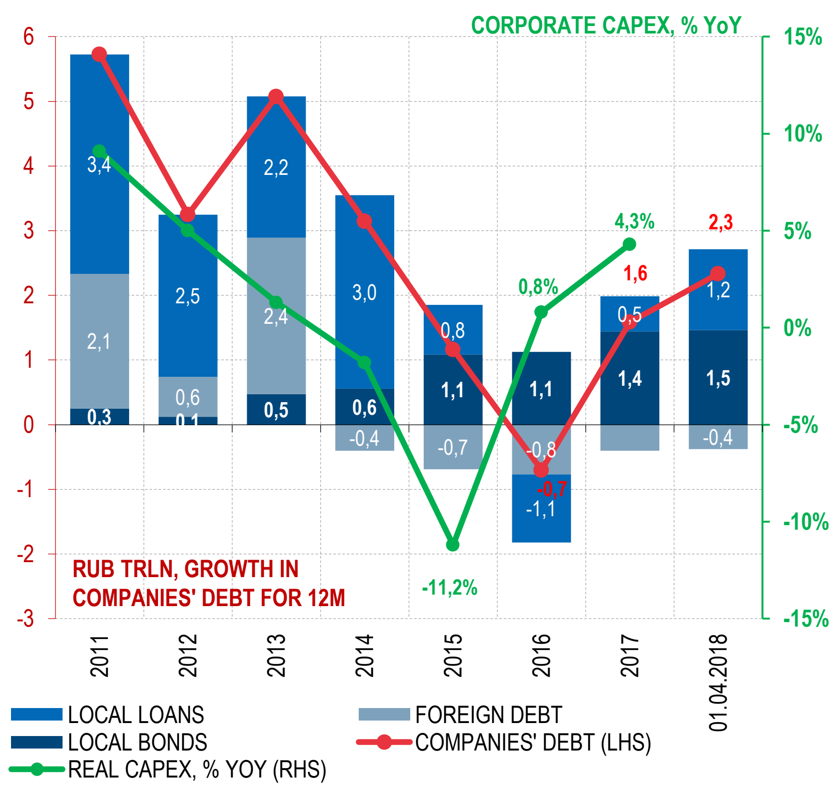
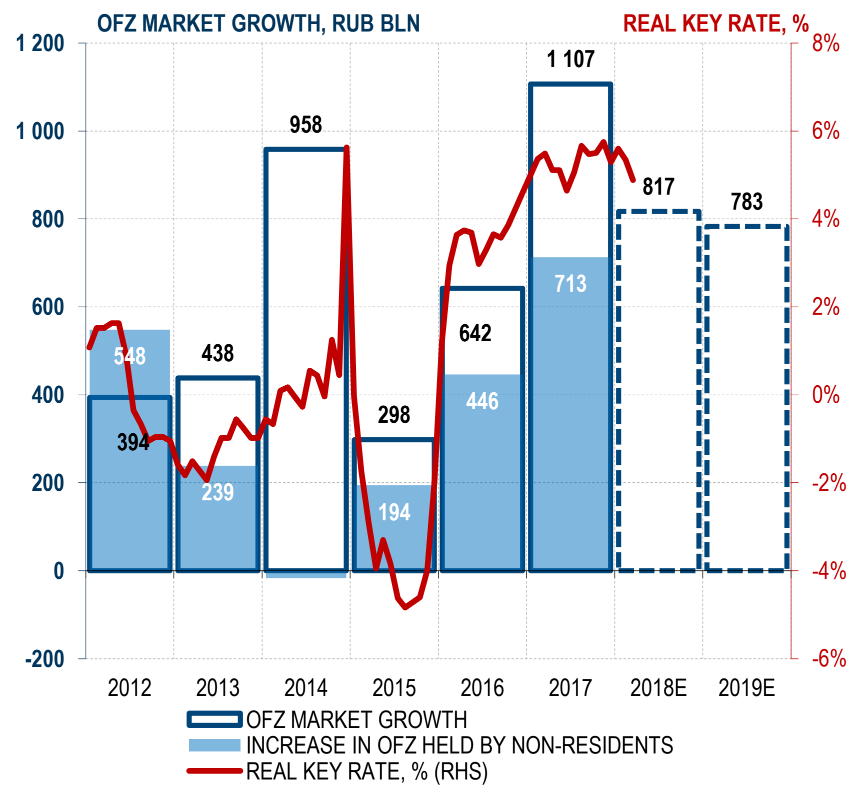
Corporate sector is back to re-leveraging on capex recovery
OFZ market booming, 2/3 of demand coming from non-residents

CORPORATE DEBT MARKET RESUMED GROWTH, REFLECTING DEMAND FROM NATIONAL CHAMPIONS



MINFIN IS ACTIVELY BORROWIG ON THE LOCAL MARKETS, STRONG DEMAND FROM FOREIGN INVESTORS ON STABLE MACRO, HIGH RATES

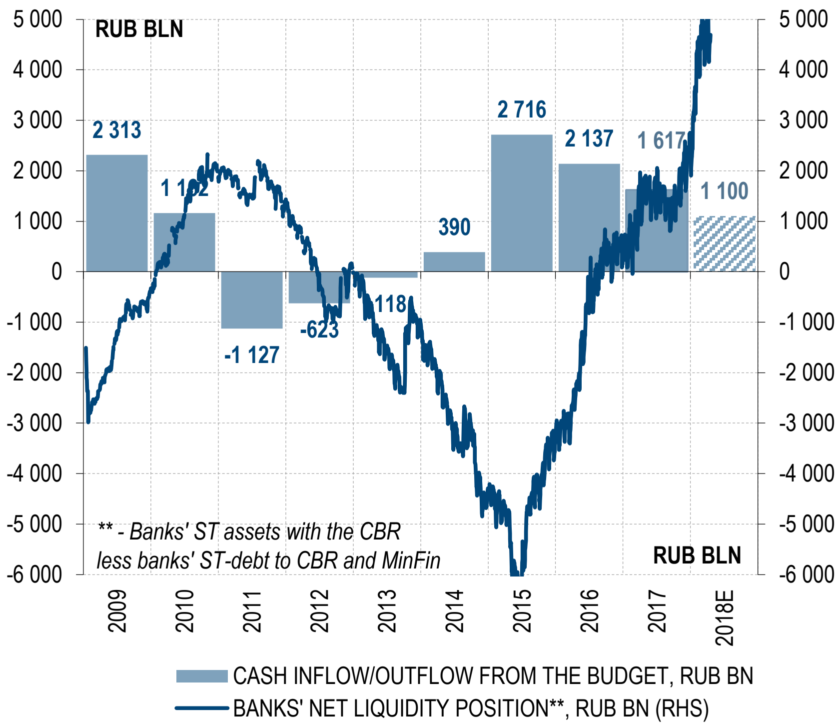


- Companies' debt increased by RUB 2.3 trln YoY as of April 1, reflecting a pick-up in investment growth (by 4.3% YoY in 2017). The domestic bond market for the non-financial sector is growing by RUB 1.5 trln YoY, reflecting demand of large high-quality borrowers substituting foreign debt. Further prospects depend on whether the capex recovery is sustainable – depends on the post-election reform agenda.
- Two thirds of OFZ market growth in 2015-17 relied on non-residents thanks to Russia's strong macro fundamentals and high real rates. Current uncertainty – new proposals in the US Congress to ban US and related parties from participating in new sovereign issuance.

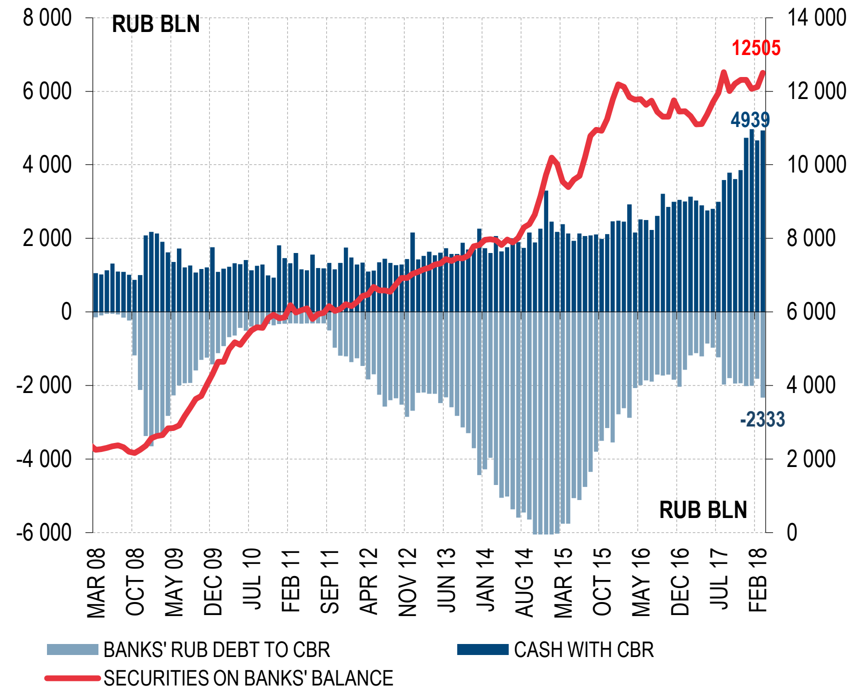
Source: State Statistics Service, CBR, CBonds, Gazprombank estimates

Local banks have excess RUB 1.5-2.0 trln liquidity, meaning high capacity for bond purchases

RUB 7.6 TRLN SPENDING FROM SOVEREIGN FUNDS IN 2015-18E PROMPTS SIGNIFICANT IMPROVEMENT IN BANKS' LIQUIDITY POSITION



... WHICH TRANSLATED INTO ACCELERATED GROWTH OF BANKS' ALLOCATIONS TO SECURITIES. THAT SAID, BANKS STILL HOLD EXCESS LIQUIDITY OF RUB 1.5-2.0 TRLN IN THE CBR

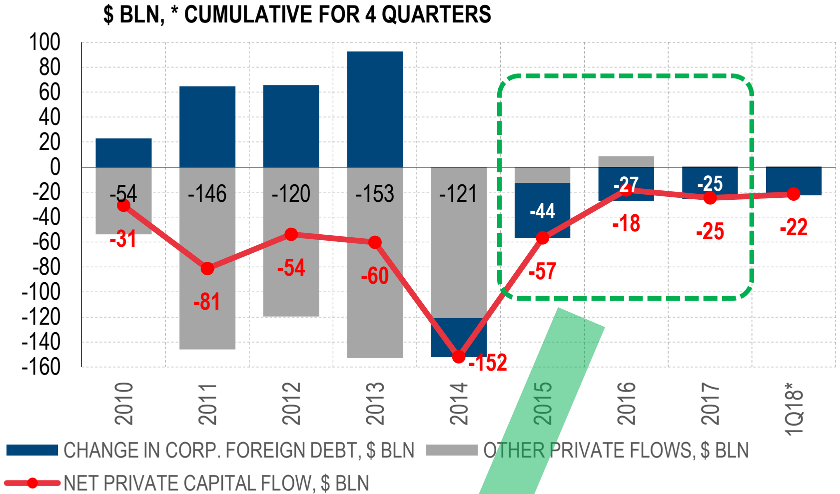


- In 2015-17, spending from sovereign funds stood at RUB 6.5 trln, which translated to redemptions of banks' debt to the CBR and an increase in banks' investment in securities by RUB 4.0 trln.
- Banks hold RUB 4.9 trln in CBR accounts, which represents an elevated level compared with RUB 2-3 trln seen in 2015-17.
- In 2018, the MinFin plans to spend around RUB 1.1 trln from sovereign funds to finance the budget deficit. These expenditures are emitting in nature, as the CBR "purchases" FX from the MinFin for newly issued rubles. CBR reserves remain intact.
- MinFin's FX purchases of additional oil & gas revenues are neutral for the money market: withdrawal of rubles in the form of taxes is offset by an inflow of rubles via MinFin interventions and higher CBR reserves.

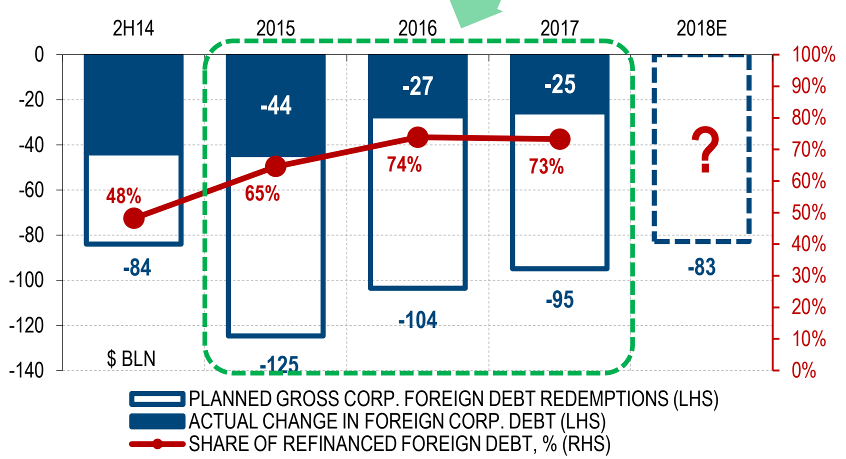
Source: CBR, Finance Ministry, Gazprombank estimates

RUB/USD should return to 57-60 by YE18 assuming no further deterioration on the foreign policy front

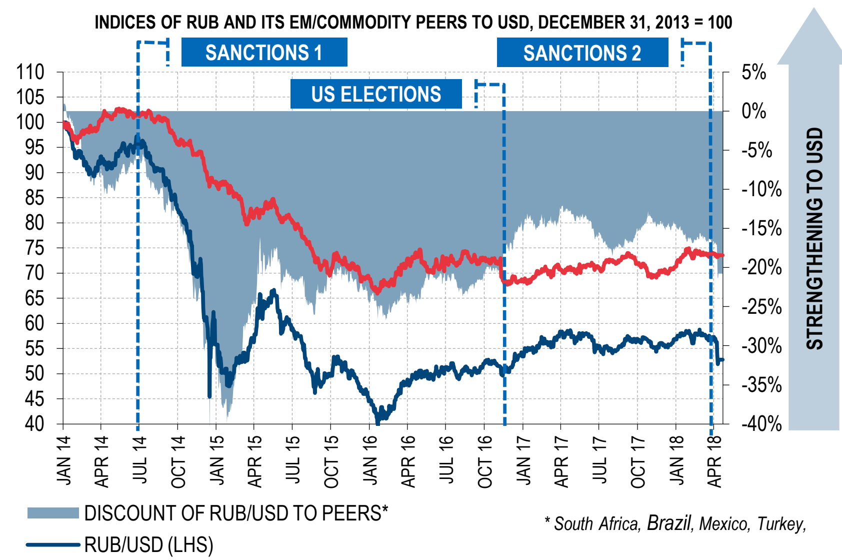
PRIVATE CAPITAL OUTFLOW IS DRIVEN ENTIRELY BY CORPORATE FOREIGN DEBT REDEMPTION…



…WHICH SHOULD BE ~$20 BLN IN 2018, UNLESS MORE CORPORATES LOSE ACCESS TO GLOBAL DEBT MARKETS



RUB DISCOUNT TO OTHER EM IS BACK TO 20%, CORRESPONDING TO LACK OF FOREIGN POLICY OPTIMISM, A LA 2015-16



- With the current account surplus sterilized by MinFin interventions due to the budget rule, **RUB is driven by capital flows**. Peak vulnerability is April-August due to current account seasonality.
- Since 2017, net private capital outflow is determined exclusively by corporate net foreign debt redemptions. **2018E may see $20 bln net outflow,** unless there is a material expansion of the US SDN/SSI sanctions list.
- **OFZ + eurobonds saw $15 bln capital inflow in 2017 and $4 bln in 1Q18**. Further prospects depend on foreign policy dynamic.
- Current RUB discount to other EMs is 20%, corresponding to lack of foreign policy optimism seen in 2015-16. **In case of no further escalation, RUB/USD should trade at 57-60 by YE18**

Source: CBR, Gazprombank estimates

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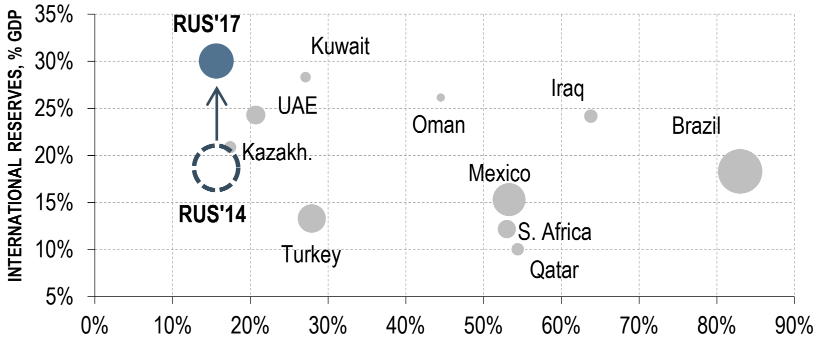
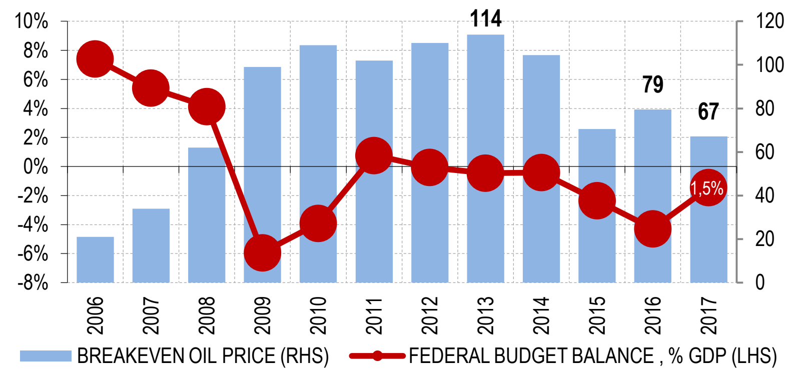
Federal budget stability remains a priority, but new state spending initiatives put LT budget risks in focus

CONSERVATIVE BUDGET AND MONETARY POLICY ALLOWED IMPROVEMENT IN RUSSIA'S MACRO STABILITY INDICATORS



* Bubble size is proportional to GDP

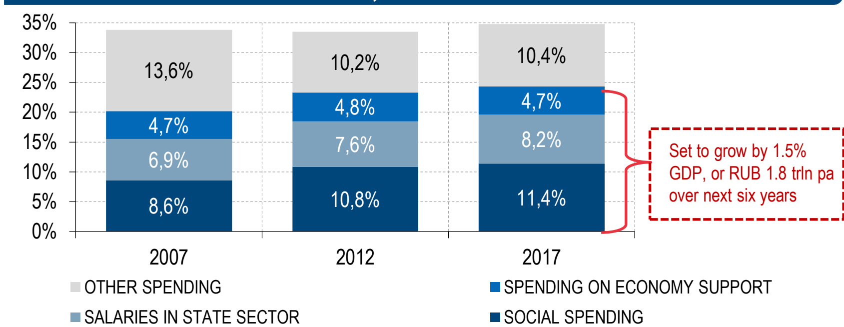
FEDERAL BUDGET BREAKEVEN DOWN TO $67/BBL THANKS TO TIGHT COST CONTROL , HIGHER NON-OIL REVENUE COLLECTION



- State spending to support maternity and child welfare to increase from RUB 2.4 trln in 2012-17 to RUB 3.4 trln in 2018-23, suggesting that annual non-pension social benefits, currently at RUB 2.9 trln or 4% of household income, are likely to increase in the coming years.
- State salary growth (accounting for 25% of Russia's 73 mln officially employed and 14% of household income) will continue going forward.
- Pensions (covering 40 mln elderly Russians and accounting for another 15% of household income) must show growth in real terms.
- State funding for road construction to increase from RUB 6.4 trln in 2012-17 to RUB 11 trln over the next six years.

Primary source of financing will be regional budgets and the State Pension Fund, which have been running a ~5% GDP deficit.

20% OF GDP ALREADY SPENT ON HOUSEHOLD INCOME AND ANOTHER 5% ON STATE INVESTMENTS, LITTLE ROOM FOR REDISTRIBUTION



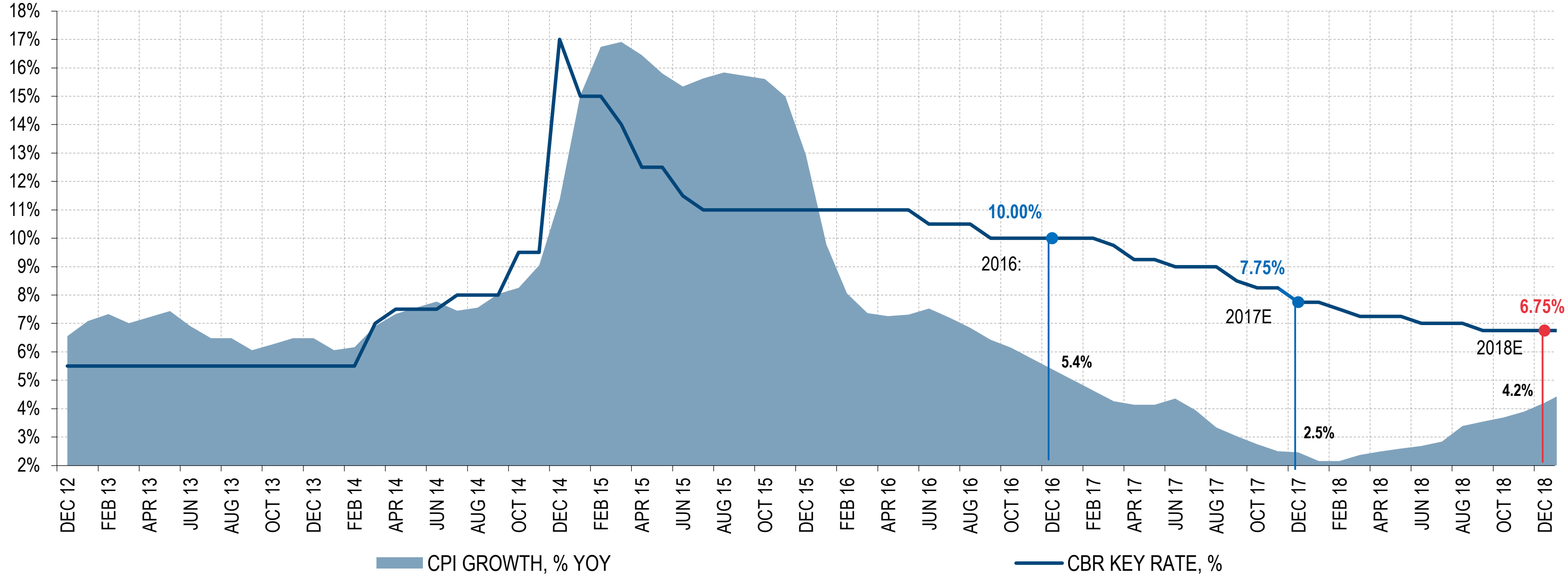
FEDERAL BUDGET BALANCE UNDER CONTROL, POTENTIAL WEAK POINTS INCLUDE REGIONS AND PENSION FUND

	2007	2014	2015	2016	2017
Balance of consolidated budget	6.4%	-1.1%	-3.4%	-4.1%	-1.5%
...federal budget (headline)	5.4%	-0.4%	-2.3%	-3.4%	-1.4%
...federal budget (net of transfers)	9.7%	4.9%	3.5%	2.6%	4.4%
...regional budgets (net of transfers)	-2.2%	-2.7%	-2.2%	-1.9%	-2.0%
...State Pension Fund (net of transfers)	-2.7%	-2.4%	-3.1%	-3.1%	-3.1%
...other social funds (net of transfers)	1.2%	-0.9%	-1.6%	-1.7%	-0.8%

Source: Finance Ministry, IMF, Economic Development Ministry, State Statistics Service, Gazprombank estimates

CBR close to conclusion of its key rate cutting cycle amid persisting reflationary risks

CPI IS DUE TO PICK UP FROM 2.5 YOY IN 2017 TO 4.0-4.5% YOY BY YE18 AMID EXHAUSTION OF ONE-OFF DISINFLATIONARY FACTORS. RECENT INCREASE IN FX VOLATILITY, RISK OF NEW LIMITATIONS ON IMPORTS AND UNCERTAINTY REGARDING BUDGETARY POLICY LIMIT THE POTENTIAL FOR CBR MONETARY POLICY EASING



- Amid exhaustion of temporary disinflation factors (weak consumer demand in 2015-16, ruble appreciation, record grain harvest), as well as the ongoing increase in transportation tariffs and excise duties, **CPI will return to a range of 4.0-4.5% YoY by year end**.
- Presidential address of March 1 suggests that budget spending to support salaries for 18 mln state employees, pensions for 40 mln pensioners, and other social payments aimed at supporting demographic issues will grow over the next six years.
- The recent expansion of US sanctions highlights ongoing foreign policy risks. Should the RUB/USD rate remain at heightened levels, the **additional inflationary effect from 10% ruble depreciation will amount to 1 pp over a six-month horizon**.
- Uncertainty regarding the external backdrop requires the CBR to halt its monetary policy easing cycle in the near term, while **in the longer term a reduction of the real rate to below 2.5-3.0% has little chance of being implemented.**

Source: State Statistics Service, CBR, Gazprombank estimates