Alfa-Bank

Macro Insights

AB-ICI: Positive sentiment fuels market

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Investment Summary

- The gap between the AB-ICI and RTS index remained wide during 2017, narrowing slightly only in December due to seasonal factors
- High oil prices triggered upward revisions to economic growth forecasts and boosted market sentiment
- Weak 4Q17 macro statistics placed ceiling on Russian growth, but the market ignored that, especially after "Kremlin list' publication

AB-ICI – temporary growth without fundamental improvements

AB-ICI mainly flat in 2017, interrupted by seasonal growth in December

The gap between the AB-ICI and RTS indexes remained wide during 2017, the AB-ICI mainly flat while the RTS strengthened driven by positive market sentiment. The AB-ICI increased by 3.0% m/m in December due to seasonality; however, we still see no improvement in fundamentals:

Economic confidence pressured by capital outflows and slow retail deposit de-dollarization

- **Economic confidence** strengthened at the end of 2017 due to a seasonal pick-up in retail deposit growth (+3.6% m/m in December, vs. 2.2% m/m in December 2016, and 8.3% m/m in December 2015). However, in general fundamental factors played against a recovery: Russian macro statistics are weak, net capital outflows accelerated y/y ($31.3 bn in 2017 vs. $19.8 bn in 2016), the level of retail deposit dollarization remains above the pre-crisis level (20.6% in 2017 vs. 17-18% in 2011-13).

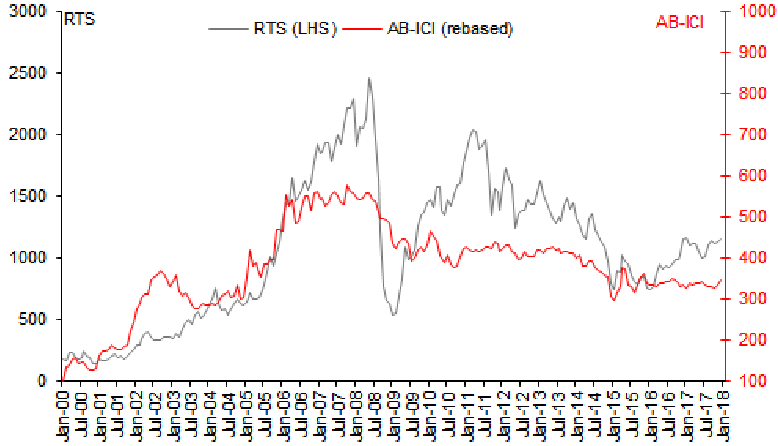
High oil prices boosted market confidence, while the threat of sanctions restricted it

- **Market confidence** was quite unstable during the year. On one hand, high real interest rates and a strong oil prices (recently surpassing $70/bbl – the highest since 2014) played in favor of it. While on the other, the threat of sanctions tightening placed a ceiling on market confidence. Despite a seasonal bond placement acceleration near the end of the year (52 in December 2017 vs. an average of 20 during the year) the number of issuances by Russian companies remained in line with 2016, when 263 bonds were placed (vs. 252 in 2017).

Despite a recovery towards the end of the year, the share of foreign banks is still below the 2016 level

- **Foreign confidence** was under pressure in 2017. Although the share of foreign banks in Russia recovered near end-2017 to 7.5%, it still remains lower than end-2016. We attribute the year-end recovery partly to statistical factors as a result of the CBR's cleanup of the banking sector in 2017. The CBR revoked the licenses of 58 banks and put three large private banks (Otkritie, B&N Bank and Promsvyazbank) under the management of the Fund of Banking Sector Consolidation.

Fig. 1: AB-ICI and RTS Index: AB-ICI up 2.8% y/y in 2017 due to year-end growth



Source: RTS, Alfa Bank

AB-ICI: Positive sentiment fuels the market

High oil prices boosted both economic growth forecasts and market sentiment

High oil prices ($65-70/bbl in November-December 2017 and January 2018 vs. $53/bbl in 10M17) have resulted in upward revisions to Russia economic forecasts by the World Bank and the IMF, which revised up their Russian GDP growth forecast to 1.7% y/y in 2018 (from 1.6% y/y earlier). The RTS advanced by 10% during December supported by the improvement in market sentiment, which was also boosted by high oil prices.

Market is under euphoria about Russia after "Kremlin list" publication; however, we do not share such view

The RTS index is now enjoying a relief rally after the publication of the recent US CAATSA report – the so-called "Kremlin list" – a list of 210 names (114 state officials and 96 businessmen), that looks like a copy-and-paste of last year's Forbes list. While it was initially expected to become a roadmap for future sanctions, it has now served only to arouse market surprise and show that the US is unwilling to exert systematic pressure on Russia's elites. However, we believe the report should be treated with a bit more cautious, as it has already caused a stir. Firstly, in US a scandal has flared-up that may stoke geopolitical tensions: according to Anders Aslund, an Atlantic Council expert, the original report was thrown out at the last minute and replaced with what amounts to a hasty copy-and-paste of the Russian government website and last year's Russian Forbes magazine. Secondly, uncertainty significantly increased after publication of the report, as (a) still there was no information on the sovereign debt report and (b) US President Trump unexpectedly decided not to impose sanctions on companies involved in major transactions with the Russian defense sector, which, however, is technically illegal, because this was not agreed with Congress. Thirdly, the US Treasury Secretary Steven Mnuchin stated that additional sanctions against Russia will be imposed; however, the market has no idea what form this may take.

Our cautious view is underscored by the weak 4Q17 macros statistics and the cloudy outlook for 2018

Our concerns is that the market is now overly optimistic, ignoring the extremely disappointing macro statistics on Russia. Firstly, 4Q economic growth in Russia decelerated to 1.2% y/y and reached only 1.5% y/y for 2017, implying that November's economic growth deceleration (-0.3% y/y accrding to Economy Ministry data) was not an anomaly, but a signal of economic weakness. We warned about this earlier, when two sectors which are indicators of future growth dynamics demonstrated a contraction in 3Q17 (manufacturing by 0.1% y/y and construction by 0.7% y/y). Secondly, the 2018 economic growth outlook is cloudy. (A) State projects (the Kerch Bridge and the Power of Siberia), which provided nearly 90% of investment growth in 2017, are nearing completion. (B) The industrial production outlook has also been dampened by proposals of production shutdowns in 11 of Russia's regions to facilitate security and safety control during the World Cup. (C) Tight budget policy (just 1% y/y growth in expenditures) and the Finance Ministry's desire to save additional oil revenues from high oil prices will limit consumption growth this year. Moreover, uncertainty surrounding the cabinet's tax initiatives in relation to personal tax will also cap consumption growth. The OPEC agreement also puts a ceiling on Russia's windfall from high oil prices, which is why we are concerned about the oil price as the main driver of growth in the Russian economy.

We downgraded GDP forecast to 1.0% in 2018; the gap between AB-ICI and RTS will remain wide

Given the aforementioned factors and the fact that the economic growth acceleration in Russia was quite short-lived in 2017, we have downgraded our GDP growth forecast for this year to 1.0% y/y (vs. the 1.5% y/y initially expected). We believe that the gap between the AB-ICI and RTS indexes will remain wide this year, as the end-2017 AB-ICI index growth acceleration was temporary due to seasonal factors, while we do not see any improvements in the fundamental factors that may narrow the gap. In the short-term, the RTS index will benefit from strong oil prices, however there is a risk of market sentiment deteriorating.

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The ratings are:

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