AB-ICI: Ceiling hinders RTS growth

Natalia Orlova (+7 495) 795-3677 NOrlova@alfabank.ru

June 5, 2017 www.alfa-bank.com Moscow

Investment Summary

- AB-ICI up 1.7% YTD and RTS growth looks overheated by comparison
- AB-ICI moves in close step with GDP – not much acceleration from 0.3% y/y growth in 4Q16 to 0.5% y/y in 1Q17
- Low credibility of tight budget policy and uncertainty over reforms place ceiling on AB-ICI and, thus, the RTS

AB-ICI shows modest 1.7% recovery YTD

AB-ICI up 1.7% YTD, but lags behind the RTS on growth

Despite the AB-ICI gaining 1.7% YTD, including some 1% m/m growth in April, the gap between the AB-ICI and the RTS index remains significant. This suggests that under the slow improvement in economic fundamentals, there remains significant risk of an RTS correction to the downside:

The main driver of improvement to economic confidence was retail deposits

- **Economic confidence** showed improvement in April mostly due to retail deposit growth, which has added a sustainable 1.8% YTD increase in the ruble-denominated segments and a 1.6% YTD gain in dollar-denominated forex deposits. At the same time, net capital outflow for 4M17 reached $21 bn, compared to $9.8 bn in 4M16, and the share of forex deposits in overall retail deposits remained relatively high at 22.5% in April;

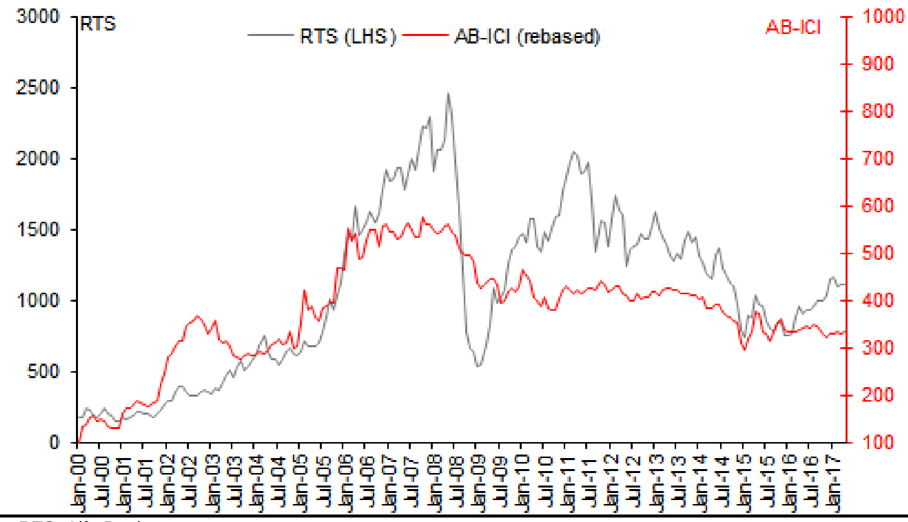
CBR monetary easing has helped market confidence indicators

- **Market confidence** continued to deliver growth, reflecting foreign investor interest towards the local Russian markets. The CBR’s decision to cut the key policy rate by 50 bp to 9.25% in April suggests an easing cycle is in place, which should support capital inflows to the local financial markets. At the same time, Russian bond durations contracted in April after almost 14 months of expansion;

Market share of foreign banks on the decline

- **Foreign confidence** was still under significant pressure, as reflected by the decline in the presence of foreign banks on the Russian market – dropping from 7.6% in December 2016 to 7.4% at April 2017.

Figure 1: AB-ICI and RTS Index: AB-ICI up 1.7% YTD in April 2017



Source: RTS, Alfa Bank

AB-ICI: Ceiling hinders RTS growth

AB-ICI will continue deviating from the RTS performance

The key observation from 4M17 is that, as predicted, the poor performance of the AB-ICI represents an implicit obstacle to a stronger RTS index recovery. The modest AB-ICI recovery reflects a number of conflicting trends in the Russian economy that are constraining the RTS to its current levels.

GDP growth was 0.3% y/y in 4Q16 and 0.5% y/y in 1Q17, not a major acceleration

The first concern is that Russia's economic performance confirms the previosuly assumed forecast that recovery in the economy would be extremely slow. According to Rosstat figures, GDP grew 0.5% y/y in 1Q17, which is only slightly above the 0.3% y/y reported in 4Q16. A breakdown of this recovery also raises questions over its quality. Rosstat reported an increase in capital investment, which rose by 2.3% y/y in 1Q17; however, this figure included the results of investment in unobservable sectors; for the observable segments, investment growth came in at just 0.4% y/y, including a 6.9% y/y decline in investment to the agriculture segment in Q1 which was the main driving force of Russian economic growth in previous years. We thus reiterate our 0.8% y/y GDP growth forecast for 2017 (the consensus forecast is 1.1% y/y, according to the Development Center polls).

Credibility of the tight budget policy is low – Finance Ministry need to fund extra indexations (RUB91 bn) and may not be able to implement a new budget rule without further amendments

Second, there is a serious degree of uncertinaty with regards to the budget policy priorities. At first glance, the Finance Ministry maintains very tight rhetoric. Since the beginning of this year, despite the recovery in oil prices to a level of 50-55$/bbl, the Finance Ministry has ruled out the possibility of increasing expenditure and started to rebuild its savings – it plans to accumulate up to RUB600 bn from extra oil revenue by end-2017. It has also indicated a plan to launch a new budget rule in the coming years. However, in reality, these plans might face obstacles. The high share of social and military obligations pose a risk of the Finance Ministry moving to fully control spending: recently, President Putin ordered extra funding of RUB91 bn to raise the salaries of 5.8 mn public-sector employees – additional military spending allocations also cannot be ruled out. In addition, the first budget rule was elaborated in 2012 and since then has been subject to regular changes. The reality is that while growth in budget expenditure has decelerated in recent years, in nominal terms, each year they continue to exceed initial cabinet targets. Thus, confidence in the promises of the Finance Ministry is very low.

The risk that president will combine proposals from Kudrin and from Stolypin club into one plan is high

Finally, while everybody agrees on the need to elaborate and implement economic reforms and Alexei Kudrin has presented his plan to the president in recent weeks, it looks like it will not be fully implemented. Most likely, the president may combine some of Kudrin's proposals (in particular, the proposal to implement legal reforms) with the Stolypin club proposals to stimulate economic growth by state guarantees and cheaper loans. Should this happen, potential growth is likely to remain low.

AB-ICI stagnation set a ceiling on RTS growth

All in all, we continue to expect that the RTS will remain driven by global financial market sentiment, while the lack of clarity of the local economic agenda will place a ceiling on its recovery and predispose the RTS towards a correction.

RATING DEFINITIONS

Alfa Bank applies a three-tier rating system for stocks under coverage. These ratings are based on the expected total stock return, which is the sum of the return to the target price and the expected dividend yield.

The ratings are:

Overweight (O/W):	Expected total stock return > 15%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
Underweight (U/W):	Expected total stock return < 0%

Owing to price volatility and our policy of not changing our ratings in response to frequent, short-term misalignments with expected returns, our ratings may sometimes not conform with the ranges indicated above.

In addition to the ratings above, we may occasionally assign the following classifications to stocks covered:

Restricted (R):	A rating, target price or financial forecasts are not disclosed owing to compliance or other regulatory considerations.
Under Review (U/R):	In response to recent or pending news flow requiring a significant overhaul or amendment of a company's financial model, the previous rating and/or target price is temporarily not disclosed.
Coverage in Transition (I/T)	Due to changes in the research team, the disclosure of a stock's rating and/or any other stock-specific information is temporarily suspended. The stock stays in Alfa Bank's coverage universe and usual disclosures will be resumed in due course.
Not Rated (N/R)	The stock is not in Alfa Bank's coverage universe at the time the research product referring to it is published.

IMPORTANT INFORMATION

The contents of this document have been prepared by Joint Stock Company Alfa Bank ("Alfa Bank"), as Investment Research within the meaning of Article 24 of Commission Directive 2006/73/EC implementing the Markets in Financial Instruments Directive 2004/39/EC ("MiFID"). Alfa Capital Holdings (Cyprus) Limited ("ACC") is distributing this document to its clients in the EEA and accepts no responsibility towards any other classes of recipient. Alfa Bank and ACC have in place appropriate conflicts of interest policies and procedures aimed at ensuring the objectivity of the information contained in this document. The information contained in this document is provided for information purposes only and is not a marketing communication, investment advice or personal recommendation within the meaning of MiFID. The information must not be used or considered as an offer or solicitation of an offer to sell or to buy or subscribe for any securities or financial instruments. In the UK, this document does not constitute a Financial Promotion within the meaning of section 21 of the Financial Services and Markets Act 2000 (as amended). ACC is regulated by the Cyprus Securities and Exchange Commission under license number CIF 025/04. This document is not for distribution to retail clients as defined by MiFID and may not be communicated to such persons. This document is not for distribution or use by any person or entity in any jurisdiction where such distribution or use would be contrary to local law or regulation or which would subject Alfa Bank, ACC or any other group entity to authorization, licensing or other registration requirements under applicable laws. The information contained in this document is the exclusive property of Alfa Bank. Unauthorized duplication, replication or dissemination of this document, in whole or in part, without the express written consent of Alfa Bank is strictly prohibited. Although the information in this document has been obtained from, and is based on, sources Alfa Bank believes to be reliable, no representation or warranty, express or implied, is made by Alfa Bank, ACC or the authors. ACC and its officers and employees do not accept any responsibility as to the accurateness or completeness of any information herein or as to whether any material facts have been omitted. All information stated herein is subject to change without notice. ACC makes no warranty or representation that any securities referred to herein are suitable for all recipients and any recipients considering investment decisions should seek appropriate independent advice. Nothing in this document constitutes tax, legal or accounting advice. Alfa Bank, ACC and their associated companies, officers, directors or employees (excluding any financial analysts or other personnel involved in the production of research), from time to time, may deal in, hold or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to the securities, financial instruments and companies mentioned in this email, or may have been, or may be represented on the board of such companies. If such circumstances arise, Alfa Bank, ACC and their associated companies have in place appropriate conflicts of interest policies and procedures to ensure that investment research remains independent and objective. A summary of ACC's conflicts of interests policy, containing details relevant to investment research, is available upon request from ACC. ACC has arranged for Alfa Bank and other relevant group entities involved in the production of research to implement equivalent policies.

Alfa Bank is incorporated, focused and based in the Russian Federation and is not affiliated with US-based Alfa Insurance.

Alfa Bank Equities

12, Akad. Sakharova prospect Moscow, Russia 107078
+7 (495) 795-3712

Research Department		**+7 (495) 795-3676**
	research@alfabank.ru	
Macroeconomics		
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677
Valeriya Volgareva	vvolgareva@alfabank.ru	780-4724
Consumer, IT & Media		
Alexandra Melnikova	a.melnikova@alfabank.ru	795-3740
Evgeniy Kipnis	ekipnis@alfabank.ru	795-3713

Alfa-Direct Research		
Geldy Soyunov	gsoyunov@alfabank.ru	641-3673
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)
Editing and Production		
John Walsh	jwalsh@alfabank.ru	795-3676 (ext. 8238)
Translation		
Anna Martynova	amartynova@alfabank.ru	795-3676

Equity Sales & Sales Trading (Moscow)		**+7 (495) 223-5500**
International		
Kirill Silvestrov	ksilvestrov@alfabank.ru	783-5133
Domestic Institutional		
Alexander Zorov	azorov@alfabank.ru	745-5621

Head of Alfa-Direct		**+7 (495) 795-3680**
Sergey Rybakov	srybakov@alfabank.ru	ext. 6399
Alfa-Direct Sales		
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083
Olga Babina	obabina@alfabank.ru	ext. 4092