Macro Insights

AB-ICI: Disappointing development

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Investment Summary

- AB-ICI pressured by negative developments in June, declined by 0.8% m/m
- Strong Russian macro statistics and better than in most other countries macro risk indicators are not sufficient to support the Russian market
- RTS may advance on rising oil prices, however, market volatility will probably prevent this growth from becoming sustainable

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AB-ICI pressured by negative developments

AB-ICI decreased by 0.8% m/m in June

The AB-ICI index came under pressure in June and declined by 0.8% m/m or 1.0% YTD, as a new round of sanctions offset the strong June macro statistics and the better macro risk indicators Russia enjoys versus most other countries:

Strong June data supportive for economic confidence

- **Economic confidence** increased in June due to the strong macro statistics, retail deposit growth (+2.6% m/m) and a contraction in net capital outflows, which decreased to +$23 bn in 1H17 vs. +$27 bn in 5M17. However, we are still concerned about the high level of dollarization (forex retail deposits), the share of which in overall retail deposits increased to 22.5% in June vs. 22.1% in May;

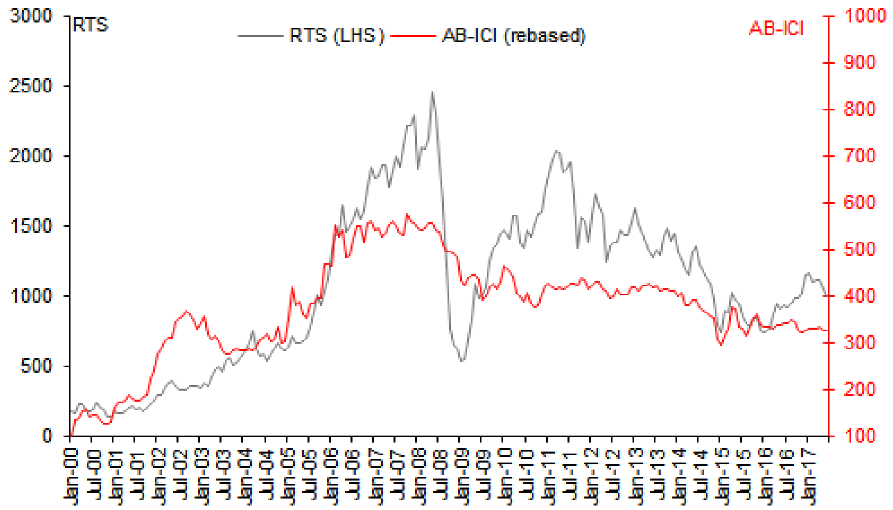
Geopolitical tensions surrounding Russia increased

- **Market confidence** remains under pressure due to the increase in geopolitical tensions surrounding Russia, particularly the latest round of sanctions. Foreign investors have taken a cautious approach to the Russian market despite the attractive rates and increased spreads between Russian and foreign bonds. We expect market confidence to remain constrained in July;

Presence of foreign banks began to recover in June

- **Foreign confidence** in Russia improved in June, as reflected by the presence of foreign banks in the market, which recovered to 7.6% from 7.5% in May.

Figure 1: AB-ICI and RTS Index: AB-ICI decreased by 0.8% m/m in June 2017



Source: RTS, Alfa Bank

AB-ICI: pressured by negative developments

Russia did not benefit from its strong macro fundamentals in June

As we stated last month, the strong Russian macro statistics and the better than in other countries key macro risk indicators (debt load and credit growth) should play in favor of Russia's investment attractiveness. However, in reality, we see that the ruble and the financial market are under pressure from negative developments, especially the new round of sanctions and the diplomatic confrontation between Russia and the US.

Market pressured by negative geopolitical developments

The ruble exchange rate is under pressure and has lost around 5-6% since mid-June as investors take a cautious approach towards the Russian market and in light of recent negative geopolitical developments. In July, the US House of Representatives voted overwhelmingly in favor of new sanctions against Russia (419 votes out of 435). The bill will place new restrictions on the Russian oil & gas sector and will complicate Russia's relations not only with the US, but also with Europe. Moreover, it limits Trump's scope to alleviate sanction; hence the hopes of sanctions being eased, which had been driving the Russian market in 1H17, have evaporated. Another negative geopolitical development is the diplomatic confrontation between Russia and the US: in response to the new sanctions, Russia has ordered the US to cut its diplomatic staff to 455 by 1 September. This has significantly narrowed the scope to reestablish Russia-US dialogue and will further pressure Russian assets and can discourage a large class of investors from the Russian market. Therefore, over the near term, the ruble and the financial market will remain under pressure and quite volatile.

CBR kept policy rate unchanged at 9%; a number of factors are against the CBR goal to cut the rate

The current situation on the markets is playing against the CBR, which was forced to keep the policy rate unchanged at 9.0% at the 28 July meeting, mainly due to the acceleration in inflation in June to 4.4% y/y. There are also a number of factors which will cloud the CBR's goal to cut the policy rate: Firstly, the undetermined pass-through effect from the recent ruble weakness (according to estimates based on previous years, 5-6% ruble depreciation can add up to 1 pp to annual inflation rate) and, secondly, the risk of the economy overheating, as suggested by the fast recovery in domestic growth (May-June results).

The Economy Ministry presented strong 2Q17 GDP results; however, there are concerns about it

Despite the Economy Ministry saying that Russia has demonstrated strong GDP growth (2.7% y/y in 2Q17 vs. 0.5% y/y in 1Q17), the expected market volatility raises concerns about that growth. This is supported by Rosstat and Gaidar Institute data on the June manufacturing business activity slowdown, and the RANEPA forecast, whereby Russia's GDP growth is limited to 1.2-1.4% y/y in the absence of structural reforms.

Oil prices can support the RTS, but anyway its growth will not be sustainable

All in all, despite previously believing that the AB-ICI index would increase due to the strong macro data and Russia's quite attractive position relative to other EM countries, in fact it has come under pressure in June and its upside potential is now limited. While we do not rule out quite strong oil prices supporting the RTS index, we see that the markets are entering a period of volatility, and the situation in Russia is complicated by negative geopolitical developments. Thus, we believe that even if the RTS index advances, any growth is unlikely to be sustainable.

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The ratings are:

Overweight (O/W):	Expected total stock return > 15%
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