Alfa-Bank

Macro Insights

AB-ICI: Weak outlook

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

September 8, 2017 **www.alfa-bank.com** **Moscow**

Investment Summary

- Economic fundamentals played against AB-ICI, which decline 1.5% m/m or 2.4% YTD
- Investors showed appetite for Russian assets, however economic confidence towards Russia decelerated
- Rising oil prices and investor interest in Russia to support RTS index, however poor AB-ICI index performance anticipated implies a ceiling on market growth

AB-ICI: economic fundamentals against index growth

AB-ICI decreased by 1.5% m/m in July

The AB-ICI and RTS indexes demonstrated opposing trends in July: the AB-ICI declined by 1.5% m/m or 2.4% YTD, while the RTS increased by 0.6% m/m. The AB-ICI index remained pressured by negative developments: deposits were flat, foreign bank presence again declined and the current account was in deficit:

July data negatively affected economic confidence

- **Economic confidence** declined due to the quite weak macro statistics: retail deposit were practically flat (-0.2% m/m), dollarization in retail deposits remained high at 22.5%, as of July 2017, the current account was in deficit ($1.3 bn), and GDP growth decelerated to 1.5% y/y in July vs. 3-4% y/y growth in May-June.

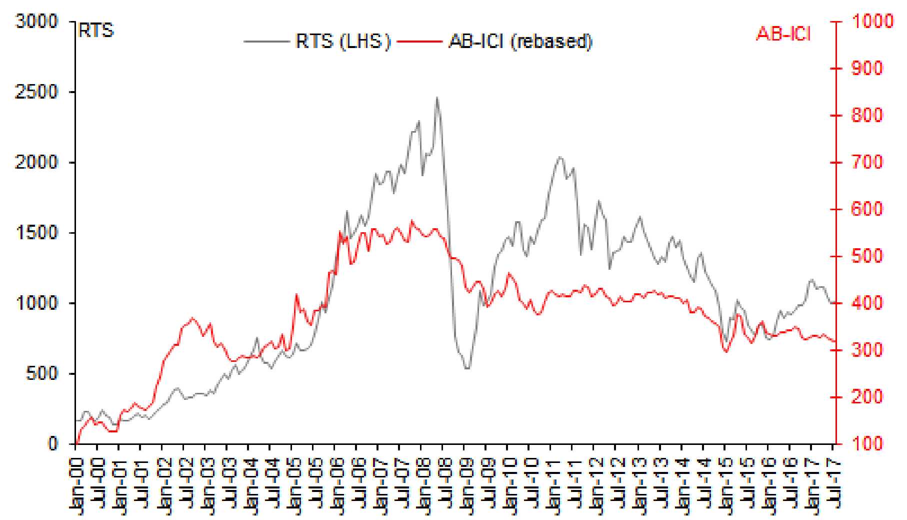
Market confidence in Russia strengthens

- **Market confidence** strengthened slightly in July, as geopolitical tensions surrounding Russia eased and appetite for Russian assets, particularly OFZ, increased among foreign investors boosting the ruble, which outperformed other major developing currencies. We expect investor interest in Russia to remain for the near term, and that should support market confidence in August.

Presence of foreign banks returns to lows of the start of the year

- **Foreign bank presence** in Russia significantly deteriorated in July: the share of foreign banks in the market returned to the low level of 7.4% of overall banks assets at the start of the year (7.6% in June).

Figure 1: AB-ICI and RTS Index: AB-ICI decreased by 1.5% m/m in July 2017



Source: RTS, Alfa Bank

AB-ICI: Weak outlook

Investor appetite for Russia returns, however macro statistics disappoint

Russia is again benefiting from an increase in investor appetite for risk, especially in the bond market. That is playing in favor of the strong results in the market component of the AB-ICI index. However, Russia's macro statistics disappointed slightly: retail, industrial production and GDP growth decelerated in July after strong performances in 2Q17; the investment growth structure in 2Q17 was still weak.

July growth statistics returned to the more appropriate levels after strong 2Q17, PMI index show weak sentiments

After the very strong growth in 2Q17, Russia's economic indicators seem to have returned to more usual levels since July. Retail trade grew 1.0% y/y in July, lagging below the 1.2% y/y gain reported in June. Industrial production growth eased to 1.1% y/y in July after a 3.8% y/y increase in 2Q17. GDP growth also decelerated in July, to +1.5% y/y, after +3-4% y/y growth in May-June. The composite PMI index for July and August both show that business sentiment is not as strong as it was in 2Q17: it was just 53-54 in July-August vs. 55-56 in 2Q17.

Investment growth was strong in 2Q17, however its structure is a concern

The main area of concern, and one that led us to take a cautious view on the Russia's 2H17 recovery, is the poor structure of investment growth. Investment growth was strong in 1H17: 2.3% y/y in 1Q17, 6.3% y/y in 2Q17 and 4.8% y/y in 1H17. However, the structure of the growth is still weak, non-observable sectors remained the driving force of that growth, which we believe is unlikely to support investments going forward. In agriculture (a sector which should benefit from sanctions and import substitution), investments continued to decline, recording a 7.2% y/y drop in 1H17 from a 6.9% y/y contraction in 1Q17. Moreover, investment growth was again mainly concentrated only in three regions – Moscow city, the southern region (Crimea) and the Far East.

Corporate lending recovery is lagging behind

Corporate lending remains weak, its recovery is lagging behind, which is another sign of economic weakness. In July, corporate lending demonstrated only 0.3% m/m growth or a contraction of 5.1% y/y (-2.6% y/y adjusted for forex revaluation). We expect corporate loan growth to reach only 3% y/y in 2017, if it continues to grow at the same rate. Moreover, although current retail lending growth is outperforming our expectations, until its growth is lower 15-18% y/y, the population's debt servicing liabilities will negatively affect consumption pattern.

Mortgage growth still not reflected in construction trends

One more concern, as we have previously expressed, is that the fast growth in the mortgage market is not really translating into a recovery in the construction sector: mortgages increased by nearly 12-13% y/y in 1Q-2Q17, while construction expanded by just 0.2% y/y in 1H17.

Negative geopolitical developments are still on the agenda

In addition, as we stated last month, there is an issue with the negative geopolitical developments surrounding Russia: new sanctions against the oil & gas sector and the diplomatic confrontation between Russia and the US (Russia has ordered the US to cut its diplomatic staff). In July, the US House of Representatives passed a law, which dramatically complicates the easing of or removal of sanctions going forward. While the financial market is currently not pricing in this factor, we believe the real sector will be negatively affected by this development going forward.

Poor AB-ICI performance implies a ceiling on market growth

Thus, certain deterioration of Russia's long-term economic fundamentals is reflected in the current AB-ICI dynamics. There is also no news with regards to cabinet plans to implement a reform agenda: Alexei Kudrin's team has presented a reform program, but the President will take a couple of months or more to express his preferences. In the absence of local triggers for a market recovery, we see the current RTS growth as fragile and expect the decline in the AB-ICI index to continue, which implies a ceiling on future market growth.

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

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**
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