AB-ICI: Moving sideways

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Investment Summary

- AB-ICI remained flat last months reflecting current account deficit, decline in foreign banks' presence despite favorable performance of the financial indicators
- Tight budget, monetary policies and lending conditions imply that AB-ICI is likely to move sideways in line with the economic activity

AB-ICI stood flat last months

AB-ICI was flat last months

The AB-ICI index remained above its local bottom of March 2016, however was flat last month. Rather favorable market sentiment toward Russia was neutralized by the structural weakness of Russian economy:

The net capital inflows funds current account deficit

- **Economic confidence** index was declining last month despite the recovery of the capital account. In August Russia got around $1bn net capital inflow, which highlighted the attractiveness of local markets; however, this inflow was compensating the deficit of the current account which apparently was around the same amount for July-August. As a result, the trust to the ruble remained rather weak: the share of forex deposits in the retail market grew to 26% in July.

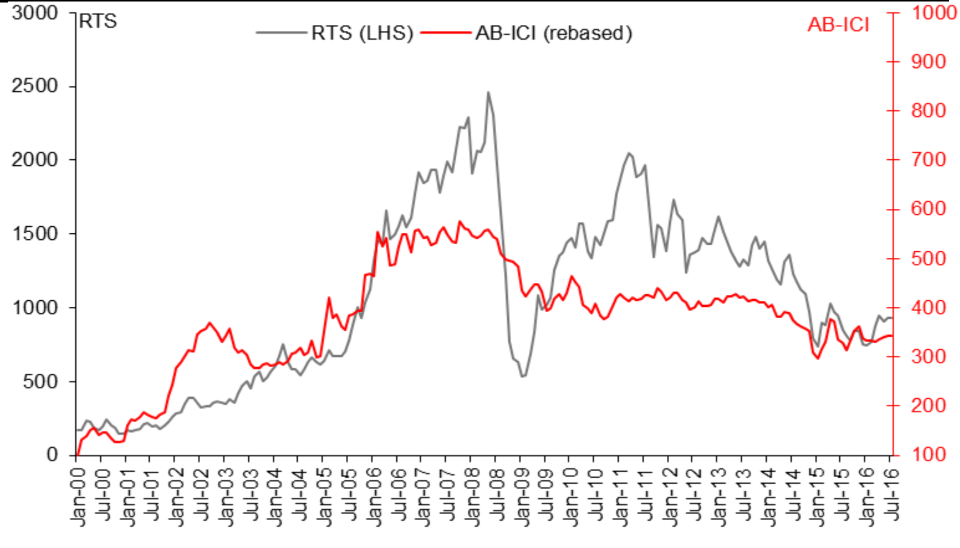
Foreign banks continue their exit

- **Foreign confidence** continues decline, reflecting a continuing exit of foreign banks from the local market. This trend is particularly important in the retail lending area where the foreign banks presence has declined from 17% in 2008-2010 to current 11%, the level of 2005;

Only financial markets show support to AB-ICI

- **Market confidence** was the area of support for the index with RTS being relatively stable since June and local fixed-income market posting signs of better activity. Russian financial markets remain in focus of investors due to the high return on fixed-income instruments and RTS, which did not recovery to 2013-2014 levels.

Figure 1: AB-ICI shows recovery from the end of last year



Source: New Economic School, RTS, Alfa Bank

AB-ICI: Moving sideways with the economy

AB-ICI is up only 1.5% YTD

The dynamic of the AB-ICI which is only 1.5% above the level of December last year is in line with the overall economic trend: Russian economy is moving sideways. The engines of growth, driving up economic activity during previous years, are all not available this time.

Budget policy is tight: public salaries are frozen; pension one-off payment due January 2017 lowers the base of upcoming indexation

First, the budget policy is much tighter than expected. The cabinet decision to freeze the federal budget expenditures at RUB15.8 trn for the next 3 years, including the electoral 2017-2018, points that the preferences of the budget policy has changed from social ones to financial ones. In other words optimizing the use of the reserve fund is a more important task than to maintain the living standard of Russian population. The painful discussion about a second increase of pensions this year ended recently with Prime Minister Dmitry Medvedev's decision in favor of a one-off payment of RUB5,000 per pensioner in January 2017. The one-off payment would cost the budget RUB200bn, however will help to significantly reduce the base for 2017 regular pension indexation. The public sector salaries are expected to remain unchanged despite upcoming elections.

The CBR now take explicit commitment to keep the policy rate unchanged until this year end

Second, the monetary policy is also relatively tight. While the CBR's rate cut on September 16 from 10.5% to 10% came in line with the consensus, its comment was hawkish and in line with our understanding that the monetary policy should stay tight. For the first time the CBR is taking a medium term explicit commitment to keep policy rate at the current level until the end of 2016. Cabinet decision to make a one-off RUB200bn pension payments in January 2017, followed by the regular indexation of pension starting from February suggests that inflation could pick up around March-April next year. The CBR has previously assessed this impact at around 0.5 pp and is likely to focus on this figure for reality check. The seasonality of the budget payments thus suggests that in the base case the rate cut could be expected only in March 2017

Retail lending market has touched the bottom; however its recovery will be delayed due to the poor income outlook and low interest of retail banks to boost their lending

Finally, the growth of the previous years was relying on the active growth of the retail lending, an engine of the local consumption boom. While the retail lending market has arrested its decline and stabilized at some RUB10.8tn over last four months; however, comparative analysis of 2008-2010 suggests that the market is lagging well behind the trend emergent from the last crisis. During that period, the contraction, which started in September 2008, reached the bottom 16 months after the beginning of the crisis, with a 12% drop, and by October 2010, the market had returned to its pre-crisis level. This time, in contrast, the contraction was far smoother, but the market is still 5% below its September 2014 level, and is moving sideways. A marked difference to the 2008-2010 experience is that retail banks have not been able to use the crisis as an opportunity. During the last crisis, they started active retail lending as early as in 2010: retail loans grew from 47% of their assets in 2009 to 55% in 2010, and their share in the retail lending market expanded from 7.2% to 9.5%, respectively. In 2016, however, retail loans still represent only 45% of retail bank assets, and their share in retail lending has continued declining to its current 9.0% level. We believe that the retail banks' strategy is partially a reaction to the deterioration in the household income trend (i.e. the freeze of public sector salaries since 2015), and partially a reaction to changes in legislation. The recently approved law on collection agencies now significantly reduces the room to collect bad loans, which in the case of the retail lending segment, represent 8.5% of the overall loan book.

AB-ICI is expected to move sideways in line with the GDP

With obstacles on all the main instruments of the growth it looks like economic activity will remain under pressure not only this, but also next year. The electoral cycle may help a little bit, however the next year growth forecast still stays at 1-1.5% y/y only. We thus expect the AB-ICI will keep delivering modest growth with no obvious catalyst for improvement.

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