Macro Insights

AB-ICI: Sentiment matters

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Investment Summary

- The AB-ICI continues to move sideways reflecting a contradiction in the main macro-economic indicators
- Sovereign ratings upgrade came as a positive surprise for Russia
- RTS remains vulnerable to geopolitical tensions and global market volatility

AB-ICI – sideways dynamic from contradictory economy trends

The AB-ICI index growth continued in January

After a seasonal acceleration in December 2017, the AB-ICI index increased by another 1.4% m/m in January, However, the scale of its recovery is still modest compared with the RTS index increase of 11.1% m/m in January; thus the gap between indexes significantly widened:

Retail deposits dynamic showed the first signs of weakness

- **Economic confidence** has been under pressure since the beginning of 2018. While retail lending continues to recover in Russia (+14% y/y), the retail deposits dynamic showed the first signs of weakness with ruble-denominated retail deposits growth decelerating to +10% y/y in January vs. an average 13% y/y growth in 2017. Additional pressure was related to the net capital outflow, which accelerated to $7.1 bn in January 2018 vs. $3.1 bn in January 2017.

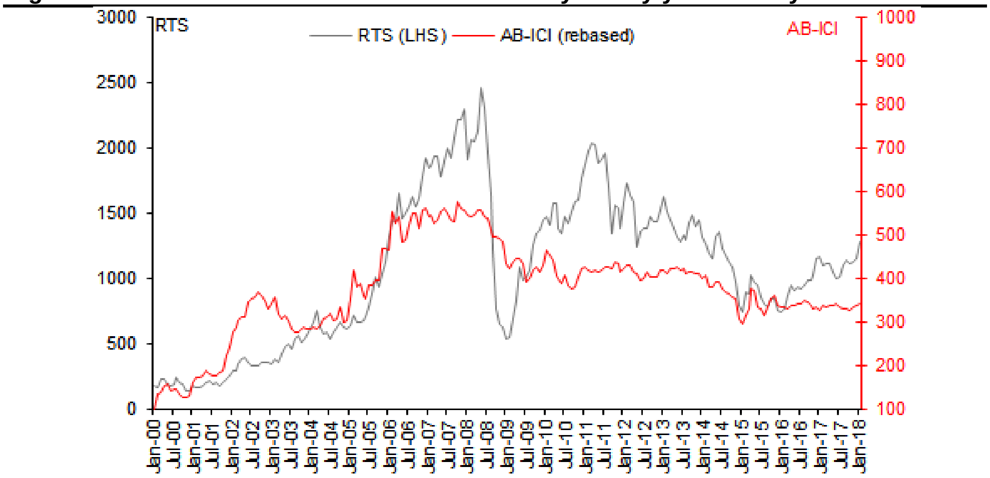
Strong market attractiveness under the S&P ratings upgrade and high rates of return

- **Market confidence** continues to look strong due to positive sentiments from quite good Russian macro indicators that reflected the S&P sovereign ratings upgrade. In addition, Russia has one of the highest interest rates among the countries with the same sovereign rating (BBB-), thus, attracting capital. However, high rates mean high risk premiums, which suggest that, given the increasing market confidence in Russia, they should decrease, thus, reducing the attractiveness of the market.

The clean-up of 3 large Russian private banks allows foreign banks to stop their market share loss

- **Foreign confidence** strengthened last month under increase of the foreign banks share on the Russian market – 7.8% of banking sector assets in January 2018 and the FDI inflow vs. outflow in the 4Q17. The clean-up of the three large private Russian banks allowed the foreign banks to accumulate funds: they increased their corporate deposits share to 7.7% in January vs. average 7.3% in 2017, retail deposits - to 5.7% in January vs. average 5.5% in 2017. However, this only looks like a temporary effect from a depositors' panic; they failed to boost their lending activity.

Fig. 1: AB-ICI and RTS Index: AB-ICI increased by 1.4% y/y in January 2018



Source: RTS, Alfa Bank

AB-ICI: Sentiment matters

The AB-IC index continues to move sideways, under …

Despite some recovery in recent months, the AB-ICI index continued to move sideways throughout the last 13 months. This dynamic is not a surprise, as the economic growth trend of 2017 was far from being stable and transparent.

… divergent trends in the macro indicators …

One issue was related to the divergence in economic indicators, mainly in retail. There was a divergence between wage and real disposable income dynamics. If the first steadily increased in 2016-2017 by 6-8% y/y in nominal terms and by 3-5% y/y in real terms; the second has decreased for the fourth year in a row (-1.7% in 2017) due to an unstable dynamic of the informal sector. Household consumption and retail trade dynamics were also questionable. In 2017, household consumption increased by 3.4% y/y, including 5.2% y/y growth in 3Q17. However, retail trade was up only by 1.2% y/y by the 2017 year-end and has grown only since April.

… gap between expectations and reality …

Another issue was the gap between expectations and reality. For example, while the OPEC+ agreement put a ceiling on the potential growth of the commodity extraction sector, the commodity segment was the leader of growth in industrial output. In 2017, it posted 2.0% y/y growth while manufacturing activity was practically flat (+0.2% y/y). The same surprise came from the agricultural sector, where the growth decelerated to 1.2% y/y last year – the lowest since 2012 - despite an extremely strong harvest. Construction sector activity also disappointed (-1.4% y/y in 2017) despite it operating in a friendly environment – i.e. strong mortgage portfolio growth of 17% y/y in 2017; and large state infrastructural projects like Kerch bridge and preparation for the 2018 World Cup.

… and the questionable structure of the Russian economy's growth

Finally, there are structural issues. Russian investment growth was 3.6% y/y in 2017, however, at the regional level, investment is unevenly concentrated in only a few regions (around 90% of investment growth in 9M17 was related to Moscow, Crimea and Far East). Moreover, further investment growth this year seems uncertain, as the construction of the number of large state investment projects will be finalized in the 1H18.

"Kremlin list", Russian sovereign ratings upgrade and the strong recovery of lending in Russia all play in favor of positive sentiments about Russia

At the same time, the downside potential of AB-ICI does not appear to be strong at the moment. The publication of the so-called "Kremlin list" was perceived as the inability of the US to come up with coherent sanction proposals and boosted market optimism in the wake of its toothless rollout. The recent S&P agency upgrade of the long-term Russian sovereign rating to BBB-, an investment grade level, came as another positive sign, especially as the US declined to place sanctions on sovereign debt. Russian securities can now be included in the Bloomberg Barclays Global Aggregate and the J.P.Morgan EMBI IG indexes, which could give Russia around $1-3 bn foreign capital inflow. Finally, the short-term growth outlook in Russia looks secure as the retail loan portfolio growth accelerated to 13.9% y/y in January vs. 12.7% y/y in December 2017. Corporate lending also showed signs of improvement with ruble-denominated corporate loans up by nearly 9% y/y after delivering a modest 3-5% y/y growth rate in 2016 and 1H17.

The current optimism could be neutralized by the materialization of additional sanctions, thus, we do not exclude a RTS downside correction

All in all, we believe that the above-mentioned trends in the Russian economy will play in favor of a modest AB-ICI recovery. However, the gap between the AB-ICI and RTS will remain significant. We do not exclude that continuing geopolitical tensions between Russia and US (recently US Treasury Secretary S.Mnuchin announced a new round of sanctions in the coming 30 days) and global market volatility will pressure the RTS index.

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The ratings are:

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