Alfa-Bank

Macro Insights

AB-ICI: Geopolitics spoil index recovery

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Investment Summary

- AB-ICI dropped by 2.2% m/m in March ahead of the financial markets turmoil
- Market and ruble dropped sharply not only on new round of sanctions but also on fears of military escalation in Syria
- Weaker growth outlook to impact AB-ICI and reduce fundamental support for an RTS recovery

AB-ICI dropped by 2.2% in March

AB-ICI contracted by 2.2% m/m in March

After four months of growth, the AB-ICI index contracted by 2.2% m/m in March. The underperformance reflecting an aversion to personal saving, flat retail deposit dollarization levels, stagnant foreign bank presence in Russia, and moderate FDI inflows:

Weak economic confidence as salary growth failed to materialize into higher savings

- **Economic confidence** remained weak in March, reflecting a gradual deterioration in the preference for personal savings. Despite the indexation of public sector salaries, retail deposits grew by just 8.7% y/y, or 0.3% YTD in March, including an 11.4% y/y increase in ruble-denominated deposits. That was in line with the trend of 2017, although salary growth accelerated from 7.3% y/y in 2017 to 12.0% y/y in 1Q18. Forex-denominated retail deposits remained at $92 bn, unchanged from the three-year average, reflecting little trust in ruble stability.

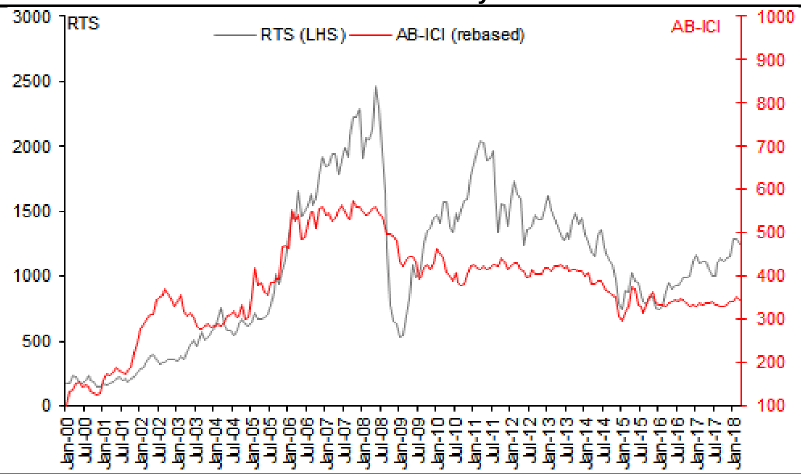
Market confidence under pressure due to global instability

- **Market confidence** saw contradictory trends in 1Q18. On one hand, strong oil prices, a sovereign rating upgrade, high Russian interest rates, and bond placements by Russian companies (in 1Q18, 61 new bonds were placed vs. 36 in 1Q17) supported positive market sentiment. At the same time, following the publication of the so-called Kremlin list, volatility on global markets and the implementation of new US sanctions, the Russian market came under pressure, which resulted in a number of postponed IPOs.

Share of foreign banks unchanged, FDI inflows decelerate

- **Foreign confidence** showed no improvement in March. The presence of foreign banks in the Russian banking sector remained unchanged at 7.7-7.9% of total assets, after an increase at the start of the year. Based on balance of payment figures, foreign direct investment decelerated to $4 bn in 1Q18 from $5 bn in 1Q17, and contributed to AB-ICI weakness.

Fig. 1: AB-ICI and RTS Index: AB-ICI contracted by 2.2% m/m in March



Source: RTS, Alfa Bank

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Coming months likely to bring AB-ICI weakness

After a promising start to the year, which capped four consecutive months of AB-ICI growth, the index declined in March, signaling the start of a new round of index weakness.

Russian market hit by sanctions, tensions in Syria and proposed countersanctions

The Russian financial market and the ruble experienced a significant increase in volatility during April. Over the course of just three days (9-11 April), the RTS plunged 12% and the ruble depreciated by 7%, weakening to RUB65/$. That was triggered by an escalation in US sanctions on 6 April, when the Treasury Department included 24 Russian businessmen and officials and 15 companies to the SDN list (Specially Designated Nationals and Blocked Persons List). That was just the latest deterioration of Russo-US relations since the start of 2018, as just prior to that, the US expelled 60 Russian diplomats (as a reaction to the alleged poising of an ex-spy in the UK), which was reciprocated in kind by Moscow. However, the 6 April measures marked a new stage in the sanctions saga as, for the first time, publicly traded companies were added to the SFN list, including EN+ and Rusal, both owned by Oleg Deripaska. The inclusion of these names triggered a collapse in their share prices. Following the ratcheting-up of sanctions pressure, the confidence of Russia investors was further eroded by a military escalation in Syria. Finally, confidence took a further hit when the Duma (the Russian parliament) responded to the US sanctions, with a draft of countermeasures. The proposed countersanctions include: a) banning or restricting imports of food, agricultural equipment and pharmaceutical goods; b) restricting the entry of US and other foreign citizens to Russia and restricting their employment in Russia (the government will define a list of people who may be impacted by this); and c) prohibiting foreign companies from providing consultancy, auditing and legal services in Russia. The only positive development was that the oil prices increased up to $73-75/bbl, which has helped to stabilize the ruble at around RUB62/$. That said, despite this support, the geopolitical environment remains generally unfriendly towards Russia for the coming months, if not quarters.

GDP growth came very weak at 1.1% y/y in 1Q18, retail trade shows no improvement, import growth strong at 19% y/y in 1Q18

In addition to the global environment, the local macro fundamentals are not strong in Russia. GDP growth was assessed at just 1.1% y/y growth for 1Q18 (Economy Ministry estimates), which is below the 1.5% y/y level initially expected. Although we maintain our 1.0% GDP growth forecast for 2018, the beginning of the year has clearly been weaker than expected. Retail trade grew 2.2% y/y in 1Q18, reflecting no acceleration from the 2.7% y/y growth in 2H17. The 1Q18 balance of payments statistics showed imports rose by 18.5% y/y, implying potentially strong full-year growth of 15% y/y, which may limit growth in a number of local industries.

Russian government plans to focus on developing human capital, however the effect of such measures on the economy is uncertain

The discussion on potential economic reforms is failing to meet positive expectations. According to recent reports, the government plan to focus on human capital reforms and to increase spending on healthcare, education and infrastructure over the next six years by around RUB10 tn. This is in line with our understanding that budget reforms will form the key component of economic decision-making. However, it remains unclear what the real effect of these measures will be for economic growth and how these plans will be funded. The Finance Minister recently indicated that he is opposed to raising personal income tax, preferring to increase budget revenues through optimizing and improving tax collections. This view is generally in line with the fact that under high oil prices Russia has little incentive to hurry with tax rate increases; thus, the reform agenda for 2018-2019 now looks even more unlikely than before.

High uncertainty suggests that growth will be limited, ruining support for RTS recovery

In the coming months, the main watch factor is the extent to which sanctions may negatively effect the Russian economy. One obvious channel that may emerge is through a more cautious approach by banks in the provision of corporate loans, however even now the banking sector holds around RUB3.7-4.1 tn of excess liquidity up from just RUB2.2-2.7 tn at the start of the year. Another factor, is that under sanctions, the degree of uncertainty in economic decision-making increased dramatically, worsening the business environment. Aside from sanctions, there are also local factors, such as the formation of a new government (following the presidential inauguration), which will also play impact the growth recovery. We initially expected that 2H18 should be weaker than 1H and the escalation in sanctions reinforces that view, suggesting that fundamentals may play against a market recovery.

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