AB-ICI: Local uncertainty intensified in May

Natalia Orlova **(+7 495) 795-3677**

July 3, 2018 www.alfa-bank.com

Investment Summary

- AB-ICI weakens in May as Russia looks less attractive than other EM countries which experienced rate hikes
- Cabinet proposal to reform pensions and increase VAT undermines 2019 growth outlook and sentiment
- AB-ICI will lack drivers once the World Cup and the Putin-Trump summit are concluded

AB-ICI: instability in uncertain environment

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

After some recovery in April, which was partially due to a statistical readjustment, the AB-ICI contracted by 1.5% m/m in May. This decline reflected negative sentiment, both global and domestic:

Flat ruble-denominated retail deposits, for first time since the start of 2018, reflect weakness in economic confidence

- **Economic confidence** weakened in May. Ruble-denominated retail deposits were flat in May for the first time since the beginning of the year. The Russian population is showing increased appetite for credit and consumption-driven growth is back on the agenda: the ratio of retail loans to retail deposits increased to 49%, the highest level since 2015. The only bright spot was that dollarization continued to decline (forex retail deposits decreased by $1.5 bn in May), however, it remains at 21% of total retail deposits, above the pre-crisis level of 17-18%.

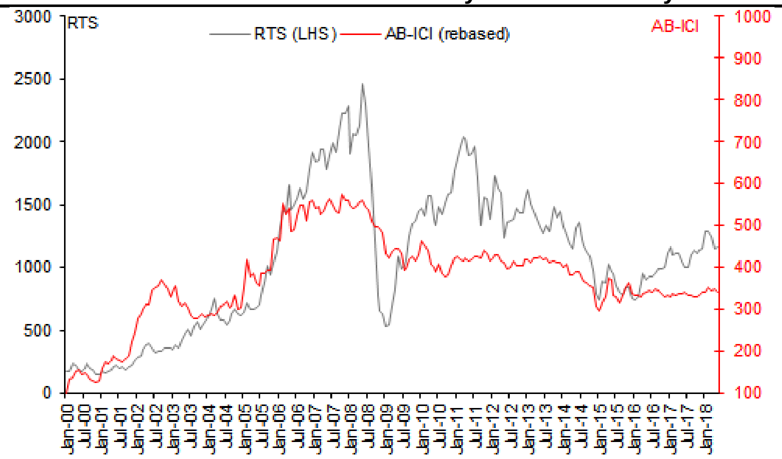
Cautious market sentiment and key rate hikes in developing countries pressure market confidence

- **Market confidence** remains under pressure, influenced by cautious global and domestic sentiment. Russia reported continued non-resident outflows from the domestic bond market, which triggered a decline in activity among local corporate issuers (26 bond placements in May vs. 28 in May 2017). It appears that the capital outflows are being driven not so much by fears of a US Fed rate hike, but by the more attractive opportunities appearing on other EM countries. For example, Turkey recently hiked its key rate from 8% to 17.75%, while Argentina raised its rates from 28.75% to 40%, rendering Russia's key policy rate of 7.25% low by EM standards.

Foreign banks performed well in only one segment in 5M18, corporate current accounts

- **Foreign confidence** was flat in May, pressured by the stagnant share of foreign banks in the Russian market. During 5M18, foreign banks performed well in only one segment, corporate current accounts, whose share increased to a historical high of 10-11% of the market from 9% in 2017. However, in other segments, foreign banks continued to show no signs of improvement, implying that their potential is limited.

Fig. 1: AB-ICI and RTS Index: AB-ICI decreased by 1.5% m/m in May



Source: RTS, Alfa Bank

AB-ICI: Local uncertainty intensified in May

Cabinet tax and pension reform plans, hawkish CBR rhetoric, and Rosstat revisions are raising uncertainty

An increase in domestic uncertainty coupled with heightened global risks led to a significant change in the index dynamics in May. The uncertainty was driven by a) the announcement of reforms to taxation and pensions, b) a change in CBR rhetoric to a more hawkish stance and c) the significant revision to Rosstat's macroeconomic statistics.

Government announces two reforms: to increase VAT from 18% to 20% and raise the pension ages; public indignation is growing

On 14 June, the cabinet announced a draft reform to the pension system and taxation: proposing to increase the retirement age to 63 years for women and 65 years for men (the current pension ages are 55 for women and 60) and to increase VAT from 18% to 20%, both effective from 2019. Although the need for budget reform has been on the agenda for some time, the announcement came unexpectedly; moreover, the current draft for pension reform looks very hawkish. The decision to announce the reforms on the first day of the World Cup suggests that the cabinet was well aware of a public backlash. Those concerns proved correct: last weekend, protests against the proposed pension reforms took place in more than 30 cities and the reforms have already triggered a sharp contraction in President Putin's approval rating from 62% in 1Q18 to the current 48%, the lowest level since 2013. Additionally, RANEPA estimated that increasing VAT from 18% to 20% will erode 0.4-0.6 pp off Russia's GDP in 2019. The recent Economy Ministry decision to downgrade the 2019 GDP growth forecast to 1.4% y/y (from 2.2% y/y initially) also confirms the negative implications of the reform for the Russian economy.

CBR surprised the market with a significant tightening in rhetoric

Cabinet action forced the CBR to react. At the last policy meeting (15 June), the CBR announced that the switch to a neutral monetary policy should be delayed: the current base-case scenario implies that a neutral interest rate is likely to be reached only in 2019, while it was previously expected to normalize this year. That implies that the CBR has changed its overly optimistic 1Q18 rhetoric to a more cautious stance. While we fully support the CBR move, such a significant change in the regulators' rhetoric does little to boost confidence in the economy.

Substantial revision to industrial production figures creates a credibility problem for Rosstat

One other recent surprise was the revision to the Rosstat statistics. The revision to last year's industrial production figures now implies that industrial production grew 2.1 y/y in 2017 instead of the 1.0% y/y initially estimated. The initial growth of 1.9% y/y in 1Q18 has been updated to 2.8% y/y, while the trend since the beginning of the year has now switched to an acceleration in growth from the deceleration previously recorded – 2.9% y/y growth in January slowing to 1.3% y/y in April. The substantial revision creates a credibility problem for Rosstat and renders macro data less reliable for macro policy decisions, i.e. increasing the risk of mistakes in the decision making process.

Upwards revision to industrial production growth figures does not translate into higher economy growth

On the back of the recent upgrade to industrial production statistics by Rosstat, the market had expected 1Q18 GDP growth to be revised upwards – for example, the CBR had anticipated GDP being upgraded to 1.5% y/y. However, Rosstat surprisingly confirmed its first estimate of 1Q18 GDP growth at 1.3% y/y, thus implying that the upgrade to industrial production growth does not guarantee an upgrade to GDP figures. Investment growth reported at just 1.8% y/y in 1Q18 vs. the 3.6% y/y figure initially estimated, reflects the weak structure of the economy, and also plays little in favor of easing uncertainty.

The are no evident driver for the AB-ICI after the World Cup and the Putin-Trump summit

Despite the increased level of uncertainty, we are not too concerned about the AB-ICI performance in June-July, as the World Cup and the summit between Putin and Trump scheduled for 16 July should support sentiment. Nevertheless, the outlook for the months following July has deteriorated: after World Cup, the country will have to refocus on the unpleasant budget reform debate, which is unlikely to provide any positive drivers to the market. In a nutshell, the AB-ICI is going to lack drivers from the end of July.

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.

Target Prices

The Target Price reflects the research analyst's informed opinion on the price which is likely to be attained by the stock within 12 months, subsequent to the date of the Target Price determination.

This document is published on a monthly basis.

Alfa Bank Equities

12, Akad. Sakharova prospect Moscow, Russia 107078
+7 (495) 795-3712

Head of Equities Konstantin Shapsharov
+7 (495) 228 8828 kshapsharov@alfabank.ru

Research Department **+7 (495) 795-**

Head of Research
Boris Krasnozhenov bkrasnozhenov@alfabank.ru
+7 (495) 795-3612

Macroeconomics
Natalia Orlova, Ph.D. norlova@alfabank.ru
795-3677

Valeriya Volgareva vvolgareva@alfabank.ru
780-4724

Metals & Mining
Boris Krasnozhenov bkrasnozhenov@alfabank.ru
+7 (495) 795-3612

Yulia Tolstykh yatolstykh@alfabank.ru
+7 (499) 923 6697 (ext. 8681)

Consumer / IT & Media
Alexandra Melnikova a.melnikova@alfabank.ru
795-3740

Olesya Vorobyeva oovorobyeva@alfabank.ru

Banking / Real Estate
Evgeniy Kipnis ekipnis@alfabank.ru
795-3713

Editorial / Production
John Walsh jwalsh@alfabank.ru
795-3676 (ext. 8238)

Translation
Anna Martynova amartynova@alfabank.ru
795-3676

Data Specialist / Analyst
Denis Dorofeev ddorofeev@alfabank.ru
795-3676

Equity Sales & Trading (Moscow) **+7 (495) 223-**

International Sales
Alexander Zorov azorov@alfabank.ru
745-5621

Alfa Direct (Domestic retail brokerage)

Head of Alfa-Direct **+7 (495) 795-3680**
Sergey Rybakov srybakov@alfabank.ru
795-3680 ext. 6399

Alfa-Direct Research
Geldy Soyunov gsoyunov@alfabank.ru
641-3673

Alan Kaziev akaziev@alfabank.ru
974-2515 (ext. 8568)

Alfa-Direct Sales
Valeriy Kremnev vkremnev@alfabank.ru
ext. 7083

Olga Babina obabina@alfabank.ru
ext. 4092