

AB-ICI: Local uncertainty intensified in May

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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%.

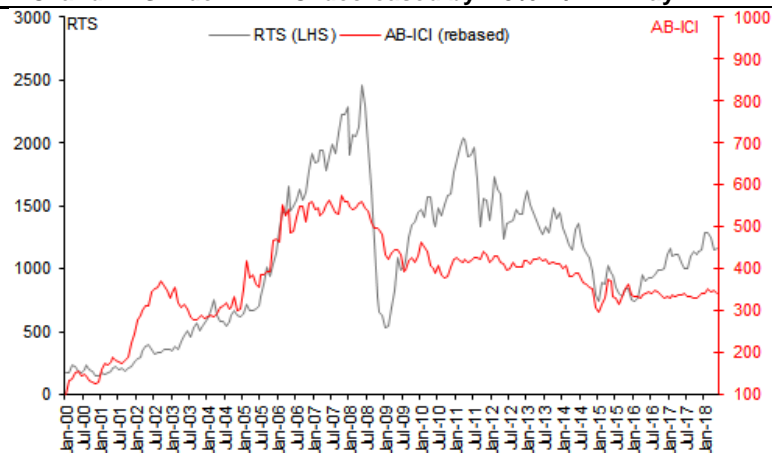
Cautious market sentiment and key rate hikes in developing countries pressure market confidence

- **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

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

CBR surprised the market with a significant tightening in rhetoric

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

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

There are no evident drivers for the AB-ICI after the World Cup and the Putin-Trump summit

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.

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, RANEP 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.

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.

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.

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.

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.

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