Alfa-Bank

Macro Insights

AB-ICI: Preparing for long pause in policy rate cut

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Investment Summary

- AB-ICI decreased by 1.0% m/m in June due to weak financial markets and foreign investments
- Increase in local inflationary risks and rate hikes worldwide will force the CBR to pause its policy rate cuts
- Under a flat key rate, the attractiveness of the local markets will remain low, damaging the AB-ICI performance

AB-ICI: no growth, despite improved economy component

AB-ICI decreased by 1.0% m/m in June

The AB-ICI continued to contract in June, dropping 1.0% m/m and 0.6% YTD. Despite the economic component of the index showing some improvement, the weak foreign and market components drove the AB-ICI lower:

Retail deposit growth and a continuing decline in share of forex deposits played in favor of a better economic component

- **Economic confidence** showed signs of improvement in June due to a number of factors. Firstly, retail deposits increased by 1.1% m/m or 8.4% y/y in June, with 1.3% m/m growth in ruble-denominated retail deposits after a flat dynamic in May. Secondly, declining dollarization supported the component performance. The share of foreign-currency retail deposits decreased to 20.3% in June – the lowest level since March. Finally, in June, Russia recorded a net capital inflow of $5.9 bn vs. outflows of $6.3 bn in April-May, according to preliminary CBR statistics.

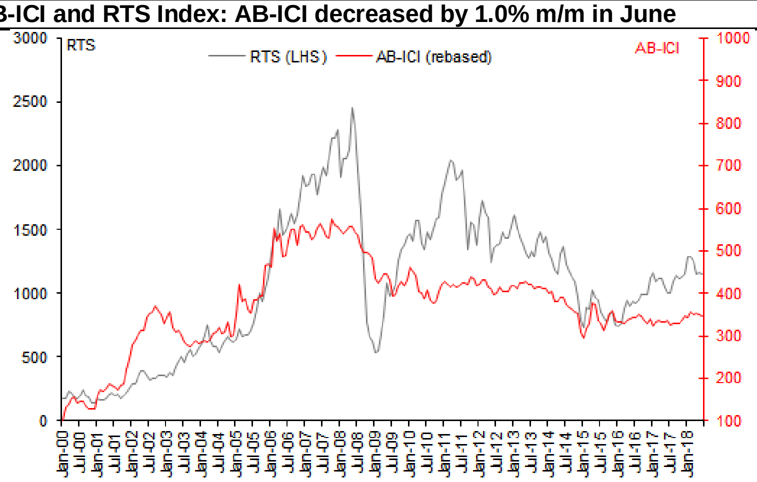
Market confidence under pressure due to low risk appetite, and bond placements at YTD lows

- **Market confidence** was weak, as local markets remained pressured by waning global appetite for risk. Structurally, the number of corporate bond placements in June was the lowest monthly number since the beginning of this year. Despite a number of companies mulling IPOs, there were no placements on the Russian market since November 2017.

FDI below expectations at $1.7 bn in 2Q18

- **Foreign confidence** was down in June, reflecting a contraction in the market share of foreign banks (7.6% of assets in June vs. 7.9% in April-May) and a decline in foreign direct investment – net FDI inflows were below expectations at $1.7 bn in 2Q18, implying a significant deceleration from $7.0 bn in 1Q18 and $13.0 bn in 2Q17.

Fig. 1: AB-ICI and RTS Index: AB-ICI decreased by 1.0% m/m in June



Source: RTS, Alfa Bank

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Capital inflows to the bond market was supportive to the AB-ICI

From 2015, the market component of the AB-ICI had provided an important support to the index, reflected in the substantial foreign capital inflows to the Russian market. Holdings of OFZs held by foreign investors more than doubled from RUB0.9 tn at the beginning of 2015 (or 19% of the total OFZ market) to more than RUB2.3 tn (34% of the total OFZ market) as of February 2018. The significant inflows were driven by the key rate cut cycle, which started in early 2015, when the policy rate was at a high of 17.0% and was reduced to the current level of 7.25%.

The CBR policy rate cut cycle seems at an end due to increased local inflationary risks …

Going forward, it is very unlikely that the CBR key rate decisions will remain a driver for capital inflows. We are near the end of the key rate cut cycle due to two reasons:

1) The domestic environment has clearly become more inflationary. First, annual inflation is increasing – as at end-July, annual inflation had accelerated to 2.6% y/y, which is the highest level since October 2017, and suggests a sharp increase from the 2.3% y/y posted in June. Second, inflationary expectations have intensified – they jumped from 8.6% in May to 9.8% in June, the highest level since October 2017. Third, the acceleration in inflation is driven by non-food price growth – it accelerated from 2.5% y/y in February-March (the local minimum) to 3.7% y/y currently – while food price growth remains fairly low. However, this may change in the coming months – according to preliminary estimates, this year's harvest is likely to be 15-25% lower than the 2017 levels (for example, the grain harvest is expected at 100-115 mn tons vs. 135 mn tons in 2017), implying an acceleration in food price growth. Fourth, the recent government decision to increase VAT rate from 18% to 20% since 2019, plays in favor of the higher inflationary outlook, given that 80% of Russian companies plan to increase product prices. Considering the above-mentioned reasons, we expect the annual inflation rate to accelerate to 3.8% y/y by year-end and to reach as high as 5% by mid-2019.

… and because of 1) geopolitical tensions, 2) trade war fears and 3) increasing rates across DM and EMs

2) The other constraint to the CBR's ability to cut the key rate is the global environment. First, the unfriendly geopolitical environment. The outcome of the Putin-Trump summit in Helsinki in July did not go as expected and, indeed, it served to worsen market sentiment by triggering fervent debate in the US to introduce new sanctions against Russia. In addition, the US and EU recently introduced sanctions on Russian companies involved in the construction of Kerch bridge. Second, the escalation of the trade war between the US and China is a serious risk factor for commodity markets and, thus, Russia. Third, developed and emerging countries are actively raising interest rates – the UK and Canada have been raising their policy rates since last year (in November 2017, the UK increased its rate from 0.25% to 0.50% and since July 2017, the Bank of Canada has raised its rates four times from 0.5% to 1.5%). Regarding EM countries, Turkey hiked its key rate from 8% to 17.75%, Argentina raised its rate from 28.75% to 40%. Fourth, the stance of the US Fed remains hawkish and experts still expect two more Fed rate hikes this year. In short, all these factors strongly oppose cuts to the CBR's policy rate.

Likely pause in the CBR key rate cut cycle reduces attractiveness of local markets in the coming years and plays against AB-ICI

Given the increase in local inflationary risks and the global environment, a continued pause in the CBR's policy rate is becoming a base-case scenario for the coming months. Also, given that the current 7.25% key rate is not very far from the neutral key rate (6-7%), identified previously by the CBR, we now do not exclude that the current rate is the bottom of the rate cut cycle, which may remain in place for some time. This suggests that the Russian market will become unattractive to foreign capital for the coming years, undermining the market component contribution potential to the AB-ICI performance.

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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%
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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.

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