Alfa-Bank

Macro Insights

AB-ICI: Four factors that pressured the market

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Investment Summary

- AB-ICI index declined by 2.3% m/m in July or by 5% since March 2018
- Fears of new sanctions, EM turmoil, increased local tax uncertainty and weak China statistics pressured the Russian market in August
- The outlook for the coming months is murky due to the US mid-term elections and weakness in the Russian growth trend

AB-ICI down 2.3%, implying more downside for financial markets

AB-ICI declined by 2.3% m/m in July

The AB-ICI decline accelerated in July, falling by 2.3% m/m; despite the index having grown by 2.5% YTD, as of March 2018, it is now down by 2.9% YTD. Despite the considerable weakness in the AB-ICI, the RTS is still up 1.6% YTD, the divergence in the dynamics of the two indexes imply that an RTS recovery from the recent retreat is unlikely anytime soon:

Economic confidence declined in July, reflecting increased net capital outflow

- **Economic confidence** was weak in July. The main reason was an acceleration in net capital outflows, which increased from $17.4 bn in 1H18 to $21.5 bn in 7M18. For comparison, in June, Russia, saw $5.9 bn of net capital inflows, but in July that had turned into a $4.1 bn net outflow, which we attribute to the market starting to price the end of the policy rate cut cycle, as discussed in our previous publication (see “AB-ICI: preparing for long pause in policy rate cut” released on 2 August);

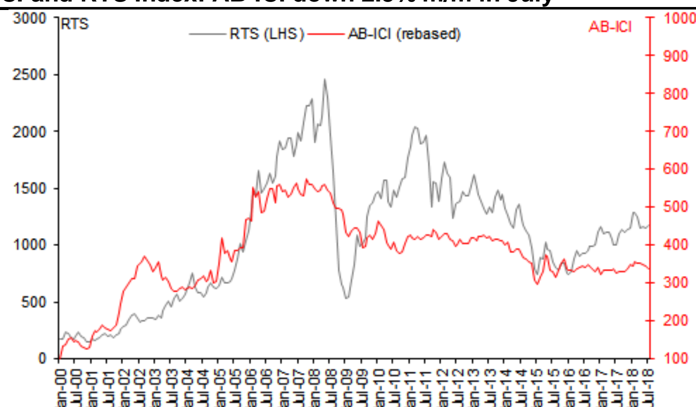
Market confidence was under pressure as foreigners exited OFZs, despite a pick-up in local placements

- **Market confidence** remained under pressure due to heightened fears of sanctions and resulted in the withdrawal of non-resident from local financial instruments. As of end-July, the share of non-residents in the OFZ market decreased to 28% of the total, from a peak of 35% in March. That said, some support came from the increase in the number of local corporate placements – in July, Russian companies placed 31 new corporate bonds, the highest number since December 2017;

The share of foreign banks in the current account segment of retail reached a historical high of 13.5% in July

- **Foreign confidence** significantly strengthened in July, due to reinforcement of the presence of foreign banks on the Russian banking market. While the share of foreign banks in total assets grew only modestly to 7.9% from an average 7.7% since the beginning of the year, they managed to increase their presence in retail deposits, where their share of current accounts grew to a historical high of 13.5% in July from an average of 13.0% since the beginning of this year.

Fig. 1: AB-ICI and RTS Index: AB-ICI down 2.3% m/m in July



Source: RTS, Alfa Bank

AB-ICI: Four factors that pressured the market

AB-ICI drop of 5% from March 2018 turned to be a good leading indicator for the current RTS and ruble instability

Despite the key components of the AB-ICI showing diverging trends in July, with market confidence weakened while foreign bank confidence showed signs of stability, the outlook for the coming months is clearly negative due the ongoing emerging market turmoil. The AB-ICI, which dropped by 5% since March, has thus proved to be a strong leading indicator of the current market instability. In August, RTS index dropped by 8% m/m, the ruble depreciated by 8% from RUB62-63/$ in June-July to RUB67-68/$ in August, reflecting a deterioration in local and global market sentiment.

Russian markets are under pressure as sanctions fears intensified ahead of mid-terms US elections

First, the market came under pressure due to mounting fears of new sanctions. On 1 August, a new bill drafted by Lindsey Graham was unveiled to US Congress, summarizing previous sanctions' proposals – it proposed to introduce new individual sanctions, sanctions on Russian-related energy projects, restrictions on investing in new OFZ issues and large state-owned financial institutions. The negative mood intensified after 8 August, when the Trump Administration introduced a two-stage set of sanctions related to the Skripal poisoning. The first stage, which came into force on 27 August, implies that Russia must give guarantees on the non-use of chemical weapons and agree to UN inspection; otherwise, in 90 days, i.e. in November, the US may implement the second tranche of sanctions, which target suspending Aeroflot flights to the US and imposing restrictions on bilateral trade. The intensification of the sanctions debate looks to be related to the upcoming mid-term elections in US due on 6 November; thus, the coming two months are going to be volatile for Russia with a heightened threat sanctions escalating. That is negative for the local markets.

Turkish financial fallout had a negative effect on the Russian ruble and market

Secondly, the selloff on global financial markets, particularly emerging markets, triggered by Turkish financial crisis, has also negatively affected sentiment towards Russia. The Turkish lira has lost 25% of its value since the beginning of August after the US introduced sanctions on several Turkish officials and placed tariffs on steel and aluminum imports from Turkey. Turkey is facing $180 bn of foreign debt repayments in the next 12 months, while the Turkish Central Bank directly has only $30 bn in its reserves, raising fears of a potential debt default. The Turkish economic fallout fueled a domino effect on emerging markets including Argentina, South Africa, Russia, as well as the European Union.

Weak Chinese statistics reflected the negative consequences of the trade war

Additional global risk stemmed from the deterioration in China's economic situation, which emerged after the publication of weak macroeconomic statistics for July. Industrial production growth was recorded at the lowest level since the beginning of the year (6.0% y/y in July-June against 6.8-7.0% y/y in April-May) and came below consensus forecast (6.3% y/y). Retail sales figures also disappointed – while analysts had expected a slight acceleration in retail sales in July vs. June, the actual figure was worse than expected – 8.8% y/y in July (9.1% y/y consensus) vs. 9.0% y/y in June. The results were seen as a reflection of the negative consequences of the trade war.

Presidential Economic Aide Andrei Belousov's proposal to raise taxation on 14 metals & mining companies spooked the market

Finally, local Russian news flow was not supportive of the markets – the proposal by Presidential Economic Aide Andrei Belousov to raise taxation on 14 companies in the metals & mining sector was untimely and placed additional downward pressure on the market. The proposal scared investors and led to increased tax uncertainty in the Russian economy.

The outlook for the coming months is cloudy due to the US mid-term elections, trade tensions and a likely deceleration in Russian economic growth

The outlook of the coming months remains very murky. First, US Congress has returned to work this week and that may bring more negative news flow with regards to the sanctions. The coming two months prior to the 6 November mid-term elections in the US are expected to be volatile for Russian financial markets. Trade war fears remain equally high on the agenda, and are forcing global investors to look for haven assets. Fundamentally, Russia is likely to face a growth contraction as a result of the end of the policy rate cut cycle, the limits on non-mortgage lending and the upcoming hike in VAT. The CBR recently downgraded its 3Q18 GDP growth forecast from 1.5-2.0% y/y to 1.3-1.7% y/y. We expected the AB-ICI and the RTS to remain weak in the near future.

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