Macro Insights

AB-ICI: Clouds gathering on growth outlook

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Investment Summary

- AB-ICI rose 0.4% m/m in August, implying some stabilization in the market going forward
- The CBR was forced to hike the key rate to redirect market attention from the forex market
- Outlook for 2019 is worsening due to a slowing consumption pattern – a constraint for the AB-ICI

AB-ICI – 0.4% m/m growth in August is not convincing

AB-ICI up 0.4% m/m in August but this recovery is not convincing

After three months of steady decline, the AB-ICI index showed some recovery in August, increasing by 0.4% m/m; but is still 2.5% down YTD. However, the trends behind the main components of the index remain weak, thus the recovery looks like a temporary respite before the decline continues:

Economic confidence decreased due to retail deposit outflows as a result of heightened sanctions concerns

- **Economic confidence** continued to deteriorate in August, significantly amplified by public concern over possible sanctions on Sberbank. This was reflected in retail deposit nervousness: ruble-denominated retail deposits decreased by RUB0.1tn and forex-denominated dropped by $1.7bn in August. Around 70% of these outflows stemmed from Sberbank accounts; however, other state banks were also impacted. The economic confidence index endured additional pressure from the continued acceleration in net capital outflows, which increased from $4.1bn in July to $5.0bn in August to reach $26.5bn for 8M18.

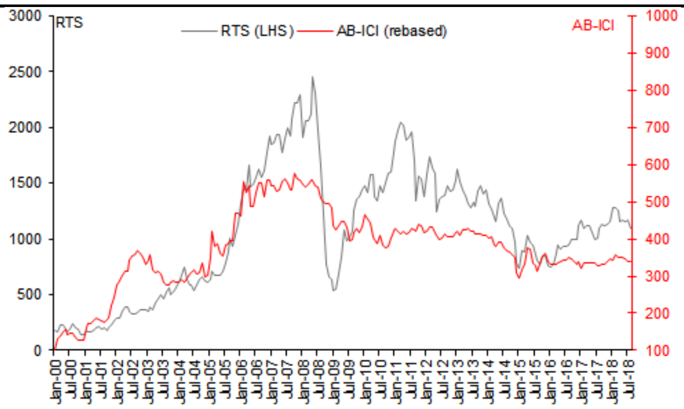
Market confidence remained pressured by subdued market sentiment

- **Market confidence** remained under pressure. August started out more or less positive with Russian companies placing 30 new bonds issues – around 2/3 alone by mid-month. However, in the second half of the month, substantial market turmoil lead to weakness in the market component. The spread between Russian and Latin American government bonds more than trebled in August vs. July and the duration of Russian corporate bonds decreased. The situation stabilized only in September when market sentiment improved slightly supported by the rally in oil prices, which moved into the $80-85/bbl range, and on CBR efforts to stabilize the market.

Foreign confidence strengthened in August, reflected by an increase in the market share of foreign banks; but that does not sustainable, as it only took place on the deposit side

- **Foreign confidence** demonstrated some improvement in August, as reflected by the increased share of foreign banks in the Russian banking market. Foreign banks benefited from deposit outflows from state banks – the retail and corporate forex deposits of foreign banks increased by $0.3bn and $1.0bn, respectively. However, this did not translate into an increase of their presence on the lending side – since 2016, the share of foreign banks remains at 6% and 11% on the corporate and retail loan markets, respectively.

Fig. 1: AB-ICI and RTS Index: AB-ICI was effectively flat -0.4% m/m growth in August



Source: RTS, Alfa Bank

AB-ICI: Clouds gathering on growth outlook

Market stabilization is good news, but the weak growth outlook is worrisome

The good news from recent weeks is that Russia has avoided the deepening global financial market turmoil: the ruble exchange rate and the capital markets have reversed their declines since mid-September. At the same time, the economic outlook is weak, which poses concerns for the AB-ICI outlook.

CBR suspends forex purchases under the budget rule, thus, influencing the exchange rate

The CBR's decision on 14 September to freeze foreign currency purchases for the Finance Ministry, under the budget rule, until the end of the year provided the market with a support level. We note that the decision to provide support to the exchange rate market did not come fast enough and resulted in excessive market volatility in August. Initially, the CBR suspended forex purchases for just one week, as soon as the local market was hit by global volatility. However, after the CBR having returned to the market for several days, the ruble exchange rate depreciated to RUB68/$, which was too close to the upper bound of the ruble's fundamental exchange rate fair level range of RUB60-70/$. As a result, the CBR extended the suspension of purchases until the end of September and then prolonged it until the end of the year at the monetary policy meeting on 14 September. The decision to influence the exchange rate was, however, masked by the CBR's hike of key policy rate from 7.25% to 7.50%. The fact that the scale of the increase was immaterial (25bp) is a clear signal that the monetary authorities did not expect this to be a tool to impact the market. The good news is that the decision to suspend forex purchases until the year-end will help to bolster the ruble exchange rate, especially against the strong oil price backdrop currently. We expect the ruble exchange rate to reach RUB62/$ by the year-end and the sensitivity of the ruble exchange rate to oil prices to increase in the short-run.

The outlook for consumption is deteriorating due to the end of the political cycle, tighter CBR retail lending regulation, the VAT increase and pension reform

At the same time, the growth outlook for the Russian economy is deteriorating. A number of reasons make us more cautious on the scale of consumption growth in 2019. Firstly, the Russian political cycle is over and, thus, salary growth is likely to weaken. Secondly, the planned VAT hike next year will place a RUB500bn burden on consumers and pension reform will erode RUB300bn from the population's spending power, as two million people will be ineligible for their pensions in 2019 under the proposed reforms – the combined sum equates to around 2% of annual household consumption. Thirdly, the expectation of weaker consumption is likely to reduce incentives for growth and salary indexation by companies. Finally, from the start of September, the CBR tightened retail lending rules (increased risk ratios on non-mortgage retail loans), which may limit the support that the lending recovery had provided to consumption. Thus, we believe that consumption growth will decelerate from 3.0% y/y this year to just 1.5% y/y in 2019.

We expect a deceleration in GDP growth to 0.8% y/y in 2019 from 1.3% y/y in 2018

Investment will be the only driver of GDP growth next year, however, its growth will also be slightly constrained. We believe that large infrastructure projects such as the Kerch Bridge and the Power of Siberia pipeline (the latter was reported to be 90% complete as of July 2018) will no longer support a recovery in investment. Only the renovation of the city of Moscow seems to be a key driver for investment growth next year. We project investment growth at 2.5% y/y this year and 3.0% y/y in 2019. However, we believe that the current cabinet's attempts to accelerate investment growth via state infrastructure investments is unlikely to be enough to compensate for the weaker consumption growth outlook. Thus, we expect GDP to grow by 1.3% y/y in 2018, however, for 2019 we downgrade our growth forecast from 1.0% y/y to 0.8% y/y.

Weak growth outlook is a challenge for the AB-ICI

All in all, we still believe the longer-term potential of the AB-ICI index is constrained, especially under the assumption of a deterioration in Russian economic growth expectations. For this reason, we are very cautious on index's recovery, even if stabilization of the financial markets provides support over the short term.

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IMPORTANT INFORMATION

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