

# AB-ICI: Predicting tough 2019

Natalia Orlova  
Natalia Lavrova

(+7 495) 795-3677  
(+7 495) 795-6336

[NOrlova@alfabank.ru](mailto:NOrlova@alfabank.ru)  
[NLavrova@alfabank.ru](mailto:NLavrova@alfabank.ru)

February 4, 2019

[www.alfa-bank.com](http://www.alfa-bank.com)

Moscow

## Investment Summary

- AB-ICI declined 1.3% in 2018 despite electoral cycle vs. 3.0% growth in 2017
- Consumption pattern showed deceleration at 2018 in line with the end of the electoral cycle
- Even if fears of sanctions ease going forward, unimpressive macro picture will prevent RTS recovery

### AB-ICI down 1.3% in 2018 despite electoral cycle

Despite 1.5% growth in 2M18, AB-ICI declined by 1.3% for full year

The AB-ICI dropped 1.3% during 2018 vs. 3.0% growth in 2017. The decline was unusual considering the electoral cycle and can primarily be attributable to sanctions fears in 2H18. In fact, in 2M18, the AB-ICI was up by 1.5%, an increase that was neutralized by market instability during the remainder of the year.

**Economic confidence** pressured by (1) forex deposit share 21.5% and (2) deceleration in ruble-denominated deposits to 8-10% y/y

- **Economic confidence** was under stress in 2018, unlike in 2017, reflecting a very unstable environment in the Russian banking sector. Two negative trends drove the index down. First, the preference for foreign currency remained strong – the share of forex deposits rebounded to 21.5% in December. Second, ruble-denominated deposit growth decelerated from 10-12% y/y in 2017 to 8-10% in 2018; this market experienced high instability in August-October, implying that local retail funding still does not represent a reliable source of funding.

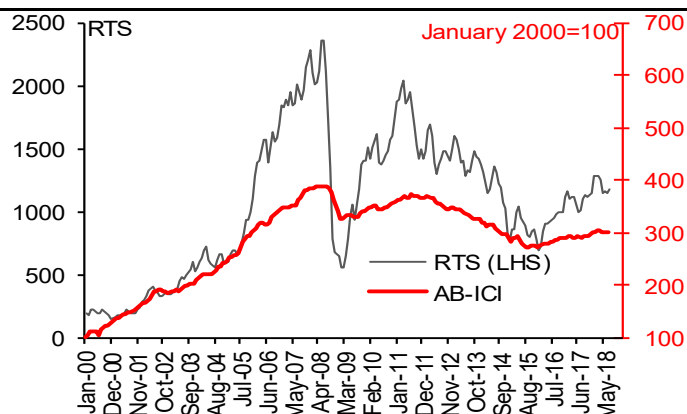
**Market confidence** remained under pressure of increasing CDS and declining maturity

- **Market confidence** remained under pressure. Although 2M18 started out more or less positive, triggered by the election cycle, noticeable external turmoil led to weakness in the market component. Sovereign CDS after falling by February to the lowest level since 2009 had reached an annual high in August, hand-in-hand with growing geopolitical tensions. The duration of corporate bonds entered a period of decline from March, indicating market restraints. Throughout the year, the external environment was primarily unfavorable, placing a ceiling on market confidence and restraining companies from making new bond issuing.

**Foreign confidence** benefited as foreign banks market share grew to 7.7%

- **Foreign confidence** demonstrated some improvements in 2018. While in 2017, the average share of foreign banks remained at around 7.4% – in 2018, the presence of foreign banks stabilized at approximately 7.7%. Foreign banks benefited from external uncertainty, which enabled them to capture additional market share under fears that new sanctions will hit state banks.

**Fig. 1: AB-ICI and RTS Index: AB-ICI down 1.3% in 2018**



Source: RTS, Alfa Bank

## AB-ICI: Predicting tough 2019

**AB-ICI decline in 2018 is a leading indicator of this year's economic concerns**

The AB-ICI decline in 2018 should be seen not only as a reflection of the high level of volatility which Russia experienced in the second half of last year, but also as a sign of the upcoming economic weakness and, thus, market weakness. As opposed to 2018 when the reason was financial market nervousness, the concerns of 2019 are more related to economic policy choices.

**Consumption pattern is likely to weaken: electoral cycle is over, spike in inflation will hit consumers and the CBR measures to stabilize retail loan growth at 22% y/y will play against faster consumption growth**

The first issue is the likely weakness in consumption patterns which is likely to materialize this year. Russia ended last year with weak consumption trend: December's retail trade growth reached only 2.3% y/y, falling below the 3.0% y/y consensus forecast and very close to our cautious 2.2% y/y estimate. In fact, aside from November's abnormal 3.0% y/y growth, retail trade growth stayed just slightly above 2.0% y/y from September and below the 2.6% y/y growth of 2018. Also, while retail trade growth figures suggest that Russia experienced an acceleration in consumption last year, the private consumption pattern is different. As opposed to the retail trade data which may have been influenced by a statistical effect from the installation of cash registers in 2017, private consumption growth decelerated from 3.4% y/y in 2017 to just 2.5% y/y in 9M18, reflecting persistent pressure on consumers. This weakness is likely to intensify going forward for the following reasons. First, the spike in inflation will hit consumption growth over the short term: we expect inflation to rise to 5.6-5.7% y/y by March-April from the current level of 5.0% y/y; that could reduce retail trade growth to around 1.0% y/y in 1Q19. Second, salary growth had decelerated as of end-2018: in December, nominal growth was particularly weak (6.9% y/y) and the unemployment rate increased to 4.8% as of end-2018. Both statistics do not inspire optimism for the consumption outlook. Finally, retail loan growth stabilized at 22% y/y in Q4 and considering the rate hike and CBR's efforts to control non-mortgage lending via macro-prudential tools, growth is likely to decelerate going forward. The combination of higher inflation, slower salary growth and lower retail loan growth is likely to result in only 1.5% y/y consumption growth this year.

**The role of the commodity extraction grew last year and revaluation of the construction results seems to be behind the 2.0% GDP growth in 2018, an estimate released by the Economy Ministry**

The second issue is that the structure of the Russia's growth is still not diversified enough. First, the dependency on the fuel sector is growing back. The increase in fuel exports explains 76% of the increase in annual export revenues in 2018 and the share of fuel export revenues rose to 59% of total export receipts last year. Extractive industry segments were the driving force behind the industrial production growth: industrial production growth accelerated to 2.9% y/y vs. 2.1% y/y in 2017 driven by the 4.1% y/y increase in commodity extraction last year (+2.1% y/y in 2017). Second, Rosstat also revised up its construction output, which is now up 5.3% y/y in 2018 after contracting 1.2% y/y in 2017; this improvement is related to investments via the "Yamal LNG" project. According to our estimates, the revision of construction data could explain the 0.5-0.6 pp of GDP growth last year, which the Economy Ministry now assesses at 2.0% y/y.

**A decline in the federal budget breakeven to oil prices to \$49/bbl and the key policy rate at 7.75% imply tight economic policy to remain**

Finally, economic policy remains very tight, which speaks against growth. In 2018, the federal budget oil-price breakeven declined to \$49/bbl: the extremely fast decline in the dependency of commodity prices was driven by the faster-than-expected increase in non-oil tax burden. The increase in VAT will assure this trend continues in 2019. Monetary policy also remains tight, with the CBR returning the key policy rate to 7.75% as of end-2018, the level seen as of end-2017. On top of the end to the policy rate cut cycle, the CBR is using macroprudential tools to cool down the lending market.

**RTS may get temporary support if sanctions fears ease but AB-ICI implies the risk of decline persists**

The only bright spot for the AB-ICI entering 2019 is that the fears of sanctions could ease going forward. The removal of Rusal from SDN list is good news for market and after March 2019 (once the Ukrainian presidential elections are concluded), the market could get another round of support. Still, with an unimpressive macro picture, Russia is unlikely to attract foreign capitals and the AB-ICI is likely to herald the RTS recovery as short-lived.

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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**
**Head of Research**

Boris Krasnozhenov

[bkrasnozhenov@alfabank.ru](mailto:bkrasnozhenov@alfabank.ru)  
+7 (495) 795-3612

**Macroeconomics**

Natalia Orlova, Ph.D.

[norlova@alfabank.ru](mailto:norlova@alfabank.ru)  
795-3677

Valeriya Volgareva

[vvolgareva@alfabank.ru](mailto:vvolgareva@alfabank.ru)  
780-4724

Natalia Lavrova

[nlavrova@alfabank.ru](mailto:nlavrova@alfabank.ru)  
795-3676(ext. 6336)

**Metals & Mining**

Boris Krasnozhenov

[bkrasnozhenov@alfabank.ru](mailto:bkrasnozhenov@alfabank.ru)  
+7 (495) 795-3612

Yulia Tolstykh

[yatolstykh@alfabank.ru](mailto:yatolstykh@alfabank.ru)  
+7 (499) 923 6697 (ext. 8681)

**+7 (495) 795-**

**Consumer / IT & Media**

Olesya Vorobyeva

[oovorobyeva@alfabank.ru](mailto:oovorobyeva@alfabank.ru)

**Banking / Real Estate**

Evgeniy Kipnis

[ekipnis@alfabank.ru](mailto:ekipnis@alfabank.ru)  
795-3713

**Editorial / Production**

John Walsh

[jwalsh@alfabank.ru](mailto:jwalsh@alfabank.ru)  
795-3676 (ext. 8238)

**Translation**

Anna Martynova

[amartynova@alfabank.ru](mailto:amartynova@alfabank.ru)  
795-3676

**Data Specialist / Analyst**

Denis Dorofeev

[didorofeev@alfabank.ru](mailto:didorofeev@alfabank.ru)  
795-3676(ext. 8086)

---

**Equity Sales & Trading (Moscow)**

**+7 (495) 223-**

**Alfa Direct (Domestic retail brokerage)**
**International Sales**

Alexander Zorov

[azorov@alfabank.ru](mailto:azorov@alfabank.ru)  
745-5621

Svetlana Golodinkina

[sgolodinkina@alfabank.ru](mailto:sgolodinkina@alfabank.ru)  
785-7416

Artem Belobrov

[abelobrov@alfabank.ru](mailto:abelobrov@alfabank.ru)  
495 785 7

**Equity Financing**

Viacheslav Savitskiy

[vsavitskiy@alfabank.ru](mailto:vsavitskiy@alfabank.ru)

Oleg Morozov

[omorozov@alfabank.ru](mailto:omorozov@alfabank.ru)  
+7 (495) 783 5101

**Head of Alfa-Direct**

Sergey Rybakov

**+7 (495) 795-3680**

[srybakov@alfabank.ru](mailto:srybakov@alfabank.ru)  
795-3680 ext. 6399

**Alfa-Direct Research**

Geldy Soyunov

[gsoyunov@alfabank.ru](mailto:gsoyunov@alfabank.ru)  
641-3673

Alan Kaziev

[akaziev@alfabank.ru](mailto:akaziev@alfabank.ru)  
974-2515 (ext. 8568)

**Alfa-Direct Sales**

Valeriy Kremnev

[vkremnev@alfabank.ru](mailto:vkremnev@alfabank.ru)  
ext. 7083

Olga Babina

[obabina@alfabank.ru](mailto:obabina@alfabank.ru)  
ext. 4092