Alfa-Bank

Macro Insights

AB-ICI: Focus on banking system

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Investment Summary

- AB-ICI increased by 0.1% after 6 months of consecutive decline
- Russia's market sentiment relatively strong and serves as the main pillar of the subdued AB-ICI recovery
- Weakness in deposit growth and strong non-mortgage growth speaks against a policy rate cut

AB-ICI up 0.1% in January

January's 0.1% AB-ICI growth stemmed from muted optimism on the financial market

After an extensive period of deceleration, the AB-ICI finally showed some signs of recovery, climbing 0.1% m/m in January. The AB-ICI's subdued growth was primarily explained by a better financial market performance, while the economic and foreign components did not take a noticeable turn for the better.

Economic confidence remained weak due to poor growth of 7.9% in ruble-denominated deposits and sustainably high forex deposit share of 21.5% in January

- **Economic confidence** was weak, as the banking system remained pressured by slow retail deposit growth and high levels of dollarization. Growth in retail deposits remains subdued, taking-into-account January's 8.9% y/y growth vs an average of 9.5% in 2018. The population demonstrated lower interest in ruble-denominated retail deposits as a means of saving, reducing growth to 7.9% y/y vs an average 8.3% in 2018. The reliance on foreign currency deposits has remained relatively high – their share of total deposits has stabilized at 21.5% since December, but in nominal terms the size of foreign-currency denominated deposits increase by $2bn. All in all, the abovementioned factors placed a ceiling on economic confidence in January.

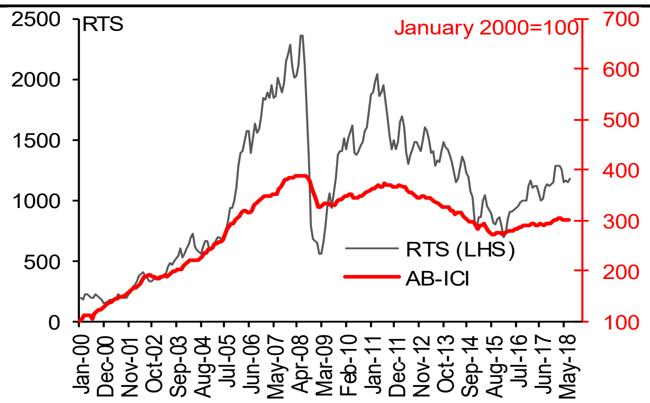
Market confidence turned positive driven by a continuing decline in CDS and the growing interest of foreign investors in the OFZ market

- **Market confidence** showed some signs of improvement in January via a reduction in financial risk due to declining sovereign CDS. The interest of foreign investors in Russia is also recovering – in January they invested around RUB55bn in the OFZ market and increased the share of non-resident holdings of OFZ from 23.6% to 24.4%. However, some pressure was exerted on market confidence by (1) falling maturity: January was the fifth consecutive month of decline in the duration of corporate bonds and (2) lack of new bonds placement.

Foreign confidence was flat as the share of foreign banks stabilized at 7.7%

- **Foreign confidence** was virtually flat as the share of foreign banks in the Russian market stabilized at 7.7%. All in all, external uncertainty in 2018 and the revocation of bank licenses by the CBR has induced a growing share of foreign banks. Despite sanctions fears foreign banks may continue to benefit as the CBR continues its clean-up program.

Fig. 1: AB-ICI and RTS Index: AB-ICI up 0.1% in January



Source: RTS, Alfa Bank

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Banking sector is an important factor to watch

Banking sector performance is usually an important indication of the economic sentiment. The statistics of 2018 suggest that despite strong headline growth figures, there are number of structural issues which will prevent easing in the monetary policy.

The number of banks in Russia decreased to 440, the share of state banks reached 65% in retail deposits market and 74% in the corporate lending area

In 2018, the CBR continued its clean-up program by revoking licenses from another 77 banks. As a result, by January 2019, only 440 banks operated in Russia. The decline in the number of banks assured an improvement in the sector's profitability, however the share of unprofitable banks is still as high as 21%. The declining number of banks has come hand-in-hand with the higher concentration of state contol in the sector – throughout 2018, the presence of state banks increased in nearly every segment: their share of the retail deposit market shifted from 63% in 2017 to 65% in 2018, while in retail loans it increased from 62% to 64%; their presence in corporate loans also increased to 74% in 2018, compared to 71% seen in 2017.

Ruble-denominated retail deposit growth was at 85% supported by interest paid and conversions from forex deposits

Apart from structural changes in the banking system, the main topic of discussion in 2018, was the instability of primary banking resourses – the local deposit market. Despite retail deposit growth reaching 9.5% y/y in 2018 vs. 7.4% y/y in 2017, we believe that the strength of funding was not as solid as it appears. Growth in the ruble-denominated segment decelerated from the 10-13% seen in 2017 to 8.3% y/y as of year-end 2018, the lowest level since 2015. This growth seems to rely on two sources: (1) the capitalization of interest on existing deposits, which represented around 65%, or RUB1.1tn, of the RUB1.7tn of ruble-denominated retail deposit growth in 2018, and (2) the likely conversion of forex-deposits into rubles, which would explain another 20%, or the RUB0.3tn, of growth in the ruble-denominated segment. In aggregate, these two factors were able to explain around 85% of the previous year's ruble-denominated deposit growth: the increase in deposits was the lowest in four years. Given the end of electoral cycle, we expect growth in 2019 to mainly rely on interest capitalization.

Despite the CBR's macroprudential efforts, the non-mortgage loan-book growth accelerated to 21% y/y last year, while growth in mortgage lending stabilized at around 25% y/y

Retail lending growth reached 22.4% y/y in 2018, showing stabilization in the second half at 22% y/y from September 2018. The initial take on this stabilization in the growth rate is that it was attributable to CBR efforts to curb non-mortgage loan growth. From September 2018, the CBR implemented new risk ratios for non-mortgage loans. However, in reality, this macroprudential tool gave a rather weak result: growth in non-mortgage loans accelerated throughout last year from 12% y/y to 21% as of end-2018, while mortgage growth rose from 17% at the beginning of 2018 to 25-26% y/y by the year-end, where it had stabilized from September. The ratio of non-mortgage loans per capita to monthly salaries reached 133% as of end-2018 from 122% in 2017. Despite remaining below 170% seen at the peak in 2013, it clearly represents a concern for the CBR due to the low market sensitivity to macroprudential measures. Another CBR concern should be that the average rate for mortgages rose from 9.4% in August 2018 to 9.7% in December 2018, which, however, according to the national decrees issued in 2018, should decline to 8.9% in 2019 and to 7.9% in 2024.

Banking statistics speaks against the key rate cut and will limit financial market performance and thus AB-ICI

Our conclusion for 2019, based on these results, is that a further rate hike would be very unwelcome and that a tightening of macroprudential steps to ensure a deceleration in non-mortgage lending is highly likely. An unchanged key rate is bad news for the bond market, which was previously driven by the expectation of rate cuts. As a result, we consider the banking sector performance as an additional argument in favor of modest expectations for the AB-ICI performance.

RATING DEFINITIONS

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%
Equal Weight (E/W):	Expected total stock return < 15% and > 0%
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Owing to price volatility and our policy of not changing our ratings in response to frequent, short-term misalignments with expected returns, our ratings may sometimes not conform with the ranges indicated above.

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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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