Alfa-Bank

Macro Insights

AB-ICI: Up 0.5% YTD despite modest 1Q19 macro data

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Investment Summary

- AB-ICI posts growth for third consecutive month, increasing by 0.1%, up 0.5% YTD in 1Q19
- Market confidence remained the key pillar of the AB-ICI, foreign investors continue to enter Russian bond market
- Poor 1Q19 results with zero salary growth in February-March and stagnant manufacturing put ceiling on AB-ICI

AB-ICI up 0.1% in March

AB-ICI increased by 0.1% in March or 0.5% YTD

The AB-ICI increased by 0.1% m/m in March – this improved performance is primarily explained by strengthening market and foreign confidence. For 1Q19, the index was up by 0.5% YTD. That said, the pillar of growth is the improved market sentiment as opposed to the macro fundamentals, which surprised on the downside:

Decelerating ruble-denominated deposit growth (to 6.6%) in March suppressed economic confidence

- **Economic confidence** remained under pressure due to decelerating growth in ruble-denominated deposits, which slowed down to 6.6% y/y in March from 7.5% in February. Sluggish deposit growth was accompanied by accelerating retail lending growth, which amounted to 23.6% y/y in March vs 23.5% y/y in February. This combination of growing borrowing and declining savings is considered to weigh negatively on overall growth prospects. Apart from that, the presence of forex-denominated deposits on the Russian market has remained relatively high, its share to total deposits accounted for 21.4% in March vs 21.5% in February, which confirms relatively high uncertainty about the Russian economy's prospects.

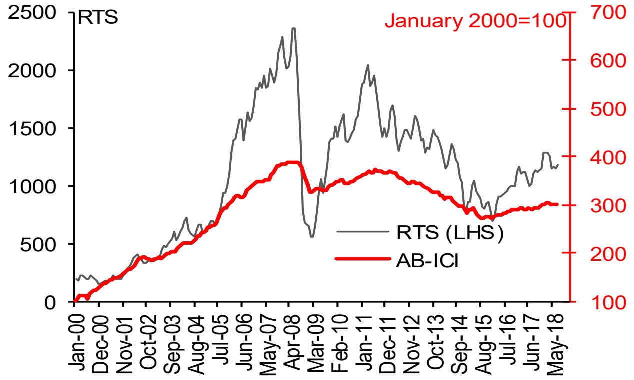
Market attractiveness strengthened under reduced external risks and an increased share of non-resident holdings OFZ to 26.1% in March vs 25.5% in February

- **Market confidence** indicated continued improvement in March. Aside from a favorable external backdrop, which was reflected in declining sovereign CDS, market confidence was also supported by the slight increased in the duration of corporate bonds, which finally materialized after six consecutive months of decline. Another important support to the index stemmed from foreign capital inflows to the Russian market – the share of non-resident's holding OFZs increased from 25.5% in February to 26.1% in March, reflecting an inflow of RUB120.4 bn. This inflow was the highest over the last 18 months and even exceeded the withdrawal of non-resident from local financial instruments seen in August-December 2018.

Foreign confidence remained strong as the share of foreign banks rose to 8%

- **Foreign confidence** remained strong as the presence of foreign banks continued to show modest growth, now accounting for 8%, which is a seven-month high. However, this did not translate into an increase of their presence on the lending side – the share of foreign banks remains at approximately 6% and 11% on the corporate and retail loan markets, respectively.

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



Source: RTS, Alfa Bank

AB-ICI: Up 0.5% YTD despite modest 1Q19 macro data

1Q19 results came poor deflating better market sentiment

Despite the positive performance of the AB-ICI in March and in 1Q19, general economic sentiment in Russia remains suppressed, creating a ceiling for the AB-ICI recovery going forward. This downside risk is primarily based on the macroeconomic performance in 1Q19, which was playing against stronger AB-ICI growth.

Real salaries indicate zero growth for two consecutive months, which dampened consumption performance, its growth decelerated to 1.6% y/y in March

The first issue is related to the divergence in retail trade growth and real wage growth. Retail trade increased by 1.6% in March – although, lagging the 2% y/y reported for February and as a result, accounted for 1.8% over 1Q19 – real salary growth remained zero for two consecutive months, implying only 0.4% growth in 1Q19, which is the lowest growth since 3Q16. Given the fact that salaries are a key component of household income, it is not surprising that real disposable income turned negative in 1Q19, declining by 2.3%, the worst result in two years. The growing gap between consumption and incomes compels households to rely more on credit resources, which leads to unhealthy consumer financial positions.

Commodity extraction is a key driving force of economic growth, while manufacturing showed weakness in growth, amounting to 1.3% y/y in 1Q19

The second issue is related to the structure of Russian growth, which indicates significant dependence on the commodity extraction sector. (1) Considering exports, it can be concluded that its weakness in 1Q19 was due to lower fuel exports as a result of the OPEC+ agreement about a reduction in oil production; non-fuel exports remained subdued, indicating only 0.5% growth in 1Q19. (2) A breakdown of industrial production also reveals the leading role of commodity extraction in total dynamics. While total industrial production growth -- decelerating to 1.2% y/y in March – amounted to 2.1% y/y in 1Q19, the commodity extraction sector delivered a stable 4.7% y/y increase in 1Q19, contributing approximately 66% to total output in 1Q19 (vs close to 14% in 1Q18). The manufacturing segment by contrast showed a deceleration in growth from around 4.0% y/y in 1H18 to 1.6% in 2H18 and 1.3% y/y in 1Q19. As a result, it added only 42% to industrial production growth in 1Q19 vs 77% in 1Q18. Moreover, its growth in 1Q19 was largely due to the February spike and cleaned from this effect its output was at best stagnant or even on a declining trend.

Fiscal policy remains tight: national projects are not anticipated to impact on economic growth in 2019 – execution of the national project spending is at only 6%

Finally, budget policy remains very tight, which also speaks against growth. Continuing fiscal consolidation, which started in 2015 and was mainly represented by government spending cuts, has moved to the next level in 2019, focusing on revenue growth. As a result, total federal budget revenue increased by 17% in 1Q19 – the increase in VAT contributed to about 50% of this growth – while federal budget expenditure grew only 8.4% with 1/3 of that spending directed to the defense sector and 2/3 to social policy. The outperformance of revenues relative to expenditures is considered to be negative for the economy. In addition, the move to more expansionary fiscal policy through the national projects also seems to be put on hold. According to our estimates (see *"National Projects: Building the Case"*), their effect on economic performance does not emerge early enough to affect 2019 growth. First, 60% of spending on the national projects this year will be infrastructure related and the effect of these projects will come with a lag. Second, execution of the national projects is lagging behind the plan – the Account Chamber reported in March, that execution of their spending is at only 6% of the full-year target.

The AB-ICI is expected to continue its recovery, but driven by sentiment rather than fundamentals

All in all, we believe that the abovementioned issues in the Russian economy will suppress economic confidence – given the recent trends, it is likely cap growth potential of the AB-ICI. As a result, the AB-ICI performance is strongly linked to the foreign and market confidence which improved due to some stabilization in stressed emerging market economies and reduced sanction risks for Russia. That said, market sentiment is fragile as proved by the 2018 experience and does not provide a convincing background for AB-ICI recovery.

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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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