Alfa-Bank

Macro Insights

AB-ICI: Deviation from RTS in focus

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Investment Summary

- The RTS is continuing to grow but is diverging from the AB-ICI which we consider a proxy of fair market value
- Lack of economic growth drivers limit AB-ICI upside and create downside risk for RTS growth

AB-ICI starting to diverge from RTS Index

AB-ICI up since mid-summer

The AB-ICI is up 1% since mid-summer but this reflects volatility in the sideways range. The RTS, by contrast, is showing continued recovery from the local low reached on May 20 and is starting to deviate from the fundamental value of the market:

Level of dollarization pressures economic confidence

- **Economic confidence** has contracted somewhat in recent months. This is primarily due to the high dollarization component of local deposits. By contrast to the 2008-10 crisis, when the share of forex deposits declined to 20% following the sharp jump in dollarization, this time around, the share of forex-denominated deposits has so far remained around 26%;

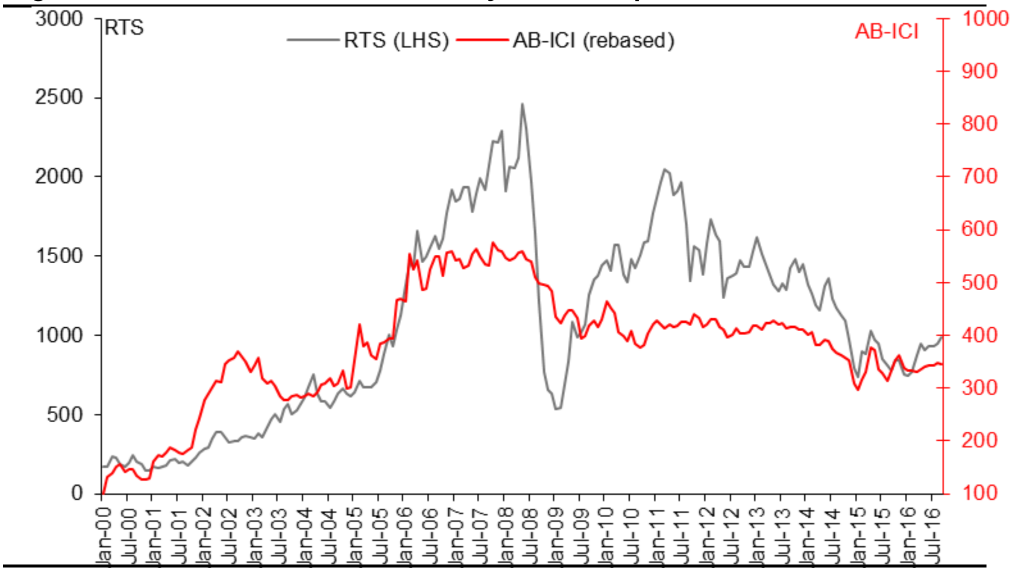
Foreign confidence improves on better FDI inflows

- **Foreign confidence** has shown improvement in recent months primarily driven by the recovery of FDI inflows to Russia. That said, since 2014, the average quarterly FDI inflows have been close to zero and have contracted substantially versus the $13.6bn in average quarterly inflows seen prior to 2014;

RTS growth remains the driver of recovery but its deviation from the AB-ICI creates risks

- **Market confidence** remains a support for the AB-ICI primarily due to the recovery in the RTS Index but also because of the increase in bond durations. That said, with the economy continuing to move in a sideways trend, we believe further market growth could create overheating risks, hence the RTS divergence from the AB-ICI is a negative sign.

Figure 1: AB-ICI and RTS index: a risky deviation pattern



Source: New Economic School, RTS, Alfa Bank

AB-ICI: Weak performance under economic stagnation

AB-ICI is following the general economic trend

The dynamics of the AB-ICI is very much in line with our understanding of the general Russian economic trend. Russian GDP contracted 0.9% y/y in 1H16; following the very unstable pattern evident in 3Q16, we expect the economy to contract by 0.8% y/y in FY16. Our pessimism is mainly formed by the lack of drivers: consumption is failing to generate growth; monetary and budget policies are both rather tight; and the economy has no means to increase leverage.

CBR commitment to a flat rate came as a negative surprise for the market

While we had expected the CBR to implement tight monetary poilcy this year, we are surprised at the extend to which it has been executed. At the end of September, the CBR announced it would pause rate cuts for the remainder of this year and probably until 1Q-2Q17. We view the open commitment for a flat nominal rate as a very negative surprise for the real sector, which was pricing in continuing monetary easing. Given the CBR's recent guidance and the relatively tight budget policy, we have cut our -0.3% y/y GDP forecast to -0.8% y/y for FY16.

Although Finance Ministry has to spend more on defense, it will still try to control expenditure going forward

Although budget policy is currently tight, this will change in the coming months. First, defense expenditure will receive an injection of RUB800bn before end-2016, and that will increase this year's budget spending from the RUB16.2tn initially announced to RUB16.4tn. In light of the RUB1.6tn federal budget deficit reported in 9M16, practically the same amount should be spent before the year-end to give an expected annual budget deficit of RUB3.0tn. Second, there will be a one-off pension payment in January 2017 and regular pension indexation will begin in February. That said, the Finance Ministry's plan to fix the level of budget expenditure for the next three years limits the scope of economic recovery.

Growth in imports will neutralize any recovery in consumption

The tight monetary and budget policy would not be a major problem if the private sector of the economy created growth drivers. However, while nominal salaries increased at a rate of 7.9% y/y in 9M16 and the unemployment rate was only 5.2% as of end-September, import growth will unfortunately completely neutralize any recovery in consumption. In 3Q16, imports were already up 4.6% y/y and we believe this is just the beginning of a recovery in imports.

Recovery in retail lending expectedly weak, corporate lending disappointing

Finally, it is not obvious if the Russian economy can generate leverage-linked growth. While retail lending is up 1.7% from its low in April and non-mortgage loans are up 1% from the bottom seen in June, we are not convinced that it could provide strong support for consumption. The increasing number of people below the poverty line should build demand for non-mortgage retail lending. The trend in corporate lending is even worse. Since the beginning of this year, forex-denominated loans have declined by $20bn while the ruble-denominated loan book is up just RUB0.5tn. The bulk of deleveraging in 2016 is attributable to the trade sector together with other unclassified sectors, which generated a substantial decline in forex-loan exposure. After posting average growth of 3.5% y/y in 1H16, the loan book, adjusted for forex revaluation, contracted by 1% y/y in August-September and is expected to decline further in 4Q16.

Limited AB-ICI upside leaves us cautious on the RTS

All in all, our growth outlook is negative, we see very limited upside potential for a recovery in the AB-ICI and, as a result, we are skeptical about the sustainability of RTS growth.

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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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