Macro Insights

AB-ICI: Divergent trends

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Investment Summary

- Modest September AB-ICI index growth of 0.6% m/m masks contradictory trends
- We are skeptical the ability of the AB-ICI to deliver strong growth considering the deceleration in 3Q17 growth, the stagnation in corporate lending and the potential end of the current rate cut cycle
- The RTS may well outperform in the short run, but risk of overheating is mounting

AB-ICI: modest growth masks contradictory trends

Modest AB-ICI growth masks contradictory trends

The gap between the AB-ICI and RTS indexes continued to widen in September, driven by modest AB-ICI index growth (0.6% m/m) and a strong RTS performance (3.7% m/m). We note that the AB-ICI index was driven by several contradictory trends:

Economic confidence virtually flat as ongoing growth in deposits was neutralized by a jump in net capital outflow

- **Economic confidence** was virtually flat in September. Despite a number of observers expressing concern about the weakness in retail deposits in 2017 (only 2.5% growth YTD), we believe the growth is sufficient and not materially different from last year. For example, ruble-denominated deposits have increased by 5% YTD, in line with the 6% YTD growth for 2016. Retail deposit growth appears weak because the high level of dollarization (22%) in the deposit base is coinciding with ruble appreciation. However, an acceleration in net capital outflow in September (the figure jumped from \$21 bn in 8M17 to \$27 bn in 9M17) is creating downward pressure on economic confidence.

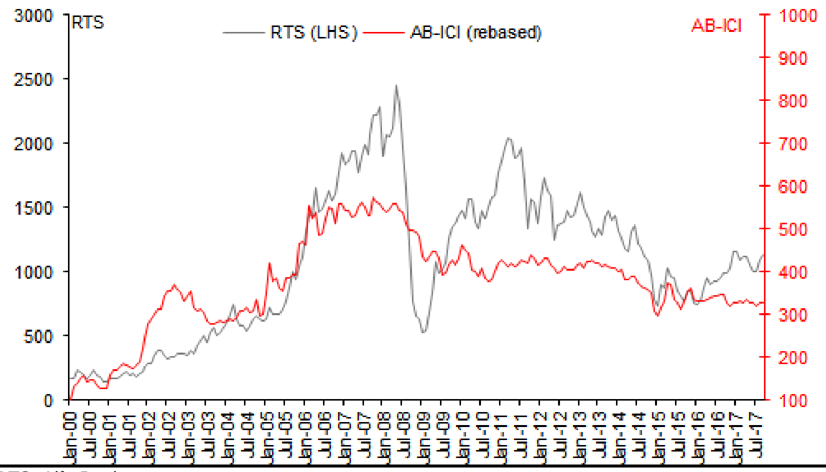
Market confidence reflects divergent trends: increased appetite for equities while bonds fall out of favor

- **Market confidence** remained unchanged, but masked divergent trends. In September, investors showed increased appetite for Russian equities driven by significant growth in the prices of key commodities. At the same time, instability in the banking system forced investors to exit banking sector bonds, resulting in an uptick in net capital outflow. Moreover, as the CBR approaches a pause in its policy rate cutting cycle (on 27 October the CBR cut the key rate by 25 bp to 8.25%), the upside potential of the bond market is becoming limited and that may be exacerbated by sanctions tightening, which would further reduce investor appetite for risk.

The share of foreign banks stopped contracting but state banks position strong

- **Foreign confidence** was also flat in September. In a positive development, the share of foreign banks in the Russian market stabilized last month — in August, the figure had dropped below 7.4%, the lowest level since at least 2007. However, there is a risk that recent Russian banking sector problems (Otkritie and B&N Bank rescues) may exert strong pressure on private banks and result in a further strengthening of state-owned banks and consolidation of the sector.

Figure 1: AB-ICI and RTS Index: AB-ICI grows just 0.6% m/m in September 2017



Source: RTS, Alfa Bank

AB-ICI: Divergent trends

The AB-ICI performance to remain flat

The AB-ICI's widening gap to the RTS is not a surprise, as the economic fundamentals behind the AB-ICI show no significant improvement. We expect the flat performance of the AB-ICI to continue as current industrial production growth is lagging behind consumption, business sentiment remains unstable and medium-terms inflation risks and the threat of sanctions tightening further both accelerate.

Despite strong consumption, industrial production growth decelerated in 3Q17 and business sentiment is weak

The strength of Russia's economic growth remains a concern – despite the consumption recovery, 3Q17 industrial production was weaker than in 2Q17. According to Rosstat, retail trade growth accelerated to 2.0% y/y in 3Q17 after 1.0% y/y in 2Q17, with 3.1% y/y growth in September. However, strong consumption did not play in favor of industrial growth, which decelerated to just 1.4% y/y in Q3 from 3.8% y/y in 2Q17 – in September industrial production growth came in at just 0.9% y/y. Moreover, Rosstat has revised down its construction figures – construction volumes are now down 2.0% y/y for 9M17. Business sentiment has also deteriorated. According to the Gaidar Institute's October business poll, the number of companies planning to shrink investment exceeds the number intending to expand activity (25% vs. 21%, respectively).

Corporate loan growth is below expectations

Corporate loan growth is also showing signs of weakness. The nominal corporate loan book is still decreasing in annual terms (-3.2% y/y in September or -1.1% y/y adjusted for forex revaluation) – it increased just 0.1% in monthly terms. Hence, we are concerned about corporate lending growth: if it does not accelerate in 4Q17, at least to 1.0% m/m growth, then achieving even 3.0% y/y growth in 2017 look unlikely. The only piece of optimism is the recovery in retail lending, which grew 8.7% y/y in September and which will probably reach 10-12% y/y growth by the year-end (vs. the initial forecast of 6% y/y growth).

The CBR close to pausing the current rate cut cycle due to increasing inflationary risks

The CBR cut the key policy rate by 25 bp to 8.25% on 27 October and we believe the financial authorities are close to pausing the cycle of rate cuts. We estimate the bottom of the rate cycle at 7.5% and expect that to be reached in spring 2018. The factor driving the expectation that the CBR will not be able to continue its cycle of rate cuts is related to medium-term inflationary risks. There are a number of factors that could drive inflation: October public sector salary indexation, a possible increase in retail gasoline prices (which currently significantly lag behind wholesale prices), and the end of the food-price deflation cycle.

More sanctions on the cards and the risk of a black swan event

One more medium-term concern for the economic recovery is a potential tightening of US sanctions. From 28 November, Russian state banks and energy companies will face a new round of sanctions, which will reduce permissible debt maturities. The US recently published a list of defense-sector companies, which could be subject to a new round of sanctions and also one more additional sanctions list can be announced at the beginning of 2018, and that will likely keep the market on edge.

Current RTS level looks overheated, downside risks exist

The substantial RTS growth (3.7% m/m) in September was driven by strong oil prices (they exceeded 60 $/bbl as we go to print) and reflecting investor appetite for Russian assets; however, given the above-mentioned concerns, we believe the market is in danger of overheating. Thus, even if the current gap between the AB-ICI and RTS remains wide for the nearest future, we do not rule out the risk of an RTS correction going forward.

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The ratings are:

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