Alfa-Bank

Macro Insights

AB-ICI: Fundamentals against the market

Natalia Orlova (+7 495) 795-3677 NOrlova@alfabank.ru

December 1, 2017 www.alfa-bank.com Moscow

Investment Summary

- The gap between the AB-ICI and RTS index remains wide, as AB-ICI records flat dynamics in October
- Growth deceleration in 3Q17 and highly concentrated investments play against an AB-ICI recovery
- Strong oil prices and risk appetite favor short-term RTS growth but sanctions threat looms

RTS benefits from higher risk appetite as AB-ICI remains flat

AB-ICI flat in October reflecting …

The gap between the AB-ICI and RTS index remains wide, as the RTS benefited from an increase in global risk appetite while the AB-ICI remained flat. A breakdown of the AB-ICI components shows a mixed trend, with improvements in the economy and market confidence offset by weakness in foreign confidence:

… an improvement in economic confidence, reflected through lower net capital outflow …

- **Economic confidence** supported the AB-ICI index in October, mainly driven by the substantial deceleration in net capital outflows ($2.8 bn in October vs. $8.9 bn of outflows in September) and a steady decrease in the level of retail deposit dollarization.

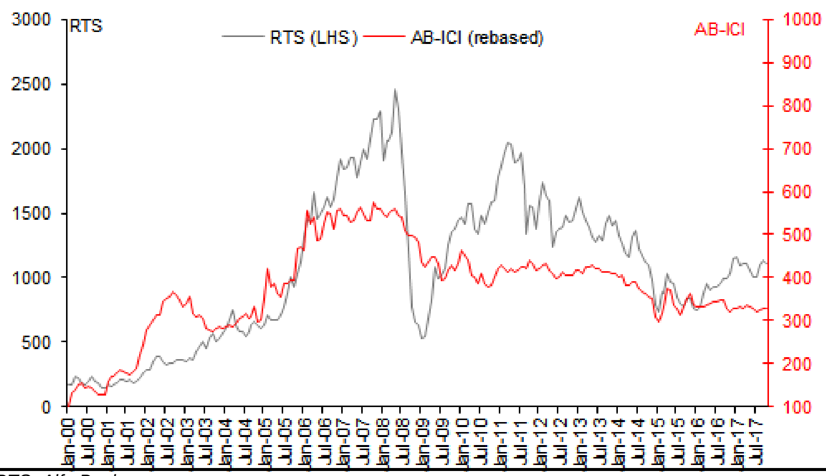
… and better market confidence observed through IPOs

- **Market** sentiment started to improve, reflecting higher foreign investor appetite for risk, stronger oil prices and relatively high Russian interest rates (increased spread between Russian rates and other EM markets). In particular, in October, there was an increase in the number of corporate bond placements – 25 placements vs. 13 and 14 in July and September, respectively. There was also an increase in IPO activity: Obuv Rossii placed a 38% stake in October, and En+ Group and GlobalTruck Management made placements in November.

Foreign confidence undermined the AB-ICI – foreign banks' share has reached a new low level

- **Foreign confidence** was the main factor undermining the AB-ICI in October. Unfortunately, foreign banks have not been able to stabilize their share in the Russian market for quite some time, and their footprint reached a new low of 7.3% in October 2017 vs. 7.6% in December 2016.

Figure 1: AB-ICI and RTS Index: flat dynamic of the AB-ICI in October 2017



Source: RTS, Alfa Bank

AB-ICI: Fundamentals still against the market

Wide gap between the AB-ICI and RTS to remain

Market sentiments improved last month, as global markets continued to grow and oil prices moved above 60 $/bbl. It is thus unsurprising that the RTS remained generally strong supported by the global backdrop. At the same time, since 3Q17, the economic trends have been rather disappointing and that has prevented the AB-ICI from recovering in line with the financial market sentiment.

In 3Q17, the Russian economy failed to repeat the strong performance of 2Q17; industrial production was flat in October

We have a number of concerns, the first of which is that growth in Russia is far from linear. In 3Q17, the Russian economy failed to repeat the strong performance of 2Q17, convincing us that it was only a one-off. GDP grew just 1.8% y/y in 3Q17, falling short of the 2.5% y/y growth delivered in 2Q17. Industrial production showed only 1.4% y/y growth in 3Q17 vs. 3.8% y/y growth in 2Q17. Moreover, in October, it continued to decelerate to a flat dynamic; even supportive factors, like an additional working day (22 days in October 2017 vs. 21 days in October 2016), failed to stimulate growth.

With investment growth highly concentrated in state projects, the outlook for 2018 could be poor if the Kerch Bridge is finalized before March 2018 and the Moscow renovation program does not gain traction until 2019

The second is that as Russian growth is highly concentrated, any trend changes in the main sectors may cause growth to decelerate. For example, negative trends in commodity extraction and manufacturing, which account for nearly 45% of overall investment, caused investment growth to decelerate to 3.1% y/y in 3Q17 after a 6.3% y/y jump in 2Q17. More than that, investments are still mainly concentrated in state projects in Crimea, the Far East and Moscow city. These three regions accounted for about 90% of the growth in 9M17. Thus, any changes to the investment schedules of these regions could significantly affect growth in 2018. We already expect it may be just 2.5% y/y next year, as we do not exclude the Kerch Bridge being finished prior to the presidential elections (March 2018) and the Moscow renovation program only gaining traction from 2H18.

Strong consumption recovery this year may face constraints in 2018, as salary growth will decelerate substantially

Finally, the main area where economic growth is gaining stable support this year is consumption. For example, retail trade in September-October demonstrated strong growth of 3% y/y and retail lending activity has been steadily increasing by 1.0-1.5% m/m since summer, implying 9.9% y/y growth in October. We believe that loan growth is likely to reach 12% y/y in 2017, which would substantially outperform our initial expectation of 6% y/y growth. However, next year the consumption trend looks likely to disappoint – while this year it is recovering just behind the 7.0% y/y nominal salaries growth recorded in 9M17, in 2018 salary indexation will be linked to this year's more modest inflation figure, which will limit both trade growth as well as placing a ceiling on retail lending capacity.

New round of sanctions may damage RTS growth

All in all, it is extremely difficult to draft a scenario in which the AB-ICI will start to deliver a fast recovery, thus it will continue to signal that further RTS growth does not look sustainable. The channel through which financial markets could be hit is obvious – a retreat could be triggered either by a correction on the global markets and/or more plausibly to new sanctions against Russia. From that point, the increased IPO activity of recent months may reflect strong concerns among the business community regarding the future valuations of local companies. Thus, while oil prices are providing short-term support for the RTS, economic fundamentals are not working in the same direction, thus a sustained long-term market recovery is not assured.

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%
Underweight (U/W):	Expected total stock return < 0%

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.

In addition to the ratings above, we may occasionally assign the following classifications to stocks covered:

Restricted (R):	A rating, target price or financial forecasts are not disclosed owing to compliance or other regulatory considerations.
Under Review (U/R):	In response to recent or pending news flow requiring a significant overhaul or amendment of a company's financial model, the previous rating and/or target price is temporarily not disclosed.
Coverage in Transition (I/T)	Due to changes in the research team, the disclosure of a stock's rating and/or any other stock-specific information is temporarily suspended. The stock stays in Alfa Bank's coverage universe and usual disclosures will be resumed in due course.
Not Rated (N/R)	The stock is not in Alfa Bank's coverage universe at the time the research product referring to it is published.

IMPORTANT INFORMATION

This report is published on a monthly basis.

Alfa Bank Equities

12, Akad. Sakharova prospect Moscow, Russia 107078
+7 (495) 795-3712

Head of Research Boris Krasnozhenov

Research Department		**+7 (495) 795-3676**
		research@alfabank.ru
Macroeconomics		
Natalia Orlova, Ph.D.	norlova@alfabank.ru	795-3677
Valeriya Volgareva	vvolgareva@alfabank.ru	780-4724
Metals & Mining/Fertilizers		
Boris Krasnozhenov	bkrasnozhenov@alfabank.ru	+7 (495) 795-3612
Yulia Tolstykh	yatolstykh@alfabank.ru	+7 (495)795 36 12
Consumer, IT & Media		
Alexandra Melnikova	a.melnikova@alfabank.ru	795-3740
Evgeniy Kipnis	ekipnis@alfabank.ru	795-3713
Equity Sales & Sales Trading (Moscow)		**+7 (495) 223-5500**
Domestic Institutional		
Alexander Zorov	azorov@alfabank.ru	745-5621

Alfa-Direct Research		
Geldy Soyunov	gsoyunov@alfabank.ru	641-3673
Alan Kaziev	akaziev@alfabank.ru	974-2515 (ext. 8568)
Editing and Production		
John Walsh	jwalsh@alfabank.ru	795-3676 (ext. 8238)
Translation		
Anna Martynova	amartynova@alfabank.ru	795-3676
Head of Alfa-Direct		**+7 (495) 795-3680**
Sergey Rybakov	srybakov@alfabank.ru	ext. 6399
Alfa-Direct Sales		
Valeriy Kremnev	vkremnev@alfabank.ru	ext. 7083
Olga Babina	obabina@alfabank.ru	ext. 4092