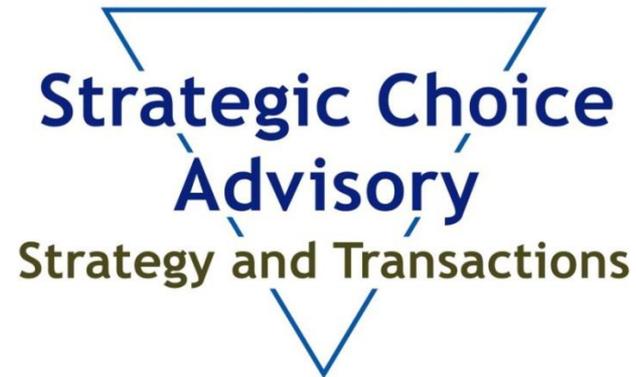


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**Strategic Choice  
Advisory**  
Strategy and Transactions

**Russia Macro Foresight**

Efficiency Improvement Becomes Key Growth Driver; Banking Sector, Consumer Demand Start Recovering with More to Come

February 2018

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# Headline growth figures may still be unimpressive, but leading indicators show rising investment and business activity, while consumption is finally starting to recover

## Key macroeconomic trends

1. Headline **GDP and IP growth figures slightly undershot government and expert forecasts**, causing quite a bit of negativity in the media
2. **Real disposable income again failed to grow**, also causing concern
3. Still, the **upward trend in all these indices is also quite obvious**

4. **CPI inflation reached a historic low of 2.5% y/y in December and 3.7% over 2017 (12-month running average)**. While this may be cause for concern, if the trend persists, for now it is helping boost spending

5. Looking more closely at GDP and IP figures, the **underperformance was largely caused by weaker growth in agriculture** (attributable to cold spring and summer in a lot of regions, as well as a high base), and **utilities (autumn and winter were much warmer than usual)**

6. Actually, underlying data shows highly encouraging trends, as **key leading indicators beat expectations. Fixed capital investment and cargo turnover grew strongly after a lackluster 2016 and dismal 2015**
7. Also, PPI inflation sped up notably. This may squeeze margins for some players, but also shows **greater pricing power amid rising demand**

8. Looking at consumer spending and population well-being, **retail trade finally managed to grow**, even if modestly, after severe contraction
9. **Real wage growth also accelerated**, supported by lower CPI inflation and maintained solid growth of nominal wages
10. Also positively, **unemployment receded significantly in 2017**

Indicator, full-year, % y/y	2015	2016	2017
Real GDP	-2.5	-0.2	1.5
Industrial production (IP)	-3.4	1.1	1.0
Real disposable income	-3.2	-5.8	-1.7
CPI inflation, 12m average	15.5	7.1	3.7
CPI inflation, December	12.9	5.4	2.5
Agriculture	2.6	4.8	2.4
Electricity, heating	-1.6*	1.7	0.1
Water, waste management		-0.8	-2.8
Fixed capital investment**	-9.6	-0.6	4.2
Cargo turnover:	0.2	1.8	5.4
o/w rail cargo turnover	0.2	1.7	6.4
PPI inflation	12.4	4.3	7.6
Retail trade	-10.0	-4.6	1.2
Real wages	-9.0	0.8	3.4
Nominal wages	5.1	7.9	7.2
Total unemployment	7.4	-0.5	-6.5

# In addition to import substitution, efficiency improvement has also become a key manufacturing and service growth driver. Exports of higher value-added goods are also growing markedly

1. Import substitution remains a major growth driver across the board, with output of higher-value added goods growing especially quickly

2. At the same time, efficiency improvement is also becoming a key driver of both production and services

3. Another emerging trend is an upsurge in exports of high value-added goods, both by local and foreign players working in Russia

Sector, % y/y	2016	2017	Sector, % y/y	2016	2017
<b>Agriculture and food manufacturing</b>			<b>Clothing &amp; footwear</b>		
Pork	13.8	9.0	Textile	4.6	7.1
Beef	6.1	5.5	Apparel	7.1	3.8
Poultry	2.8	7.4	Footwear & leather products	4.4	4.3
<b>Processed food</b>	<b>3.1</b>	<b>5.6</b>	<b>Chemical manufacturing</b>		
Fish fillet	16.3	27.6	Total chemical manufacturing	6.3	4.3
Vegetable preserves	-17.3	30.3	Pharmaceuticals	7.0	12.3
Cereals	3.6	7.7	Plastics & resins	6.3	4.2
<b>Machines &amp; equipment</b>					
Cars	-7.4	21.0	Computers & electronics	-2.0	16.4
Cargo railcars	28.8	49.1	Semiconductors & devices	N/D	16.7
Tractors	16.1	11.5	Food processing equipment	N/D	7.3
Washing machines	14.4	11.7	Medical equipment	2.9	5.8
<b>Miscellaneous other</b>					
Steel structures	0.1	7.9	Furniture	-2.7	8.7
Cargo turnover	1.8	5.4	Non-woven materials	26.6	11.1
Fuel pellets	5.2	29.6	Fodder feed	4.0	7.8
Building materials	-6.0	2.5	Fertilizers	2.7	8.2
<b>Exports to non-CIS, 2017, % y/y</b>			<b>Exports to CIS, 2017, % y/y</b>		
Optical, medical devices	29.3*	Plastics	15.3**	Machines & equipment	27.9*
Mechanical equipment	24.0*	Inorganic chemicals	22.4**	Cosmetics & perfumes	51.3**
Cars	40.4**	Food products	23.3**	Food products	9.3**

# Banking sector indices improve visibly, albeit loans to corporates are recovering more slowly. FDI inflows stay solid, while overall corporate debt burden decreases, improving market liquidity

## BANKING SECTOR

- **Key banking sector indices either returned to zero growth after significant declines or posted sizable and much-welcome increases in 2017**
- While the sector is not out of the woods yet, as evidenced by stepped up cleansing and asset consolidation by the CBR, the tide is starting to turn
- **Overdue debt rose only moderately, showing improved payment discipline**
- **Still, profit dipped after soaring in 2016 (mostly on speculative FX trades)**

Indicator, % y/y	2016	2017	Indicator, % y/y	2016	2017
Total assets	-3.5	6.4	Total liabilities	-5.3	6.7
Loans to individuals	1.1	12.7	Corporate deposits	-13.8	9.2
Loans to corporates	-9.5	0.2	Individual deposits	4.2	7.4
Total overdue debt	-5.1	3.5	Corporate funds on correspondent accounts	-3.7	6.4
Investment in securities	-2.6	8.0	Own funds	14.0	4.1
Cash & equivalents	-0.3	19.6	Current year profit	4.8-fold	-15.1

## MONETARY AGGREGATES

- **National-definition money supply expanded further by 10.5% y/y in 2017, after growing 9.2% the previous year. Broad money also remains on an upward trend. Thus, overall market liquidity continues improving**

## PUBLIC SECTOR

- **The federal budget deficit made up 1.5% of GDP, according to preliminary data, equal to 8.9% of budget revenues in 2017**
- The State Reserve Fund has been merged with the National Welfare Fund, holding USD 66.26bn as of Feb 1, 2018. This, in addition to USD 449.8bn in FX reserves (as of Feb 2), **gives Russia a significant liquidity cushion. Still, tightening Western sanctions and likely spending sprees in this year of presidential elections continue to exert pressure on public finances**

## EXTERNAL SECTOR

- **The current account and BoP surpluses remained strong, thanks both to higher oil prices and growing non-oil&gas exports**
- Inbound FDI made up a solid USD 23.2bn in 2017 vs. USD 30.1bn in 2016 (revised upward). Despite the decline to a level just above the historical average over the past decade, **FDI remain a key funding source for Russian companies**
- Government foreign debt grew by USD 19.1bn (37%), driven by the state budget deficit. However, while corporate foreign debt rose by USD 10.7bn, banks' foreign debt declined by 14.9bn, showing **reduced overall debt pressure on the economy**

## Key expectations and investment ideas for 2018

1. **Efficiency improvement should become an increasingly important growth driver in both production and services. And an excellent investment opportunity: if you want to make money, make someone more efficient!**
2. **Import substitution should continue spurring economic growth**, and serving as an investment opportunity for both local and foreign players (whether acting independently or together with a Russian partner)
3. **Consumer demand will continue recovering gradually, but until it really takes off, overall economic growth will remain moderate.** What can unlock consumer spending? Apparently, it would take inflation to remain low (which is quite likely), and companies to further recover and start increasing wages at a faster rate to accommodate business expansion (also likely). Thus, **gradual growth acceleration appears to be the most plausible scenario**
4. **Market liquidity may be affected by the continued fallout with the West**, especially if sanctions extend onto fixed income instruments (not overly likely now). Plus, it will remain susceptible to oil price fluctuations. However, in the base case scenario, **further gradual liquidity improvement should continue, allowing corporates to step up new investments**
5. **FDI inflows, staying strong despite the sanctions, should provide further liquidity injections**, and will be increasingly welcome by Russian companies trying to expand. To note here: judging by the latest foreign trade data, **investment in Russia is starting to become attractive not only for the possibilities offered by the domestic market, but also for exporting higher value-added goods to other countries**

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