Analytical Forecast for 2018

MERA CAPITAL

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Global market

Global FX/Rates: In Need of a Catalyst

KEY DEVELOPMENTS

In reality, 4Q has been unremarkable. Aside from a brief wobble mid-quarter, the risk environment has been quite upbeat. Decisions by systemically crucial central banks have been digested easily by markets, leaving the dollar range-bound. Low volatility has enabled major equity indexes, such as the S&P 500, to repeatedly reach record highs. The ECB was the main focus among central banks in 4Q. In late October, it extended its QE program to end 3Q18, but it is to halve its pace of buying to EUR30 bln per month starting in 2018. The euro took the decision in its stride. The same can be said of the events in Catalonia at the start of October, when a referendum saw voters favor independence from Spain. Overall, EUR/USD has held within a tight 1.161.19 range this quarter, something we had anticipated following an earlier break above 1.20. The US rates story has been quiet, apart from the telegraphed 25 bp hike to 1.50% on December 13. Prior to this, the focus had been on Fed personnel. Markets were unperturbed by the nomination of existing Fed Governor Jerome Powell to replace Janet Yellen as the chair in early February. Several other key positions will also need to be filled in coming months. Elsewhere, regional stories that threatened to spread further afield have stayed contained. For instance, markets have shown little reaction to North Korea's regular missile tests. In Europe, UKEU Brexit negotiations have remained relatively cordial amid slow progress.

STRATEGIC VIEW

There should be a rather benign backdrop at the start of 2018. The outlook for the Fed and ECB is clear, with new Fed Chair Powell likely to tread carefully and the ECB committed to QE to end 3Q. However, despite very accommodative monetary policy, 2018 should be the year in which liquidity provision from key central banks begins to decline. This need not precipitate a sudden deterioration in risk sentiment, but it does mean that gains might be tougher to come by. If there is to be a surprise next year, it might come from Japan, where the Bo-J could move to end its policy of yield curve control. As seems to be the way of recent years, politics will stay at the fore. Looming large in November are US midterm elections, where President Donald Trump's Republican Party risks losing control of both the Senate and House. Prior to that, a Special Counsel investigation into Trump's election campaign is likely to reveal its findings. Europe too will face challenges. As we go to print, Germany has yet to form a coalition government. Italy faces elections by no later than May, and anti-EU parties are polling well. All the while, Brexit negotiations will continue. Overall, our view is that the overall risk environment will be quite upbeat but more vulnerable to event risks. Valuations in many asset classes are stretched, and volatility may start to trend higher. For now, we are cautious on US rate tightening, forecasting just two hikes in 2018. Should a market that currently seems to believe in the Fed's three hike view be forced to move toward four hikes, sentiment might be tripped up. We also think the Eurozone reflation story could regain momentum next year. This would help EUR/USD toward our 2018 target of 1.24. However, ECB rate hikes are not on the agenda until 2019. Tapering of ECB QE to zero will come to the fore toward the middle of the year.

TOP PICKS

Buy EUR/USD, spot 1.1750, target 1.24 by end 2018.

Global Bonds: Still Unfazed

KEY DEVELOPMENTS

In 4Q17, the global bond markets have lived up to even some of the most enthusiastic expectations. Major investor concerns, primarily over geopolitics and global monetary policy, have dissipated. For instance, the spat between the US and North Korea, which sent ripples through the financial markets in 3Q17, has produced only minor perturbations this quarter. Worries also emerged over the nomination of a new Fed chair ahead of the end of Janet Yellen's term in February, particularly when the hawkish John Taylor was named as a top candidate, but they too faded upon the selection of Jerome Powell, who is expected to stick close to the Fed's current policy. Even news on the progress of the US Republicans' tax reform bill, which might be signed before the year end, has failed to lift US Treasury yields higher, keeping market sentiment benign. The long end of the US Treasury curve has shown neutral to negative dynamics. The 10y yield is only 15 bps higher since the start of the quarter at 2.48%, while the 30y yield has slid 2 bps to 2.84%. Meanwhile, the 2y note has added 39 bps in yield to trade at 1.87%. This divergence has led to a significant flattening of the curve. The 2s10s spread has narrowed to 61 bps, the lowest in over a decade. In this benevolent market environment, EM credit spreads have shrunk and EM borrowers have issued a record volume of new debt this year.

STRATEGIC VIEW

The Fed currently anticipates three rate hikes next year, and fed funds futures price in an over 60% likelihood of the first increase coming in March. The further policy tightening will both raise and flatten the US Treasury curve. We expect the 10y yield to finish next year in the 2.75% area, around 35 bps higher than where we expect it to end this year. The short end of the curve, which is more sensitive to monetary policy, will see a more pronounced increase, bringing the 2s10s spread down to 30 bps or so. The ECB will reduce monthly asset purchases under its QE program from the current EUR60 bln to EUR30 bln in January-September. The regulator has so far given few hints as to its further plans. President Mario Draghi has confirmed that the QE program is open-ended, and that the ECB is ready to step in and provide more stimulus if needed. The tapering will likely also lift yields across the Bund curve. We expect the yield on the 10y German note to rise from the current 0.30% to around 0.80%. The year 2018 should be more challenging for EM hard-currency debt, but we do not envisage a significant deterioration in the market environment. EM sovereign credit spreads have narrowed in all three of the Fed's tightening cycles since 1998, and we do not expect 2018 to be any different. On the aggregate level, we see EM credit spreads shrinking further, while yields could post a moderate increase. At the same time, as the global monetary conditions tighten, we are likely to see market fragmentation along the lines of credit quality. We believe the spread differential between stronger and weaker names could widen next year. The outlook for EM local-currency debt is more mixed and, in our view, skewed to the upside. Based on this year's events, there is little reason to expect the dollar to strengthen versus EM currencies. We therefore see the overall positive mood in the local debt markets continuing.

Global Equities: An Ease to Easing

KEY DEVELOPMENTS

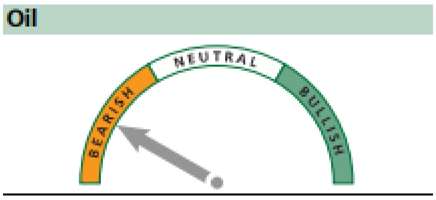
For the most part, major governments and central banks maintained their previous courses in 4Q. This, along with a lack of big global surprises and continued QE and low rates, allowed equities to continue rising. Given the largely stable macro environment, political events generated headlines but failed to meaningfully shake markets. Temporary bumps included multiple North Korean missile tests, the independence debate in Catalonia, a well telegraphed extension of the OPEC+ deal and ample questions, but few new developments, about the course of the Chinese economy and policy. The unsteady progress in Brexit talks has also been in focus in Europe. Somewhat contrary to our earlier expectations, DMs (MSCI World +5%) outperformed EMs (+2%), driven by Japan (+8%) and the US (+6%). US valuations have continued to rise – the S&P 500's 12month blended forward consensus P/E climbed 3% to 18.3, its highest level since a spike in 2009, while that of the global market exUS edged up a less impressive 1% to 14.2. Global equity investors have continued to wait for the outcome of efforts to pass a US tax reform bill and then fiscal stimulus measures to either suck funds into or push them out of the world's largest equity market. Continuing progress on a bill that would lower average US corporate tax expenses likely drove the US market's inflows and outperformance this quarter, though as of this text a final version of the bill had not yet been passed. In EMs, South Korea (+9%) led the group, followed by Russia (+5%) and a number of Asian markets. Laggards included Turkey (11%), Mexico (11%) and Brazil (9%). As for global sectors, IT has fared best (+8%), while utilities was worst off (1%), in part reflecting a prorisk environment.

STRATEGIC VIEW

In the coming quarter and year, we expect the long, drawn-out end of QE to spur higher volatility and, perhaps, return some interest from passive to active investments. Given the arguably outsized influence of US policy on global equities at present, the November midterm elections and continuing investigations into the Trump presidential campaign's activities will be in focus. Brexit negotiations and the formation of a government in Germany will also be watched. Russia's major EM peers have their own potential catalysts, including a general election in Brazil and the last full year of the Zuma presidency in South Africa. China's growth, huge debt and economic policy will be as followed as ever. In the coming weeks and months, we expect tax initiatives in the US aimed at revving up growth to lead to outperformance there. That said, they are already partially priced in, in our view, with US P/Es at their highest levels in nearly a decade. Since the initiatives may be underwhelming at best in terms of their support for the tech sector, later on we expect steady, if low, global growth and low yields to make EM equities again the most attractive combination of risk and reward. This may not be entirely reflected in the broad indexes, as another round of EM placements may swallow up inflows starting as early as end 1Q18.

Oil: Challenges Ahead

KEY DEVELOPMENTS



The Brent price surged by around $8/bbl to as high as $64/bbl in the two months before the OPEC+ meeting on November 30. There were several drivers. First and foremost, strong rhetoric endorsing an extension to the output cut deal was heard from key officials. Investors responded by beginning to aggressively price in an extension to end 2018. Also supporting the oil price was a new wave of political uncertainty enveloping the Middle East, as well as inventory drawdowns in OECD countries and a Keystone pipeline disruption in the US. At the event that everyone had been waiting for, OPEC+ extended the deal on its current terms by another nine months, to end 2018. This result had come to be seen as the most likely by the time the meeting finally took place. Officials delivered the extension without setting off a widely feared price correction (traders had purchased put options in substantial volumes to protect themselves from a selloff). A major concern was that OPEC+ would formally extend the deal but allow it to be reviewed or revised at the next meeting in June, leaving an escape hatch for any participants looking to bail. However, when announcing the extension, OPEC+ officials largely allayed these fears by emphasizing that the main target was to draw global inventories down by another 150 mln bbl and that the deal would remain in place until that was achieved. In mid-December, oil prices were supported after the entire Forties pipeline network in the North Sea, which carries around 40% of North Sea oil and gas, had to be shut down after a crack was discovered. This was the first time since 2011 that the pipeline was fully shut down.

STRATEGIC VIEW

Not much has changed since the extension. OPEC and the IEA had long ago adjusted their supply and demand forecasts for 2018 to account for an extension all the way to end 2018. Their views, however, strongly differ when it comes to demand growth next year. OPEC sees global demand growth at 1.51 mln bpd next year, while the IEA sees it at 1.28 mln bpd (both project growth at 1.52 mln bpd this year). Given the looming seasonal oversupply in 1H18, the extent to which demand grows will largely determine whether the market rebalances next year. Investors are still guessing whether global stockpiles will build next year, as anticipated by the IEA, or shrink, as forecast by OPEC. The direction of changes in global inventory levels will largely determine the trajectory of oil prices next year. We think prices will be pressured in 1H18 on stock builds and surge in 2H18 on stock draws. US tight oil production, which was briefly hampered by a dip in prices, is now back on the rise and remains the main threat to the rebalancing of the global oil market. A strong divergence in the estimates for US shale output next year is a worrying sign and highlights the challenges that lie ahead. The strength of the shale recovery (along with demand) will play a key role in determining where US inventory levels are headed next year and will be another crucial factor driving oil prices.

TOP PICKS

Short Brent ahead of seasonal stockpile build. We expect Brent to come under pressure from seasonal stockpiling in January, undermining sentiment and faith in a market rebalancing. We recommend shorting Brent with a $65/bbl target in 2Q18, and we recommend doing this through the front-month contract, as it should move faster and further than other contracts when the futures curve starts to flatten.

Gold: On the Defensive

KEY DEVELOPMENTS

The geopolitical uncertainty that drove gold to a YTD high of $1,350/oz in 3Q17 started to fade in 4Q17. Price gains on North Korea-related tension have become very short-lived. This behavior is typical, as the higher the level of concern over a certain risk, the less susceptible the market becomes in terms of price reaction. In October and November, gold was trading sideways in a fairly tight range of $1,2651,300/oz. The buildup to the December Fed rate hike, the third of the year, started to take center stage. Price volatility was especially low in November, when gold gradually clawed its way from $1,270/oz to $1,300/oz. US core inflation remained at 1.71.8% y-o-y, stubbornly below the Fed's 2% target and providing little ground to fully justify further policy tightening. The "mystery" of low inflation was one of the main factors providing fundamental support for gold in November. However, Janet Yellen later argued that the US economy had gathered steam and that inflation should pick up, eventually hitting the Fed's 2% target and warranting three rate hikes in 2018. A tightening labor market, rising wages and strong US GDP data ultimately contributed to the December Fed hike decision. In late November, Treasury yields and the dollar drew strong support from the revised US 3Q GDP growth estimate of 3.3%, which exceeded expectations and rendered the third hike of the year a foregone conclusion. It also triggered the process of gold pricing in the yearend rate hike. This process was only intensified by dollar strength stemming from a US tax reform bill that is expected to boost US economic growth and diminish gold's safe-haven appeal. As a result, gold retreated by $60/oz to just below $1,240/oz in the run-up to the Fed's December meeting. Following the rate hike, the dollar came under pressure and gold pushed back toward $1,260/oz. Despite subdued inflation data for November, the Fed retained its three-hike outlook for next year. Ahead of the meeting, some had even expected the Fed to provide hints that next year could see four hikes. Still, the markets remain somewhat skeptical with regard to the Fed's plans, barely pricing in two moves.

STRATEGIC VIEW

Next year could hold anything from two to four rate hikes in the US. Other Western central banks are also either considering or already implementing (e.g. the UK) tighter monetary policy. The process of this being priced in prior to next year's Fed meetings will pressure gold in the same way as it did in 2017. Tighter monetary policy entails more downside than upside risk, as it implies money flowing from non-yielding assets such as gold into low-risk sovereign bonds. However, we do not expect rate hikes to drive the dollar significantly higher, as inflation is likely to remain below target despite assurances to the contrary from the outgoing Fed chair, and given the political uncertainty in the US. The US government will remain under pressure: the official investigation into President Trump's alleged collusion with Russia during last year's election campaign brought its first charges in 2017. The US political drama and geopolitical tension should continue to support gold next year, providing a counterbalance to the effects of the slow normalization of Western monetary policy. The upshot is that gold is likely to continue to struggle during the Fed's rate hike cycle. We see it averaging $1,250/oz next year.

TOP PICKS

Start reducing exposure to gold toward end 1Q18, as the lead-up to the March FOMC meeting will likely see the liquidation of long gold positions.

Russian market

Oil and Gas: Don't Confuse Stocks with Bonds

KEY DEVELOPMENTS

The energy sector has generally underperformed the rest of the market over the past 12 months. The oil price sagged in the middle of the year, falling to about $45/bbl in June, while the ruble actually strengthened. This led to a drop in estimates for most names (though less so for Novatek). When the oil price began growing again in August, the energy sector followed. As a result, the RTS is set to end the year roughly flat, though there have been wide variations in the performance of individual oil names. Tatneft, boosted by two dividend hikes this year and a doubling in its MSCI 1040 weighting, has performed the best in 2017, along with Gazprom Neft; Rosneft and its subsidiary Bashneft have fared the worst.

STRATEGIC VIEW

The sector is becoming characterized by low growth and high but barely growing dividend yields. This is anathema to the very idea of equity securities, especially in emerging markets. It could also prove a disadvantage should global interest rates continue to rise, something that analysts widely anticipate. Nobody denies the advantage of a high dividend yield in a market like Russia, where distributions are a way for shareholders to take some of the risk of owning the securities off the table. However, the market has so far proven reluctant to accept a lower yield from Russian companies with high distributions, which could be a bad sign if growth fails to materialize and dividends fail to keep on rising. It is one thing to own Gazprom Neft – its production will grow at a circa 4% CAGR in the medium term, it will triple its free cash flow yield over the next two years and will probably end up doubling the dividend as well, pushing it well into double digits. But stocks like Gazprom, Tatneft, Surgutneftegaz prefs and, to some extent, Lukoil, which all offer a 56% yield, might end up stuck in a rut. Rosneft is a separate case, which we discussed at some length in our recent report.

TOP PICKS

Gazprom Neft. The company will generate about $1.5 bln in free cash flow in 2018, assuming $50/bbl oil, and this could double by 2019. We believe a doubling of the dividend, currently $1 bln, is also possible, which would mean a circa 12% yield perhaps as soon as 2018.

Novatek. Several factors are converging to make 2019 the next pivotal year for Novatek. They include the full ramp-up of Yamal LNG, the appearance of the first cash flows to Novatek and a potential subsequent decision to hike its dividend; the entrance of partners into Arctic LNG2 and the Kamchatka transshipment projects (and probable cash payments to Novatek for the stakes); the launch of the North Russkoye cluster; and the first dividends from SeverEnergia. The anticipation for this will build throughout 2018.

Lukoil. The decision to fully or partially cancel the treasury shares – and the subsequent announcement of a buyback – could prove to be the main corporate event in the Russian energy space in 2018.

Metals and Mining: China Goes Green and Clean

KEY DEVELOPMENTS

In recent months there has been a noticeable divergence in the prices of base metals and steel bulks. Copper and nickel have come under a bit of pressure due to market concerns over the demand slowdown in China in the seasonally slow winter season. The latter, meanwhile, have been supported by aggressive capacity shutdowns aimed at tackling environmental problems. Aluminum prices have slumped along with base metals. The market has started to doubt the size of capacity cuts and the efficiency of the supply-side reform in the aluminum market, the latter being a much newer and more modern industry than steel, which has long been plagued by old and lossmaking plants. Meanwhile, phosphate fertilizer prices have started to recover, as we called in November, on inflation in raw materials prices, spurred by China's fight against pollution. Gold prices have been weak due to Fed rate hikes and have generally lacked triggers.

STRATEGIC VIEW

The campaign to improve the environment in China will continue next year. The government is focusing on further capacity cuts (steel, aluminum, coal), boosting recycling (more scrap usage), importing products that are too polluting to produce domestically and hiking environmental taxes, which should further boost inflationary trends in the metals and fertilizer space. We thus believe that the relatively strong prices current seen across the metals and fertilizers universe may very well be sustained, meaning another strong year of earnings for the sectors' Russian companies. While steels, nickel (and likely gold) may hold at current levels, we expect to see some strengthening in aluminum and phosphate prices once recent raw materials price hikes and cost growth for marginal producers are fully priced in.

TOP PICKS

Evraz. Thanks to the recent rise in coal prices and recovery in steel prices, we expect Evraz to beat the consensus and our estimates for 2017 with EBITDA of around $2.6 bln, which should facilitate deleveraging and ensure generous final dividends to be paid next year.

RUSAL. This name is our top pick, as an anticipated recovery in aluminum prices in 1Q18 driven by inflation pressures and supply restrictions should boost the stock.

Financials: Divergence Between the Strong and the Weak Set to Continue

KEY DEVELOPMENTS

This year has been another mixed one for financials stocks. Once again, the standout names have been TCS, which finally broke back through its October 2013 IPO price, and Sberbank, for which the prefs have outperformed the commons on expectations of higher dividends (which were broadly met at the recent 201820 strategy day) given its excellent profitability and potential capital generation. In Russia, VTB has once again been the overwhelming laggard, and Bank of St Petersburg has also struggled, probably not helped by a rather shocking year for several of Russia's largest privately owned banks, as three of the top five have failed and been forced into the CBR's new banking sector rehabilitation fund. It has also been a disappointing year for Moscow Exchange's share price, which has fallen slightly, in line with the Russian market. Elsewhere, Georgian banks had a much better first half than second half, helped by the seasonality of the Georgian lari. The same was true for Halyk Bank, which rallied strongly in 1H17 on expectations of a potentially advantageous acquisition of Kazkommertsbank (KKB), which so far seems to have been the case. Finally, OTP Bank has had a good year, benefiting from a robust economic showing in its core markets, Hungary and Bulgaria, and recovery in Russia and Ukraine.

STRATEGIC VIEW

The divergence we have seen this year between the fortunes of strong, wellmanaged banks and the weak is likely to continue in 2018. It should be a profitable year for Russia's traded banks, with 10%+ EPS growth for all our covered names (including Sberbank). That said, it will probably be a challenging year for core banking business, as banks need to adapt to the low inflation, low interest rate environment, and margins are likely to come under pressure as loan yields reprice downward. A few factors should be supportive for banks, such as a likely recovery in credit growth (probably mid-single digit corporate loan growth and 1015% retail) and a gradual macro improvement, which should help push risk costs down. The CBR's ongoing banking system cleanup is likely to support deposit flows into the biggest banks, especially state-owned. But with a fairly challenging net interest income outlook, we think banks will step up the focus on transactional fee income, and "digital ecosystem" is likely to become even more of a buzzword as other banks look to follow TCS and Sberbank's lead. There will be a fair bit happening on the regulation front, including IFRS9 and likely consumer protection regulation through PTI limits, while Sberbank will become the first Russian bank to adopt IRB. For Moscow Exchange, the key issue for 2018 will probably be the introduction of a unified collateral pool, which over time could be supportive for trading volume growth, as investors can manage their collateral more efficiently, but may be another drag on interest income. Looking beyond Russia, 2018 will see KKB merging into Halyk Bank, which we think should have a good year, while BGEO will undertake a demerger, which should allow for much clearer capital allocation for investors. Finally, OTP Bank looks very hungry for M&A.

TOP PICKS

TCS. After two phenomenally strong years, one starts to question how much further TCS can run, but we remain positive on the stock, as we think it will have another excellent year in 2018 (EPS up 40%) on its strong positioning in the early credit cycle and as its noncredit businesses build up steam.

Bank of St Petersburg. We anticipate a stronger year all around for the bank, with the retail business growing nicely and risk costs falling, all of which should help deliver low to midteen ROE. The stock has been a value trap for a long while, but earnings have been steadily improving for several quarters, and given the dearth of Russian financial stocks, interest in the name could pick up.

Telecoms and Media: Digital Ad Market and Mobile Prices Are on the Rise

KEY DEVELOPMENTS

Internet stocks were the top performers in the TMT space this year, with Yandex and Mail.ru Group soaring a respective 59% and 54%. This was thanks to the strong digital ad market and company specific factors such as an Android search share boost for Yandex (due to the Russian antitrust ruling against Google) and positive surprises in the games segment for Mail.ru Group. Meanwhile, mobile carriers' stocks are set to finish the year barely flat, despite improved revenues and EBITDA and mobile price hikes on the market. The reasons are specific to each company. MTS has been pressured by risks stemming from parent company Sistema's legal tussles with Rosneft and Bashneft. MegaFon has been affected by Telia's placement and the management playing down dividend expectations. VEON has seen two share placements from Telenor. Rostelecom commons dropped 23%, undermined by the stock's removal from the MSCI indexes and uncertainty over the size of its dividend. Kcell soared 53% on no news and is now trading at a 2018E EV/EBITDA of 6.4, which we find unjustified.

STRATEGIC VIEW

We think next year should see continued strong growth in digital advertising, which should further benefit from the structural redistribution of marketing budgets from other advertising media and non-ad marketing spending (such as BTL). This should again fuel both Yandex's and Mail.ru Group's ad revenues. Declining cost of equity should also be supportive for these two names. We anticipate a mixed picture for the mobile telecom sector next year. We estimate dividend yields of 10% for MegaFon and MTS and 7% for VEON. Mobile prices are on the rise, and we doubt that MTS's selective price trimming can change that. The second part of the Yarovaya law (storage of the content of user connections) should come into force in July, but neither the implementation scheme nor the carriers' spending on that have been finalized, which could imply intensified news flow on this front. The deadline for clarification of the US sanctions law is the end of January, including the "oligarch report." We do not take a view on the individuals that could be added to the list, but we could see negative sentiment around some of our stocks as a result. Alisher Usmanov no longer has beneficiary control over MegaFon or Mail.ru Group, as he cut his stake in USM Holding to 48% in 2014.

TOP PICKS

Yandex. Yandex's structural growth story continues. Further out, catalysts include a further increase in the company's mobile search share on Android devices (we will be looking for evidence of this in the 4Q numbers) and the presentation of the new strategy for the taxi business, with some details on these expected by January. Also, we will be looking for more color on ecommerce partnerships and plans.

Mail.ru Group. We continue to like Mail.ru Group's strong structural position in social networking, its momentum in gaming and recent successes in increasing audience and engagement for several relatively young projects, such as Youla and Delivery Club. Catalysts could come from the core ad business and value crystallization of the abovementioned projects.

VEON. VEON is our top pick in the telecom space for 2018. We think the stock should benefit from a gradual but steady increase in FCF and dividends via opex and capex optimization.

Consumer: Household Consumption Recovery, Mixed Company Trends

KEY DEVELOPMENTS

After three years of decline in real terms, consumption returned to growth in 2H17. Aiding this turnaround was historically low inflation. This was in line with what we had predicted, although we had expected real consumption growth to emerge only in 4Q17, whereas this ended up happening in 3Q17. Anecdotally, a number of chains have begun telling us that consumer demand has picked up again. Although price is definitely still the most important criterion, "affordable quality" is gaining ground. Some retailers have noted that promos on relatively expensive items have resulted in trading up.

STRATEGIC VIEW

Generally, the sector is following the pattern that we described in our October report "Solving an Economic Puzzle." We have previously discussed how it took several years for consumption to fully adjust to lower household incomes. For consumers, this entailed trading down and reduced bulk purchases. For retailers, it involved more promotions and pressure on margins. Now, however, from a macro perspective, the industry is poised for faster growth (we assume a 56% expansion in nominal terms in 2018, versus 4.8% in 2017). We expect a slightly higher pace in 1Q18 (on a weak base) and subsequent normalization thereafter. Meanwhile, the main sources of uncertainty and risk are company specific. At the moment, X5's market share is just below the critical 25% level in Moscow Region and St Petersburg, its number one and number three revenue contributors (when a company's market share exceeds 25% in a region, the FAS prohibits new store openings there). Thus, there is a brief window of opportunity for aggressive expansion in these areas before market shares are recalculated. Magnit, meanwhile, is targeting a business turnaround by the middle of 2018 (once most of its stores have been renovated). Store openings and turnarounds are normally accompanied by increased promotional activity, so these two companies may create a drag on the sector's financial performance. Although we do not yet account for these developments (or the positive impact from trading up), it will be important to keep a close eye on them in 2018.

TOP PICKS

X5 Retail Group. The company remains our top pick. Although X5 saw its topline growth decelerate slightly in 2H17, it remained the fastest growing public food retailer, on our estimates. Revenue growth should stay in the 2025% range in 2018. Maturing stores will support the margins, although the growing share of stores outside of the Moscow and St Petersburg metropolitan areas will have the opposite effect. Still, the stock is trading at a discount to Magnit on EV/EBITDA.

Lenta. While we are generally cautious on hypermarkets (which are losing customers to convenience stores), Lenta is outperforming the industry average for the format. The company offers good exposure to the macro recovery and should see topline growth climb to 23% in 4Q17. Its ROIC is also rising thanks to lower capex and the acquisition of ROIaccretive lease rights. Still, the stock trades at undemanding multiples. We are positive on the name after the recent correction and expect the chain to be the first to benefit from the recovery in consumer demand.

Detsky Mir. The company is showing tight opex control and strong topline growth, driven by LFL sales growth as well as new store openings. We think it will be able to maintain a unique combination of superior revenue growth, high ROIC, strong cash generation and consistently solid dividends.

Utilities: Modernization on the Agenda

KEY DEVELOPMENTS

This year was quite successful for the Russian thermalgenerating power companies. We saw higher payments for capacity built under capacity supply agreements (CSA), as many of the new power units entered their seventh year of operations, when payments kick in. The increase in CSA payments was a key factor for growth in 2017, coming in a period of otherwise sluggish growth for electricity prices and payments for capacity not built under CSAs that should continue until 2020. But in 2021, as a result of the capacity auction held in September, prices in both price zones were set significantly higher than those that had been set for 2020. In the Siberian price zone, the increase is mostly attributable to plans for new aluminum smelters leading to a projected increase in demand, while for the European price zone, it is mostly associated with the decommissioning of old capacity.

STRATEGIC VIEW

The decline in interest rates this year is set to negatively impact capacity payments under CSAs next year. The rate of return used to calculate capacity tariffs for the new units is directly linked to government bonds, with a 14% rate of return when government bonds are yielding 8.5%. For the calculation of 2017 capacity prices, the bond yield was set at 10.21%, implying a 15.8% rate of return (16.8% for InterRAO UES, since the company did not conduct a share issue). Given the declines in rates and bond yields this year, we expect the yield to be set much lower and capacity payments to see some decline in 2018. If the yield is set at 8.0%, for example, the rate of return will fall to 13.4% (14.4% for InterRAO UES). In some cases, that will be offset by more generating units entering their seventh year of operations and starting to receive higher payments under CSA. The government has approved the outline of a plan for a second mechanism to encourage investments into the modernization of thermal generation. It will be similar to the CSA mechanism, with guaranteed return on investments. The final version has not been agreed, nor the list of projects to which the companies can choose to apply the mechanism. We expect to get more clarity in 1H18, followed by the gencos adjusting their investment plans. Projects chosen are expected to be designed in such a way as to not affect the fair valuation of the companies, but they will still affect their cash flows, as capex will increase significantly (most gencos are not conducting major expansion projects currently).

TOP PICKS

InterRAO UES. Valuationwise, the company looks very attractive thanks to its strong balance sheet, with a net cash position and strong cash flow generation. Potential changes to the dividend policy to increase payouts are the most visible catalyst that could lead to a rerating.

Transport: Operating Environment Set to Improve Further

KEY DEVELOPMENTS

The year 2017 was quite successful for most of the transport sector, and many companies saw a strong improvement in their operating results. The Russian aviation market expanded 20.2% y-o-y in 11m17 in terms of passenger turnover, reaching a new record. The rail market demonstrated positive dynamics as well, with freight volumes adding 3% y-o-y and freight turnover 6.5% y-o-y in 11m17 thanks to increased coal volumes. The Russian container market also returned to growth this year, growing 15.8% y-o-y in 11m17. However, this did not translate into an improved financial performance for certain companies. Aeroflot, for example, posted weak results for 9m17. Its EBITDA was down 30.9% y-o-y on the back of lower yields, which were a result of the stronger ruble. Meanwhile, in the rail freight market, rates rose significantly this year and reached levels that justify investment in new rolling stock.

STRATEGIC VIEW

The Russian aviation market is in good shape. In our view, low inflation, a relatively stable exchange rate, lower interest rates and growing incomes provide a strong base for further growth, albeit at a slower pace. We anticipate a low-double-digit increase in passenger turnover in 2018. The exchange rate should work in Aeroflot's favor, as the ruble is expected to weaken. All in all, we anticipate 15% yoy EBITDA growth and even higher net income growth. The same macro factors mentioned above should lead to a pickup in imports and, hence, container volumes. However, the rail freight market will likely remain balanced, with lease rates stabilizing, as higher prices for new railcars will be offset by lower interest rates.

TOP PICKS

Aeroflot. We anticipate a 50% dividend payout for 2017, which, based on our estimates, would translate into R10.6 per share and a circa 7.0% yield. The outlook for 2018 is brighter: we forecast dividends of R15.25 per share and a 10% yield.

Global Ports. We believe the Russian container market is set to continue growing in 2018 and beyond, and Global Ports offers a leveraged play on the recovery. The company posted positive FCF even at the bottom of the cycle, and we expect cash flows to grow significantly in the coming years.

Real Estate: Opportunities and Challenges

KEY DEVELOPMENTS

The first half of the year was challenging for the sector. Two of Russia's three public homebuilders reported a y-o-y decline in presales in 1H17 on a high comparison base and a stillsluggish market. However, the 3Q17 results showed a recovery in growth (presales were up 13% and 17% y-o-y for Etalon Group and LSR Group in ruble terms), which we expect to continue in 4Q17. Despite the recovery in presales, the stocks have not done well this year. PIK Group has fared the best, down just 2.5% YTD. LSR Group has fallen 15.0%, while Etalon Group shares are off by 20.5% following a share sale by its two main shareholders, Baring Vostok Capital Partners (BVCP) and the Zarenkov family.

STRATEGIC VIEW

Declining interest rates should remain the top macro theme for the sector next year. Lower rates should stimulate demand for mortgages. In 10m17, Russian banks' mortgage issuance was up 20% y-o-y in terms of volumes and 30% in value terms, although some of this credit-driven demand has replaced so-called "installment plan" financing from developers, which was used for as much as one third of new home purchases. This helps explain the subdued overall presales growth for the sector. Next year, we expect mortgage rates to decline another 150200 bps from the current average of around 10% to reach

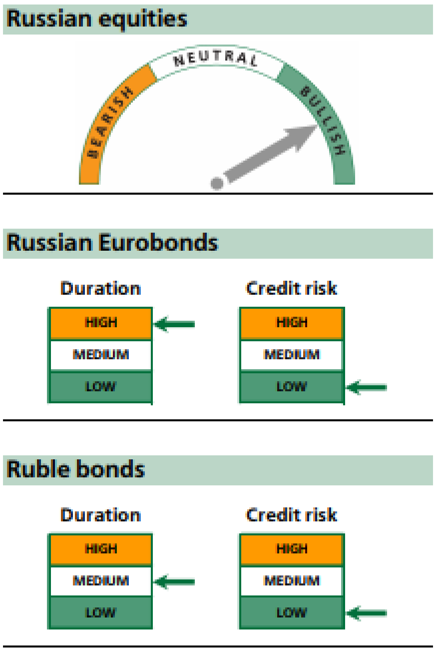
8.08.5%, with subsidized rates (subsidized either by the government or developers) reaching as low as 67%. This should continue to fuel demand given Russia's still-low mortgage penetration, which we estimate will reach 6.0% of GDP by end 2017. A second positive factor in 2018 will be the switch to new accounting rules (the 2017 results will be reported under IFRS 15 standards), which is likely to lead to an increase in reported revenues and net income and make homebuilders appear cheaper on multiples. Derating, on our estimates, may shave off as much as 1525% from the current multiples. We also see two factors that will present a challenge for the investment cases of homebuilders next year: legislative uncertainty and share overhangs. Possible changes in legislation are still under discussion but are likely to prove advantageous for larger homebuilders with access to bank financing. The overhang factor, however, is more a guessing game of who and when. BVCP has another 5.7% to sell in Etalon Group, while PIK Group guided for an SPO on a two year horizon. The share overhang could restrain the performance of both stocks.

TOP PICKS

LSR Group. Over the last three months, LSR Group has outperformed its rival and our long standing top pick Etalon Group by 5 pp, but we think there is potential for further outperformance. While LSR has fallen behind on bringing new inventory to market and is still having trouble selling some of its projects, we anticipate a pickup in its operating performance over the next few quarters. More new launches and an easing base should make for higher presales growth, while debt looks to have already peaked, offering a positive outlook for deleveraging and the possibility of a return to higher dividends for 2019.

Russian Equities: Ripe for Rerating

KEY DEVELOPMENTS



Russian equities are set to close the year flat, missing out on the impressive EM rally (MSCI EM is up 30% YTD). Oil and gas stocks have been weak this year and have been the main contributor to Russia's poor performance. The energy sector has suffered from excessive ruble appreciation, and even higher oil prices have proved insufficient to offset the negative impact on earnings. The retail sector has been another major underperformer. The country's largest retailer, Magnit, has struggled to withstand this year's macro headwinds and has slipped 40% YTD, as its operating results have missed investors' expectations. On a positive note, the financial sector has been one of the best performers, as the country's largest banks have consistently managed to deliver better than expected results. The steel sector has been propelled by soaring commodity prices, while media/IT has been the best performing sector, primarily on the back of multiples expansion. The macro backdrop has been quite mixed. High real rates have proven detrimental for economic growth and caused the ruble to appreciate in 1H17, and both of these effects have been negative for the corporate sector. However, nominal rates have been coming down fast. Cost of debt has fallen by around 150 bps on a blended basis. In theory, this should have led to a commensurate compression in cost of equity, but the equity market has failed to price in the lower rates. We investigated this issue in more detail in our September report "Russia's Cost of Equity: Poised to Catch Up With the Bond Rally."

STRATEGIC VIEW

We believe the factors underpinning Russia's underperformance have already disappeared, and the macro situation points to a market rerating. The ruble has started depreciating and no longer looks overvalued relative to oil. The switch to a tighter version of the budget rule will entail larger interventions on the FX market. Our economists estimate that at a $63/bbl Brent price, FX purchases could reach $50 bln next year. This should drive the ruble even lower and benefit the market and exporters in particular. Another important factor in play is the normalization of the equity risk premium. We expect cost of equity to catch up with falling bond yields and ERP to compress by 100200 bps. Cost of debt could decline another 50 bps as banks continue repricing loans to catch up with the bond market. Lower cost of capital should generate some 20% upside for the market, in our view.

TOP PICKS

Buy Lukoil. The decision to fully or partially cancel the treasury shares – and the subsequent announcement of a buyback – could be the main corporate event in the Russian energy space in 2018.

Buy Gazprom Neft. The company should generate about $1.5 bln in free cash flow in 2018, assuming a $50/bbl Brent price, and this could double by 2019. We believe a doubling of the dividend, currently $1 bln, is also possible, which would mean a circa 12% yield perhaps as early as 2018.

Buy LSR Group. We anticipate a turnaround in the company's operating performance in 2018. More new launches and last year's low base should contribute to a significant pickup in growth. The debt load also looks set to ease, allowing for higher dividend payouts in the future.

Russian Eurobonds: Looking for Upgrade

KEY DEVELOPMENTS

Russian Eurobonds have fared pretty well this quarter, performing broadly in line with EM peers. Recent events in the US, including developments in the investigation into Russia's interference in the 2016 presidential election and talk of potential new sanctions, have had a negative impact on Russian assets, though the news has done little to alter investors' overall positive attitude toward Russian credit. The Russia 5y CDS has narrowed 17 bps to 125 bps so far in 4Q17, while spreads between Russian sovereign papers and US Treasuries have tightened 9 bps on average. Performance along the Russian curve has varied across tenors, as the flattening of the Treasury curve has resulted in corresponding shifts in Russia's curve. While notes with maturities of 10y and longer have posted gains, their yields sliding 2 13 bps, shorter papers have risen 1022 bps in yield, tracking the short end of the Treasury curve.

STRATEGIC VIEW

The performance of US Treasuries will largely set the tone for Russian sovereigns next year. The further Fed tightening could translate into long-dated Treasuries' yields rising 3040 bps. We also expect the Treasury curve to flatten, with the spread between the 10y and 2y points tightening from the current 55 bps to 2030 bps. If we are right, then the overall performance of Russian sovereign paper is unlikely to be strong, at least in 1H18. However, in 2H18, sentiment might be boosted by developments in the wake of the presidential election, such as possible changes in Russia's economic policy. Next year's main event will be the presidential election on March 18, which will likely have a significant impact on the political and economic landscape and foreign policy. We hope that it will help pave the way for improvement in both the economy and relations with the West. If it does, bondholders will benefit. We believe there is a good chance that Russia will see at least one sovereign rating upgrade next year given its improved economic fundamentals and the higher oil prices. Further grounds for positive rating actions could emerge when the new government begins to take shape and the economic agenda comes into focus after the elections. Hence, we see a higher likelihood of rating upgrades in 2H18. Once Russia receives its second investment-grade rating, Russian sovereigns will be eligible to return to a number of bond indexes and will reappear on the radars of more conservative investors. Hence, we expect spread compression of 2030 bps along the Russian sovereign curve.
We should mention at least one negative factor that could come into play in 2018. The US Treasury is

currently conducting an investigation into the impact of a potential ban on investments in Russian debt by US persons or entities. The results of the investigation should be reported to Congress by the end of January. We do not think that the probability of an actual ban is high, since relations are not that poor at the moment and given the amount of money US investors already have invested in Russian sovereign debt and the lack of consensus on sanctions between the US and EU. Nevertheless, news flow could bring headwinds for Russian Eurobonds in 1H18.

TOP PICKS

Buy Russia 47. This is the new benchmark on the market. We believe the market's initial negative reaction to the tap of this issue was excessive and find the current price levels attractive.

Buy Global Ports 23. The Global Ports 23 is the highest-yielding BB-rated paper in Russia. The company is generating positive FCF and reducing its debt.

Ruble Bonds: Faster Rate Cuts

KEY DEVELOPMENTS

The CBR surprised the market with its 50 bp rate cut in December. The surprise came not only from the magnitude of the cut, but also from the accompanying statement (see the "Russia FX/Rates" section for more). The year 2017 saw 225 bps of cuts to the key rate, more than even many optimistic analysts had expected. The curve finally took on a positive slope in 4Q17, with the 1s10s spread widening to 60 bps from virtually zero at the beginning of the quarter. The Finance Ministry fulfilled its borrowing program for the year, placing a net R1.1 trln of OFZs, with R136 bln in net issuance coming in 4Q17. It seems that locals have been doing most of the buying this quarter ahead of the introduction of tougher liquidity coverage ratio requirements and upcoming OFZ redemptions. Nonresidents have been fairly-inactive, as is typical late in the year. They have been cautiously buying OFZs amid rising DM rates and sliding OFZ yields. Although locking in profits ahead of the year-end may have been tempting, we believe many investors ultimately opted to stay invested in OFZs given the lack of substitutes.

STRATEGIC VIEW

Inflation reached and then fell well below the CBR's 4% target this year. Now the regulator is faced with the decision of whether to speed up its rate cuts in response to the low inflation or maintain the current pace. The CBR's credibility is quite high at the moment, as its prudent approach to monetary policy has already borne fruit. The bank appears to have the independence to manage inflation, but the main concern now is how the Russian economy will react to the combination of relatively high real rates, low inflation, low growth and the looming threat of tighter sanctions next year. While we do not expect the US to prohibit investments in OFZs, we see the probability of an ease in sanctions as quite low. We therefore think the CBR will stick to its current monetary policy stance, cutting the key rate 1 pp per year and keeping the slope of the OFZ curve positive. We believe the curve should move closer to 6% by end 2018 and expect the slope to remain mild due to expectations of further cuts from the CBR or a lack of sufficient supply on the market owing either to high demand from investors or the Finance Ministry's inability to issue more paper because of internal constraints. Having weighed all these factors, we estimate that short-dated OFZs will be trading near 6.5% by end 2018, while yields on longer paper will be in the 7.0% area. Due to continued rate cuts, floaters will remain less attractive than nominal OFZs. Meanwhile, the CPI linker could become more attractive than comparable nominal OFZs if inflation rises from the current 2.7% to 4.0% next year, or if nominal OFZs underperform amid a general deterioration in the OFZ market. Should inflation remain low, expectations of accelerated rate cuts would provide a boost to nominal paper, while CPI linkers would become less attractive.

TOP PICKS

We recommend buying the 5y OFZ 26220 in light of the ongoing CBR rate cuts. The belly of the OFZ curve should continue to outperform longer-dated issues as the curve steepens in 1Q18.

For those with more of a long-term focus, we recommend buying long-dated paper such as the 10y OFZ 26212. This strategy is also appropriate for investors unconcerned about the prospect of new US sanctions prohibiting OFZ purchases.