November: more fuel needed to sustain growth

GAZPROMBANK

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Still an oil story

The October rebound in oil prices has helped to improve the performance of Russian capital markets. Ruble-denominated stocks added almost 10% on average, while RTS index staged a 16.8% increase due to the 6.0% ruble revaluation. Moreover, global tensions eased a little in October, allowing for a $56 mln inflow of capital into Russia-dedicated funds in the last week of the month, reversing an earlier outflow of $54 mln. It is worth noting that this was the first inflow since early July.

However, the degree of uncertainty and political disintegration – both within individual countries (Greece, Italy) and in the eurozone as a whole – remains high. As a result, trading in the stock markets may remain volatile throughout the end of the year unless sustainable progress is made on European debt issues. Also neglected so far is the voting on new budget cuts in the US, due November 23. Although we do not anticipate further cuts of the US sovereign ratings (as lack of political consensus has already been accounted for in the latest S&P move, and punishment for the same issue seems unlikely in a short period of time), this might bring additional volatility into the market.

Unimpressive fundamentals

Despite rather strong consumer confidence indicators, producers do not seem to be equally optimistic. Moreover, Russian economy in 3Q11 returned to its full capacity. Therefore, in order to further increase output firms need to undertake larger capital investments, which are strongly dependent on expectations of stable demand for final products. Although RDI demonstrated a healthy increase in September, a potential acceleration of inflation towards the end of the year (due to seasonal factors) and limited potential for increase in the marginal propensity to spend makes LT consumption trend look uncertain.

ST forecasts:

- *External sector and exchange rates*. We anticipate no major shocks to the price of oil in November unless Greece fails to secure financing from the EU, which would imply an inevitable default as soon as in December. Urals is likely to trade within the range $108–115/bbl, averaging ca. $110/bbl. As a result, the balance of trade is likely to remain barely unchanged from its October value: we estimate the surplus to amount to ca. $15 bln. Assuming that the total net outflow of capital falls within the latest CBR forecast, financial account deficit if October-November will total $12–15 bln (although it may actually exceed these forecasts in case of a major turmoil in the global financial markets). In our base-case scenario, ruble might trade in the range RUB 30-31 against US dollar, averaging RUB 30.5/USD. The dual-currency basket might decline to below RUB 35.5 as a result of potential weakening of euro against USD.
- *Real sector and price level*. We anticipate that seasonal factors' influence on the price level dynamics will diminish further in November, resulting in acceleration of consumer prices growth to 0.7-0.9% MoM. This will transpose into YoY growth of 7.3-7.5%. As a result, RDI dynamics might decelerate slightly to 2.8-3.0% YoY. However, retail sales may increase by as much as 9.5% as consumer confidence remains fairly strong. Capex and industrial production are expected to grow at a pace of 8.3% (mostly due to the low base effect) and 3.0% respectively (YoY).

Key indicators: November forecast

Indicator	November 2011F	2011F MED	2011F GPB Research
Real sector			
GDP, YoY	–	4.2%	3.9%
Industrial production, YoY	3.0%	4.8%	3.5%
Capital investments, YoY	8.3%	6.0%	6.8%
Retail sales, YoY	9.5%	5.3%	4.3%
Private sector			
Real income, YoY	3.0%	1.5%	4.4%
Accrued salary, RUB	–	23,940	23,784
External sector			
Trade balance, $ bln	15.0	188	153.6
Average oil price (Brent), $/bbl, av.	110	108	108
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	7.4%	6.5–7.0%	7.8%
Refinancing rate, eop	8.25%	–	–
Bicurrency basket, RUB (avg.)	35.5	33.38	35.0
Exchange rate, RUB/USD (avg.)	30.5	28.6	30.0

– no forecast available;

Source: MED, Gazprombank estimates

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Leading indicators

Money and credit

Lending activity in September remained strong. The amount of loans outstanding to the corporate sector over the 12M period ending September 11 increased by 22.4%, while the gauge for consumer loans added 30.8%. However, persisting global risks and tightening financing conditions for banks may lead to a slowdown in lending. Money multiplier in October remained at its September level of 2.9x.

Energy consumption

Power consumption in October declined for the first time since January 2011: overall energy utilization diminished by 0.6% YoY. Monthly dynamics, however, accelerated - from 4.9% a month before to 8.8% in October. This, however, could be attributed to the beginning of heating season. As a result, industrial production is likely to exhibit a modest deceleration of growth in October.

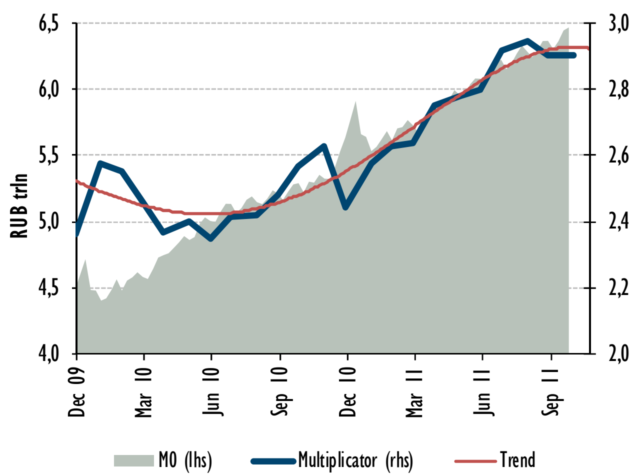
Economic activity

Manufacturing activity demonstrated the first increase in four months, as measured by PMI for October. The value of the indicator rose to 50.4, indicating a marginal improvement in producer sentiment. The largest contribution to PMI dynamics came from renewed growth of new orders, pointing to strengthening demand. The acceleration of growth, however, looks so far too fragile to justify an upward revision in industrial production growth forecast.

Confidence was relatively higher in the services sector, where respective PMI rose to 53.5 points in October. However, the long-term seasonally adjusted trend is on the verge of changing direction to the downside as the current index values remain below the 12M average.

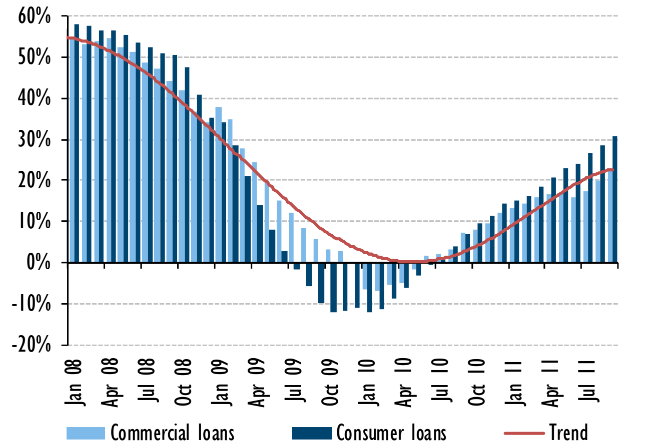
Shipping volumes continued to stagnate in September as YoY growth decelerated to 0.5%, and even such a modest increment was largely attributed to the low base effect. Cargo transportation actually fell 1.6% MoM. Despite strong sales domestic production may be under pressure due to persistently high share of foreign goods in the consumer basket and low capacity for import substitution.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprom ank estimates

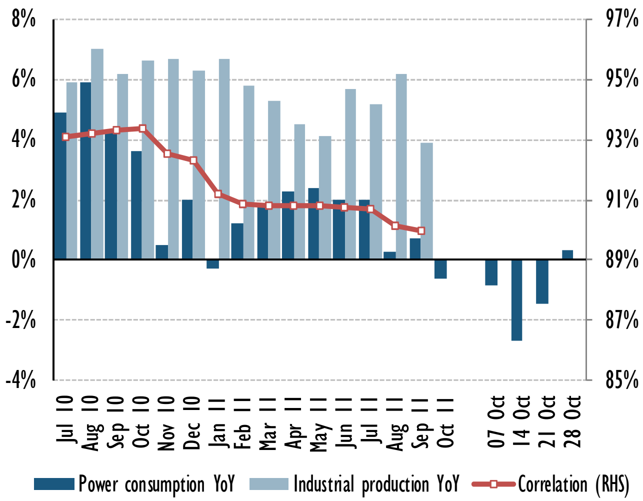
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

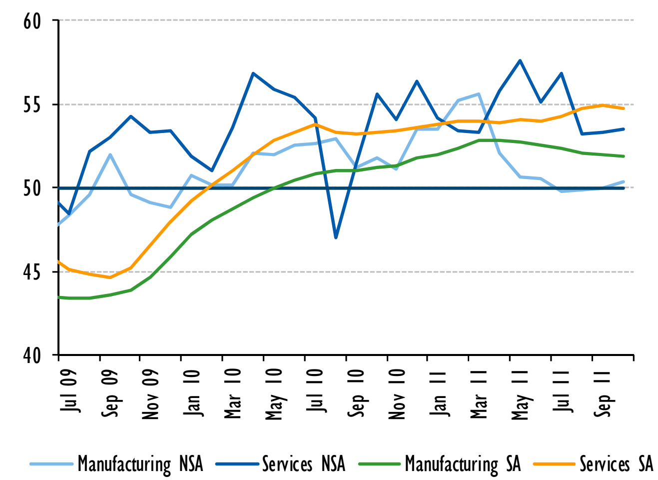
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

Current economic environment

Production and output

According to our calculations based on preliminary 3Q11 GDP estimates published by MED (+1.1% QoQ, SA data), output gap shrunk to zero, indicating that Russian economy has returned to its sustainable long-term trend. This implies that the economy is currently operating at its full capacity with limited potential for expansion without additional capex.

Furthermore, a deceleration of LT growth rates makes it harder to attain the pre-crisis levels of output: the current GDP is still 1.6% below its 2Q08 peak in real terms. Even if oil prices continue to increase throughout 2012, this will hardly be sufficient to support strong outlook for the economy as a whole. Notably, the average oil price that warrant balanced budget execution have increased substantially to above $125/bbl for the next few years.

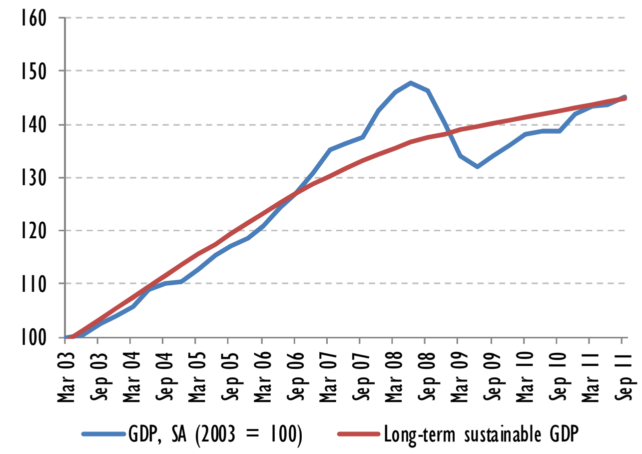
A considerable slowdown was observed in September across all major processing industries: overall production rose 3.7% YoY (slower than 6.2% a month before), which is consistent with a 0.3% decline MoM on a SA basis. Capex rose moderately in September (+1.8% MoM) while the YoY increase was 8.5%.

External sector

External trade surplus in September rose to $15.8 bln as a result of lower imports. The latter might have been affected by ruble depreciation in September (by almost 12%), although we assume that investment and consumption demand weakness due to the uncertainty of future economic prospects contributed to the dynamics to a larger degree.

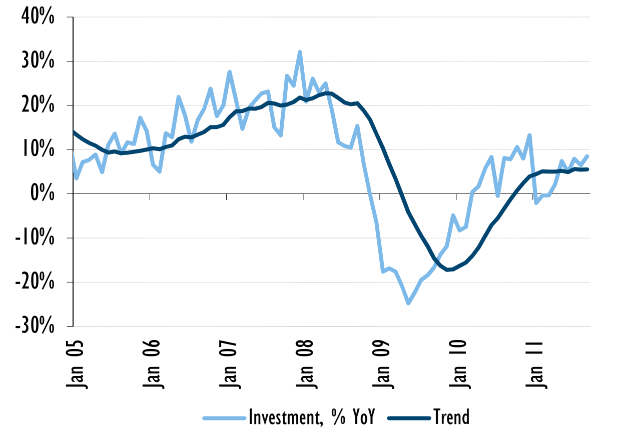
External pressure on ruble eased considerably in October as some progress towards resolution of the Greek debt problems was reached within the EU. Ruble appreciated 6.0% versus USD, and to a lesser extent - against the euro (+2.7%). Value of the CBR dual currency basket moved away from the upper border of the range, and became RUB 1.7 cheaper than in late September (4.3%).

Russian economy has reached full capacity level



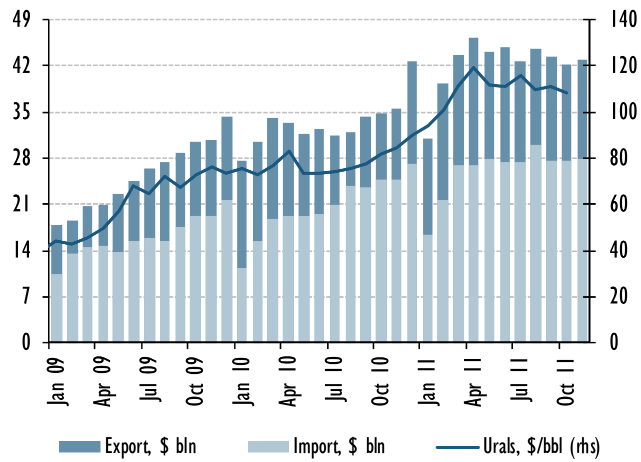
Source: Rosstat, MED, GPB calculations

Investment in working capital, % YoY: only slightly above trend



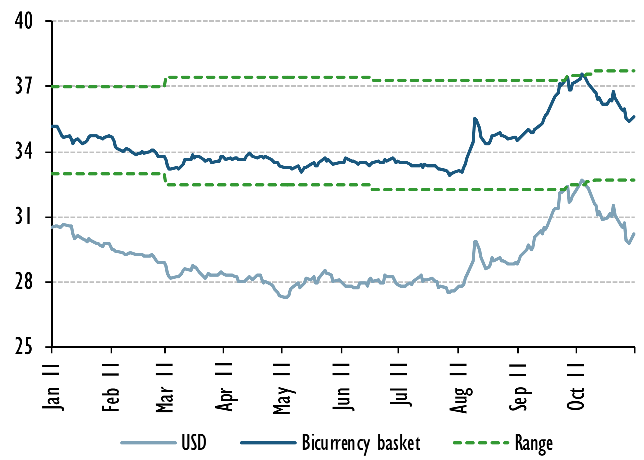
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble exchange rates



Source: Bloomberg, CBR

Exchange rate

Exchange rate volatility (as measured by the standard deviation of the dual-currency basket during the month divided by the mean value of the gauge) diminished slightly in October despite the large absolute changes in the currency values. Our index of Exchange Market Pressure (EMPR) for October was barely unchanged at 36 points after hitting the historical high of 86.8 (out of 100) in August. Net sales of currency by the CBR in October are estimated at $5 bln (33% lower than a month before).

The recent developments (including sale of foreign reserves by the CBR) prompted fine-tuning of the latest CBR forecast of net capital outflow for 2011. The regulator now anticipates capital flight to amount to $73.6 bln - up from the previous estimate of $70 bln and twice as much as was initially expected for the full year ($36 bln).

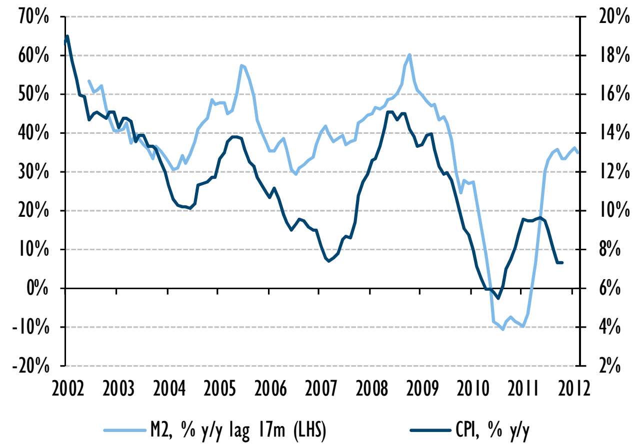
Consumption and price dynamics

Real disposable income in September demonstrated the strongest dynamics in almost a year, adding 3.2% YoY. Yet, YTD RDI is still below 9M10. This, however, did not prevent retail sales turnover from growing at an almost 2-digit pace: the indicator of consumer demand increased 9.2% YoY in September.

The unemployment rate decreased marginally in September, to 6.0%. The move, however, was entirely attributed to seasonal factors: after adjusting for them 6.6% of the labor force remain unemployed. The marginal propensity to save continued to decline in September, heading for historical lows. This was accompanied by further acceleration of consumer lending (+3.6% MoM), which indicates reasonable confidence among population.

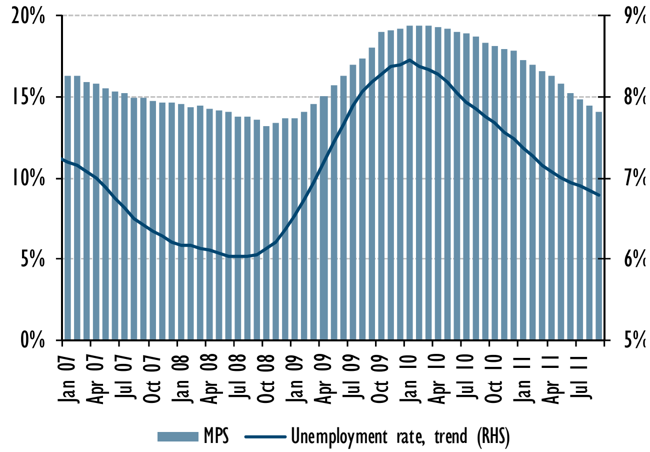
Consumer prices in October added 0.5% after zero growth in July and September and actual deflation in August (-0.2%). This indicates the end of seasonal influence from declining prices of agricultural products and the impact from ruble devaluation on prices of imported goods (which constitute a substantial share of consumer basket). YTD inflation remains well below the CBR target for the year (≤7.0%) and amounts to 5.3%.

Inflation and money supply dynamics: risks are evident



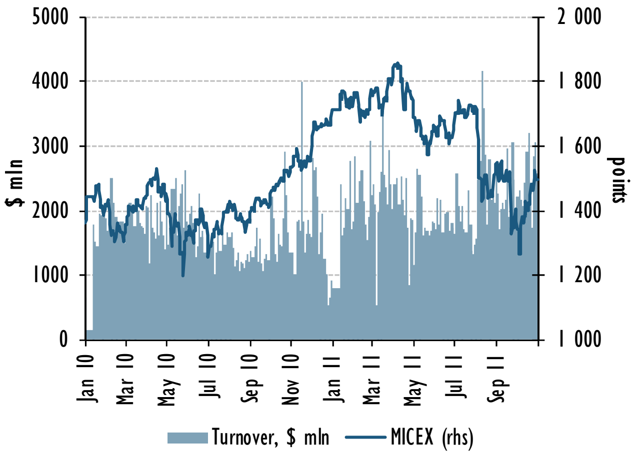
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



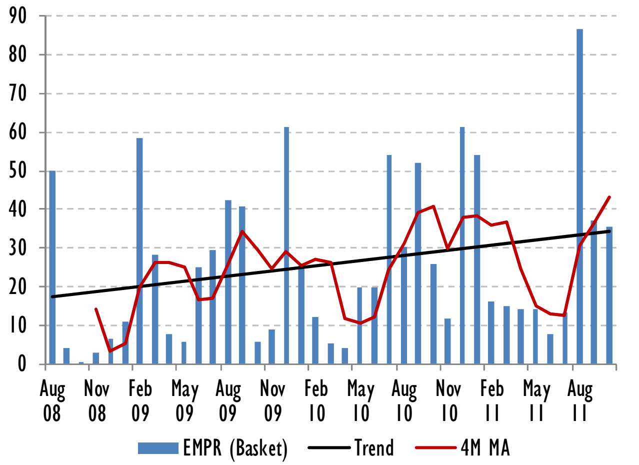
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Index of exchange rate 'freedom' (EMPR)



Source: CBR, GPB calculations

Appendices

1. Economic situation abroad

Europe: the major news-maker

European leaders were busy in October negotiating a new framework for dealing with the region's debt crisis. October 22-23 summit was followed by another one (October 26), where broad consensus on Greek debt restructuring and recapitalization of European banks was reached after 10 hours of debates.

However, we do not share the overwhelming optimism of market participants that followed the decision. First of all, no exact schedule or mechanism for restructuring has been announced. Second, the negotiated Tier 1 capital requirements of 9% of RWA after 50% write-off on Greek debt leave banks with more than 100 bln euro shortage of high-quality capital. Finally, the approaches to increasing the firepower of EFSF by funds raised from private sources do not eliminate the uncertainty of its effectiveness.

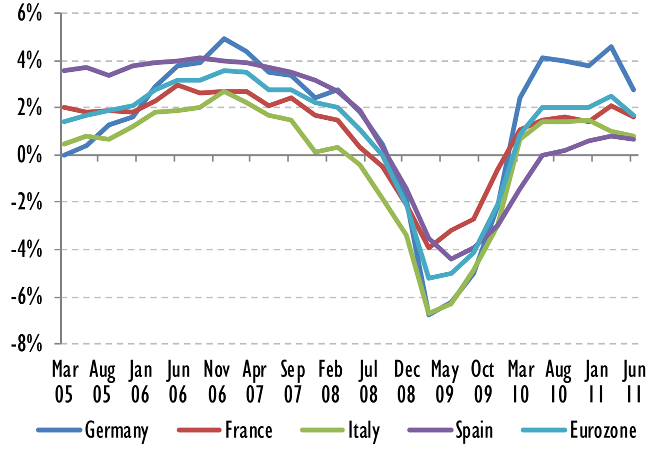
In addition to the above-mentioned drawbacks, Greek PM announced a referendum on the proposed terms of the new aid package. European leaders will try to persuade Papandreou during the G-20 summit in Cannes that rejection of the negotiated conditions is inconsistent with eurozone membership, and will suspend the disbursement of funds until the referendum results are published (referendum was later abandoned, and Greek PM agreed to step down and resign). Still, the high uncertainty will prevail in the markets.

US: not as bad as it seemed

US data in October eased fears of recession to some extent. GDP growth in 3Q11, according to preliminary estimates, amounted to 2.5% (annualized). At the same time, employment seems to improve a little (APD reported an increase in private payrolls of 110K), although this is still not enough to drive unemployment down.

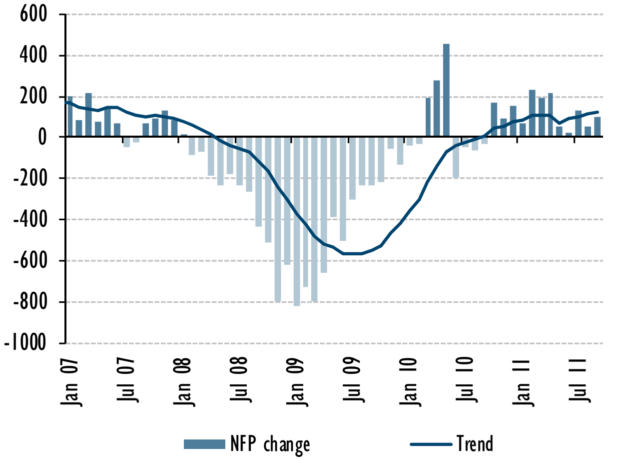
FRS in its November FOMC statement said that it is expecting moderate growth and stands ready to use available tools to promote a stronger economic recovery. Such a combination of relatively positive forecasts and commitments to expansionary monetary policy is a rare occurrence and was welcomed by the markets.

Key European economies: growth rates are tumbling



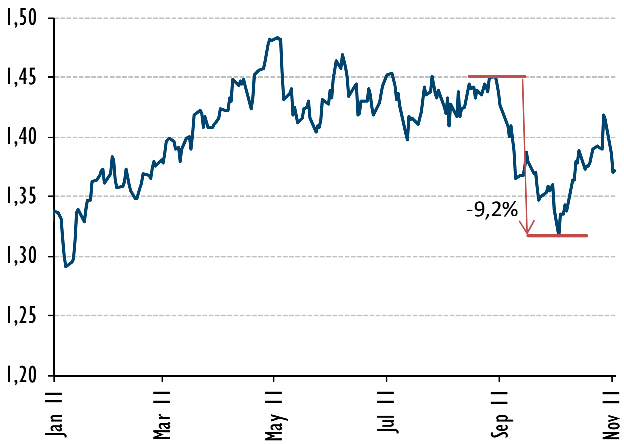
Source: Bloomberg

Change in non-farm payrolls, thousand



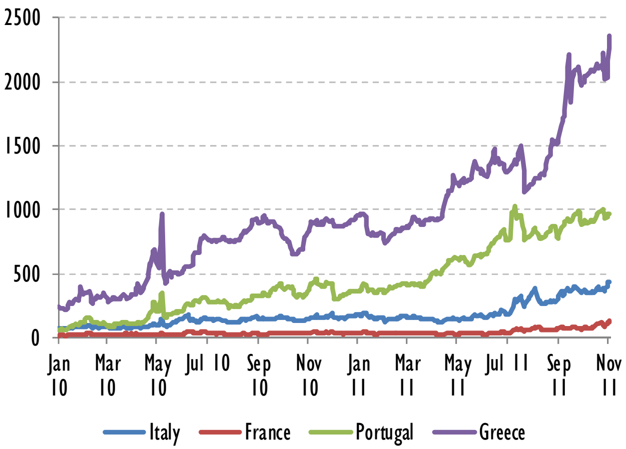
Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

European sovereign bond yield spreads dynamics (w.r.t. German Bunds of comparable maturity)



Source: Bloomberg, GPB calculations

2. Commodity markets

Fundamentals

China manufacturing activity slowed down in October: PMI dropped to 50.4 points, which is the lowest value since February 2009. Sentiment in the services industry also cooled a little bit last month, but still indicates a confident expansion (PMI value was at 57.7 points). Chinese imports ceased to grow in September, demonstrating a marginal decline of 0.3% MoM. Their value, however, is close to the all-time high of $155.6 bln, indicating no immediate threat to fundamental demand for commodities.

Increase in OPEC production in October (by 125K bbl/day, according to Bloomberg survey) as gains in Libya and Angola outpaced the Saudi cut also weighed on market prices as the demand outlook remained uncertain.

Oil prices were rather volatile in October: Brent traded in the wide range $100-115/bbl. However, dynamics was influenced primarily by the global uncertainly perceptions rather than fundamental factors.

Other determinants

Most of major currencies recovered their losses (at least to some extent) against USD in October. Dollar index fell 3.0% over the month, and euro rose in value by 3.5%.

Oil futures curve remains downward-sloping, indicating market expectations of a price decline over the next 8 months. However, the curve shifted up substantially in October - by $8.7-9.2, depending on the contract's maturity. Notably, a month ago market participants anticipated a drop below $100/bbl in the beginning of the next year, but they do not expect such a sharp correction anymore. We consider this to be a positive sign. Moreover, the slope of the curve remains rather flat, indicating no major shocks to the price level in the near future.

Metals and other indicators

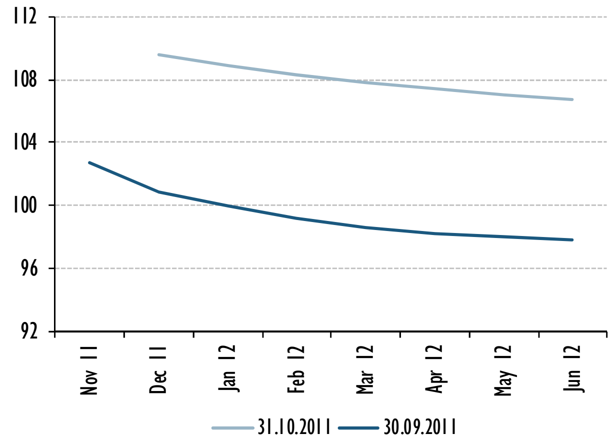
Base metals recovered part of September losses, adding 5.3% in the spot market while futures rose by almost 10%.

Gold has also increased in value despite a pick-up in the appetite for risk by mid-October. The metal gained 5.6% over the month.

Urals price dynamics, USD/bbl.

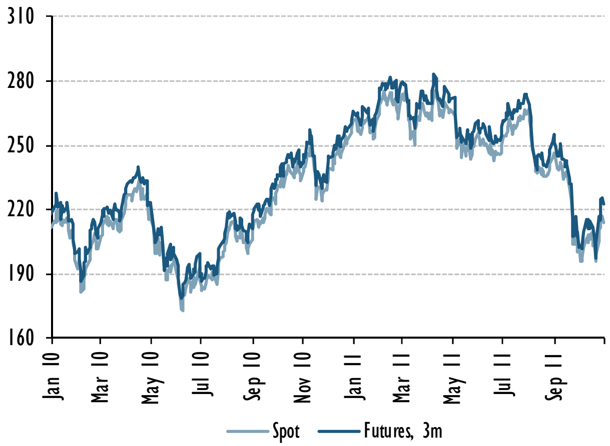
Source: Bloomberg

Brent futures, USD/bbl.



Source: Bloomberg

Base metal price indices, points



Source: Bloomberg

Baltic Dry Index (shipping rates), points

Source: Bloomberg

3. Money and fixed income markets

Money & FI markets abroad

Indicators of dollar liquidity soared in October: TED-spread widened to 44.5 bps, the level last observed in mid-2010, while 1-year interbank borrowing costs (LIBOR) climbed to 0.94% (+7 bps). A similar gauge for loans denominated in euros rose by only 4 bps to 2.08%.

Central banks continued to provide large volumes of funding, especially in Europe. ECB on October 6 promised to provide unlimited liquidity to banks in the eurozone. It also reestablished 12M loans, and pledged to buy covered bonds up to the amount of 40 bln euro. These measures are likely to prevent further deterioration of financing conditions, but may be insufficient in case of another spin of turmoil in Europe.

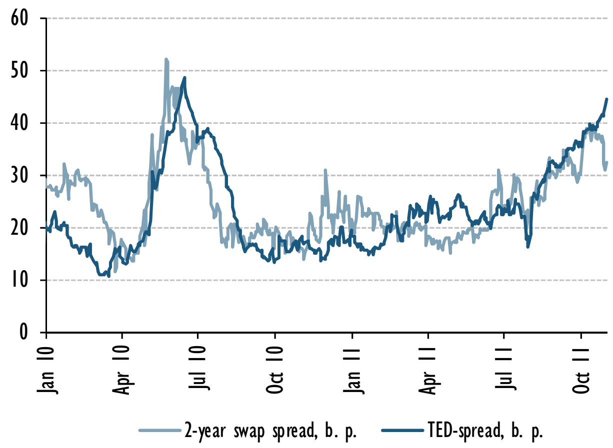
The yield of 10-year UST rose above 2.0% in October as investors seemed to be more willing to invest in risky assets. But the situation can easily reverse in the near future as the equilibrium in the markets remains fragile.

Russian money & FI markets

Russian banks became even more indebted to the regulators in October than they were in September. Net liquidity position sunk close to minus RUB 1.0 trln. Minfin pledged to auction sufficient amounts of budget funds to refinance the redemptions due in November, just as it did a month before. Moreover, the CBR increased limits on its REPO auctions to RUB 1.0 trln, standing ready to substitute any shortage of funds from Minfin. As a result, interbank rates remained somewhat upbeat, but did not rise beyond 5.5% (o/n lending to first-tier banks).

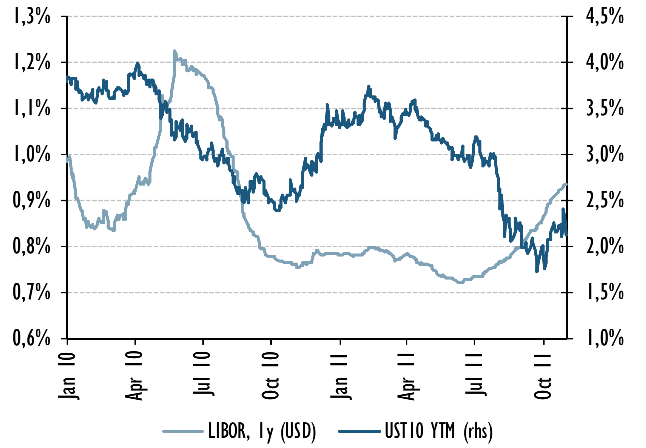
European leaders in October managed to inspire some confidence on investors, leading to a rebound in the global risk appetite. Russian eurobonds were among other asset classes that benefited from this: Russia 30 YTM fell 95 bps (to 4.31%), and UST drop contributed 29 bps more to narrowing of the spread between the two (by the end of the month, the yield differential stood at 210 bps). This was accompanied by a substantial decline in the price of insurance against Russia's sovereign default: 5Y CDS spread shrunk 110 bps to below 200 bps.

Key MM spreads, bps



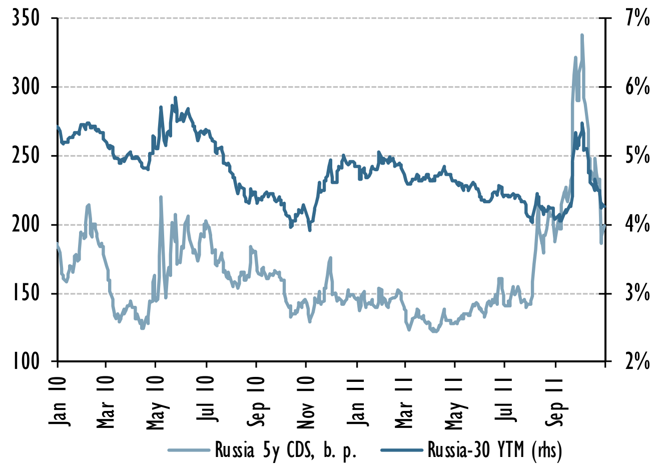
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



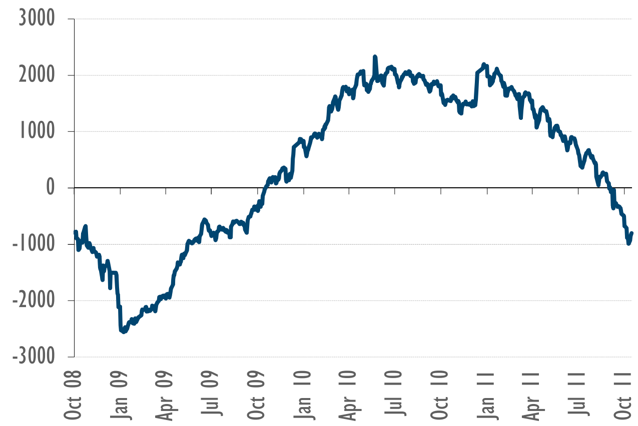
Source: Bloomberg

Russia credit quality indicators



Source: Bloomberg

Russian banks' net liquid position (NLP*), RUB bln



* NLP = (Corr. accounts + Deposits with the CBR + Holdings of OBR) – (Total liabilities before CBR and MinFin)

Source: CBR, Gazprombank calculations

4. Stock markets

Investors took their revanche on global stock markets in October as easing tensions in the eurozone allowed them to resume purchases of risky assets. Depressed valuations have been providing lucrative opportunities, but risk aversion remained too high throughout August and September to allow the upside to be realized.

Although the consensus on new Greece aid package and recapitalization of European banks was reached only in the last decade of the month, stocks began to climb a few weeks in advance. US exchange-traded companies received additional support from 3Q11 financial results that beat EPS estimates by an average of 5.8%.

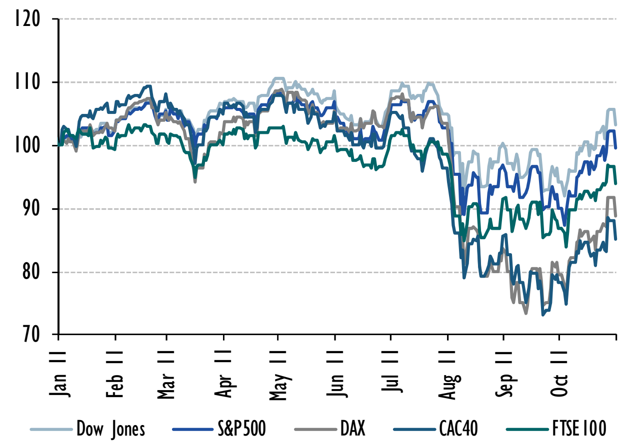
The implied volatility in the markets subsided gradually towards the end of the month, as indicated by the VIX index in the US and VSTOXX index in Europe. However, most of the indicators point at fragile appetite for risk (although there has been a temporary decline in demand for UST after the EU summit, 10-year treasury yields remain at levels close to 2.0%).

Capitalization of bank shares in the US increased by 9.4% (broadly in line with the market : S&P 500 index added 10.8% in October). However, the fact that one of the largest brokers in the US (MF Global Holdings) filed for bankruptcy in the last day of the month has not yet been fully incorporated into market sentiment. As a result, financial stocks may underperform in November. European banks added only 5.9% as investors tried to reconcile the negotiated 50% write-off of Greek debt with the sector's profitability and capital adequacy.

According to S&P/IFCI dynamics, Russian stock market outperformed most of its EM peers in October, adding ca. 17% (dollar-adjusted return). This compares to an average yield of 12.8% among the 21 developing countries for which the investable indices are calculated. Two of the other three B(R)IC countries - Brazil and China - performed almost equally well (indices rose 18.4% and 16.8% respectively), while India was in the lowest quartile of the distribution (+7.1%).

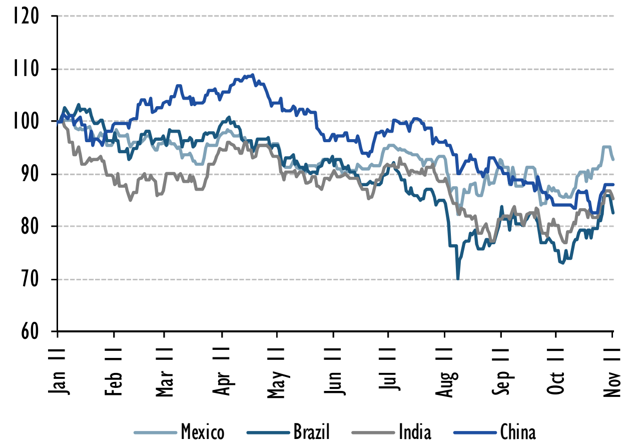
RTS index added 16.8% in October while MICEX only rose by 9.7%, stopping short of the 1,500 point threshold. The discrepancy between the two benchmarks resulted from significant revaluation of ruble versus USD (+6.0%).

DM stock markets dynamics, January 2010=100



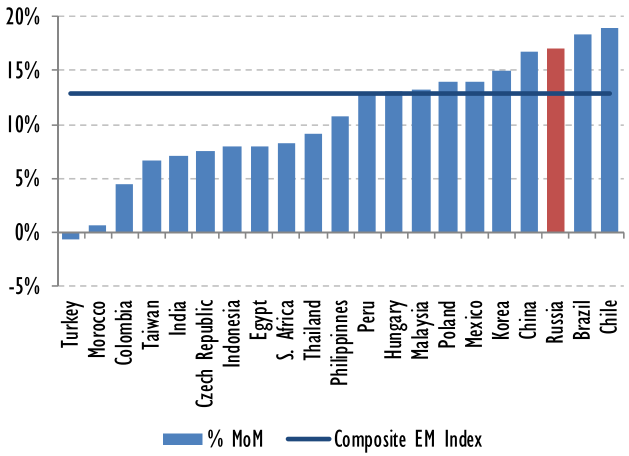
Source: Bloomberg

EM stock markets dynamics, January 2010=100



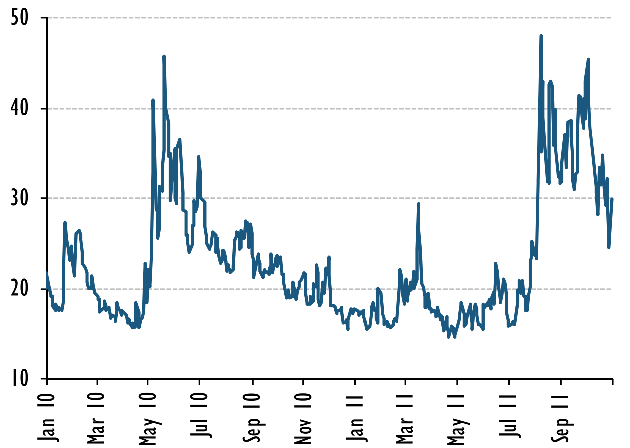
Source: Bloomberg, Gazprombank estimates

EM dynamics comparison (October)



Source: S&P/IFCI

VIX (implied volatility index)



Source: Bloomberg

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