

April: all hopes on the second quarter



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▶ 1Q10 results: a disappointment

Despite higher than expected oil prices in the first quarter, followed by upward revisions of Russian GDP growth forecasts by a number of observers (including World Bank), we are reluctant to review our outlook for 2011. Our major concern comes from a slack in investment activity (capex in January-February decreased by 2.3%) and a decline in disposable incomes (by 3.4% in the first two months of the year). At the same time, above-the-forecast inflation rates leave the regulator with limited tool choice to address the problem of sluggish economic activity.

▶ 2Q11: now or never

High oil prices observed since the beginning of the year are likely to provide a positive contribution to short-term growth rates. The 'flip side' of this coin might be a slowdown in non-O&G sectors because of limited incentives to increase productivity and efficiency. Furthermore, sustaining observed growth rates in the real sector will become even more challenging in the 2Q, as the low base effect will cease to affect statistics. Among other risks, we note the persistent uncertainty over consumer demand recovery, as well as ruble appreciation both in nominal and in real terms, which makes imported goods more attractive, hurting competitiveness of Russian manufacturing products.

Leading indicators have so far provided a mixed impression. Although the sentiment in both manufacturing and services sectors remain positive, equilibrium conditions in the market for borrowed funds have so far implied restrained demand for credit. However, we expect investments to return on the upward trend as output growth increases capacity utilization.

▶ ST forecasts:

Basing our view on the current and prospective trends, we expect the following developments in the near future:

- ◆ **Real sector and prices.** We expect manufacturing to grow at an average monthly pace of 4.5–5.5% YoY throughout 2Q11, although the risks that might impede such prospects are still acute. Retail sales dynamics is likely to remain positive (+2.5% YoY), although constrained by further decline in RDI, affected by high inflation rates. We expect the price level to increase by 0.5% MoM in April (implying the annualized figure of 9.8%); a further slowdown is unlikely due to reluctance of the CBR to hike rates. Despite the fact that April is traditionally a weak month for investments, the last year's low base might ensure a small positive figure for the indicator (+2.5% YoY).
- ◆ **External sector and exchange rates.** We share a positive view on the near-term commodity price levels, supported by the geopolitical instability in the Middle East and North Africa. Under our base-case scenario, Urals price will average at \$110/bbl, and we anticipate trade balance to be \$16.5 bln in April. Although we observe that exchange rate policy remains the priority for the CBR, we believe that further tightening is inevitable, and thus RUB is likely to appreciate further. Our ST targets are 28.0 for RUB/USD and 33.3 RUB for CBR's dual currency basket.

Key indicators: April forecast

Indicator	April 2011F	2011F	
		MED*	GPB Research
Real sector			
GDP, YoY	—	4.2%	3.9%
Industrial production, YoY	5.0%	4.1%	3.5%
Capital investments, YoY	2.3%	9.0%	8.8%
Retail sales, YoY	2.5%	4.8%	4.3%
Private sector			
Real income, YoY	-0.5%	3.3%	4.4%
Accrued salary, RUB	—	23,490	23,697
Foreign economy			
Trade balance, \$ bln	16.5	128.1	142.0
Average oil price (Urals), \$/bbl.	110	81	94
Stock market			
RTS, points	2050–2100	—	2,200
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	9.8%	7.0–8.0%	8.0%
Refinancing rate	8.25%	—	—
Dual currency basket, RUB (avg.)	33.3	35.53	33.72
Exchange rate, RUB/USD (avg.)	28.2	31.3	28.61

— no forecast available;

* latest available forecast

Source: MED, Gazprombank estimates

Leading indicators

▶ Money and credit

Narrow monetary base (including cash in circulation and required reserve balances at the CBR) added 14% in March, reaching RUB 5.77 trln. However, evidence on credit activity remains mixed. Banks' loan portfolio continued to increase in February and March, but at a slower pace than the stock of money (as indicated by the money multiplier, whose value declined in March).

We believe that higher RRR imposed by the CBR (4.0–5.5%, effective April 1) are unlikely to become a restrictive factor for lending activity: an estimated drain of ca. 40 RUB bln will hardly affect the total liquidity stock, now at above 1.1 RUB trln. The demand for loans, however, is likely to remain weak unless investment activity will show signs of a rebound.

▶ Energy consumption

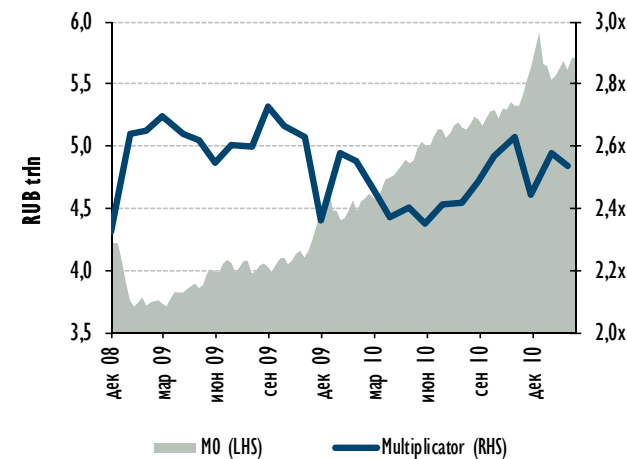
Although there has been a certain discrepancy between energy consumption and industrial output growth rates in 2010, we believe that a hike in power usage in March might indicate some acceleration of manufacturing activity, although weather conditions might've affected the numbers, as well.

▶ Economic activity

Manufacturing activity throughout the first two months of the year remained strong: sector PMI, according to HSBC estimates, rose to 55.2 – the maximum value since January 2008. Yet, the actual production growth has decelerated over the same period (from 6.7% YoY in January to 5.8% in February). Although we believe that a fading low base effect has contributed to such dynamics, its influence didn't vary much over these two months.

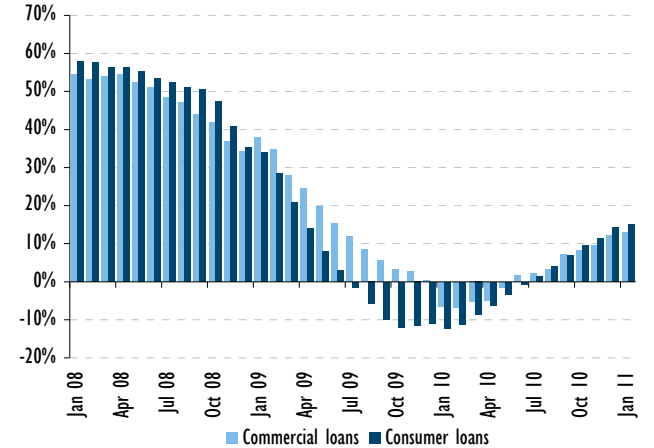
Sentiment in the services sector, however, continued to worsen. Although February PMI is still above 50 (implying that optimism still prevails), a second consecutive decline might imply a shift in expectations.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

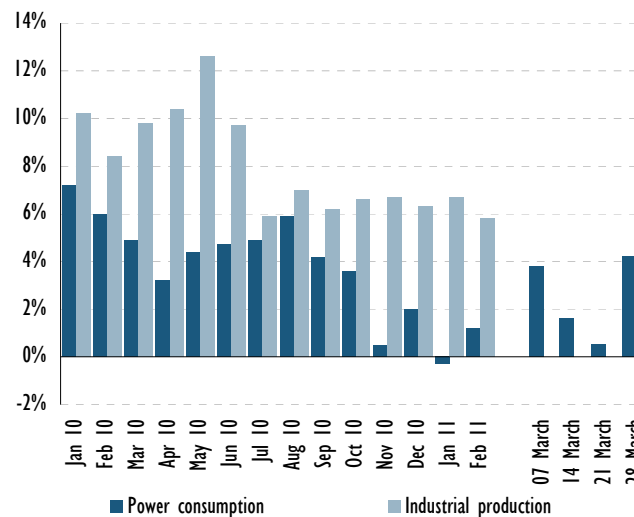
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

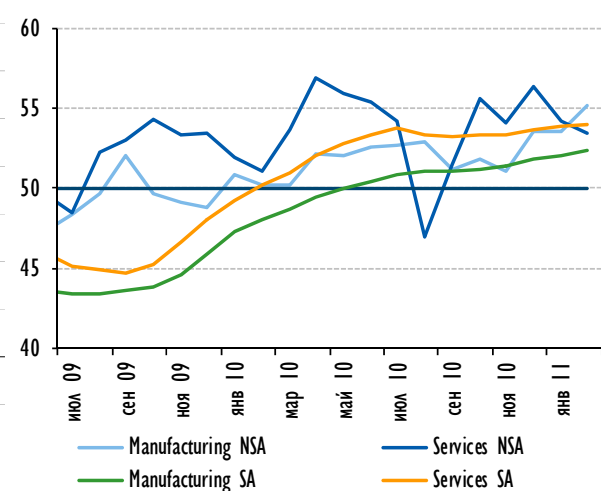
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

Current economic environment

- ▶ **Industrial production** showed a modest slowdown in February (to 5.8% YoY from 6.7% YoY in January). Although manufacturing remains the key contributor to the overall dynamics of industrial production (+10.2% YoY), seasonally adjusted figures actually demonstrated a decline by 0.4% MoM in February and a stall in the general IP index.

However, GDP added 0.2% in February, according to MED estimates, after a 0.3% decline in January. The drivers for such dynamics, however, remain obscure.

- ▶ **Investment in productive capacity** fell 2.3% over the first two months of 2011, as compared to the same period of 2010, despite the low base effect. After seasonal adjustment, the data showed only a modest rebound in February (+1.7% MoM) after hitting the lowest levels since mid-2009 in January. Given that capex was supposed to become one of the key drivers of economic recovery in 2011, such dynamics looks worrisome.

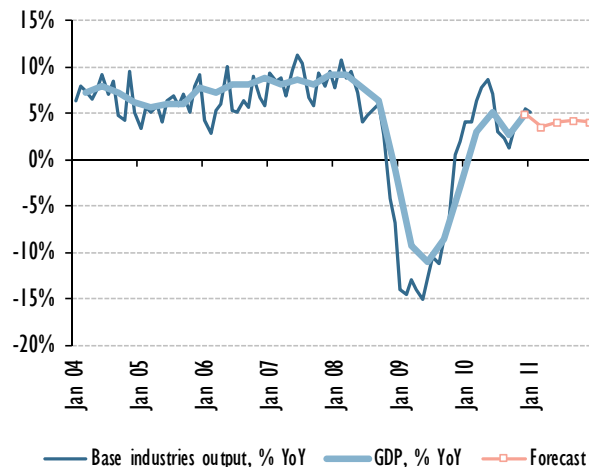
- ▶ **External sector and exchange rates**

The CBR policy and official reserve dynamics indicate that net inflows of external trade revenue continue to outweigh capital flight from Russia, providing the reasons for ruble appreciation and intensified interventions in the FOREX.

According to MED estimates, the trade balance YTD totaled \$34.4 bln, while the net outflow of capital over the same period only offset \$17 bln. The CBR interventions, according to preliminary estimates, reached ca. \$9.2 bln in February-March (although a change in official reserve balances suggests a somewhat smaller figure).

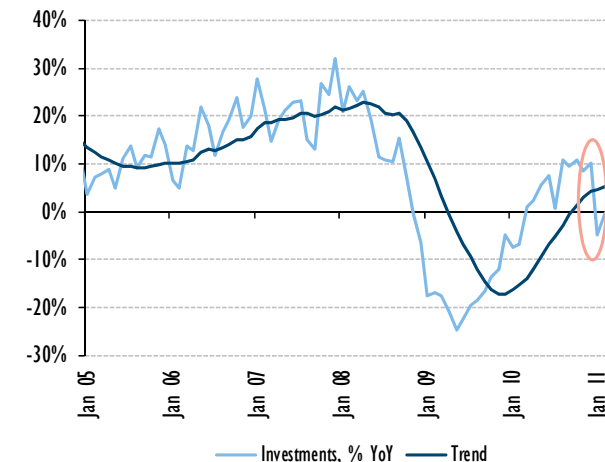
Moreover, the CBR widened the range of admissible dual currency fluctuations to RUB 5.0, effective March 1: we estimate the new borders to be 32.45–37.45 RUB/basket. The exchange rate versus USD reached a local bottom at 28.1105 on March 4. We believe that if the CBR limits the resistance to further appreciation, ruble may fall below 28 vs. USD during the coming weeks.

Base industries output vs. Russia's GDP in 2004–2011F



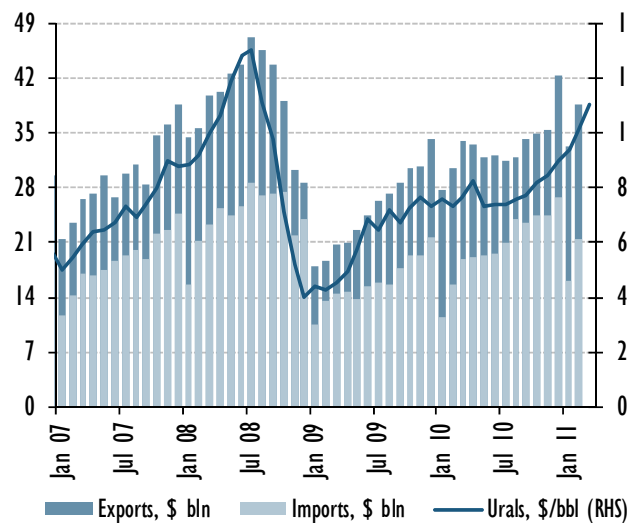
Source: Rosstat

Investment in working capital, % YoY



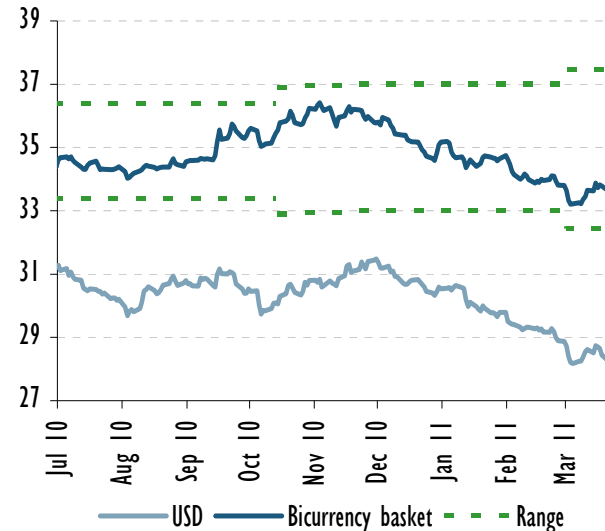
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble rate curves



Source: Bloomberg, CBR

▶ **Consumer confidence**

Factors affecting consumer confidence indicate a negative sentiment. RDI, which is one of the key determinants of consumer demand, continued to decline in February, contributing to the total 3.4% YoY fall over the first two months of the year. Furthermore, unemployment rate still remains above the year-end figure of 7.2%, despite a small decline from its January peak. The latter, however, could partially be attributed to seasonal factors.

Meanwhile, marginal propensity to save continued to decline, indicating a greater willingness of the population to spend. Yet, we believe that without a further decline in unemployment, the marginal propensity to spend will be constrained by the depletion of incomes as a result of high inflation.

▶ **Inflation**

Inflation risks continue to pose threats to long-term sustainable growth. According to the latest data available, prices increased 3.6% YTD, fulfilling more than 50% of the CBR forecast for 2011. Although the core inflation lags behind, contributing only 56% to total growth in prices, monetary factors retain a high degree of influence over them (M2 has grown at a monthly pace exceeding 30% YoY since mid-2010).

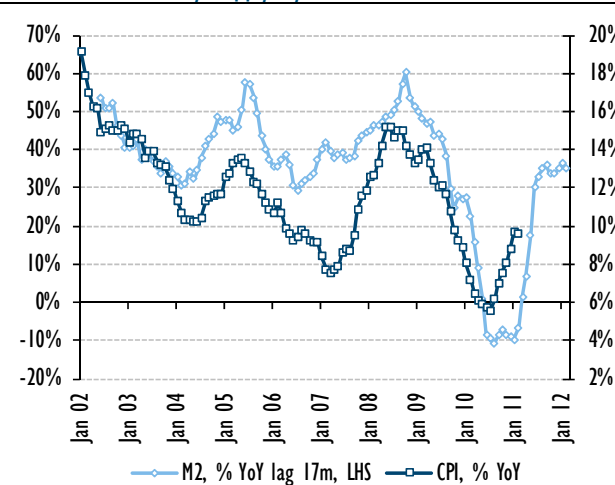
Even more surprising was the latest CBR decision to leave key interest rates intact. Given the current inflation levels, borrowing costs should be at least 2 pps higher than now.

▶ **Capital markets**

The “soft patch” at the global markets constrained demand for Russian assets, limiting rise in stocks by 1.8% MTD for MICEX and by 3.0% for RTS. The difference in growth may be attributed to ruble appreciation.

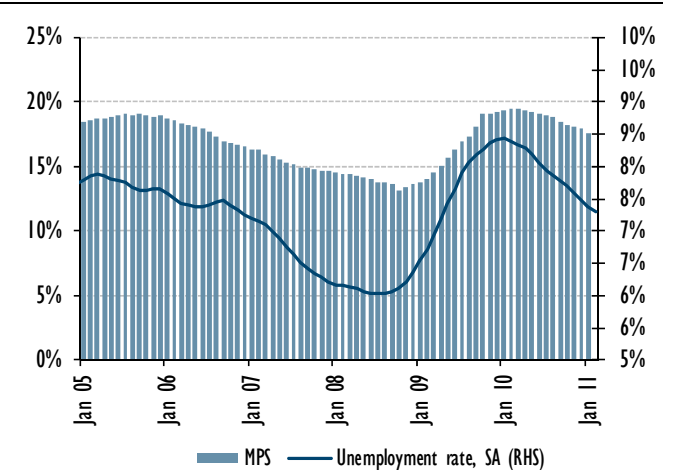
Although high oil prices are likely to result in smaller budget deficit, Minfin continues to borrow in the market by issuing long-term OFZ (March issues totaled RUB 91.7 bln). Demand for this debt is likely to increase due to the CBR’s reluctance to lift rates, and Minfin might take advantage of this by extending the supply of OFZ.

Inflation and money supply dynamics: risks are evident



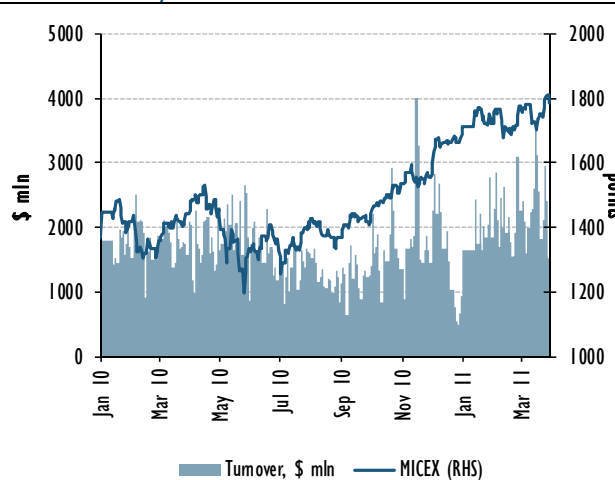
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



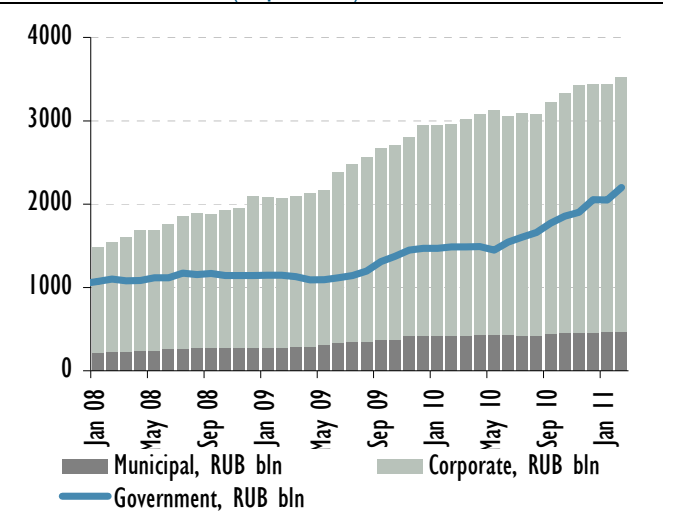
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

▶ USA

US CPI added 2.1% YoY in February, for the first time in 9 month topping the Fed target inflation rate. However, although some FOMC members are already advocating monetary tightening, we believe it to be a distant prospect.

First of all, the key contribution to the total CPI comes from food and fuel prices, while core inflation remains subdued (1.1% YoY). Second, macroeconomic data still supply mixed evidence on business activity. Labor market statistics looks encouraging, with payrolls adding more than 200K in March (according to ADP estimates), while housing sector remains depressed.

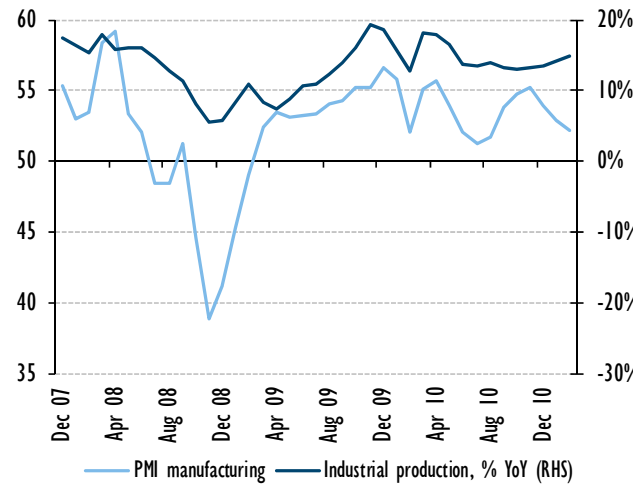
▶ Europe

The results of the latest EU summit were a big disappointment to the market. European leaders failed to produce a detailed framework for the permanent rescue mechanism, as well as for pan-European stress tests of the banking sector. As a result, the effective lending capacity of the existing EFSF remained intact.

At the same time, the situation in peripheral European states deteriorated further. Rating agencies continued to downgrade Greece, Spain and Portugal: the latter's sovereign rating was cut by S&P twice in a week – by the total of 3 notches. Portugal has to redeem ca. 9 bln euro of debt until the end of June, having no more than 5 EUR bln in cash. Given the high costs of borrowing in the market, the chances of Portugal to apply for financial aid grew substantially.

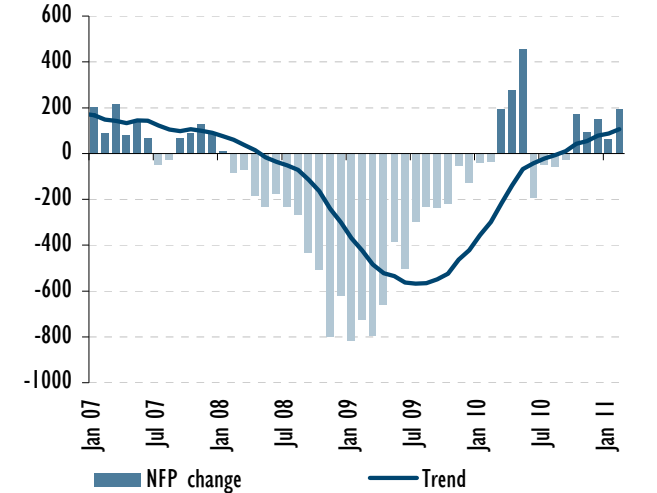
The European currency, however, continued to strengthen on the speculation that ECB might begin to raise rates to fight inflation. We believe that the European currency is highly overvalued, given the debt problems in the regions, and monetary tightening will inevitably increase the burden on EFSF. Moreover, the effectiveness of contractionary policy, in our view, is limited due to mostly non-monetary nature of inflation in the eurozone.

China's manufacturing indicators



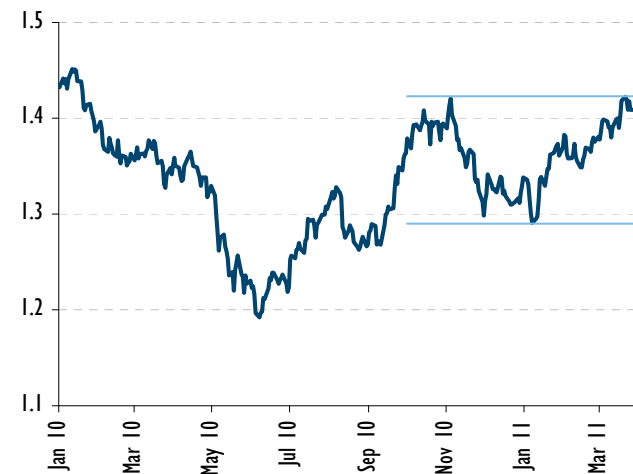
Source: Bloomberg

Change in non-farm payrolls, thousand



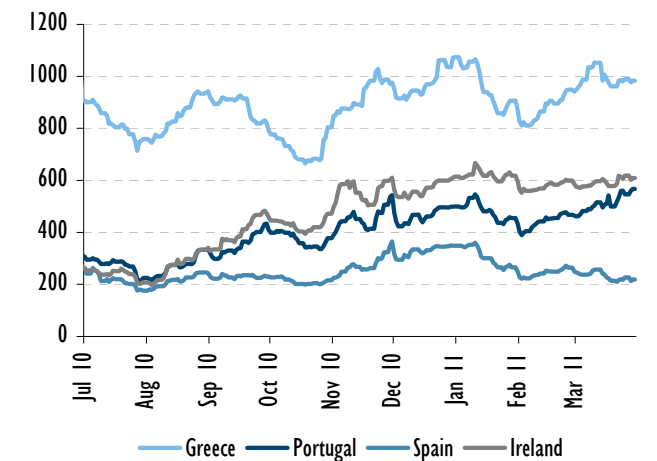
Source: Bloomberg, Gazprombank estimates

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics (eurozone)



Source: Bloomberg

2. Commodity markets

▶ Oil

World oil markets in March were dominated by fears of irregular supplies from North Africa and the Middle East as geopolitical turmoil is spreading through the region. As a result, Brent traded in the range of \$105–115/bbl. Continuing increase in crude oil stockpiles in the US was unable to halt growth of prices for WTI: futures with May delivery added 6.5% in March, although the discount to the European oil remained close to historical high (\$14.5).

However, the surge in spot prices forces market players to review their expectations of future dynamics. The futures curve became inverted, although the general levels perceived by analysts are still above the values observed a month ago.

▶ Metals

Metal prices rebound in March after falling on negative trade balance statistics in China (there was an external trade deficit of \$7.3 bln in February, which was partially attributed to a halt in the economic activity due to Chinese New Year celebration). Notably, China manufacturing PMI is expected to increase to 52.4 in March, indicating acceleration in economic activity.

The earthquake in Japan caused considerable damage to the country's infrastructure, spurring expectations of potential rise in demand for construction materials. Base metal prices increased by 6.0% after reaching a local bottom on the 15th of March.

Gold slid until mid-March, but then reversed its direction as the general risk aversion strengthened. Spot price reached \$1427.8/OZ (+1.1% MTD).

▶ General indicators

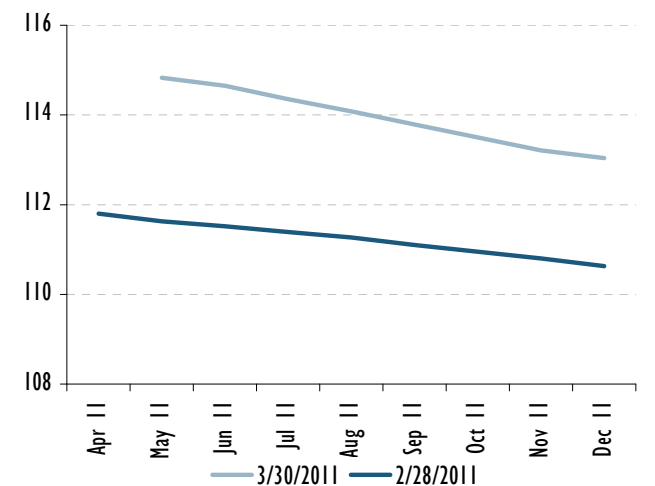
Japan's reconstruction may boost volumes for dry-bulk shipping lines which currently struggle with overcapacity. Baltic Dry index has increased by 25% MTD.

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

According to Head of FRB of St.-Louis James Bullard, the US economy demonstrates sufficient evidence of recovery, which might become a base for a downward revision of QE-II targets. However, Mr. Bullard is not a voting member of the FOMC this year, and this opinion is not shared by other members of the committee, so we believe that FRS will take no immediate action to cut potential volume of UST purchases at the meeting on 26-27 April.

Moreover, even if the Fed decides to halt purchases, this does not imply a switch to contractionary policy: markets remain abundant with liquidity, and potential base rate hikes are not expected to occur in the next 12 months (according to interest rate futures dynamics, the probability of Fed rate increase to at least 50 bps over this period is less than 50%).

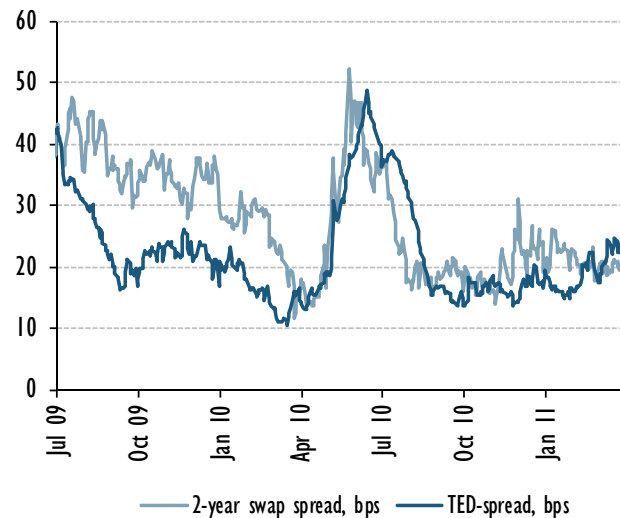
MM rates in the US remain low (3M LIBOR exceeds the Fed rate by 5–6 bps, 1Y rates are stable at below 0.8%), while the key spreads fluctuate within a narrow range (TED-spread: 17–25 bps; 2-year swap spread: 17–21 bps).

▶ Russian money market

The Russian money market continues to enjoy high levels of liquidity. Despite the CBR's decision to raise the required reserve requirements (RRR) by 50 bps since the beginning of March, the estimated outflow was more than compensated by Minfin depository auctions. As a result, the total amount of liquid assets accumulated on the banks' balance sheets remained above RUB 1.2 trln throughout the month (except for a few days, when tax payments drained some part of these accounts).

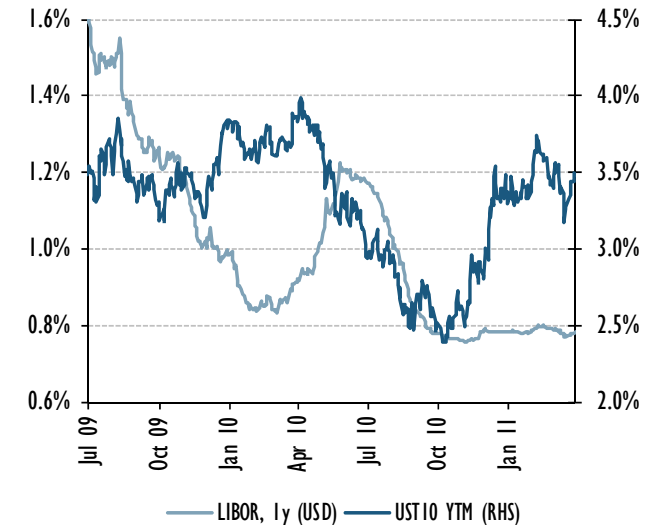
The interbank rates generally remained close to the yields on CBR deposits: Tier 1 banks were able to borrow o/n at 2.5–3.1%. Given the loose policy adopted by Minfin, CBR attempts to drain some liquidity from the market would be futile and interest rates will therefore stay unaffected.

Key MM spreads



Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



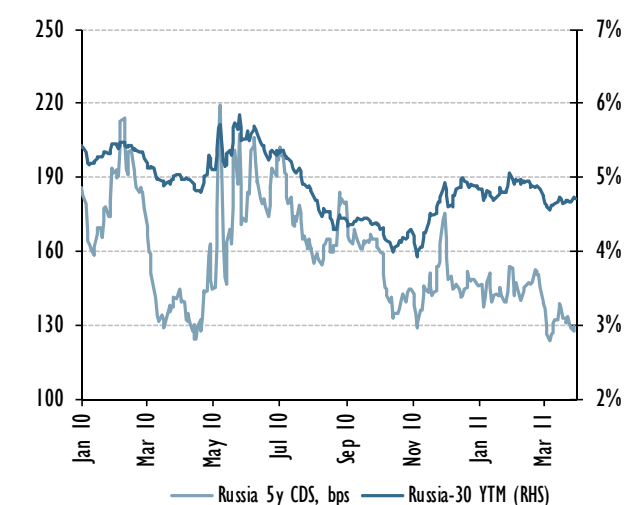
Source: Bloomberg

EMBI+ spread



Source: Reuters

Indicators of credit quality of Russia's sovereign debt



Source: Bloomberg

4. Stock markets

▶ Developed markets

Natural disasters in Japan resulted in a sharp fall of local indices. However, the drop was relatively modest, given the scale of disruption caused by the earthquake and tsunami, as well as by the crisis at the nuclear plant 'Fukushima-1'. Nikkei 225 lost 16% in three days following the events of March 11, but then rebounded to 9750 points.

The reaction of other stock markets worldwide was limited. However, the volatility has increased sharply in response: VIX index reached a local maximum at 29.4 points on the 16th of March, but then the fears faded away and the indicator returned to the levels below 20 points, but in general remained above its pre-crisis levels.

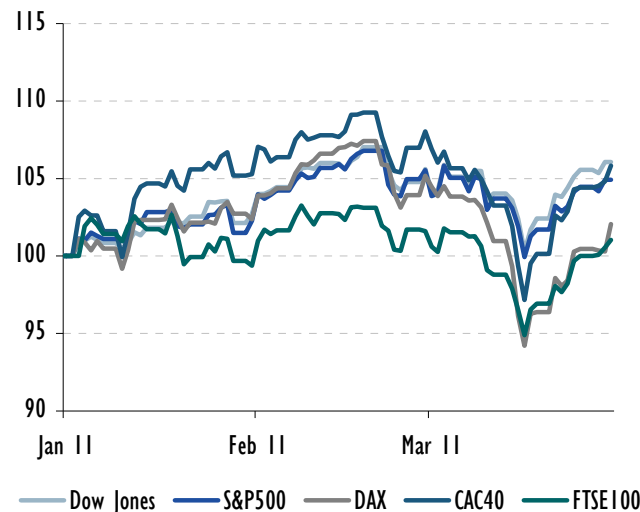
Most of the key indices in developed countries fell in March (losing 0.5–3.0%), affected by persistent uncertainties over the European debt resolution. Financial stocks underperformed the market in March, falling 2.4% and 6.9% in the US and Europe, respectively. Stress-test results of European banks are to be released in June, and until then the outlook of the sector is expected to remain gloomy.

▶ Developing markets

The cumulative inflow into Russia-dedicated equity funds in March totaled \$718 mln. When compared to the outflow of \$1.7 bln from GEM funds, Russia must have retained its position in the world's best-performing markets. Yet, at the end of March Russia only ranked number 16 among the world primary indices.

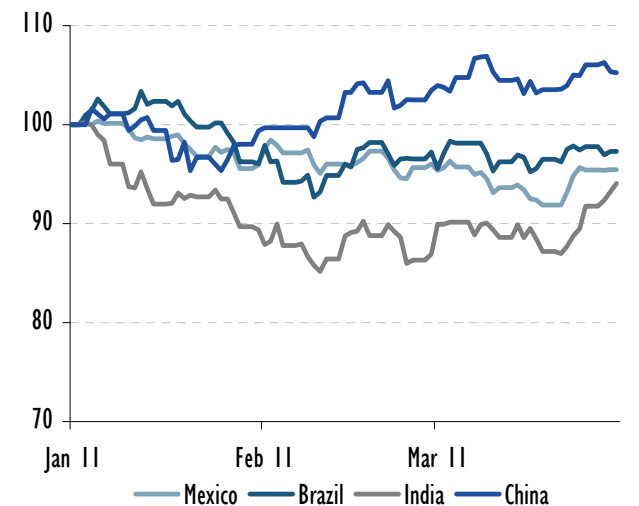
Oil price dynamics will continue to support demand for Russian stocks, while other sectors might underperform. In general, evidence of the degree of risk-aversion in financial markets remains mixed: CDS spreads on European sovereigns continued to widen, while the yields on 10-year UST are close to their local maximum at 3.5%.

DM stock markets dynamics, January 2010=100



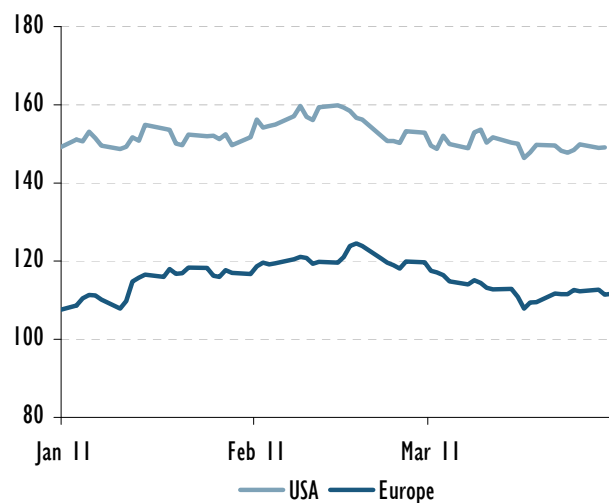
Source: Bloomberg

EM stock markets dynamics, January 2010=100



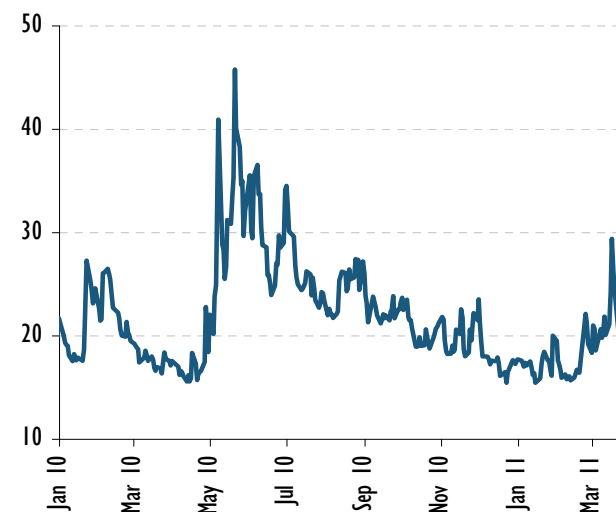
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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