

September: the last chance to make a difference



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▶ Is the worst over yet?

Russian markets plunged in August following suit of their foreign peers amid the sell-off of risky assets in the environment of high uncertainty over the future of world economy. The consequences for the real sector, presumably, were less dramatic, but growth indicators were unimpressive nonetheless. The weak 1H11 GDP dynamics prompted MED to downgrade its full-year forecast, albeit slightly, and even so drivers for acceleration of economic activity in the 2H11 are not evident, especially given the sluggish July figures.

Russian economy continued to operate close to its full capacity level, and capex picked up only slightly in July, leaving the longer-term trend flat. That, along with the weakening oil prices' growth potential and tumbling producer confidence, poses the risks of dull GDP dynamics throughout the rest of the year. Inflation slowdown should be distinguished among positive developments, contributing to resumption of RDI growth, but price dynamics is mostly attributed to seasonal and technical (i. e., high base effect) factors.

Overall we see a shift from inflationary to slowdown risks, which, together with tightening of ruble liquidity might induce the CBR to ease its monetary policy, especially as the regulator is no longer constrained by the need to counter ruble appreciation (due to a change in exchange rate trend). However, we do not anticipate any major changes in the key interest rates until the end of the year – the decision will likely be postponed until early 2012.

▶ ST forecasts:

- **External sector and exchange rates.** We believe that oil prices will fluctuate around \$110/bbl (Urals) as the uncertainty about the global economy growth remains. At the end of September, commodities might derive some support from the Fed if the latter agrees on additional stimulus package, but at the moment we do not consider this scenario as a base case. Ruble is unlikely to drop much further, although the Russian currency is expected to remain under pressure from high risk aversion and narrowing trade surplus (which we anticipate at some \$15 bln in September). Ruble, in our view, will average at 28.9 vs. USD, and the value of the dual-currency basket is likely to fluctuate within RUB 34-35 range.

- **Real sector and price level.** We expect seasonal factors to further contribute to inflation slowdown. Even if prices in September remain stable, YoY inflation is likely to decelerate to 7.3-7.5% by the end of the month. The extension of the trend throughout the year would, however, indicate weakening demand. In the ST, we expect RDI to rebound further (by 4.0–4.5% YoY), adding to strong performance of retail sales, although unnaturally high seasonal unemployment rate may limit improvement in consumer confidence. Retail sales will, presumably, add 6.5% YoY in September.

Capex remains the key variable that is likely to determine the MT and LT trend of the Russian economy. Potential fiscal and/or monetary easing in the early 2012 may boost demand in the ST, but the impulse is unlikely to be sustainable in the LT if it is not backed by capex. Yet, uncertainty over future demand (as indicated by stagnating new orders in manufacturing) may limit capex growth by 2.5% YoY. Industrial production may demonstrate an increment of 3.5–4.0% YoY in September.

Key indicators: September forecast

Indicator	September 2011 F	MED*	2011 F GPB Research
Real sector			
GDP, YoY	–	4.1%	3.9%
Industrial production, YoY	3.5%	4.8%	3.5%
Capital investments, YoY	2.5%	6.0%	6.8%
Retail sales, YoY	6.5%	5.3%	4.3%
Private sector			
Real income, YoY	4.5%	1.5%	4.4%
Accrued salary, RUB	–	23,940	23,784
External sector			
Trade balance, \$ bln	15	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%	8.5%
Refinancing rate, eop	8.25%	–	–
Bicurrency basket, RUB (avg.)	34.5	33.38	32.72
Exchange rate, RUB/USD (avg.)	28.9	28.6	27.5

– no forecast available;

* latest available forecast

Source: MED, Gazprombank estimates

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Leading indicators

▶ Money and credit

Lending picked up in July, with credits to nonfinancial sector adding 1.6% MoM and consumer loans extending by 3.7% MoM. The trend remains positive, and, given the high and rising monetary base (+2.2% MoM) and a record-setting value of the money multiplier (at 2.92x in July), is likely to persist.

However, the remaining uncertainty about the pace of consumption recovery may limit demand for commercial loans, while tightening liquidity conditions may impose some constraints on bank's activity in issuing new loans.

▶ Energy consumption

Electricity consumption was almost flat in August, adding a modest 0.4% YoY. Still, as weather conditions over the last month of the summer were not as extreme as a year ago, there is some scope for industrial production growth. However, the last years' high base effect might drive YoY growth rates below 5.0%.

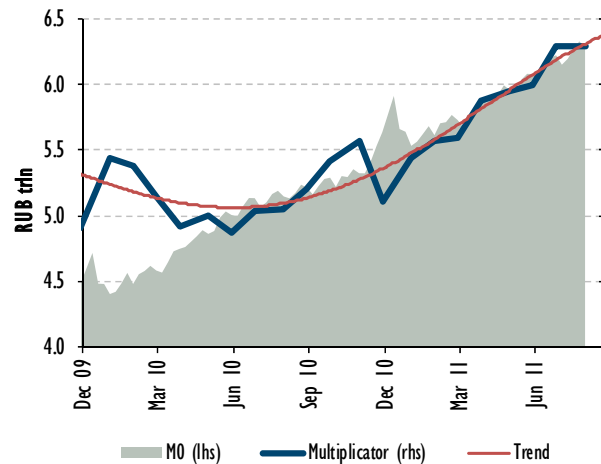
▶ Economic activity

Business sentiment in August continued to linger below the 50-point threshold, as measured by the manufacturing PMI. Index value has barely changed from a month before (49.9 vs. 49.8 in July), indicating that producers' expectations neither improved, nor deteriorated much. New orders contraction was one of the key reasons defining PMI dynamics in August.

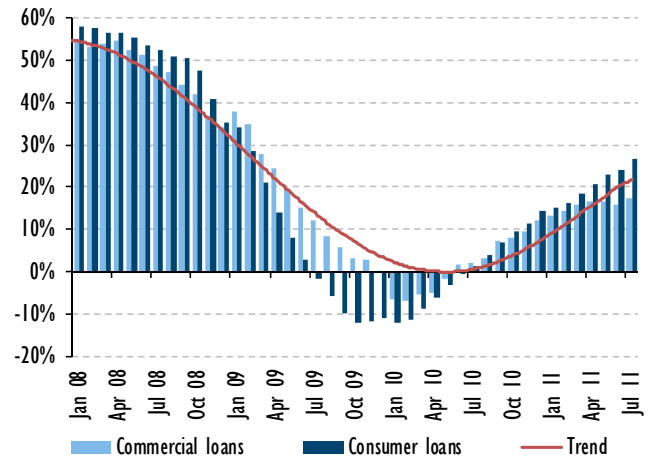
Sentiment in services industry deteriorated sharply in August: PMI, although still well above the 50-point threshold, fell to 53.2 points, indicating the risk of a potential slowdown.

Shipping volumes rebounded only slightly in June, adding 0.2% MoM after slumping as much as 4.5% a month before. Year-on-year growth rates decelerated, however, (presumably, due to higher base effect) to 4.4% YoY after rising by 7.2% YoY in June.

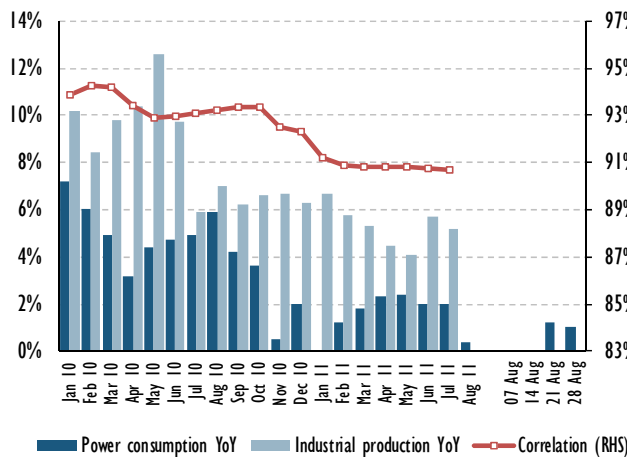
Monetary base and multiplier (M2/M0)



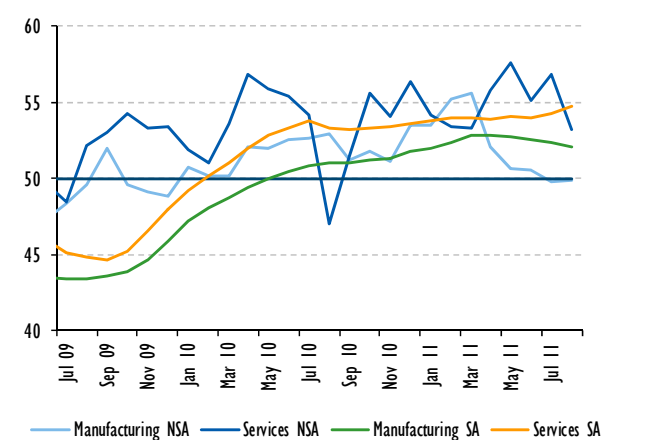
Lending volume*, % YoY



Power consumption vs. industrial production, % YoY



Russia's PMI, points



Current economic environment

Russian GDP rose 3.4% in 2Q11, according to the preliminary assessment by Rosstat, falling short of MED's estimate of 3.7%. This contributed to a slowdown of 1H11 dynamics to 3.7% YoY as compared to a 4.1% increase in the 1Q11. This encouraged MED to downgrade its full-year forecast, albeit marginally: from 4.2% to 4.1%. Yet, MET representatives pointed at the possibility of a more severe revision if growth doesn't pick up in the 2H11.

In seasonally adjusted terms, GDP growth accelerated slightly in July – to 0.4% MoM from 0.2% in the previous month. However, several factors point to weak prospects of growth acceleration in the near future.

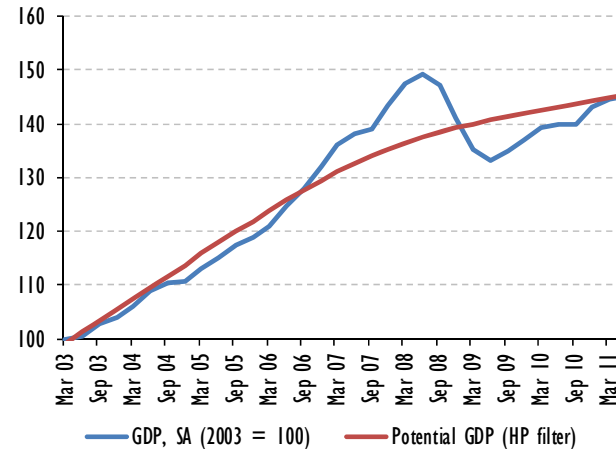
First, the contribution of industrial production to the overall economic activity in July was negative: output (SA) contracted by 0.2% after rising in March-June. Second, real GDP has almost converged towards its potential LT equilibrium level. Positive deviations from the trend are achievable in the ST, but are hardly sustainable in the longer run unless capex picks up. Finally, oil prices are unlikely to provide strong stimulus to the Russian economy after rising significantly in 1H11. All that said, we anticipate a 3.9% rise in the GDP in 2011.

Investment in productive capacity rose 7.9% YoY in July after temporarily decelerating to 4.9% a month before. However, the LT trend remains flat. Moreover, seasonally adjusted figures indicate a 0.9% decline in capex in June.

External trade surplus in July widened to \$18.3 bln. Export volumes were almost unchanged at \$45 bln while import contracted by 2.8%. The situation, however, might have changed in August, when average Urals price dropped below \$110/bbl (-5.3% MoM). We believe that trade balance might have contracted to some \$15 bln.

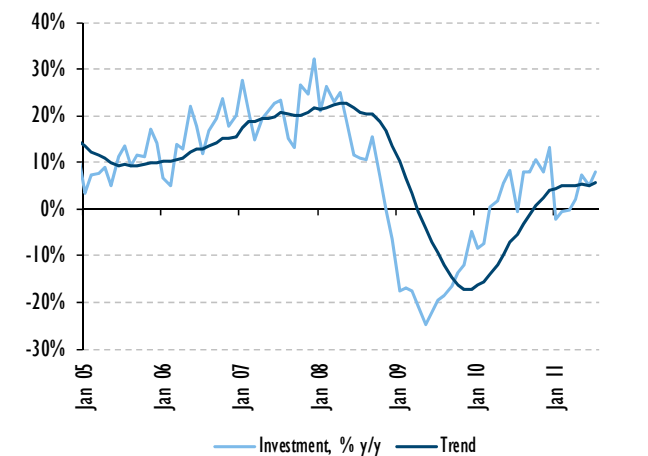
Ruble depreciated sharply in the beginning of August as the turmoil at the global financial market spurred outflow of capital from risky assets. However, FX reserve dynamics (BS value climbed to \$544 bln in mid-month) indicates that the CBR's policy has not changed much: according to our estimates currency purchases went on throughout first three weeks of August, and only in a week ended August 26 the regulator sold \$2.2 bln.

Real GDP (2003 = 100) and potential GDP dynamics



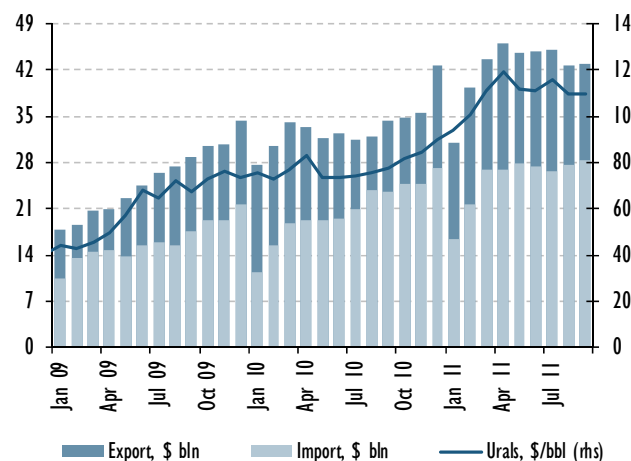
Source: Rosstat

Investment in working capital, % YoY



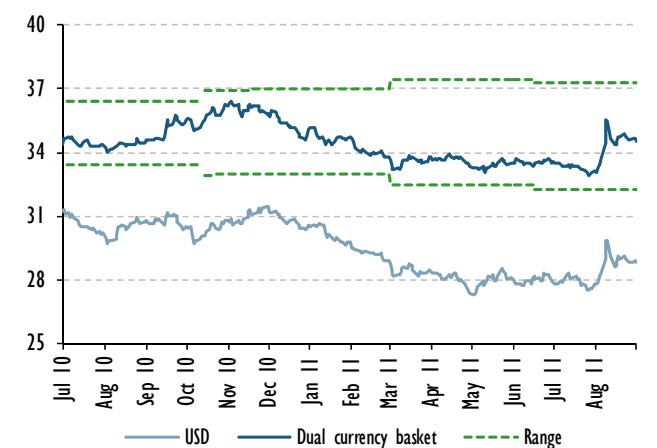
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble exchange rates



Source: Bloomberg, CBR

Exchange rate volatility (as measured by the dual currency basked standard deviation during the month) in August climbed to a maximum since February 2009. Our index of Exchange Market Pressure (EMP) for July almost doubled as compared to its June value, to 13.5 points. However, the reading of 13.5 out of 100 (absolute ER freedom) still indicates a relatively high degree of the CBR's presence in the FX market.

Consumer confidence: RDI stabilized in July after rising by 3.4% MoM in June. This, combined with further decline in savings rate and acceleration in lending, contributed to a 0.6% increment in retail sales turnover in July (SA data). However, unemployment rate unexpectedly rose in July to 6.5%, and after accounting for seasonal changes the indicator was revised upwards - to 6.9%. This might negatively affect consumer sentiment and impair demand growth in the future.

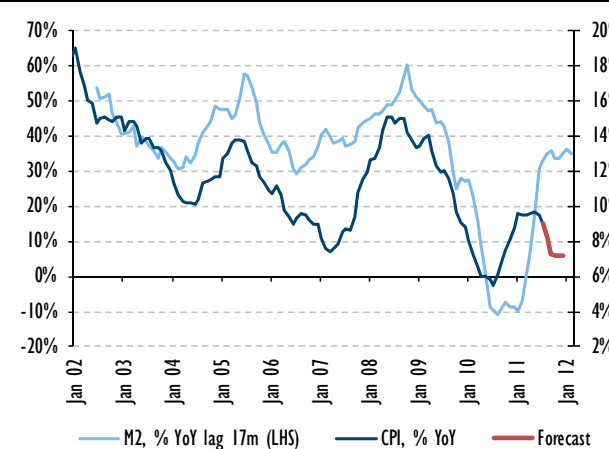
August became the first month of the summer when **deflation** was actually observed. Prices fell during two of the five weeks, resulting in a 0.2% decline over the month. A seasonal drop in the price of agricultural products provided the key contribution to the overall dynamics. Yearly inflation diminished to 8.2% from 9.0% in the beginning of the month.

The Ministry for Economic Development (MED) has recently revised its inflation forecast downwards by lowering the upper boundary of the 6.5-7.5% range to 7.0%. We believe that the forecast is achievable, especially given the intensification of high base effect, although risks of a significant acceleration in prices towards the end of the year remain. We should also mention that lower inflation rates signal weak demand.

Capital markets: Fluctuations in the world equity indices were amplified in the Russian market by its high sensitivity to changes in investors' sentiment and an outflow of speculative capital.

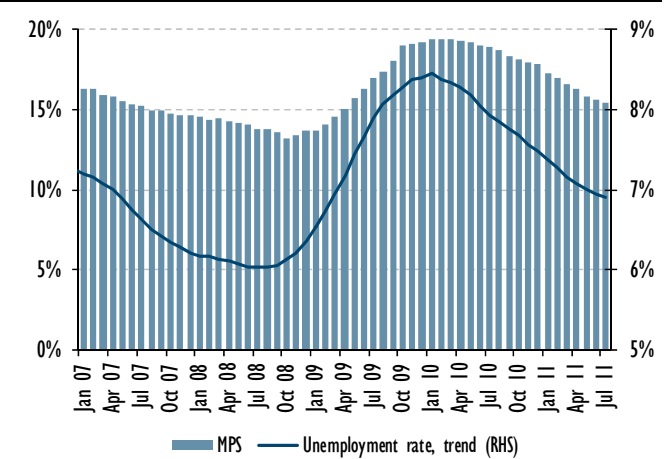
Ruble liquidity squeeze limited demand for debt instruments, including OFZ. However, MinFin's rate-setting policy (at or below market yields) indicated that government's needs for financing at the moment can be easily adjusted downwards. As a result, only RUB 25.3 bln of OFZ were sold in August, this is some 28% of the planned amount.

Inflation and money supply dynamics: risks are evident



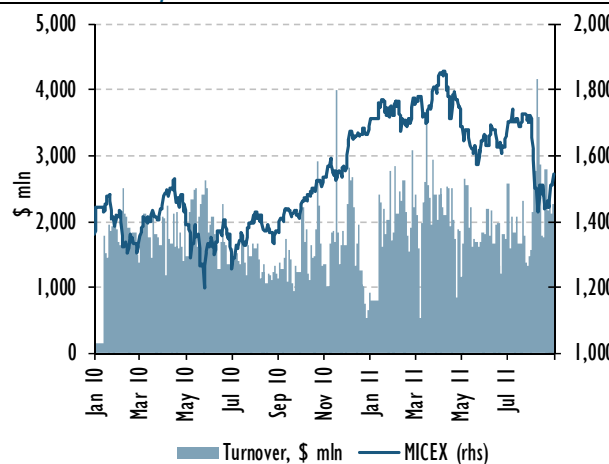
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



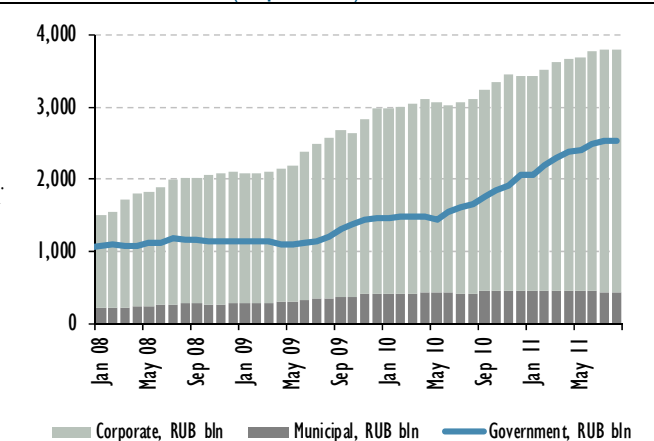
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

Overall, market fundamentals in August were not very encouraging. Soon after the US Congress adopted the legislation on higher public debt limit and budget cuts, markets were shaken by S&P's decision to lower the US sovereign credit rating by one notch to AA+. The lack of political consensus and inability to contain debt growth were named as the key reasons for the downgrade.

Weak macro statistics published throughout the rest of the month weighed heavily upon investors' sentiment. The yearly Central bankers' conference in Jackson Hole, which was considered to be the last resort for market inspiration, didn't provide the anticipated relief. Although Bernanke stated that the US economy doesn't require an immediate stimulus, and extended September meeting of the FOMC to two days instead of one, market participants are still looking forward to QE-III, even if it comes later than was expected.

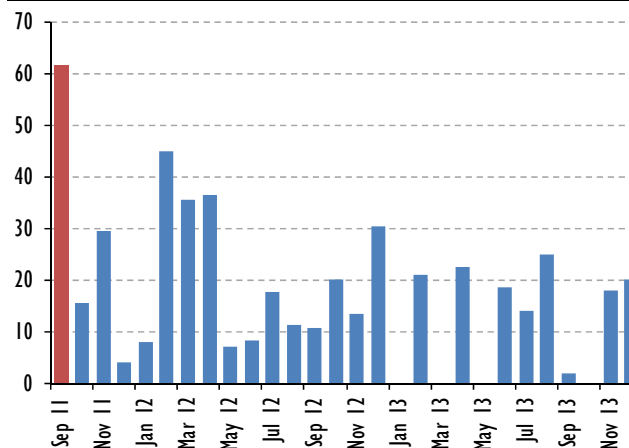
We don't expect the FOMC to announce new round of QE in September, in less than a month after the Fed head Ben Bernanke denied the necessity of new stimulus measures. Moreover, the efficiency of potential new measures seems limited given the record low rates in the United States.

Risks in Europe persisted throughout August. Norway's requirement for EU guarantees on Greek debt rollover spurred concerns that the troubled country will be unable to convert its maturing liabilities into longer-term bonds as more creditors would demand explicit guarantees.

As the situation in sovereign debt markets deteriorated, with risks of rating downgrades spreading to Italy and then France, ECB intervened by purchasing the countries' bonds to contain the surge in yields. Moreover, the central bank extended ST loans to financial institutions in order to prevent liquidity squeeze.

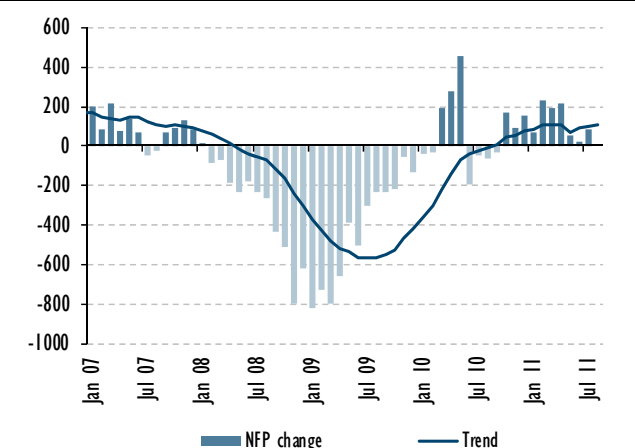
This being said, we assume that the ECB might ease the pace of interest rate hikes, leaving the key rate at 1.5% until at least the end of the year. Euro, although still volatile, fluctuated close to \$1.45, in spite of less aggressive expectations of widening interest rate differential between the eurozone and the US.

Italy's debt redemption schedule, EUR bln



Source: Bloomberg

Change in non-farm payrolls, thousand



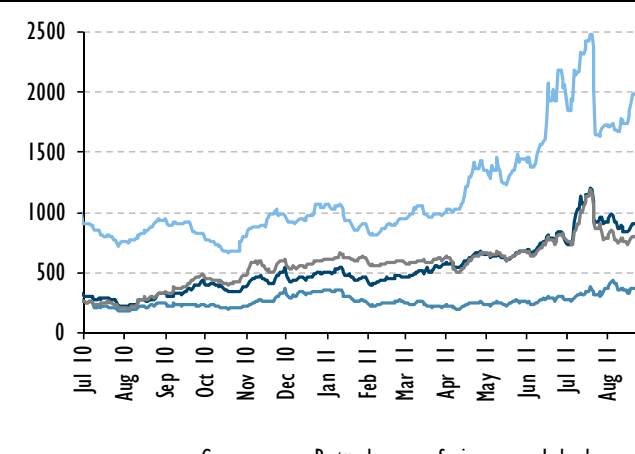
Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics on Eurozone members' debt



Source: Bloomberg

2. Commodity markets

▶ China

Manufacturing activity in China accelerated slightly in August, although the PMI missed estimates and amounted to only 50.9 points. A similar indicator calculated by HSBC again turned out below the 50-point threshold, indicating a decline in business activity, yet only marginal (the index reading was 49.9 p.).

Trade statistics, however, are somewhat more reassuring. Imports accelerated in July, adding 22.9% YoY, and are expected to continue growing at a pace above 20% in August. Trade balance strengthened to \$31.9 bln in July, reaching the highest value since January 2009. Thus, there is little scope for fundamental demand for oil to decline, despite the recent and the projected slowdown of the US economy.

▶ Oil

Oil prices in August remained volatile: Urals first dropped below \$102/bbl on concerns the US economy is poised for a recession, but later bounced back to above \$115/bbl.

Futures imply a decline in prices, even from the current levels, which are lower than previously anticipated: contract curve shifted downward by \$2-4/bbl, depending on the contract's maturity, with the most severe decline occurring on the long end. This implies, in our view, that investors do not anticipate the third round of QE from the Fed that could spur a rally in commodity markets.

In the longer term, levels below \$100/bbl of Brent crude seem very unlikely, as even the OPEC members' budgets are balanced at prices of \$100 or above. Therefore, we presume that a potential decline in prices in September will be limited by \$2-5/bbl even if no QE-III is announced.

▶ Metals and other indicators

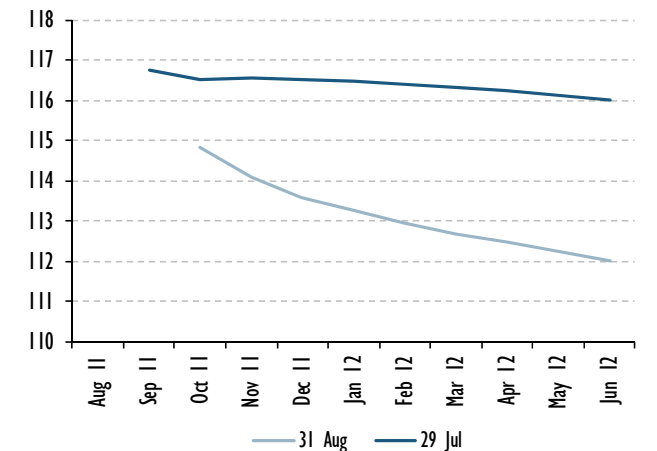
The demand for safe haven spurred a rally in defensive assets, with gold being one of the key beneficiaries. Spot prices for the precious metal surged to an all-time high, reaching \$1900/Oz on August 23.

Urals price dynamics, \$/bbl



Source: Bloomberg

Brent futures, \$/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

Liquidity indicators abroad provided a mixed picture in August. 3M borrowing costs in Europe cooled a little after ECB extended its marginal lending facility to provide liquidity to market participants. However, LOIS spread continued to widen, reaching a local maximum (since April 2009) at 69.7 bps on August 10. USD LIBOR surged in August, adding more than 7 bps since the beginning of the month and reaching 0.33%. TED-spread doubled over the month.

UST yields dropped to all-time lows in August despite the US sovereign rating downgrade by S&P. Interest rates on 10-year bonds cut through the 2.0% support level in mid-August, and the yield on 2-year government securities fell below 0.25%, flattening the UST yield curve on the short end. Such behavior indicates that US Treasury assets still represent safe haven during the times of financial turmoil. Even gold cannot fully substitute UST in this role due to its lower liquidity and limited supply.

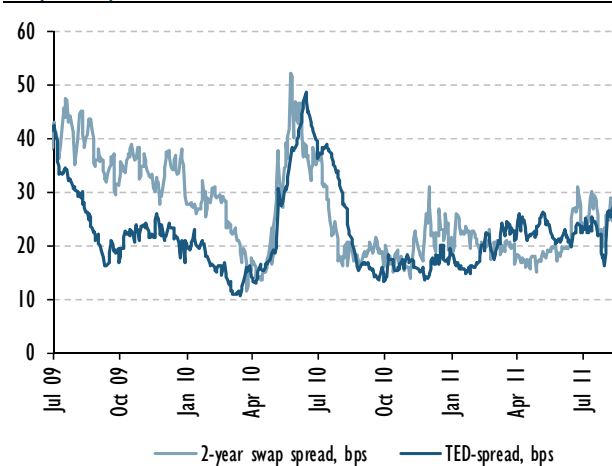
▶ Russian money & FI markets

Russian banks ended August with their net liquidity position squeezed to nearly zero (on August 29, NLP reached a local minimum of RUB 50 bln). Despite the fact that most of the liquidity pool was drained during the last weeks of the month by tax payments (correspondent accounts and deposits with the CBR dropped by RUB 354 bln), borrowing costs started to climb from the very beginning of August. O/n bond REPO rates on MICEX went up 135 bps over the month, heading towards 5.5%.

O/n interbank rates rose only in the last two weeks of the month, shifting into 4.0-4.5% range. We expect the federal budget to become a net provider of liquidity only by late autumn, and until then the money market is likely to remain tight, with budget deposits from MinFin serving as the key source of funds for ST needs.

Ruble bond yields were pushed up by lack of ruble liquidity: OFZ curve shifted by 22-50 bps, depending of the bonds' duration. Eurobonds prices were barely changed in August, but Russia 30 spread to UST widened by 60 bps (to 192 bps) after a sharp drop in UST yields.

Key MM spreads



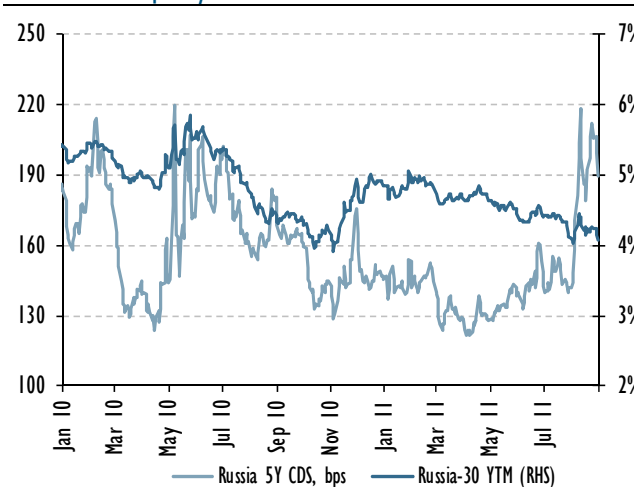
Source: Bloomberg

1Y LIBOR and 10Y US Treasuries yield



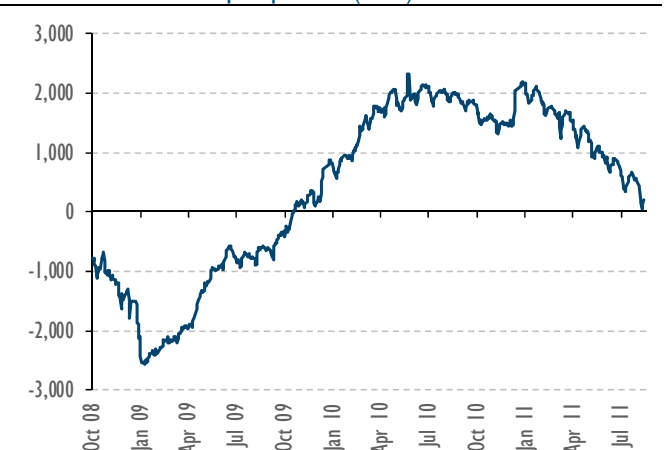
Source: Bloomberg

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

August has once again proved its reputation for being one of the worst months for stock markets. S&P's decision to lower US sovereign credit rating on August 5 prompted unprecedented equity sell-off worldwide. Most of DM indices erased whatever YTD gains still remaining by the beginning of the month, and DJIA was among the few that had almost recovered the losses incurred. S&P 500 fell 5.7%, and European indices plunged 7-20%. As a result, valuations across the globe declined to their lowest levels in years.

Spain, Italy and France were forced to impose temporary bans on short selling, and then extended them: Spain and Italy - until the end of September, and France - until November 11.

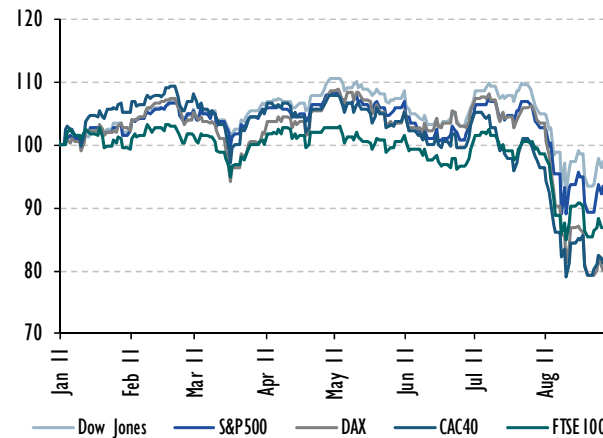
Financial shares continued to underperform the market, losing more than 10% in the US and almost 17% in Europe. Investor confidence in the sector performance was undermined by concern over regional banks' exposure to sovereign debt and potential liquidity problems.

VIX index of implied volatility more than doubled during August to 48 points, which is the maximum value of the indicator since March 2009. Although index has recently declined, it remains well above the 'normal' level of ca. 15-25 points.

Russian market in August underperformed most of its EM peers, with MICEX index sliding 9.3% and RTS losing as much as 13.4%. The discrepancy in rates can be attributed to ruble depreciation during the month by some 5%. Only stock markets in Hungary and Turkey performed worse than Russia, according to S&P/IFCI. Losses in all B(R)IC countries' primary indices were limited to a maximum 8.4% decline.

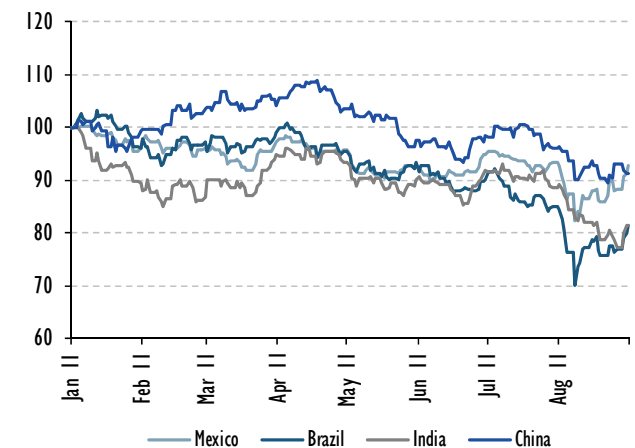
We expect stock markets to remain extremely volatile throughout the rest of the year as exposure to key risks remains. US macroeconomic data should be closely watched in anticipation of the two-day FOMC meeting (20-21 September), as well as developments in state-by-state ratification of EU Summit suggestions concerning the use of EFSF fund to purchase sovereign debt in secondary markets.

DM stock markets dynamics, January 2010=100



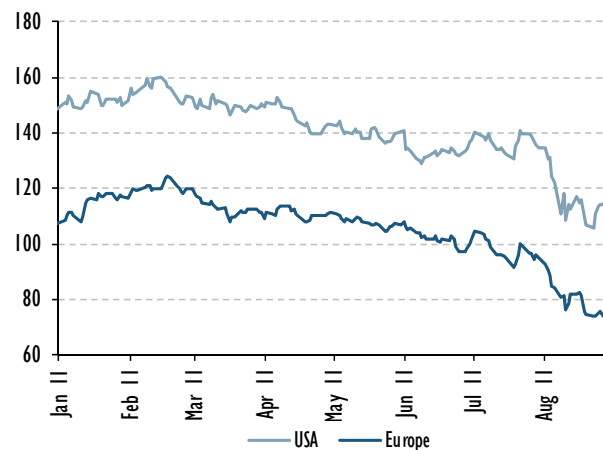
Source: Bloomberg

EM stock markets dynamics, January 2010=100



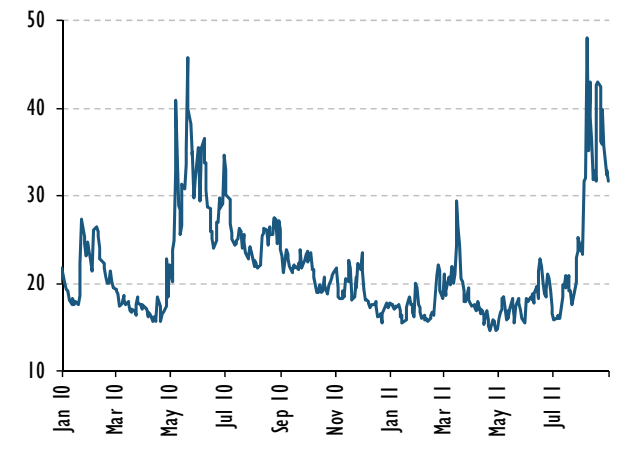
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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