October: surviving in a hostile environment

GAZPROMBANK

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High exposure + escalated risks

It's all about oil…

The Russian economy has by all means retained its high vulnerability to price shocks in commodities. A 12.1% decline in the price of Urals oil in September triggered a proportional drop in the value of Russian ruble against the US dollar, as well as an almost twofold plunge in equities (RTS index lost 21.2% over the month). Moreover, the indicators mentioned above are only short-term ones; as for longer-term risks, they have not been realized yet, but if oil price dynamics does not improve in the near future, their impact on the Russian economy may appear extremely adverse.

…and general risk aversion

Now that even the Fed admits that there are serious downside risks for the global economy, the tensions in financial markets escalate. The lack of political consensus among the EU members, regulators' impasse over new stimulus measures, and rising concerns over banks' solvency – all these contributed to the high uncertainty and volatility in the markets for risky assets.

Unimpressive fundamentals

The Russian economy continues to operate near its full capacity, and a modest pick-up in capex in August has been insufficient to provide a strong stimulus for growth. Although inflationary pressure remains subdued, the recent devaluation of domestic currency might fuel faster price growth in the coming months due to the high share of foreign goods in the average consumption basket. At the same time, stagnating RDI might limit the impact once the local bottom of propensity to save is reached. The CBR's capacity to stimulate the economy is not evident, as both lower rates and higher liquidity volumes supplied to banks are likely to result in further weakening of ruble.

ST forecasts:

- *External sector and exchange rates*. We believe that oil prices in October will "do their best" to retain the $100/bbl threshold, although day-to-day quotes may be quite volatile. Yet, the average price is likely to be substantially below September level, negatively affecting export value. Although we expect import growth to decelerate due to ruble depreciation and weak income dynamics, the trade surplus may fall below $10 bln in October. Capital outflow from Russia is likely to continue as long as the uncertainty over the European debt crisis persists. As a result, ruble may remain under pressure from external factors, but we expect the CBR to continue interventions at the border of the dual-currency basket corridor (in September, the regulator sold $8 bln of foreign currency). As a result, ruble will average at 32.5 vs. US dollar and 37.0 vs. the CBR basket.
- *Real sector and price level*. We anticipate that the influence of seasonal factors over the price level dynamics will diminish substantially in October, resulting in no further YoY inflation slowdown. Furthermore, prices in October may reflect the recent ruble depreciation, as well. RDI is likely to perform poorly in October, with the maximum potential growth of 0.7% YoY. However, retail sales may increase by as much as 8.4% as consumers will increase spending in this uncertain environment. Capex and industrial production are expected to grow by 4.7% and 4.5% YoY respectively.

Key indicators: October forecast

Indicator	October 2011F	MED*	2011F GPB Research
Real sector			
GDP, YoY	–	4.1%	3.9%
Industrial production, YoY	4.5%	4.8%	3.5%
Capital investments, YoY	4.7%	6.0%	6.8%
Retail sales, YoY	8.4%	5.3%	4.3%
Private sector			
Real income, YoY	0.7%	1.5%	4.4%
Accrued salary, RUB	–	23,940	23,784
External sector			
Trade balance, $ bln	9.5	188	153.6
Average oil price (Brent), $/bbl, av.	100	108	108
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	7.3%	6.5–7.0%	7.8%
Refinancing rate, eop	8.25%	–	–
Bicurrency basket, RUB (avg.)	37.0	33.38	35.0
Exchange rate, RUB/USD (avg.)	32.5	28.6	30.0

– no forecast available;

Source: MED, Gazprombank estimates

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Leading indicators

Money and credit

The lending activity in August remained strong. The amount of loans outstanding to corporate borrowers over the 12-month period ended August 2011 increased by 20%, while the gauge for consumer loans added 28.5%. However, the dynamics may slow down in the months to come due to the mounting uncertainty over global growth and oil prices. The money multiplier steadied in September at 2.9x (close to its historical high), and is unlikely to change significantly due to the liquidity shortage experienced by banks.

Electricity consumption

Power consumption in September rose only marginally, adding 0.7% YoY. The elimination of last year's high base effect implies that any increment in power utilization can be attributed to higher production volumes. In this context, a 0.7% growth doesn't look very inspiring.

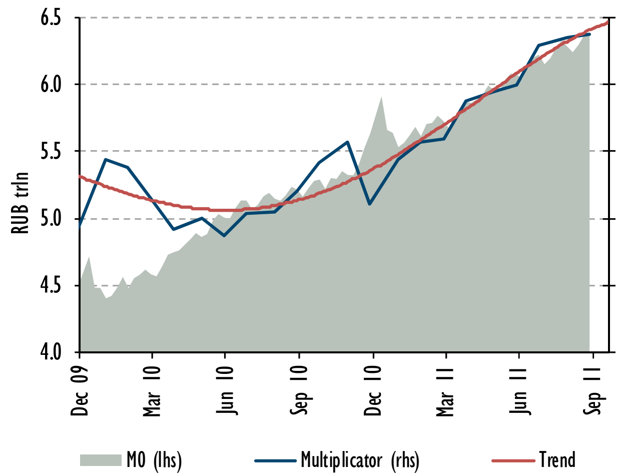
Economic activity

The manufacturing activity stalled in September, as indicated by Purchasing Manager Index (PMI) of 50. The average reading for the third quarter was 49.9 points – the lowest level since 4Q09 and way below the after-crisis average of 52.2. The surveyed companies pointed to weak demand, both internal and external.

The services sector demonstrated more confidence in the future, as indicated by the value of corresponding PMI at 53.3 points in September, virtually unchanged from the previous month.

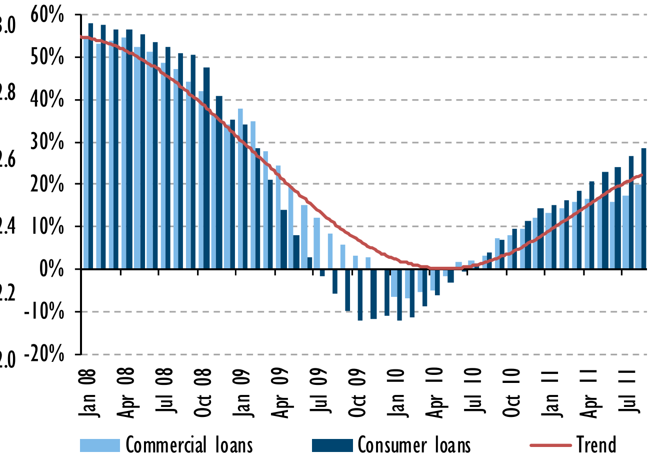
Shipping volumes decelerated sharply in August, adding only 1.8% YoY after a 4.4% increase in July and a 7.2% YoY growth in June. Cargo transportation actually fell 2.1% MoM, indicating risks of stagnating demand, as feared by producers. Despite the strong sales dynamics domestic production may face lower demand due to the persistently high share of imported goods in consumer basket. However, the recent ruble devaluation may diminish the negative impact, albeit only partially, as the import substitution capacity remains limited.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

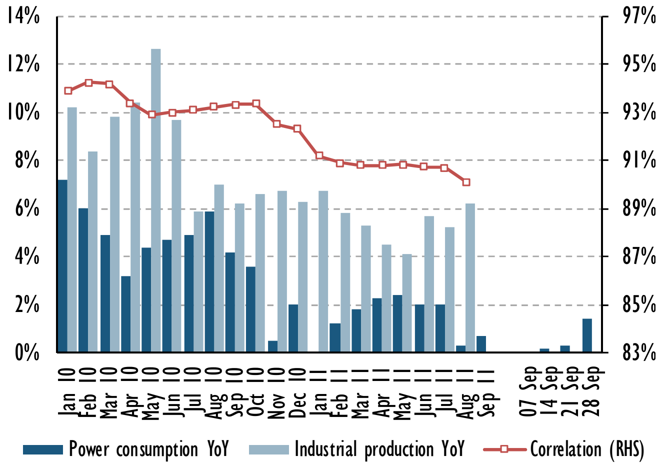
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

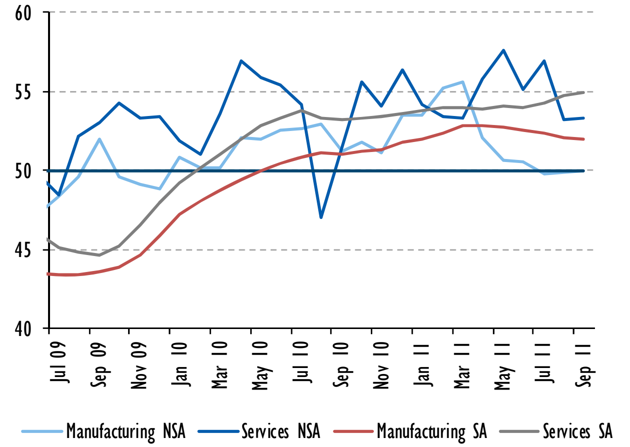
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

Current economic environment

Higher-than-expected oil prices throughout 1H11, on the one side, benefited Russian economy in the form of budget revenues that exceeded forecasts and stable external trade surplus, but reduced the incentives for restructuring, leaving the country vulnerable to commodity price shocks. Once the budget parameters were revised upwards, the reverse action might be much more painful, especially given high non-O&G deficit.

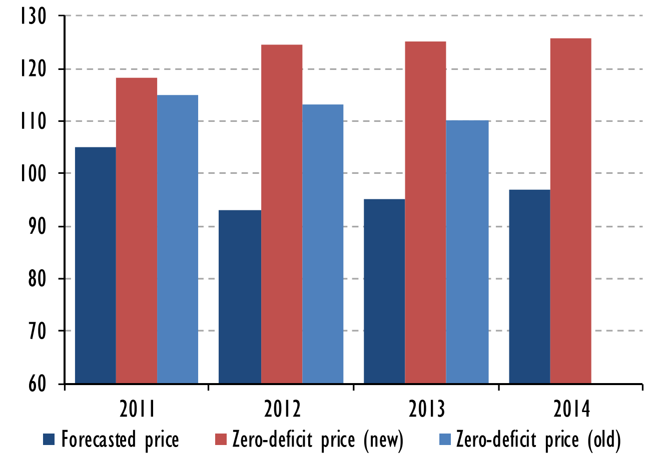
According to the Budget law (effective July 2011), the average Urals price of $118.3/bbl ensures zero deficit in the current year. Similar gauges for 2012–13 have been revised up to $124.6 and $125.2 from $113 and $110 respectively. Given that the reserve fund has shrank to less than 1/5 of its value prior to the crisis of 2008–09, missed oil price forecasts in the following years might hurt.

Russian GDP rose 5.2% YoY in August, according to the preliminary MED estimate: up from 4.2% YoY a month before. However, seasonally adjusted growth rates have not changed at all, and stood at 0.4%. The contribution of various sectors was mixed: the industrial production rebounded from a 0.2% decline in July by adding 0.4% while the construction activity, on the contrary, declined by 1.2%.

Investments in productive capacity rebounded slightly in the previous month, adding modest 0.5% which is not enough to offset a 0.9% decline in July. This contributed to a slowdown of the YoY growth to 6.5% from 7.9% a month before. The long-term trend remained flat, indicating no breakthrough in productive capacity over the next few months.

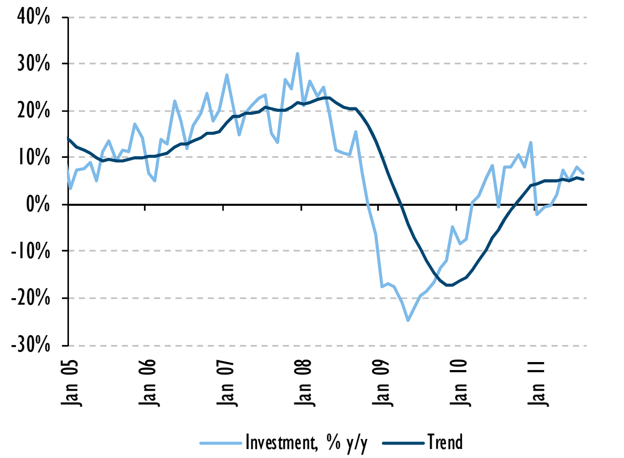
External trade surplus in August shrunk to $12.8 bln (-15.6% MoM). The exports value was almost unchanged despite a sizeable decline in oil prices and totaled $43 bln. Imports rose by 1.8% MoM. We do not expect a serious contraction of external trade balance in September as the average Urals price has temporarily stabilized, even though import growth rates might remain high (at 25–30% YoY).

Oil prices that balance federal budget: appetites grow…



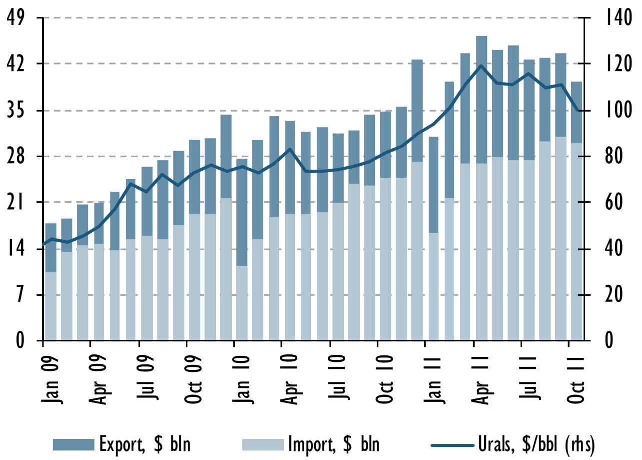
Source: Minfin

Investment in working capital, % YoY: still stalling



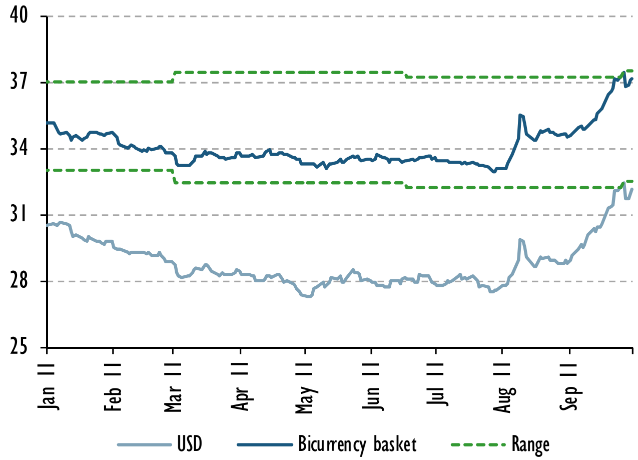
Source: Rosstat, Gazprombank calculations

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 basket standard deviation during the month divided by the mean value of the gauge) in September climbed to the highest level since January 2009. However, despite the CBR's claims on the shift of its policy towards inflation targeting, our index of Exchange Market Pressure (EMP) declined to 36 points after reaching the historical high at 86.8 (out of 100) in August, indicating a drop in the freedom of exchange rate determination. Total currency sales by the CBR in September are estimated at $8 bln.

The turmoil in the international financial markets spurred the outflow of capital from risky assets, intensifying pressure on ruble. This, combined with fewer interventions in the forex market by the CBR, led to ruble depreciation in September (by 11.6% vs. USD and 7.6% vs. the dual-currency basket).

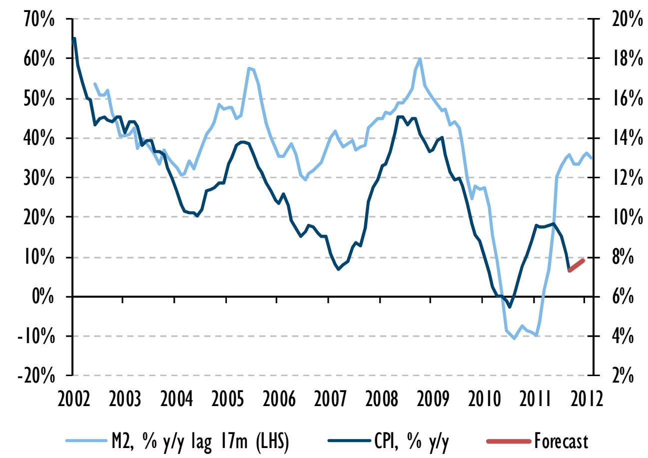
The data on prices, demand, and consumer confidence draw a mixed picture. There was actual deflation in August (-0.2%) while retail sales growth accelerated to 1.4% MoM after rising by 0.6% in July. At the same time, RDI continued to stagnate, adding just 0.1%.

At the same time, consumer confidence seems to be strong: the average propensity to save declined further in August (to 4.8%). We believe that spending will remain strong in September, but largely due to the high uncertainty over the future value of savings in an environment of falling ruble. Notably, currency purchases in August amounted to more than 5% of disposable incomes, the highest percentage since September 2009.

Capital markets: The fluctuations in the world equity indices were amplified in the Russian market by its high sensitivity to changes in investor sentiment and an outflow of speculative capital. MICEX index dropped by 11.6% in September, RTS plunged by 21.2%. This discrepancy may be fully attributed to ruble depreciation.

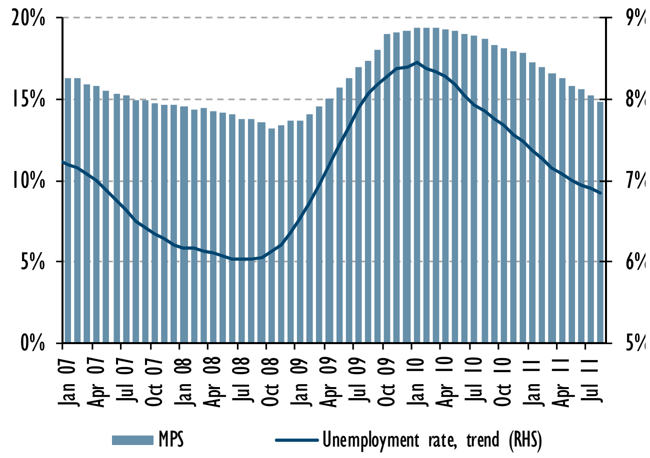
The ruble liquidity squeeze limited the demand for debt instruments, including OFZ. MinFin's rate-setting policy (at or below market yields), as well as the decision to cancel several auctions, indicated that the government's needs for financing at the moment can be easily adjusted downwards. As a result, only RUB 19.4 bln of OFZ (some 43% of the planned amount) were sold in September.

Inflation and money supply dynamics: risks are evident



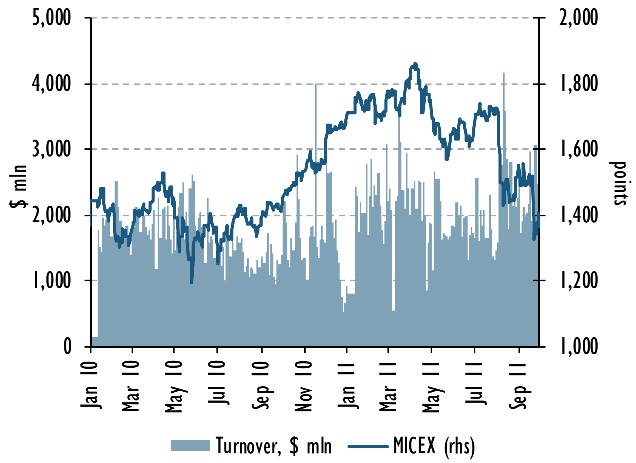
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



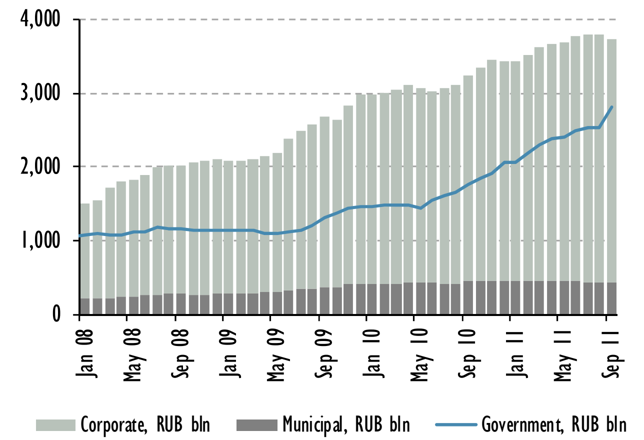
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

Operation Twist

The results of extended 2-day FOMC meeting disappointed investors. First of all, because the Fed abstained from providing more stimulus to the economy in the form of QE-III. Second, because Ben Bernanke explicitly stated that downside risks to growth have increased substantially.

The actual move adopted by the Fed had been broadly expected and therefore priced in long before it was announced. The regulator decided to rearrange its holdings of the government securities by extending the average duration of portfolio. The Fed plans to finance $400 bln purchases of UST with maturities of 10 to 30 years over the following 9 months through sale of treasuries with maturities of 3 years or less. However, the actual impact of the adopted action on the yield curve, as well as its efficiency in stimulating growth in the longer term, still remain obscure.

Rating actions: banks downgraded all over the world

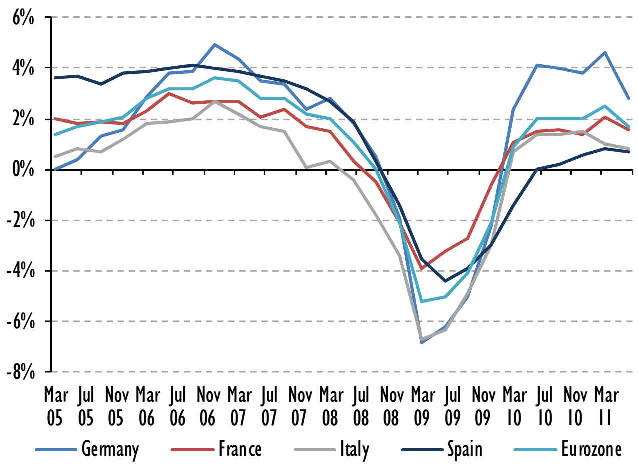
Rating agencies intensified their campaign of credit risk reassessment. Besides the downgrade of Italy's sovereign rating by S&P (followed by a similar move by Moody's in early October), revisions were concentrated in financial sector. Two major French banks (Societe Generale and Credit Agricole) each lost 1 notch of their Moody's ratings while BNP Paribas's rating remained under review. The agency also downgraded two US banks (BofA and Wells Fargo).

A report by the IMF aggravated the fragility in the European banking sector: according to the Fund's estimates, the credit risk exposure of financial institutions in the region rose to $300 bln, and banks may require urgent recapitalization in case of a major credit event (such as a sovereign default).

Fundamentals: mixed, but biased towards weakness

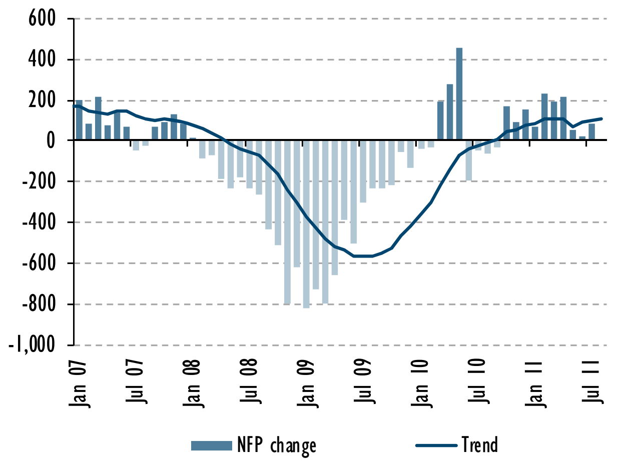
There were a few positive surprises in September (including data on sentiment among both manufacturers and consumers in the US), the overall picture remained depressed. IMF revised its global growth estimates downward for 2011 and 2012 to 4.0% in both years from 4.3% and 4.5% respectively. For the US, the forecast was cut to 1.5% and 1.8% from respective 2.5% and 2.7%.

Key European economies: growth rates are tumbling



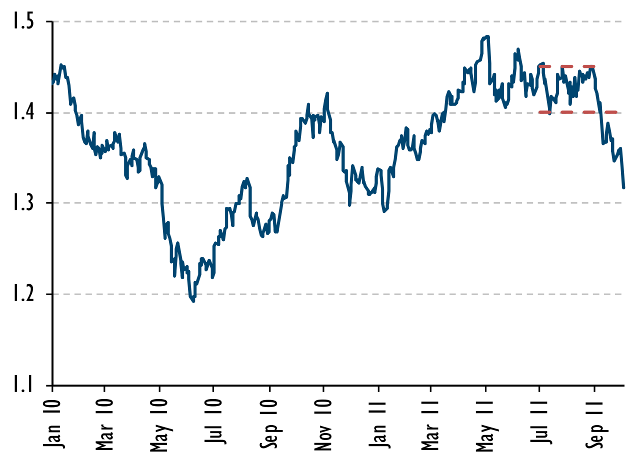
Source: Bloomberg

Change in non-farm payrolls, thousand



Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

Global GDP projections

			Latest forecast		Last revision (Sep.)	
	2009	2010	2011	2012	2011	2012
USA	-3.5%	3.0%	1.5%	1.8%	-1.0%	-0.9%
Eurozone	-4.3%	1.8%	1.6%	1.1%	-0.4%	-0.6%
Japan	-6.3%	4.0%	-0.5%	2.3%	0.2%	-0.6%
UK	-4.9%	1.4%	1.1%	1.6%	-0.4%	-0.7%
Russia	-7.8%	4.0%	4.3%	4.1%	-0.5%	-0.4%
China	9.2%	10.3%	9.5%	9.0%	-0.1%	-0.5%
India	6.8%	10.1%	7.8%	7.5%	-0.4%	-0.3%
Brazil	-0.6%	7.5%	3.8%	3.6%	-0.3%	0.0%
World	-0.7%	5.1%	4.0%	4.0%	-0.3%	-0.5%

Source: IMF WEO

2. Commodity markets

Fundamentals

The data on manufacturing activity in China remained mixed. According to the official statistics, industrial output expanded in September. However, HSBC published PMI reading of 49.9 points for the second month in a row, indicating a stall in production. The discrepancy between services PMIs was even larger (HSBC's PMI was at 53, while the official data suggested a stronger value at 59.3). However, it should be underscored that both estimates indicated expansion, as well as acceleration, as compared to the previous month.

The Chinese external trade balance shrunk to $17.8 bln (-43% MoM) in September, but imports demand remained strong. Growth of imports accelerated in September to 8.3% MoM (from only 2.8% in August) and to 30.4% YoY (vs. 23% a month before).

However, the risks of global economic slowdown continued to weigh heavily on commodity prices. Oil dropped by 12% in September, approaching the threshold level of $100/bbl (Urals). Base metal prices plunged by 17.5%.

Other determinants

One of the monetary factors affecting global oil price dynamics was dollar appreciation against other currencies. Dollar index (DXY) increased by 6% over the month.

Oil futures curve remains downward-sloping, indicating market expectations of further decline in prices over the next 8 months. Moreover, the curve shifted down substantially in September, by $11-15, depending on the contract's maturity. At the moment, market participants anticipate spot prices of Brent to fall below $100 in early 2012. The slope of the curve, however, remains rather flat, indicating no major shocks to the price level in commodity markets in the near future.

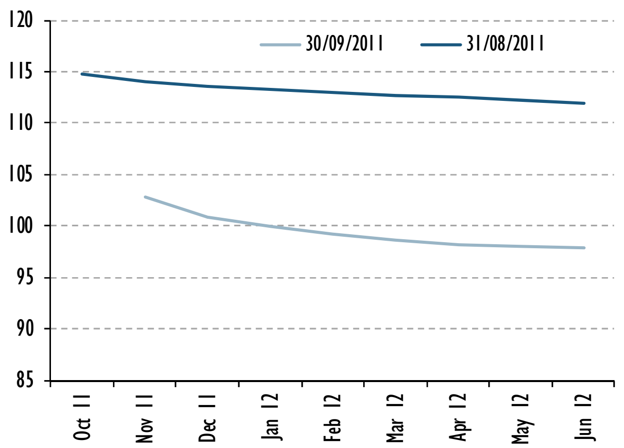
Metals and other indicators

Investors in gold started a massive selloff after the spot price of the precious metal reached a record high at $1900/oz on Sep., 5. As global risks intensified, players preferred to reallocate their savings towards the more liquid, yet higher-quality instruments (e.g., UST). As a result, gold prices plunged by 15.4% from the maximum level.

Urals price dynamics, USD/bbl.

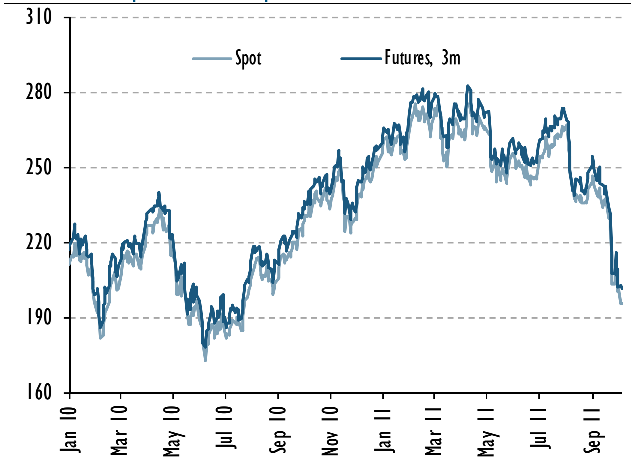
Source: Bloomberg

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

Liquidity conditions tightened in September in both the US and eurozone. Cost of short-term funding in USD increased by 6 bps (as measured by 3M LIBOR), while the money market spreads continued to widen.

In Europe, the lack of confidence in the bank's solvency prompted a number of US MM funds to close limits on the supply of dollar liquidity to European counterparties. However, the squeeze was contained by the ECB's decision, together with central banks of other developed countries (including the BoE, as well as the central banks of Switzerland and Japan), to resume the practice of currency REPOs with the assistance from the Fed.

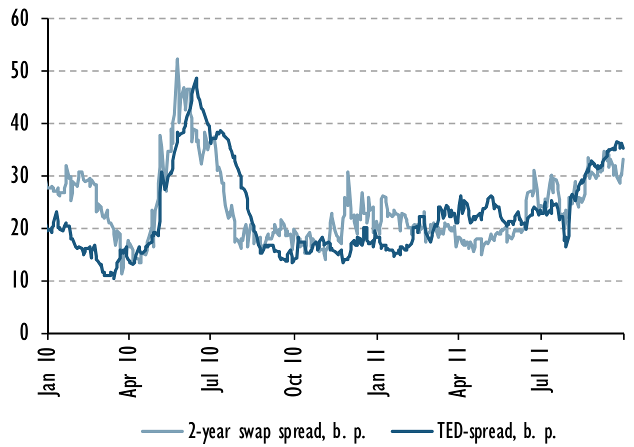
10-year UST yields were mostly below 2.0% throughout September, reaching an all-time low at 1.67% on September 23. Such dynamics indicates that US Treasury securities are still considered to be a virtually risk-free asset during the times of financial turmoil. Dollar appreciation (by 6.2% against the basket of 6 major currencies) can also be viewed as evidence of higher demand for dollar-denominated assets.

Russian money & FI markets

The net liquidity position of Russian banks by the end of September slid below zero and reached an absolute value of RUB 250-300 bln. The primary reason for the deterioration of NLP was the increased liabilities to Minfin (the amount of budget funds allocated to deposits with commercial banks exceeded RUB 1.0 trln) and the CBR (REPO claims rose to RUB 200 bln from virtually zero at the end of August). Moreover, the bulk of ruble liquidity supplied by the regulators with a high degree of certainty has been used to speculate in the forex market, driving the ruble exchange rate up by 11.6%.

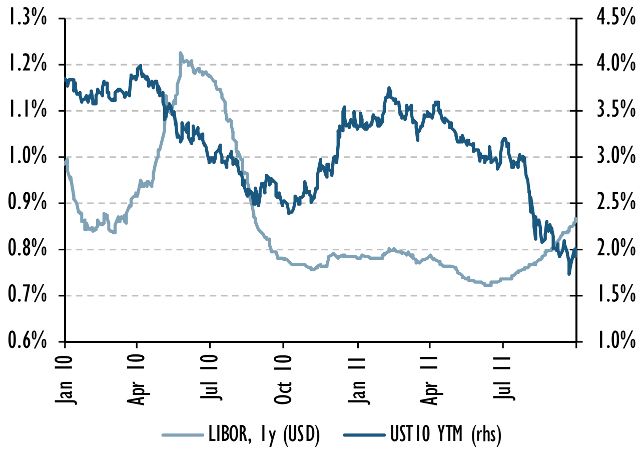
Russian Eurobond market broadly mimicked equities in September as factors affecting investor sentiment were basically the same. It should be noted that the Russian CDS spread has widened substantially – to 323 bps, the highest level over the last two years. Russia-30 YTM rose to 5.26% (+120 bps), while its spread to UST-10 widened to 334 bps.

Key MM spreads



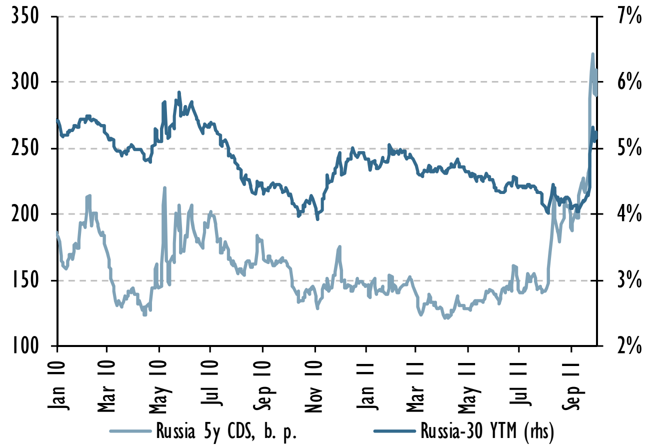
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



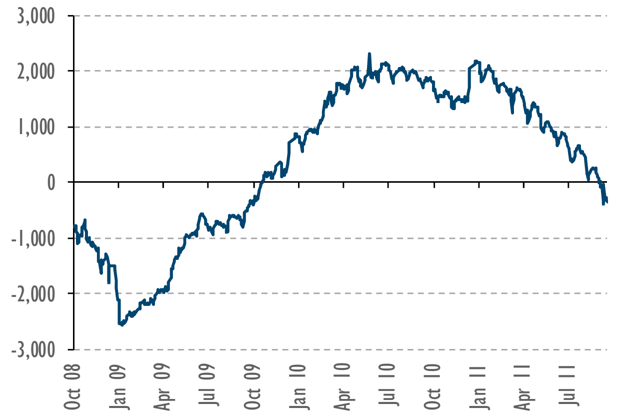
Source: Bloomberg

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

Unfortunately, the poor stock markets performance in August was not followed by a rebound in September. Most of DMs lost 5-8% of their capitalization, while the range of losses in EMs was much wider (1.5-26%).

Throughout September, Europe almost monopolized the leading role as the supplier of bad news. The lack of broad political consensus on further measures to enhance financial stability, the postponed decision on the transfer of the sixth tranche of financial aid to Greece, as well as the continuing ratification of proposals on increasing the EFSF firepower, weighed heavily on investor sentiment.

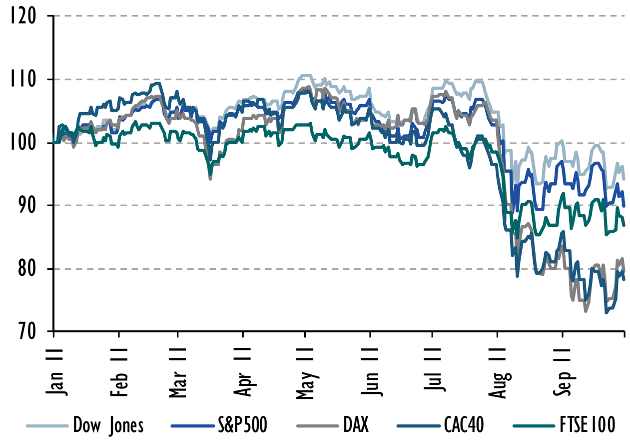
Although concerns over banking sector stability continued to mount in September, financial stocks demonstrated declines broadly in line with the market (-6.3% in the US and -6.6% in Europe). We believe that in case of deterioration of liquidity positions and/or rising volumes of margin calls the downside potential can materialize in October, and banking stocks are likely to underperform the market. Belgian bank Dexia has become the first to receive the government support in early October, and presumably may not be the last.

VIX index of implied volatility resumed its upheaval, ending September a little short of a local maximum reached in the beginning of August (48 points). The level of the indicator is close to values of May-June 2010, when the first rescue package for Greece was being negotiated.

The Russian market in September underperformed all of its EM peers, as well as all DMs, with MICEX index sliding 11.6% and RTS plunging as much as 21.2%. The more severe decline in the dollar index can be attributed to an 11.6% depreciation of ruble during the month. Losses in all the primary indices of B(R)IC countries were limited to a maximum of 8.1% (in the continental China).

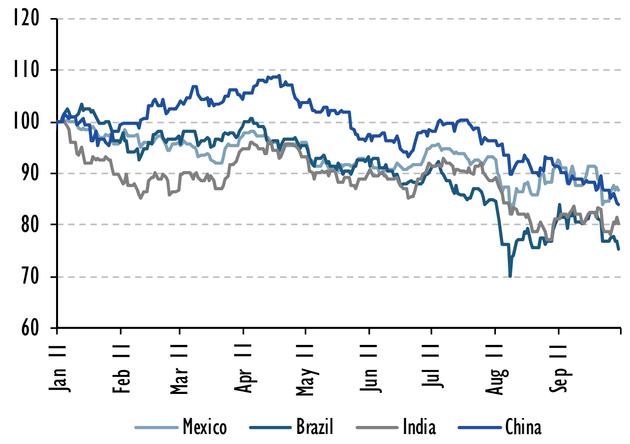
The Russian market at the end of September remained one of the most oversold in the world: investors are valuing the local equities at 6.4 P/E, comparable to Greece (6.3x), and exceeding only comparative valuations for Ukraine and Latvia. However, potential upsides are unlikely to be realized in the near future as the exposure to key risks remains high, as well as the volatility.

DM stock markets dynamics, January 2010=100



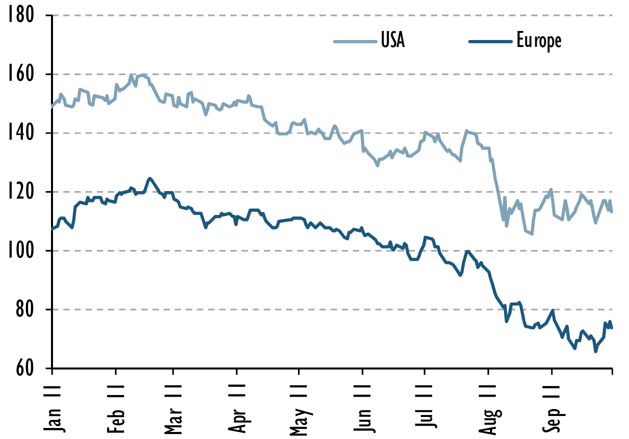
Source: Bloomberg

EM stock markets dynamics, January 2010=100



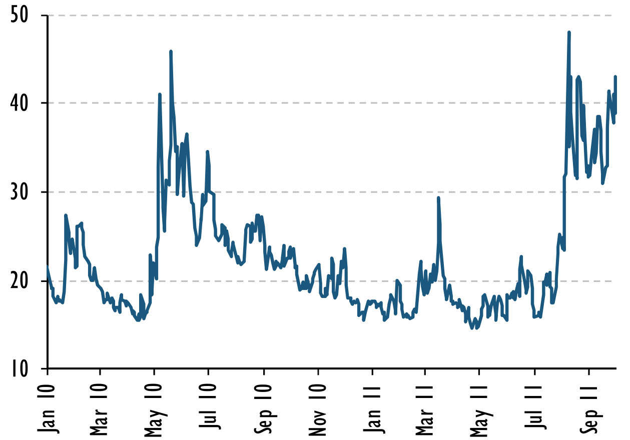
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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