

Time to look for alternative drivers



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▶ IQ11 record now complete, but still a disappointment

Despite minor upward revisions to the 1Q indicators, the overall picture remains worrisome. Although Rosstat had upgraded retail trade statistics to 3.6% and 5.8% YoY in January and February, respectively (adding to an overall increase of 4.7% YoY in 1Q11), continuing slump in real wages and RDI in March (by 0.4% and 3.4% YoY respectively) leaves little hope for strong consumption demand dynamics throughout the second quarter. Moreover, investment demand remains subdued, with capex falling as much as 15.4% QoQ in January – March even with seasonal and calendar adjustments in place.

▶ 2Q11: a cool spring

Historical and forward-looking indicators imply that growth rates so far exceeded expectations because of high oil prices. The longer-term influence of this is the prolonged and enhanced vulnerability to external shocks and discouragement of innovation and investment in non-O&G sectors of the economy. Although sentiment in the manufacturing sector remains positive, the diminishing influence of a low base will pose more challenges to producers to keep up with current growth rates. Among other risks, we note ruble appreciation both in nominal and in real terms (due to high inflation), which hurts competitiveness of Russian manufacturing products.

Key indicators: February forecast

Indicator	May 2011F	MED*	2011F GPB Research
Real sector			
GDP, YoY	–	4.2%	3.9%
Industrial production, YoY	4.0%	5.4%	3.5%
Capital investments, YoY	1.5%	6.0%	6.8%
Retail sales, YoY	3.5%	3.8%	4.3%
Private sector			
Real income, YoY	0.0%	1.5%	4.4%
Accrued salary, RUB	–	23,940	23,784
External sector			
Trade balance, \$ bln	19.1	195.1	151.8
Average oil price (Brent), \$/bbl, av.	122.5	105	108
Stock market			
RTS, points	1970–2020	–	2,200
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	9.7%	7.0–7.5%	8.5%
Refinancing rate, eop	8.50%	–	–
Bicurrency basket, RUB (avg.)	32.8	33.38	32.72
Exchange rate, RUB/USD (avg.)	27.0	28.4	27.5

– no forecast available

* latest available forecast

Source: MED, Gazprombank estimates

ST forecasts:

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

- External sector and exchange rates.** We believe that fundamental and speculative factors will continue to support oil prices at levels above \$120/bbl (Brent), although we do not rule out temporary corrections. This, combined with higher CBR rates is likely to fuel a steady inflow of currency, leaving ruble under pressure to appreciate. In our base-case scenario, Brent price will average \$122.5/bbl. Trade balance will inflate to \$19.1 bln despite high import growth rates (ca. 40%). Although the CBR is likely to intervene in the FOREX to suppress further appreciation of the Russian ruble, the exchange rate is likely to fall below 27.0 RUB vs. USD by the end of the month. Strengthening against the basket of currencies may be partially offset by EUR/USD dynamics, but the indicator may well test the lower boundary at 32.45 RUB.
- Real sector and price level.** We see little scope for improvement in the real sector in May. Consumption demand is likely to be fuelled entirely by increased credit activity and inflation expectations, while RDI dynamic is expected to lag behind due to high CPI growth rates. We expect retail trade to demonstrate a 3.5% YoY rise in May, while RDI will remain flat as compared to the similar period of 2010. Moreover, ruble appreciation may divert demand towards external supplies further undermining competitiveness of the Russian manufacturing sector. We downgrade our expectations of industrial production growth to 3–4% YoY throughout the second quarter. The general price level, in our view, will show only marginal deceleration in May (to 0.4% MoM and 9.7% YoY) due to seasonal factors. Investment activity is expected to remain subdued, although the rudimentary influence of last year's low base may justify the figures at +1.0–2.0% YoY.

Leading indicators

► Money and credit

Narrow monetary base (including cash in circulation and required reserve balances at the CBR) growth accelerated to 2.5% MoM in April after a 2.0% increase in March, reaching 5.87 RUB trln. The money multiplier remained stable at ca. 2.6x, which indicates some credit activity in the banking sector.

It should be noted that a substantial increase in retail sales in March (+4.8% YoY) combined with a decline in RDI (-3.4%) over the same period might be interpreted as evidence of greater consumer lending activity in March.

► Energy consumption

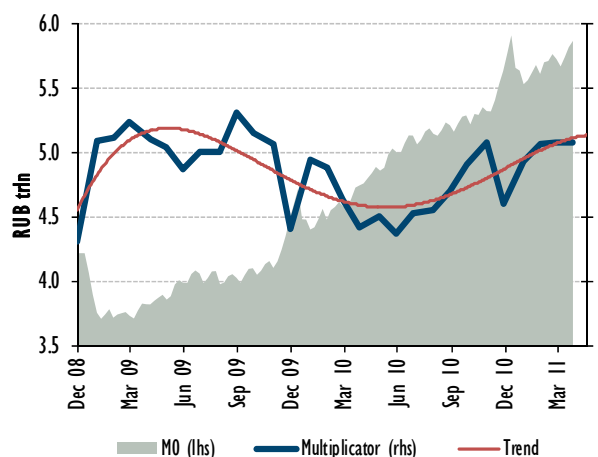
Correlation between energy consumption and industrial production has been slowly increasing since November 2010, when it suddenly dropped from almost 100% to a local bottom of 20%. Still, however, the value of the indicator below 40% does not allow to infer a strong linear relationship between the two variables. Furthermore, high growth rates of power consumption in April might be associated with prolonged cool weather rather than an increase in economic activity.

► Economic activity

Manufacturing activity in April decelerated, according to PMI dynamics: index dropped to 52.1 points from 55.6 in March, although it still remains above 50 points, which indicates the threshold between an improvement and a deterioration of sentiment among producers.

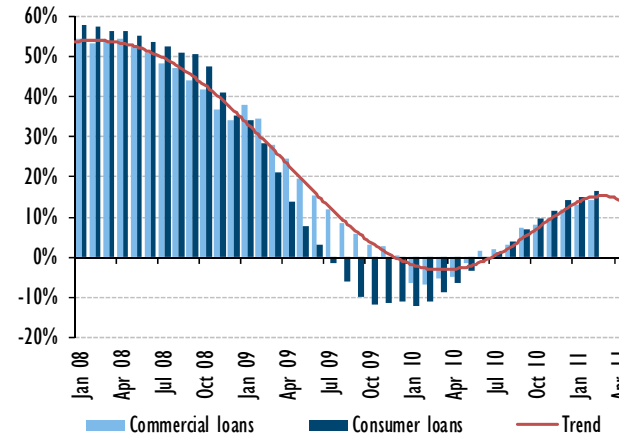
A worrisome signal came from the transportation sector: freight turnover had decelerated to 3.7% YoY in the first quarter 2011, while in the first two months of the year it demonstrated an increase of 5.3% as compared to the similar period of 2010. Transportation can be used as a proxy for future sales; therefore, a slowdown might indicate the reluctance of companies to increase their stocks of finished goods in the absence of certainty over future demand.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

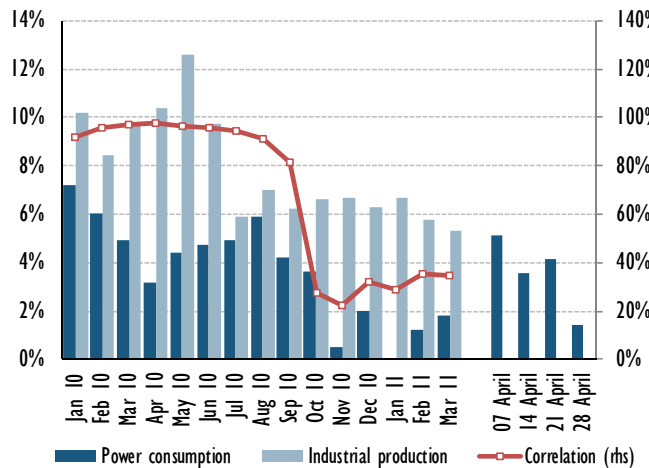
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

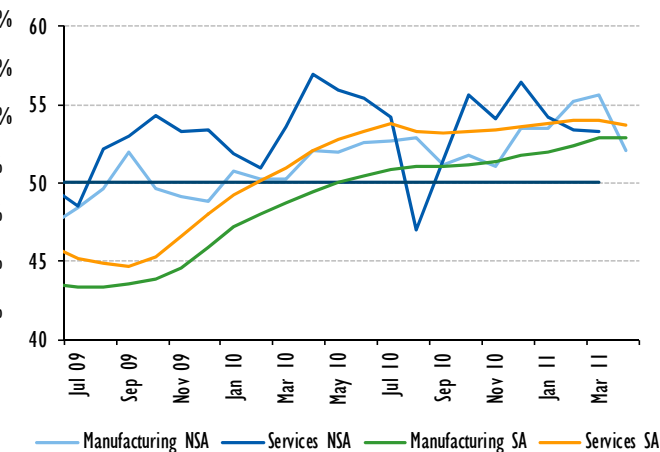
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



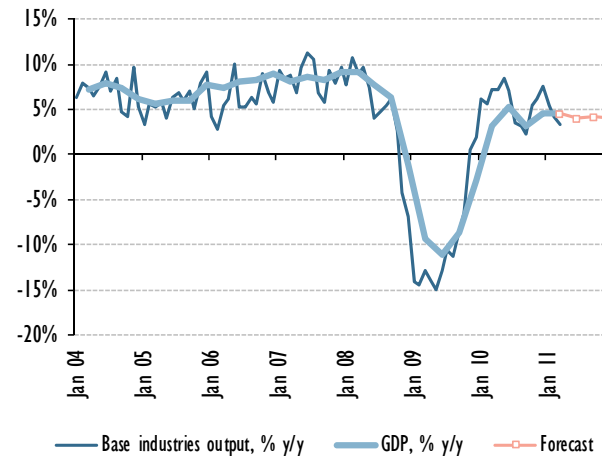
Source: Bloomberg

Current economic environment

- ▶ **Industrial production** continued to decelerate in March, adding 5.3% YoY after increasing by 6.7% YoY in January and by 5.8% YoY in February 2011. Such dynamics could be partially explained by high base effect, which obscures the actual production figures. According to MED estimates, seasonally adjusted figures demonstrated an increase in production of 0.7% MoM in March after a halt in February. Manufacturing remained the key contributor to the overall industrial production figure making up for more than 83% of the total.
- ▶ **Seasonally adjusted GDP** added 0.3% in March, contributing to a 1.3% increase over the first quarter of 2011. We believe that high oil prices are the key reason behind such an acceleration of growth. In the longer run, however, they might discourage production elsewhere, while potential ruble appreciation may weigh on domestic industries' competitiveness.
- ▶ **Investment in productive capacity** fell 0.3% in March, resulting in a total decline of 11.5% over the first quarter. After seasonal adjustment, the drop in investment activity looks even more impressive: -15.4% over the first three months of the year.
- ▶ **External sector and exchange rates**
Foreign reserves at the CBR continued to climb last month, reaching \$517.2 bln on April 22 (+\$13.4 bln MTD) – maximum since October 2008. At the same time, volatility of dual currency basket had decreased substantially: the indicator fluctuated in the narrow range of 33.3-33.9 RUB. In our view, these factors indicate ongoing CBR interventions in the FOREX (we estimate their total volume in April to come close to \$7.5 bln).

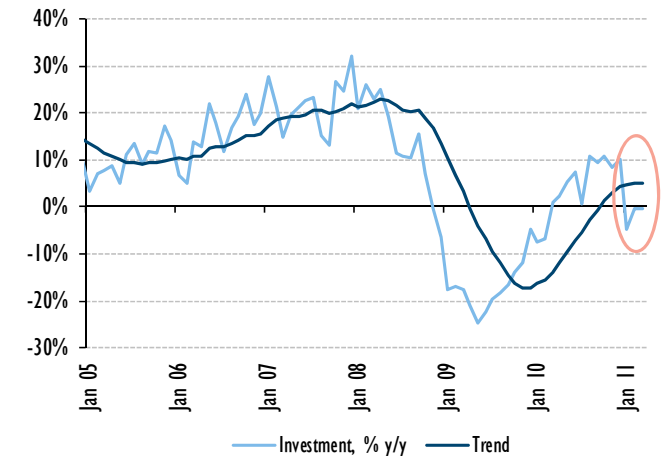
Although we do not believe that a 25 bps rate hike by the CBR will reverse the capital flow towards Russia, it may well intensify pressure on the ruble, especially in the environment of persistently high oil prices, which contribute to positive and rising trade surplus. As a result, we believe a further appreciation of the ruble is on the way despite CBR's resistance.

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



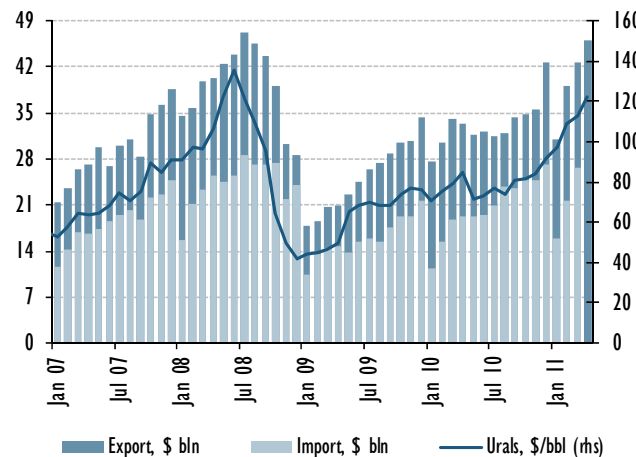
Source: Rosstat

Investment in working capital, % YoY



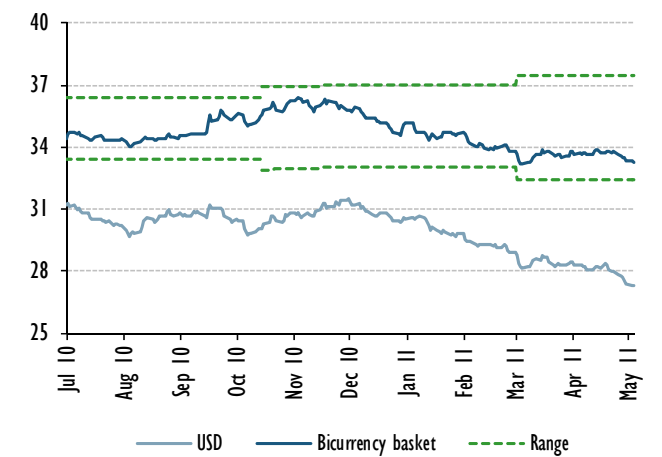
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble exchange rates



Source: Bloomberg, CBR

▶ **Consumer confidence**

A rise in retail trade turnover given a decline in RDI in the first quarter of 2011 looks somewhat confusing, although indicators of household confidence imply an increase in the marginal propensity to consume. The seasonally-adjusted unemployment rate decreased to 6.4% in March, while the savings rate among individuals continued to decline.

In our opinion, the following inferences can be made from the facts described above. First of all, inflation remains one of the key obstacles to income growth. Second, inflationary expectations stimulate current consumption, therefore becoming a self-fulfilling prophecy.

▶ **Inflation**

The CBR's decision to increase interest rates from the beginning of May has finally indicated the regulator's concern over accelerated growth in consumer prices. According to the most up-to-date estimates, CPI increased by 4.2% YTD, while year-over-year increment was 9.6% – well above the target level for 2011. We believe that fulfilling the current forecasts might require a further hike in interest rates of as much as 1.5-2.0 pps, although CBR's priorities are still somewhat skewed towards exchange rate controls.

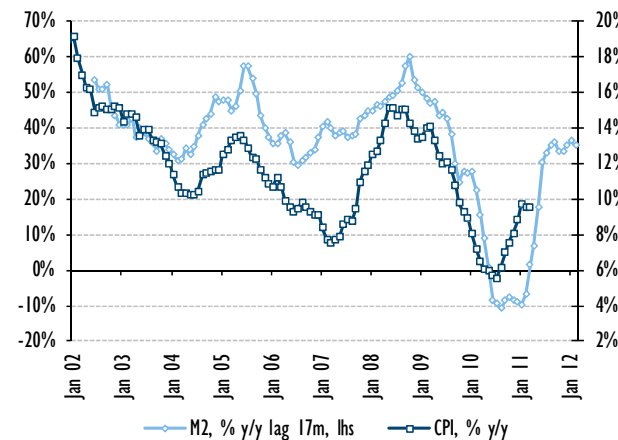
Notably, attempts to impose administrative controls over some components of the CPI (e.g., fuel) proved to be ineffective: artificially created deficit in some regions of Russia might limit the scope of further pressure on the general price level.

▶ **Capital markets**

Russian stock market underperformed most of its EM peers in April, with RTS index sliding 0.8%, and MICEX down by almost 4.0% (such a discrepancy in indices dynamics is attributed to RUB/USD exchange rate fluctuations).

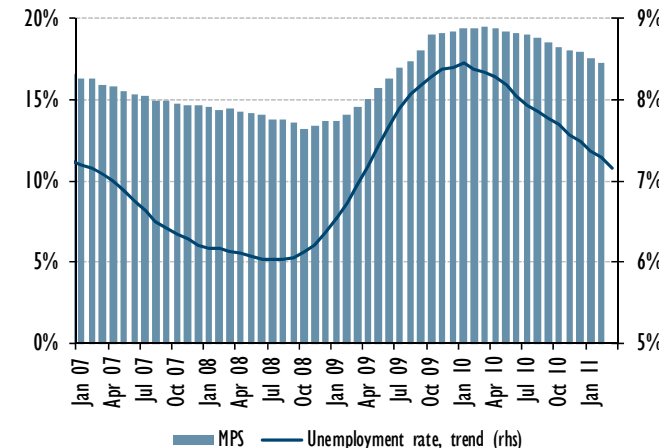
Although high oil prices are likely to contribute to smaller budget deficit, Minfin continues to borrow in the market by issuing LT OFZ, although the issue volumes have decreased to ca. 71.5 RUB bln in April from 91.7 RUB bln in March.

Inflation and money supply dynamics: risks are evident



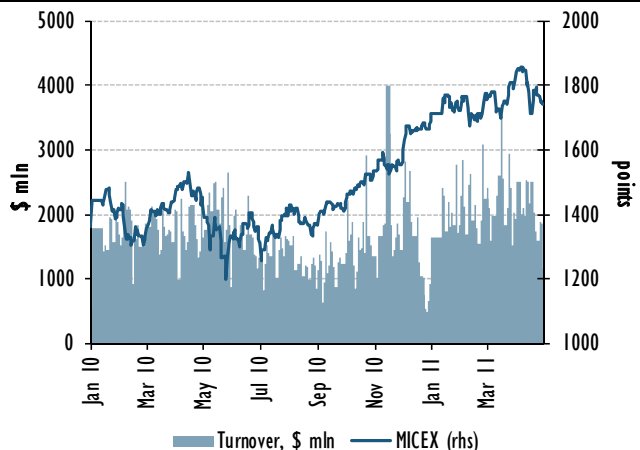
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



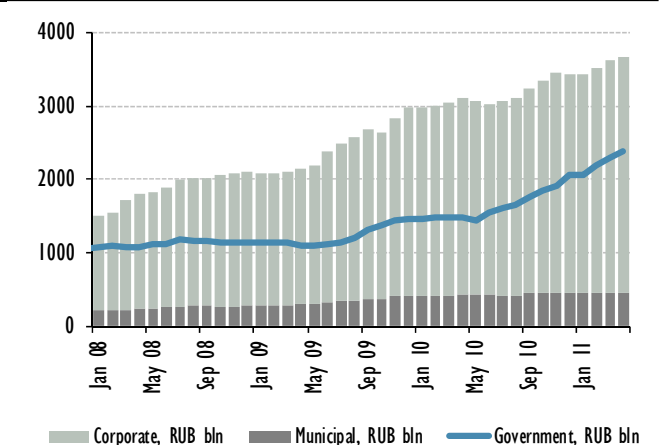
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

▶ USA

The S&P agency was one of the key newsmakers in April: it confirmed the US sovereign rating at AAA, but downgraded its outlook to “negative”, indicating a one-in-three chance of downward rating revision over the next two years. The US debt burden (as well as legislative obstacles to further borrowing) was the key concern behind the rating action.

However, we see no serious risk of a US downgrade, because it would trigger a global re-evaluation of assets as the traditional risk-free benchmarks would no longer apply. Moreover, economic fundamentals generally look strong: although GDP in the 1Q increased by only 1.8%, falling short of a 2.0% consensus forecast, consumption data actually beat estimates, showing a 2.7% increment over the same period. Labor market statistics remain mixed, with jobless claims rising, but employment on an upward trend.

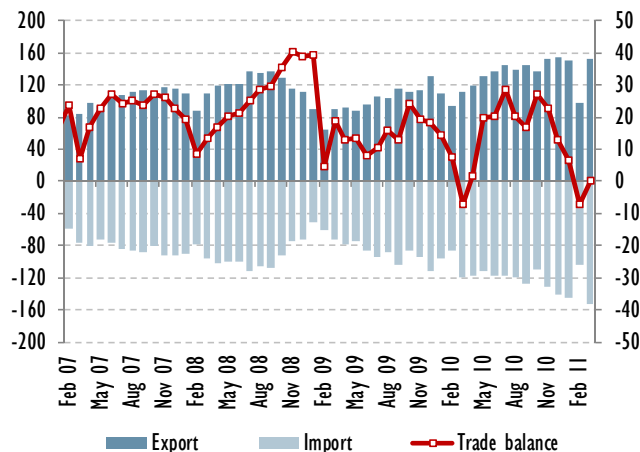
▶ Europe

ECB on April 7 took action to hike the base interest rate by 25 bps to 1.25% to stem accelerated inflation. The regulator’s mandate requires it to guarantee price stability, while maximum employment is not explicitly stated as one of the priorities.

Fundamentals for the Eurozone, however, do not look very strong: data on improvement in economic activity and confidence remains diverse across countries, while Greece may opt to restructure its debt. The key question is whether the European banking system can handle sovereign debt restructuring and whether other countries are to follow the example of Greece.

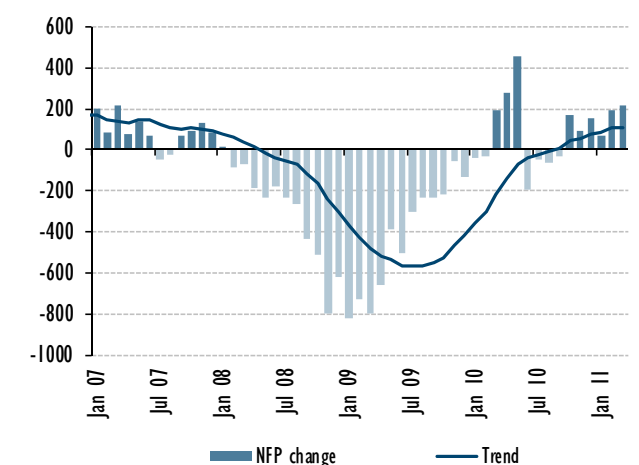
The CDS on Greek bonds skyrocketed in April to a record high at 1400 bps, while euro continued to climb, ignoring the fundamental problems and focusing mostly on widening the interest rate differential between the EU and the US.

China’s external trade indicators, \$ bln



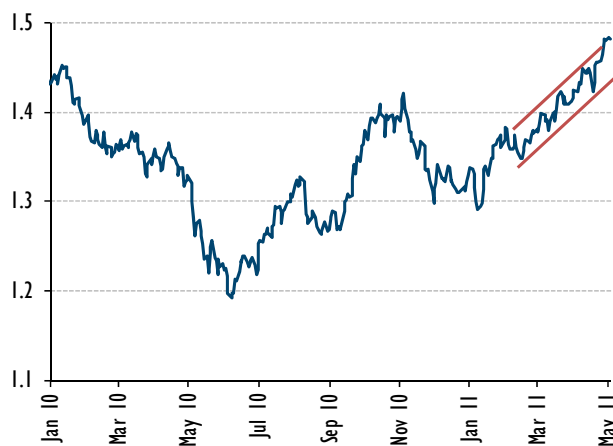
Source: Bloomberg

Change in non-farm payrolls, thousand



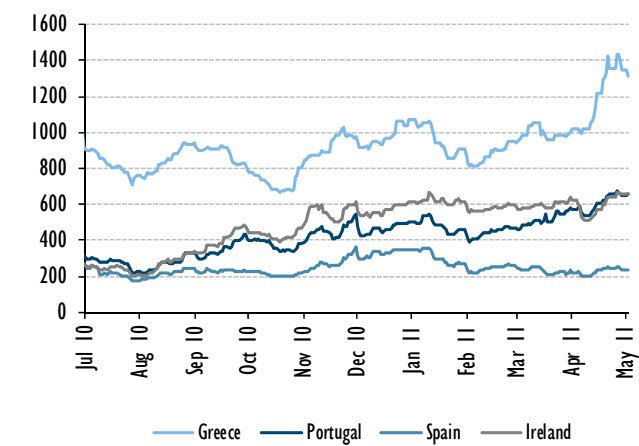
Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics on Eurozone members’ debt



Source: Bloomberg

2. Commodity markets

▶ Oil

Oil prices throughout April were supported by both fundamental and speculative factors. Ongoing tensions in Northern Africa and the Middle East provided enough grounds for fears of supply disruptions, while dollar depreciation against the major currencies, which intensified after the FOMC statement, provided stimulus for speculative purchases,

Brent oil traded in the interval \$115-125/bbl during the month, and the trend was generally positive with minor corrections. Despite a downward slope of the Brent futures curve, the overall level perception had shifted upwards as compared to the respective values a month ago. Market participants generally expect prices to remain above \$120/bbl over the next 10–12 months.

▶ Metals

Metals demonstrated modest growth in April, supported by a number of factors. A negative Chinese trade balance figure in February was probably a temporary event (long holidays during the New Year celebration halted external transactions), as implied by the March rebound to a positive, although modest, \$140 mln. Despite some deceleration of economic activity, indicators are still supportive of economic optimism: Chinese PMI in April decreased to 52.9 from 53.4 in March, but remained above 50 points. Another factor that may positively impact the demand for metals is the need for infrastructure recovery in Japan.

Base metals prices in April increased by 1.0% after falling by 2.8% in March. Gold reached an all-time high at \$1,563.7/oz on the last trading day of April, adding almost 10% over the month on global risk aversion.

▶ General indicators

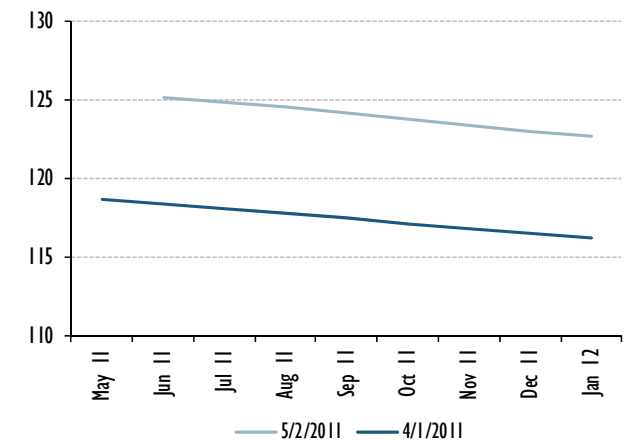
The stimulus provided by a potential increase in dry-bulk shipping, arising from Japan's reconstruction needs, was not strong enough to prompt the freight cost index to increase. The Baltic Dry index resumed its decline in April (-17.1%), depressed by overcapacity.

Urals price dynamics, USD/bbl



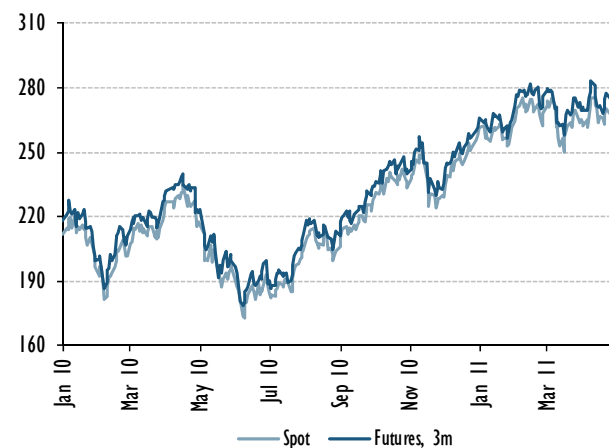
Source: Bloomberg

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

Fears that the Fed might withhold further stimulus measures and gradually shift towards tighter monetary policy did not materialize. Fed Chairman Ben Bernanke during his press-conference following the release of the two-day FOMC meeting results reassured markets that there will be no revision to QE-II targets and interest rates are likely to remain at extraordinary low levels for an extended period of time (at least until the end of September).

Notably, the interest rate futures dynamics still imply only illusive chances of policy tightening by the end of the year: the increase in perceived probability of a rate hike to 0.5% now stands at no more than 21% – even lower than before the latest FOMC decision.

MM rates in the US remain low: spread between 3m LIBOR and the Fed rate shrunk to ca. 2 bps, 1y rates decreased by 3 bps – to 0.76%. Key spreads indicated somewhat mixed dynamics, although remaining in a narrow range: TED-spread climbed to 21–26 bps while 2-year swap spread declined to 15–18 bps.

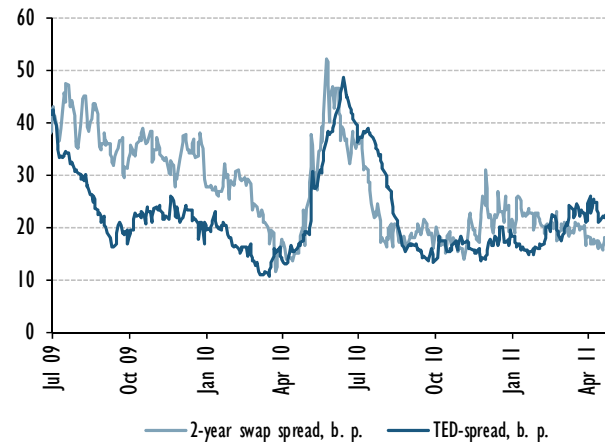
▶ Russian money market

Russian money market experienced a liquidity squeeze as a result of tax payments. Deposits with the CBR and correspondent accounts shrunk to 865 RUB bln from ca. 1.4 trln at the beginning of the month. This was accompanied by a surge in interbank rates to 4.5–5.0% (o/n loans to first-tier banks).

The CBR's reluctance to further increase reserve requirements in these circumstances was rational, while the decision to hike rates by 25 bps came as a surprise to the market: inflation rates have exceeded regulatory targets ever since the beginning of the year, justifying monetary tightening. The timing of the action, however, was unexpected.

We believe that CBR will continue to intervene in the FOREX, thus supplying the market with ruble liquidity, potential budget surplus (given persistently high oil prices) might drain some of this inflow.

Key MM spreads



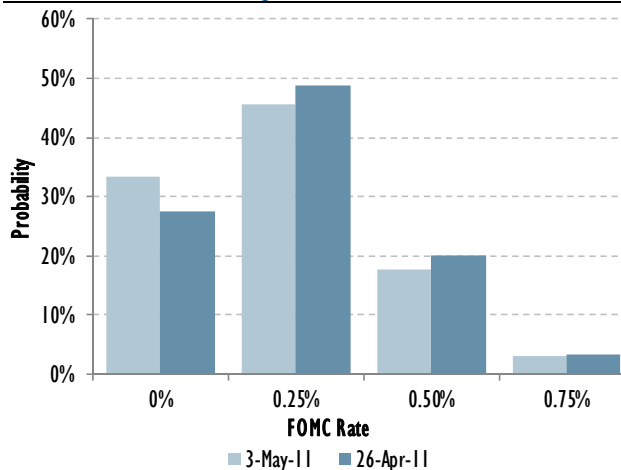
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



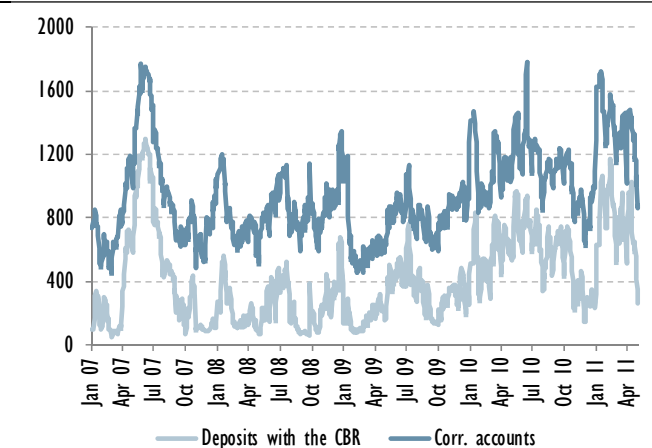
Source: Bloomberg

Implied probability distribution of possible FOMC rate decisions at December, 13th meeting



Source: Bloomberg

Liquidity in the Russian banking system



Source: CBR

4. Stock markets

▶ Developed markets

Stock market dynamics in developed economies in April can be characterized by consolidation in the absence of strong drivers for growth (corporate profits topped forecasts in ca. 75% of companies who have reported results since April 11, but failed to provide enough stimuli) or concerns for profit taking. S&P's decision to downgrade US sovereign rating outlook to 'negative' from 'stable' triggered a sharp correction worldwide, which, however, quickly rebounded. This, together with a decline in the implied volatility index (VIX) to pre-crisis levels (ca. 14.5–15.5 points), indicates the reluctance of players to close long positions.

Indices in the US and Europe added on average 3.0–4.0% (German DAX increased as much as 6.8%). Banks underperformed the market, increasing by less than 2.0% in Europe and slumping 4.3% in the US on weak 1Q financials as compared to other sectors.

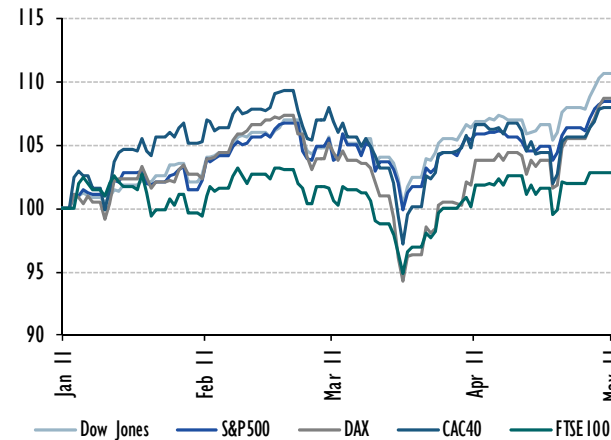
Notably, May is historically seen as a bad month for stocks, so we do not rule out the possibility of a sell-off before the summer.

▶ Developing markets

GEM equity funds received a net inflow of funds of ca. \$6.2+ bln in April, of which only \$0.9 bln were dedicated to Russia. As a result, Russian stock market underperformed most of its EM peers, despite high oil prices.

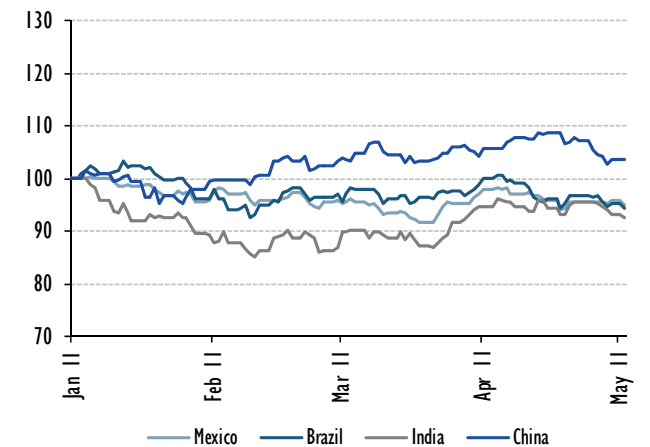
The general degree of risk aversion throughout the world remains high, as indicated by persistently high CDS spreads on some European sovereigns, as well as by UST yields that resumed their decline as a result of intensified 'flight to quality'. With all this in mind, we do not expect a serious rebound in EM indices in May.

DM stock markets dynamics, January 2010=100



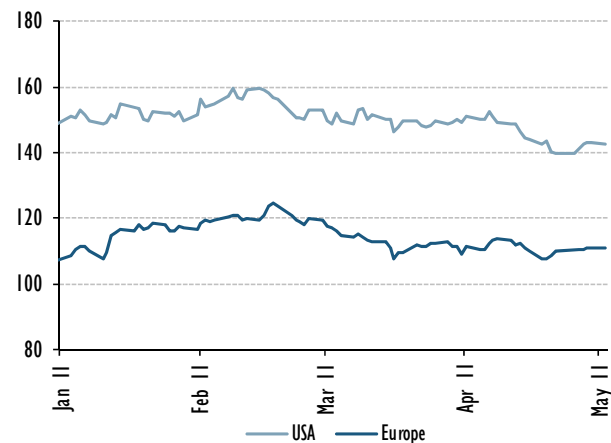
Source: Bloomberg

EM stock markets dynamics, January 2010=100



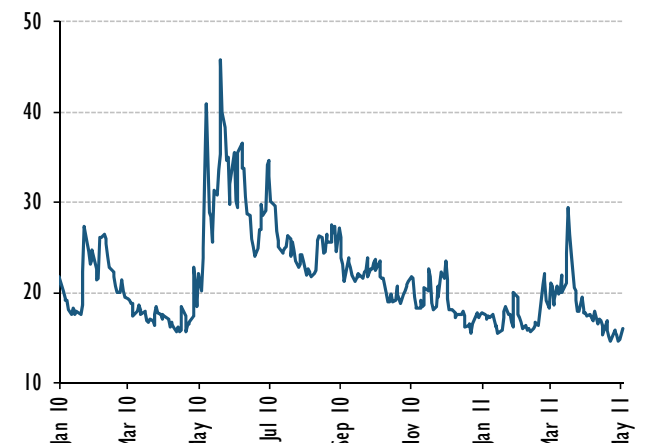
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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