February: assessing start dynamics

GAZPROMBANK

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Key indicators: February forecast

Indicator	February 2011F	2011F MED*	2011F GPB Research
Real sector			
GDP, y/y	–	4.2%	3.9%
Industrial production, y/y	4.5%	4.1%	3.5%
Capital investments, y/y	9.8%	9.0%	8.8%
Retail sales, y/y	3.1%	4.8%	4.3%
Private sector			
Real income, y/y	2.5%	3.3%	4.4%
Accrued salary, RUB	–	23,490	23,697
Foreign economy			
Trade balance, $ bln	15.0	128.1	125.1
Average oil price (Urals), $/bbl.	98.6	81	94
Stock market			
RTS, points	2,000	–	2,200
Exchange rate, inflation and rates levels			
Inflation (CPI), y/y	10%	6.0–7.0%	8.0%
Refinancing rate	8.0%	–	–
Bicurrency basket, RUB (avg.)	34.0	35.53	33.72
Exchange rate, RUB/USD (avg.)	29.3	31.3	29.60

- no forecast available;
* latest available forecast

Source: MED, Gazprombank estimates

2010 results: could've been better

2010 results revealed that the economic crisis had not stimulated structural changes and that the lack of internal drivers restricted the pace of recovery. GDP growth of 4.0% was modest, even compared to developed countries (US GDP, according to preliminary data, increased by 2.9% after a decline of only 2.6% in 2009, while the plunge of the Russian economy in that year amounted to 7.8%). At the same time, inflation remains a problem: monetary authorities were unable to keep CPI growth rates within the forecasted limits (initially at 6–7%, they were raised to 7–8% in September), and prices increased by 8.8%.

2011: new drivers are not evident

Russian economy as it enters 2011 is not in its best shape. The low base effect that helped key indicators to demonstrate high growth rates throughout 2010 is no longer expected to affect statistics. Meanwhile, a certain degree of uncertainty over the pace of internal demand recovery (as well as over the sources of its satisfaction) remains in place, thus limiting activity in manufacturing. The unexpectedly warm January may have provided a positive impulse for constructions, while hurting utilities, so the overall effect is likely to be neutral.

Leading indicators so far give a mixed impression. On the one hand, PMI indices indicate a further rise in economic activity and optimist both in manufacturing and services sectors. On the other – credit availability to borrowers in the nonfinancial sector might worsen if the CBR continues to tighten monetary policy. At the same time, investment demand so far seems to be depressed: unfilled factory orders continued to decline, which indicated the presence of excess capacity in most of the industries.

ST forecasts

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

- *Real sector and price level*. Industrial production growth is likely to be negatively affected by the absence of the low base effect (on the technical side) and by low competitiveness of the products (on the fundamental side). We expect the official figures to decline to 4.5% y/y. Fundamentals for capital expenditures remain weak (because of excess capacity), but the growth figures will be supported by technical factors for a short while. In February, we expect capex to increase by 9.8%. Retail sales dynamics are likely to remain positive, but the year-on-year figure is may decelerate further due to diminishing low base effect. However, accelerating inflation (up to 10% y/y), fuelling inflationary expectations, may drive demand up.
- *External sector and exchange rates*. We share a positive view on the near-term commodity price levels, based on worldwide liquidity abundance, and enforced by the geopolitical instability in the ME. Under our base-case scenario, Urals price will average at nearly $99/bbl, and we do not anticipate the trade balance to fall below $15 bln in February. Although we observe that the exchange rate policy remains a priority for the CBR, we believe that further tightening is inevitable, and thus the RUB is likely to appreciate further. Our ST targets are 29.0 for RUB/USD and 33.8 RUB for CBR bi-currency basket.

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Leading indicators

Money and credit

The monetary base surged in December, when the financial system, as usual, received the bulk of year-end budget expenditures. However, the money supply lagged behind, despite a visible increase in lending activity (at least by Sberbank). As a result, the money multiplier leveled at 2.5x, coinciding with the year average.

Despite sufficient amounts of liquidity accumulated by Russian banks (deposits with the CBR and correspondent accounts amount to 1.4 trln RUB), an increase in RRR, effective 1 February, and a general course to tighter monetary policy might restrict credit availability to no-financial sector in 2011.

Energy consumption

High degree of correlation between energy consumption and industrial production (ca. 90%), observed in 2008–2009, did not continue into 2010. A change in Rosstat approach to output estimation, as well as extreme weather conditions might've contributed to such change in relationship between the two variables.

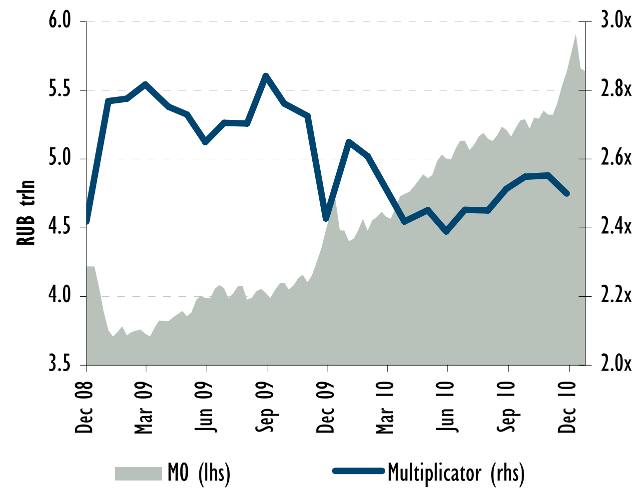
We associate low y/y energy consumption growth rates in January 2011 with the high base effect of last year and do not expect the key industries to exhibit a serious slowdown.

Economic activity

Manufacturing activity in January remained strong: sector PMI, according to HSBC estimates, remained at its 33m high (53.5 p.). Producers indicated new orders acceleration to the maximum pace since 2008, while unfilled orders continued to decline, which indicated the presence of excess capacity in most of the industries.

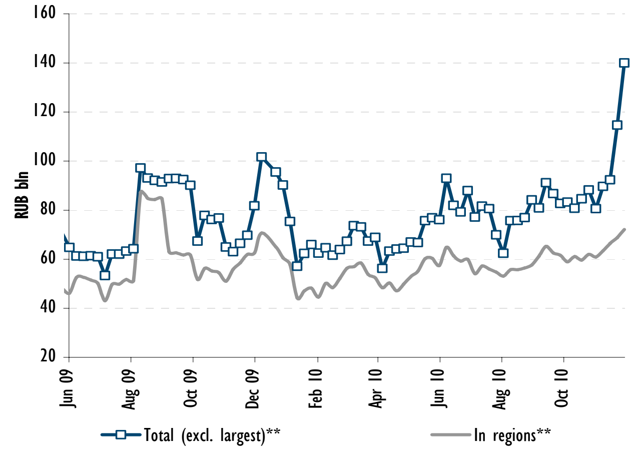
Services demonstrated a modest deceleration of economic activity, but remained on the rise with sector PMI at 54.2 p., well above the 50 p. threshold, as well as above the 2010 year average (53.6 p.).

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

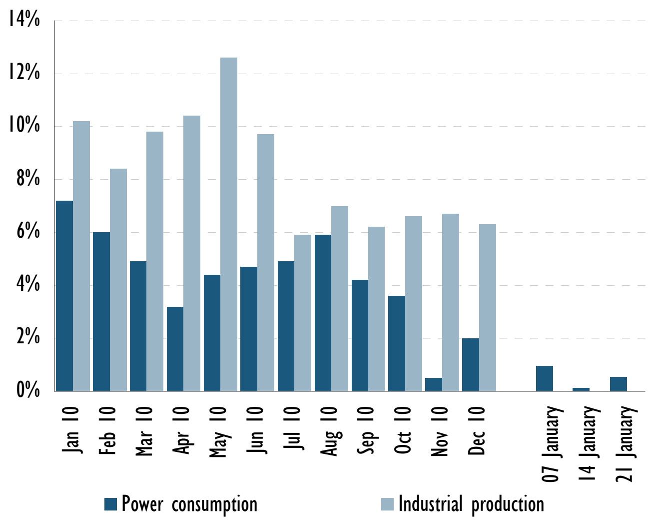
Sberbank's lending volume*, RUB bln



* weekly volumes;
** 4-week average

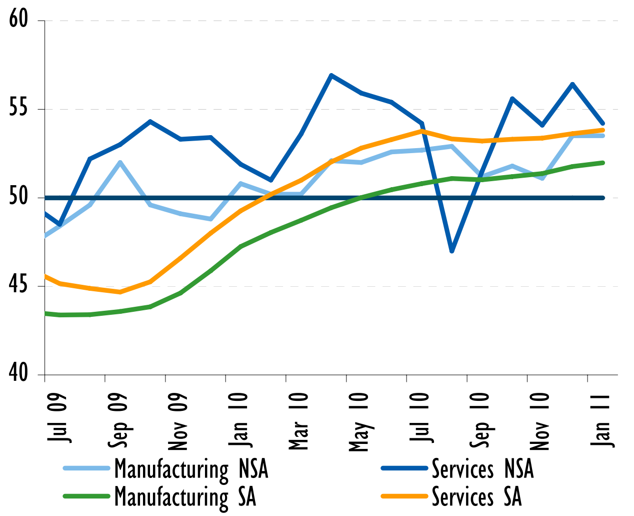
Source: CBR, Gazprombank estimates

Power consumption vs. industrial production, % y/y



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

Current economic environment

- **Industrial production** in 2010 only partially recovered after the preceding slump, adding 8.2% in total. A change in methodology used by Rosstat (an upward revision of industries' contribution to GDP) resulted in a growth figure for GDP of 4.0% y/y. However, Russian economy has yet to reach pre-crisis levels.

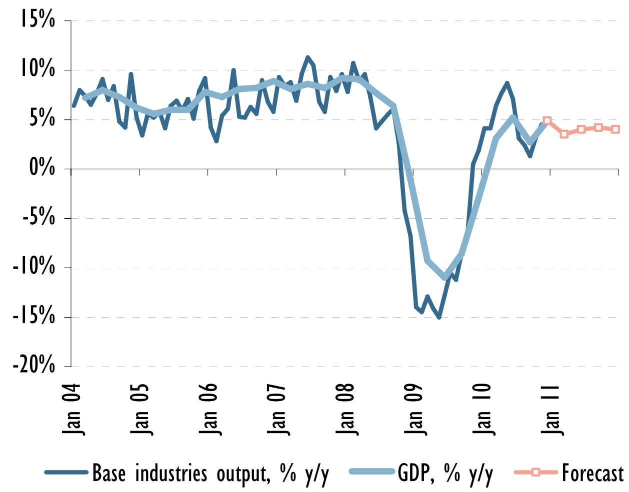
  Mining and utilities in 2010 grew by 3.6% and 4.1% respectively, while manufacturing took the lead on the rebound and increased output by 11.8%. It is noteworthy that this component of industrial production suffered the most in 2009: activity plunged by more than 15%.
- **Investment in productive capacity** in 2010 increased by 6.0%, despite the low base effect (in 2009 investment was cut by 16.2%). Companies were reluctant to increase capex in the environment characterized by high degree of uncertainty over the pace of demand recovery and low capacity utilization.
- **External sector and exchange rates**

  The fears of severe ruble depreciation towards the end of the year did not come true despite the unexpectedly high capital outflow: CBR estimated capital flight in 4Q10 only to amount to $23 bln, and the overall yearly figure reached almost $40 bln. Bi-currency basket lost 1.7% in value in December.

  In January, the ruble appreciated further, especially against the USD (by 2.4%). The bi-currency basket reached 34.75 RUB by the end of January (-1.2%), and we believe that it could've been even lower if the euro did not rebound responding to EU measures.

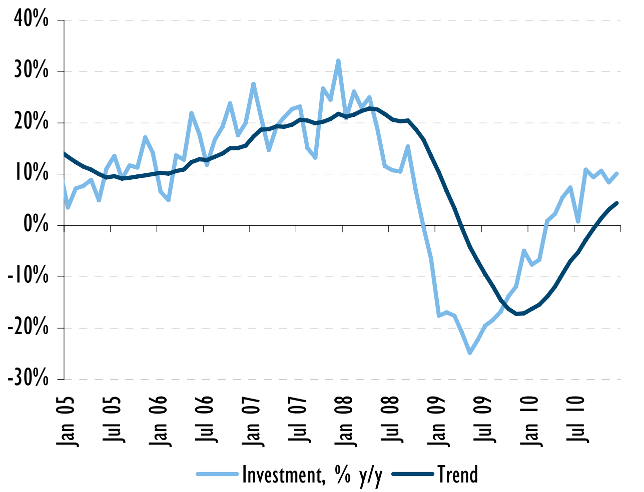
  We believe that the CBR did not undertake any major interventions in the FOREX market in January. Although reserves increased by $5.3 bln YTD, most of this change was due to revaluation, while we estimate net purchases of currency to not exceed $100 mln. External conditions remained rather favorable: oil prices exceeded $100/bbl (Brent), and the outlook for further dynamics remains positive. This is likely to contribute to a higher net inflow from external trade.

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



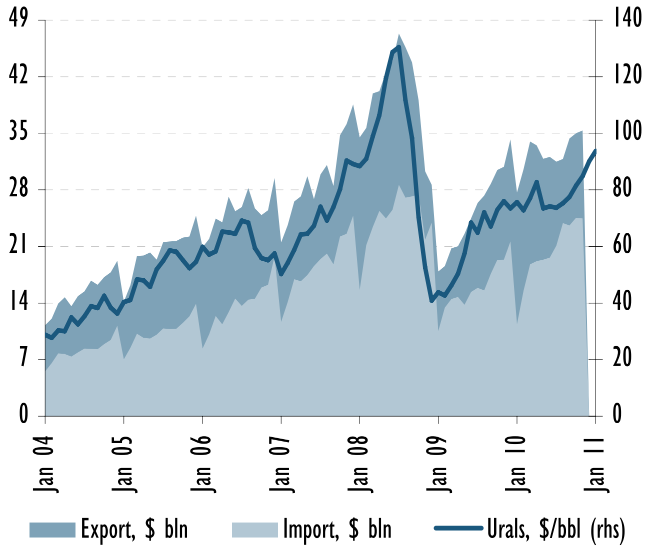
Source: Rosstat

Investment in working capital, % y/y



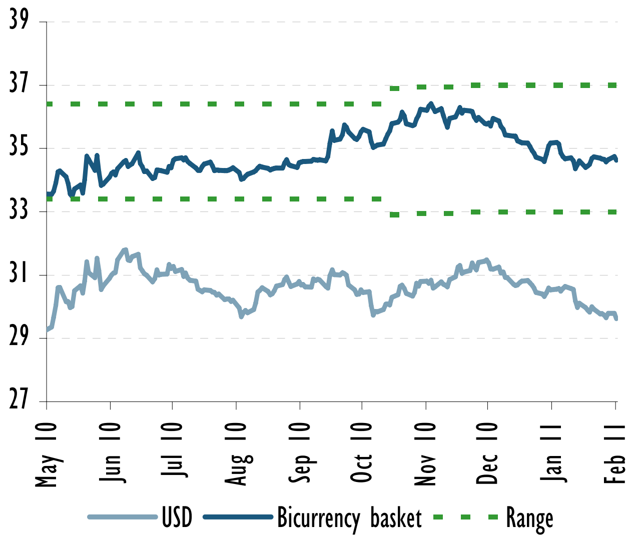
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble rate curves



Source: Bloomberg, CBR

- **Consumer confidence**

  Although surveys of producers' sentiment revealed a modest improvement in demand expectations, consumer confidence indicators supply mixed evidence. Unemployment rate unexpectedly jumped by 0.5 pp (which is a lot even taking into account seasonal factors) to 7.2%. Marginal propensity to save continued to decline, although at a slower pace, and currently stands at ca. 14.5% of real disposable income.

  The low base effect almost ceased to affect the figures for retail trade turnover by the end of the year, and in December growth decelerated to 3.4% y/y. The overall increment in 2010 amounted to 4.4%, almost erasing the previous year's loss (-4.9%).

- **Inflation**

  Inflation risks became a major threat in January after jeopardizing the regulator's plant to keep prices growth within the limit of 7.0% and then within 8.0%, in 2010.

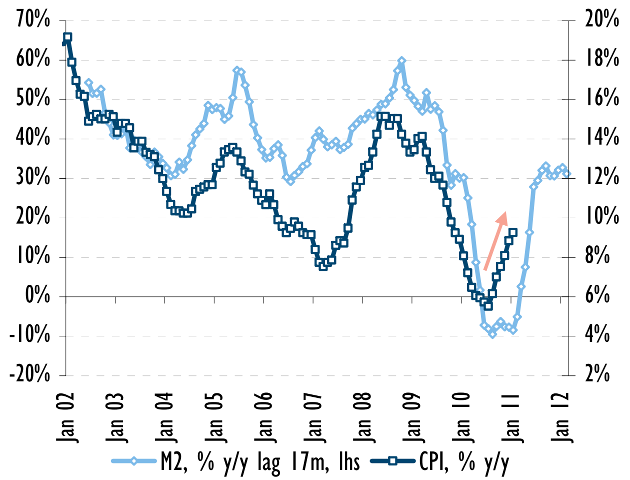
  Prices grew 2.4% YTD, and despite the number of non-monetary factors affecting their dynamics (tariffs indexation, food inflation, etc.), the monetary component also adds its share. In this environment the decision to increase RRR by 0.5–1.0 pp, and the reluctance of the CBR to increase interest rates, points to the following conclusions: the forecast for this year (CPI growth of 6–7%) is likely to be revised upwards, and the regulator is concerned with the ruble appreciation.

- **Capital markets**

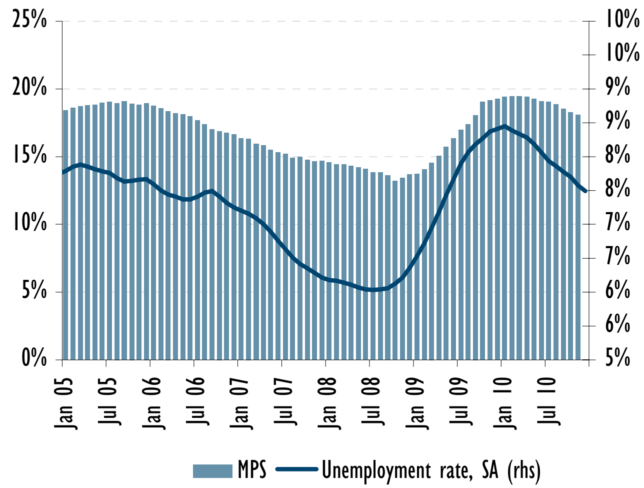
  Inflow into Russia-dedicated funds YTD exceeded $1.0 bln, and the stock market outperformed most of its EM peers (MICEX +2.1%, RTS +5.7%).

  Minfin continued to borrow in December, making up for most of the debt increase (154 RUB bln, net). However, budget deficit in 2010 proved to be less than expected (1.8 RUB trln, or 3.9% of GDP). The success of 2010 borrowing program now depends on the CBR monetary policy.

Inflation and money supply dynamics: risks are evident



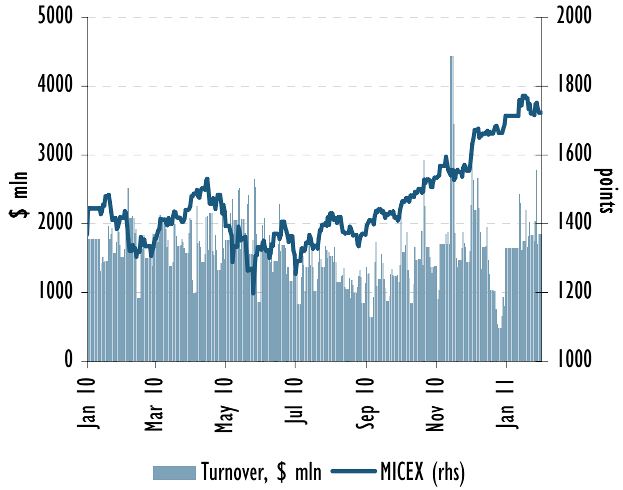
Consumer confidence indicators



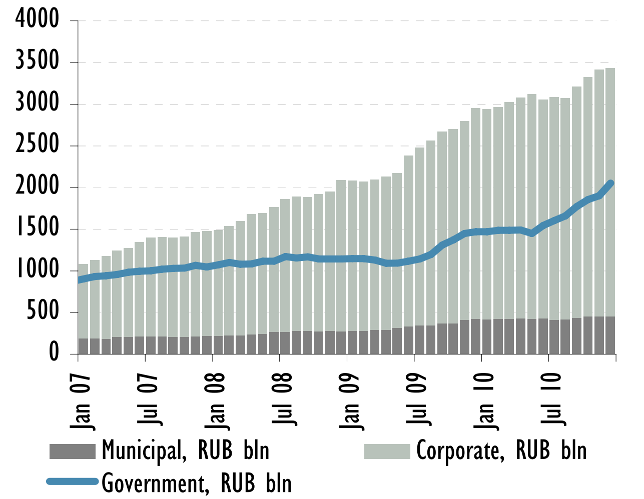
Source: Rosstat, MED, Gazprombank estimates

Source: Rosstat

Stock market dynamics



Bond market volume (at par value)



Source: Bloomberg

Source: Cbonds

Appendices
1. Economic situation abroad

- USA

There are signs that the US economy is improving, although at an uneven pace across the various sectors. Preliminary estimates of 4Q10 GDP growth missed forecasts, but nevertheless accelerated in 3Q10: the key indicator added 3.2% q/q (annualized) vs. 2.5% in the previous quarter.

Yet, labor market remains weak despite a modest improvement in NFP. This area together with housing sector was indicated as the key threat to recovery by the FED in its FOMC statement from January 26. Rotation of voting rights within the FOMC did not affect the outcome of the meeting: continuing with QEII was supported unanimously.

- Europe

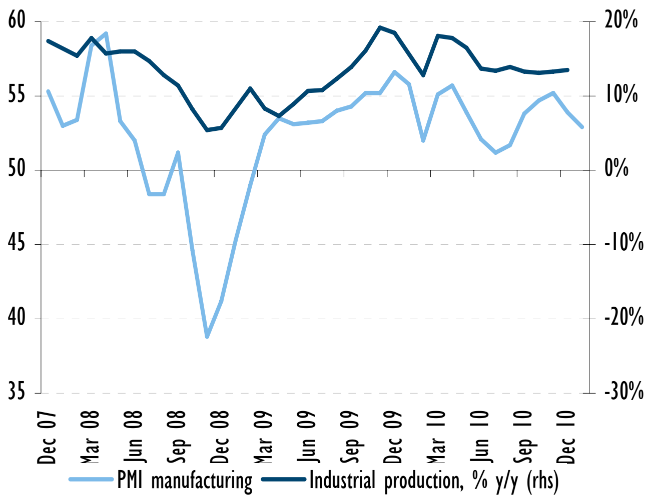
In January, Ireland conceded to the EU–IMF pledges to accept aid package to prevent contagion. Yet, markets are anticipating a more systematic approach to dealing with highly indebted countries: EU leaders at the January Summit agreed to develop a long-term mechanism of financial assistance (scheduled to be released in March).

Economic data within the eurozone remains somewhat mixed. However, successful sale of EUR 5.0 bln EFSF bonds indicates that investors have trust in the region as a whole (and in the common currency, which added 6.6% after reaching a bottom at $1.2907 earlier this year), although their attitude to member states may differ (as indicated by the CDS spreads).

- China

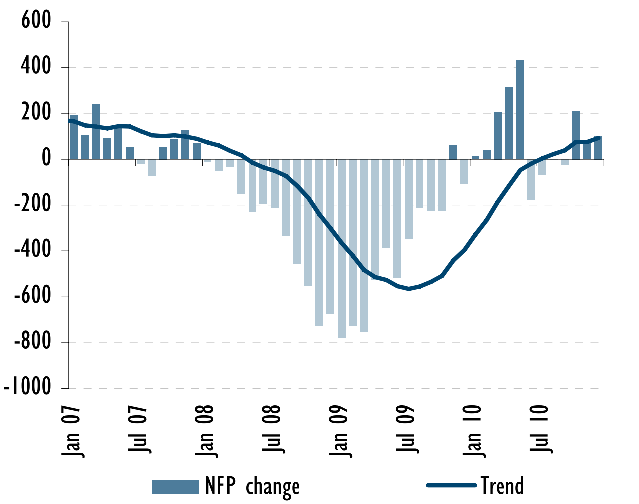
Accelerated inflation (4.6% in 2010 – 1.6 pp above the PBoC target) raises concerns that further monetary tightening is on the way. A recent hike in RRR (to 19%) illustrated that regulators are indeed trying to stem prices growth, but their tool kit is limited. Keeping CNY artificially undervalued deprives the authorities of a right to increase interest rates, however restrictive the capital controls in place.

China's manufacturing indicators



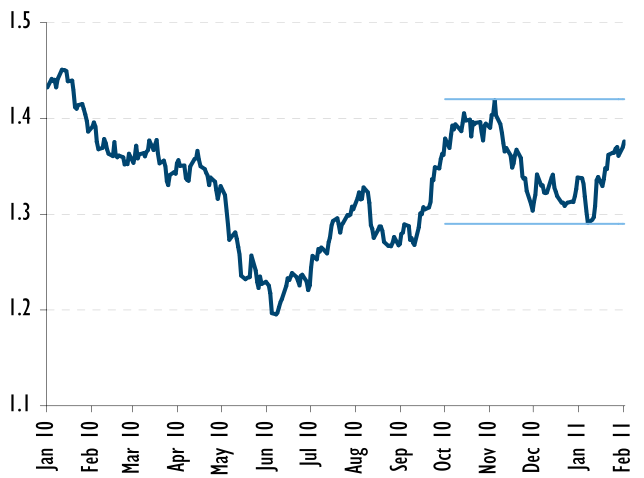
Source: Bloomberg

Change in non-farm payrolls, thousands



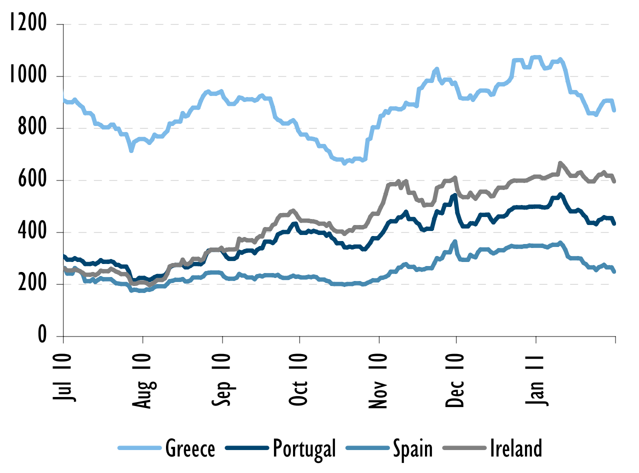
Source: Bloomberg, Gazprombank estimates

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics (eurozone)



Source: Bloomberg

2. Commodity markets

- Oil

Oil prices continued to climb, although the difference in quotes between the US and European markets widened. Further accumulation of crude inventories, accompanied by a temporary halt in Alaskan pipeline was weighing on the American WTI prices, while European markets were spared of that influence. Brent–WTI spread widened to $12 at the end of January.

The general outlook for oil prices remains positive. Futures curve shifted upwards by $6.3–6.6, depending on the maturity of the contract. The geopolitical instability in NA countries and risks of contagion to the ME region also seems to support the hawkish outlook on oil price dynamics in the near future.

- Metals

China manufacturing sector, which appears to be the key consumer for metals (especially steel), continued to expand: PMI in January demonstrated a modest decline to 52.9 p., but remained well above 50, indicating positive dynamics of industrial production. Base metals prices increased by 1.3% YTD, while futures contango widened from 1.9% at the end of 2010 to 2.7% as of the end of January. This points to optimistic expectations by market participants.

Gold, on the contrary, declined by almost 6% YTD as uncertainty over the pace of economic recovery subsided, decreasing the investment demand for the metal.

- General indicators

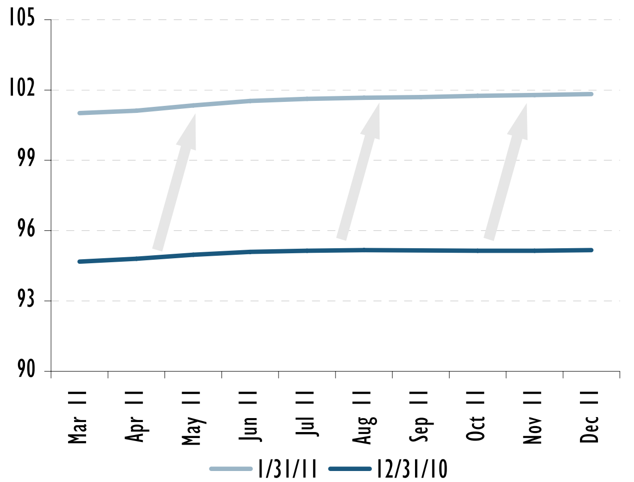
Baltic Dry index has recently become a poor indicator of the world trade, as there are a number of factors affecting freight rates. The indicator declined by 37.6% YTD and currently stands at 1107 pts. (a minimum for two years).

However, there are two key influences: dry-bulk fleet is expected to increase by 13% this year (as ships ordered in 2007 and 2008 are leaving shipyards) and Chinese New Year halted economic activity in the country for as long as one week.

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

Money markets worldwide remain abundant in liquidity. Ben Bernanke in his most recent speech pointed out that the US economy needs to see faster rate of jobs creation for a sufficient period of time before unwinding stimulus measures. We therefore expect QEII (purchasing up to $600 bln of LT UST by the end of 1HJ011) to be executed in full and do not rule out further monetary easing.

MM rates in the US remain low (3m LIBOR exceeds the Fed rate by 5–6 bp, 1-year rates are stable at below 0.8%), while the key spreads fluctuate within a narrow range (TED-spread: 15–17 bp; 2-year swap spread: 20–25 bp).

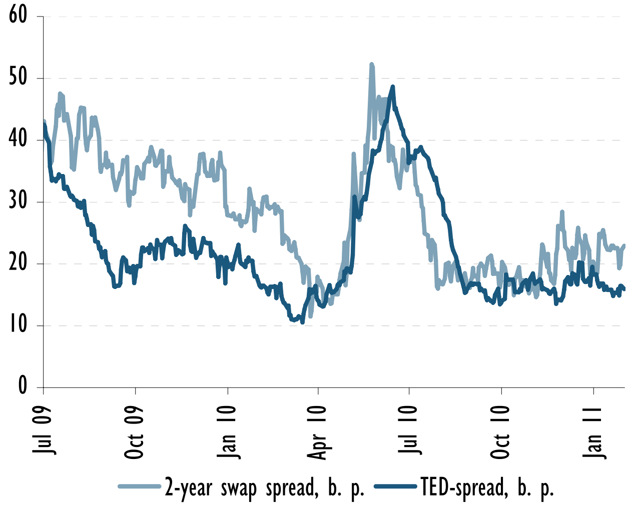
UST yields are so far the only indicator that demonstrates worrisome dynamics: since the beginning of February 10-year UST rate increased by more than 20 bp, reaching the vicinity of 3.5%. Despite the common belief that UST yields are reacting to higher inflation expectations, spread between 10y UST and 10y TIPS remained almost unchanged, which points to some other source of higher costs of borrowing for the US government.

Russian money market

The Russian MM has fully recovered after the tough times in November – December 2010, when tax payments erased a significant part of the liquid cushion on the banks' BS. Budget year-end expenditures contributed to higher balances of CBR deposits, as well as correspondent accounts: up to date banks managed to accumulate more than 1.4 RUB trln in liquid assets.

The interbank rates generally remained below the yields on CBR deposits: Tier 1 banks were able to borrow o/n at 2.0–2.75%. Although we expect that monetary tightening is on the way, so far CBR actions did not affect the interbank market: the recent RRR increase could only drain 50–60 RUB bln.

Key MM spreads



Source: Bloomberg

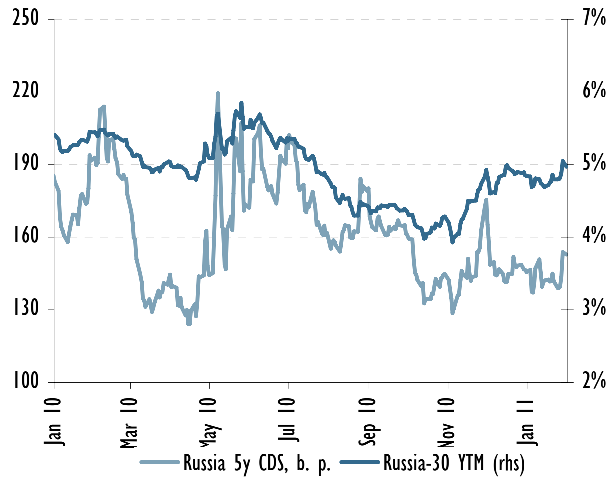
1-year LIBOR and 10y US Treasuries yield

Source: Bloomberg

EMBI+ spread

Source: Reuters

Indicators of credit quality of Russia's sovereign debt



Source: Bloomberg

4. Stock markets

Developed markets

The 4Q10 reporting season in the US is nearing the end, and despite certain discrepancies among sectors and particular companies within those sectors, the overall impression is rather positive. Ca. 75% out of the 500 S&P index members beat market forecasts on EPS by an average of 7.4%. Basic materials and technology companies have poised record growth in earnings (by 57% y/y and 34% y/y respectively). The companies' expectations for 2011 are modest but positive as well: earnings are expected to increase by 10–15% on average in the following four quarters.

However, extended tensions in Europe (concerning the financial health of the most indebted countries) prevented the DM indices from exhibiting high growth rates in January: key indicators added 2.5–5.0% YTD. Financial stocks in the US were lagging behind with an increment of only 2.0%, while in Europe banks stocks rallied (+8.0%).

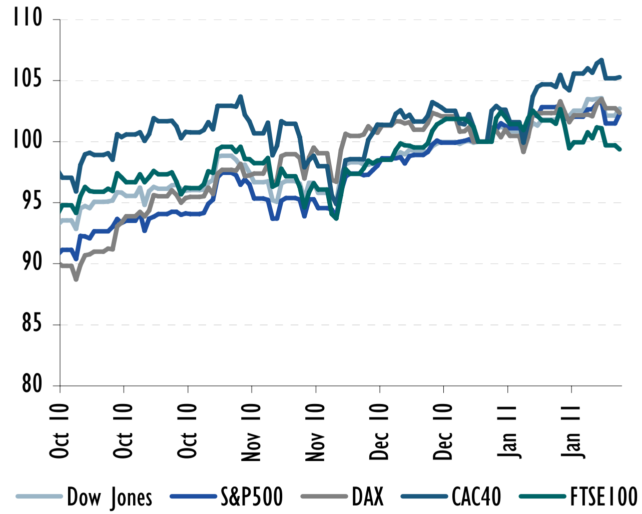
It should also be noted that VIX index (which shows implied volatility in the market) recently increased by almost a third, exceeding 20 points.

Developing markets

Russia was the best performer among the EM. While BIC indices slumped by 4.0–10.0% in January, both RTS and MICEX demonstrated positive dynamics.

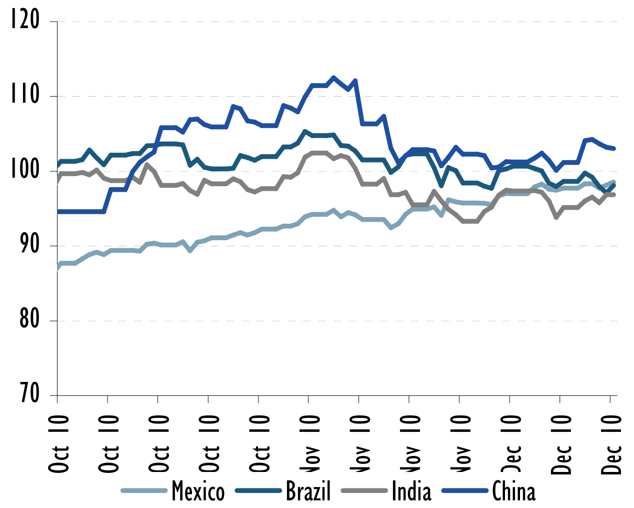
We believe that the key factor that contributed to such a poor performance of EM was the enforcement of capital controls by the monetary authorities (especially in Brazil and China), diverting some of the flows towards alternative recipients of investments. However, relatively low risk appetite of global players could make the growth of the Russian market at the current pace unsustainable. However, as long as commodities continue to support the inflow of funds into Russia we don't expect a major correction.

DM stock markets dynamics, January 2010=100



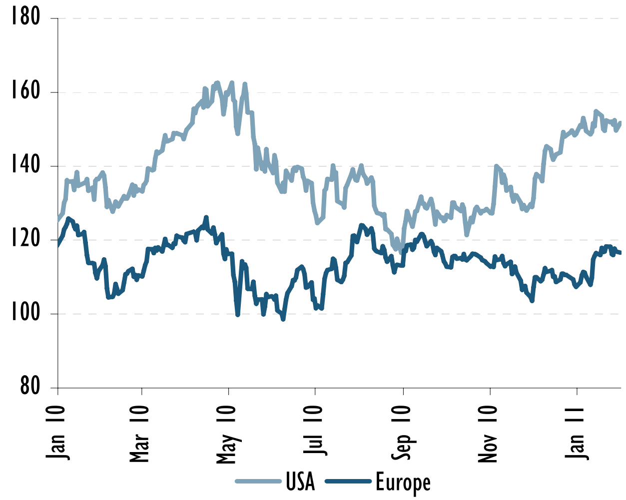
Source: Bloomberg

EM stock markets dynamics, January 2010=100



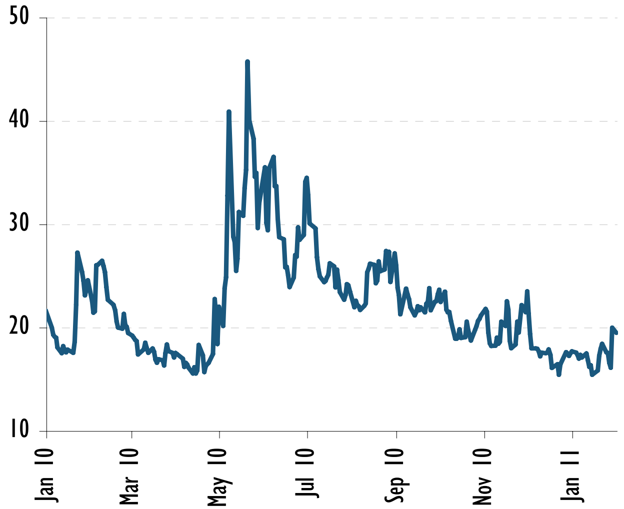
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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