June 2011: challenge of ambition

GAZPROMBANK

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April – May 2011: a cool spring

Despite higher-than-expected oil prices, the real sector indicators in the first four months of the year demonstrated poor dynamics and some of them even got downgraded from preliminary estimates. First half of spring brought no relief, with transportation volumes decelerating and economic confidence fading. Although there has been some improvement on the demand side (with some recovery in investment activity and acceleration in retail trade turnover), growth rates remain subdued. Given high inflation risks, the regulator has to deal with conflicting objectives of maintaining price stability and promoting economic growth.

June 2011: any warmer?

We lay our hopes on investment activity as a key driver of economic growth. There is, however, a number of prerequisites for this, including strengthening consumer confidence and attractive financing opportunities. As a number of companies have already postponed their IPOs, we believe that it will take some time for capex to return to pre-crisis levels.

Inflationary pressure may ease a little over the summer months due to a seasonal decline in the price of agricultural products. Still, other factors (including fuel deficit in some regions and the embargo on vegetables import from the EU) are unlikely to allow any significant slowdown in CPI growth rates, posing an obstacle to disposable income recovery.

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 there is potential for trade surplus to squeeze slightly in the coming months due to lower oil prices on the one hand and higher import growth rates, fuelled by potential increase in investment demand, on the other. This, together with ongoing capital outflow as a result of high risk aversion, may ease pressure on the ruble. We expect crude oil prices (Brent) to average $115 in June, contributing to a trade surplus of $14.5 bln. Diminishing FOREX interventions by the CBR enhanced by lower external pressure on the currency might allow the ruble to depreciate to an average of 28.5 RUB vs. USD and 33.7-34.2 RUB vs. the dual currency basket.
- *Real sector and price level*. The scope for improvement on the demand side, in our view, remains limited. Supply-side parameters may find some support in decelerating ruble appreciation (although inflation rates at 9.6-9.8% YoY are likely to ensure a weak appreciation in real terms). Real disposable incomes, in our view, will continue to suffer from high growth rates of the CPI, which leaves our projection for June at a negative 2.5% YoY. However, expectations of higher incomes and the revival of credit activity are likely to provide stimuli for retail demand. As a result, sales may rise by almost 5.0% YoY in June, with a likely increase in the share of imported products. Industrial production may demonstrate a seasonal increase, but due to the diminishing low base effect, the actual figure, in our opinion, is going to be limited to 4.5% YoY. Investment may rebound to 4.4%, gaining momentum after stronger seasonally-adjusted growth in April.

Key indicators: June forecast

Indicator	June 2011F	MED*	2011F GPB Research
Real sector			
GDP, YoY	–	4.2%	3.9%
Industrial production, YoY	4.5%	5.4%	3.5%
Capital investments, YoY	4.4%	6.0%	6.8%
Retail sales, YoY	4.9%	3.8%	4.3%
Private sector			
Real income, YoY	-2.5%	1.5%	4.4%
Accrued salary, RUB	–	23,940	23,784
External sector			
Trade balance, $ bln	14.5	195.1	153.6
Average oil price (Brent), $/bbl, av.	115	105	108
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	9.7%	7.0–7.5%	8.5%
Refinancing rate, eop	8.25%	–	–
Bi-currency basket, RUB (avg.)	34.0	33.38	32.72
Exchange rate, RUB/USD (avg.)	28.5	28.4	27.5

– no forecast available;

Source: MED, Gazprombank estimates

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Leading indicators

Money and credit

Monetary base continued to grow in May, although at a slower pace than a month before: the combined figure for cash in circulation and the required reserve balances at the CBR increased by 2.1%. The money multiplier in April also stood at an almost historical high of 2.75x.

The data supplied by the CBR on general credit activity suggests that lending has recently accelerated: the amount of commercial loans added 16.6% over the last 12m as compared to a similar period a year ago while consumer loans were up by 20.7% over the same period. Overall, it suggests that the MM is likely to remain close to its historical high, which provides grounds for further inflationary pressure in the near future.

Energy consumption

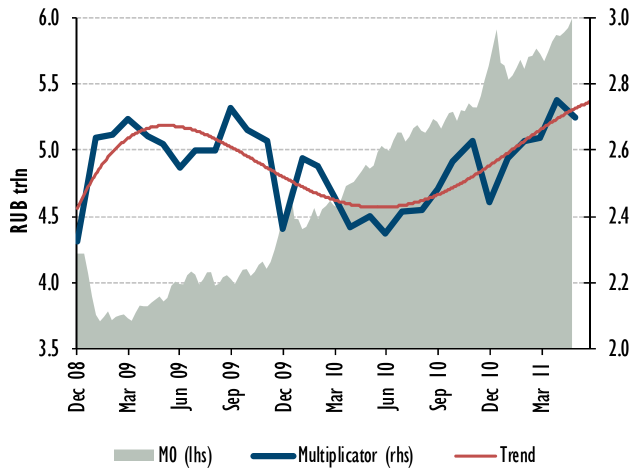
Industrial production decelerated in April despite higher energy consumption figures. We believe that this divergence may be attributed to technical factors (such as the high base effect in manufacturing). The absence of the 'weather factor' during the summer months allows us to presume that the correlation between the two variables is likely to recover, at least to some extent. Therefore, May growth rates of 3.0-3.5% YoY can infer a modest increase in economic activity.

Economic activity

Economic sentiment in May, however, remained subdued. The Manufacturing PMI dropped to 50.7 points from 52.1 in April. The figure only marginally exceeds the 50 p. threshold, indicating the slowest rate of growth in manufacturing activity since December 2009.

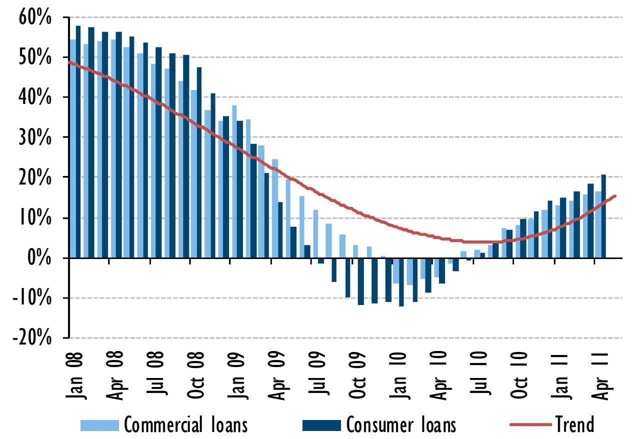
Yet, there has been a further slowdown in transportation volumes in April: the indicator added 3.1% over the first four months, while the 1Q increase was at 3.7%. The dynamics may be interpreted as reluctance of companies to increase stock of finished goods as prospects for future sales remain obscure.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

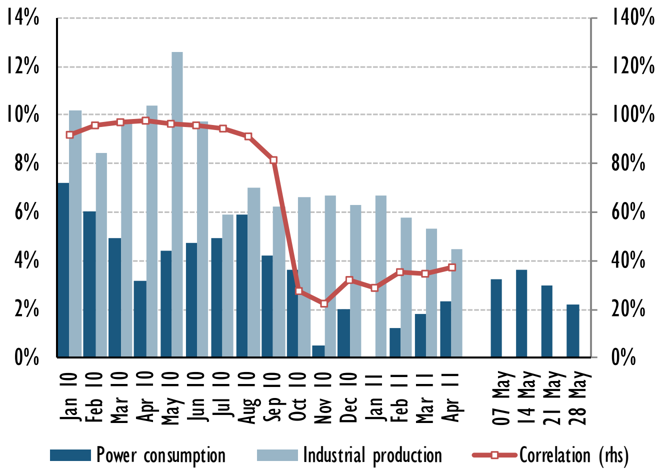
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

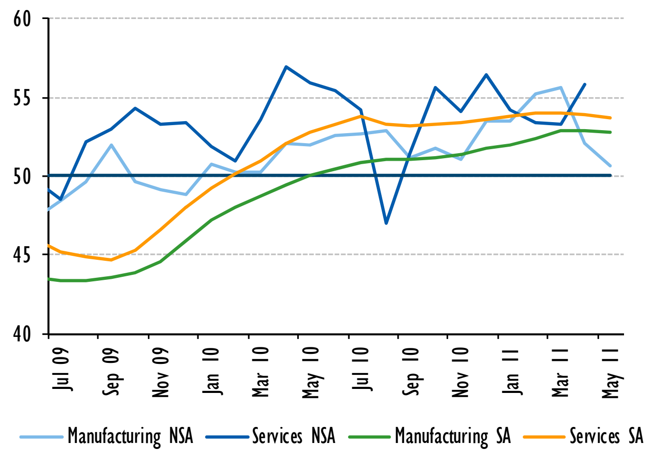
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

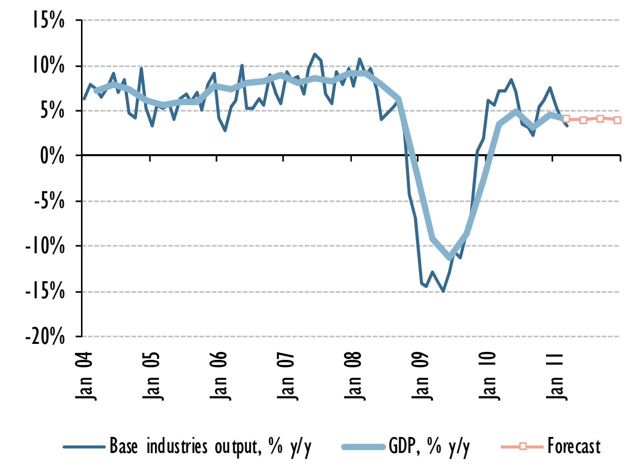
Current economic environment

- **Russia's GDP** in the 1Q added 4.1% YoY, according to data supplied by Rosstat, falling short of the 4.5% increase previously estimated by MED. The seasonally adjusted figures were therefore revised downwards to a negative 0.1% in January, and marginally positive 0.1% and 0.2% in February and March, respectively. Economic growth slowed down again to 0.1% MoM in April. Industrial production (+0.3%) provided a positive contribution to the overall GDP figure, but it was offset by a further slump in construction (-1.3%). Ongoing decline in RDI poses another serious concern for further economic growth.
- **Industrial production** in April decelerated further: to 4.5% YoY from 5.3% YoY in March. The seasonally adjusted increase in output amounted to only 0.3%, down from 0.7% a month before. Mining exhibited a decline in output by 0.6% (SA). Industrial production was also affected by deceleration of manufacturing output growth to 0.6% from 1.0% in the previous month (SA), combined with an increase in its share to 84.3% from 83.0% a month before.
- **Investment in productive capacity** finally ceased falling and added 2.2% YoY. However, even a seasonally-adjusted increment of 5.3% MoM is yet unable to offset the decline by 15.2% over 1Q11. We believe it to be a positive sign, although in the longer run, this might negatively affect external trade balance.
- **External sector and exchange rates**

  Foreign reserves at the CBR reached a local maximum of $524.7 bln in the week ending May 6 and then started to decline. This can be partially attributed to revaluation, while the CBR, according to our estimates, purchased ca. $2.6 bln during the month of May, down from $3.7 bln last month.

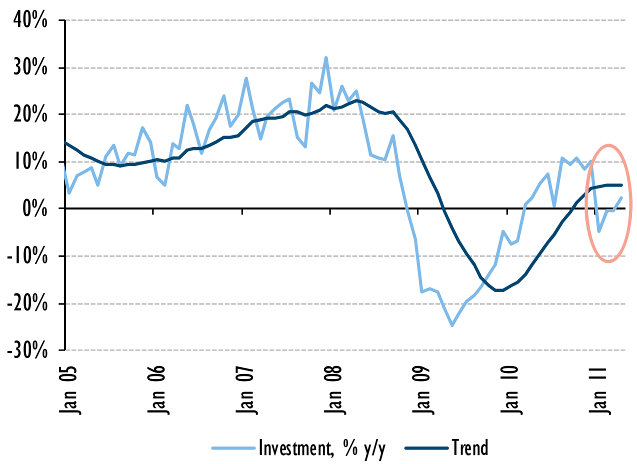
  Ruble demonstrated a modest depreciation in the first half of the month as external pressure on the currency eased a bit. The demand for ruble liquidity rose sharply in the second half of May as banks had to transfer taxes to the budget. The dual currency basket headed for its local minimum of 33.18 RUB after a modest increase to 33.37 RUB in mid-May.

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



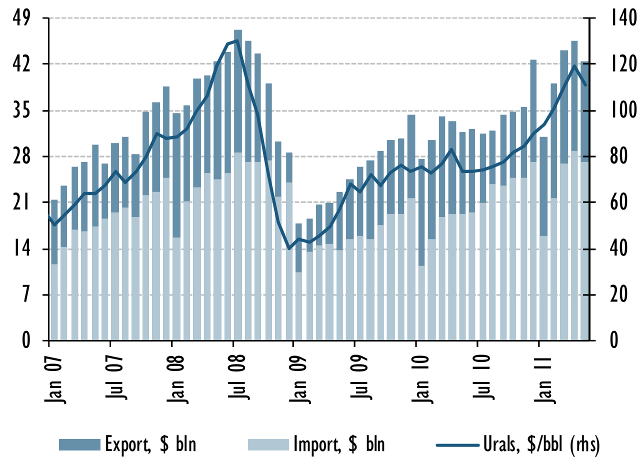
Source: Rosstat

Investment in working capital, % YoY



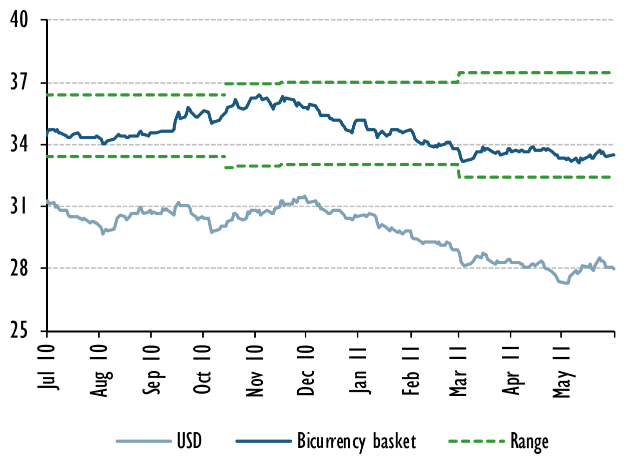
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble exchange rates



Source: Bloomberg, CBR

- Consumer confidence

Consumer confidence so far remains high despite weak fundamentals. The unemployment rate in April increased to 7.2% (seasonally adjusted figure rose to 6.8% from 6.4%), while real disposable income added 8.1% MoM, still remaining 3.8% below the level of a year ago. Retail sales turnover continued to increase, and even accelerated in April, adding 5.6% YoY. This indicates a further decline in the marginal propensity to save and a higher demand for loans.

Deceleration of imports despite a somewhat higher investment demand, however, indicates a halt in stock accumulation by domestic importers, which is a sign of uncertainty over future demand dynamics. Furthermore, high inflation rates are likely to restrain RDI growth in the coming months, aggravating the situation.

- Inflation

CBR's decision to leave interest rates unchanged (with the exception of the deposit rate) indicates that promotion of economic growth remains a priority for the regulator. Inflation stabilized at the 0.1% weekly rate, but yearly price increases (9.7% as of May 30) are still well above the target. CPI added 4.8% YTD, challenging the forecast of 7.0-7.5% for 2011.

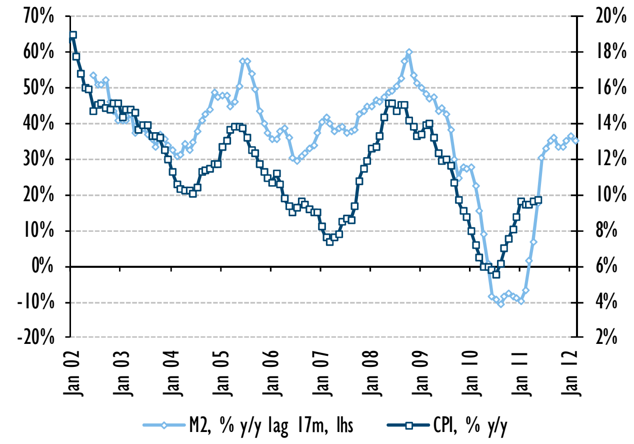
It should also be noted that producer prices have added 9.3% YTD, indicating a serious surge in costs of intermediate goods. Retailers will not be able to squeeze their margins infinitely, which may result in further hikes in consumer prices during the second half of the year.

- Capital markets

The Russian stock market continued to underperform most of its EM peers in May, with the RTS index sliding as much as 6.8% and MICEX down by 4.3%. A greater fall in the dollar index may be attributed to weakening of the Russian currency against the dollar.

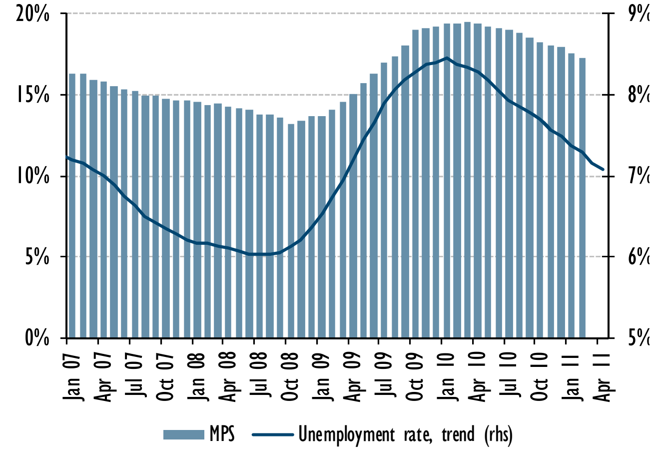
The debt markets were dominated by Russia RUB Eurobonds issue of 50 RUB bln in addition to 40 RUB bln sold in February 2011. Therefore, Minfin hasn't given up on its financing plan for the year yet.

Inflation and money supply dynamics: risks are evident



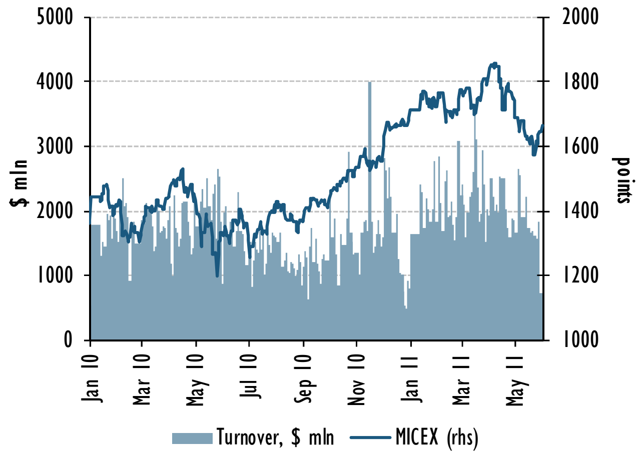
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



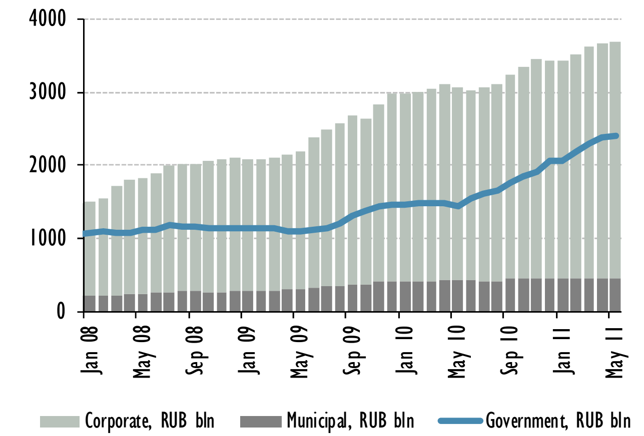
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

Europe

Europe remained one of the key newsmakers in May. Sovereign credit ratings cuts by S&P and Fitch, combined with a high degree of uncertainty over the next IMF tranche and the ability of the current government to meet its fiscal goals, exacerbated by rumors that Greece might drop out of the Eurozone, all added to higher global risk aversion. The CDS spreads on Greek debts soared to a maximum of 1,480 bps on May 24, followed by prices of insurance against Portugal and Ireland defaults (680 and 676 bps, respectively).

The European currency lost more than 5% through the first three weeks of the month, but a recent rebound from a local minimum of 1.4048 indicates that tensions in the region are easing a bit. Jean-Claude Juncker, who leads the group of euro-area finance ministers, promised that the final decision on Greek aid would be drawn by the end of June, ruling out debt restructuring.

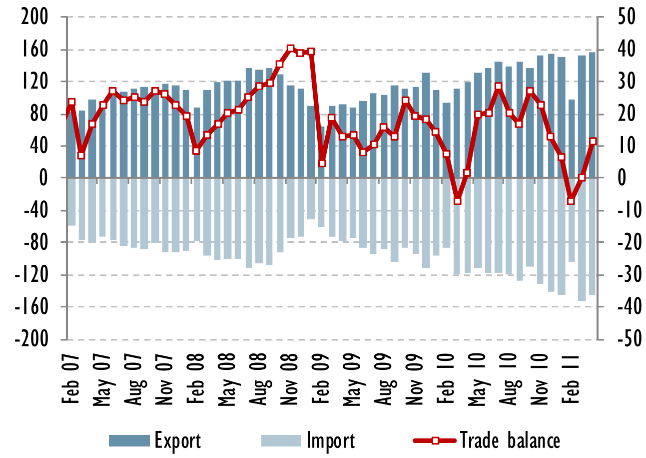
Now that Germany seems to have stopped pushing ahead with its proposal to reschedule Greek debts and China said it would purchase EFSF/EFSM bond issues to finance troubled countries' bailout, the problem may be temporarily set aside and other factors might come into light.

USA

US fundamentals in May were reported to be quite weak. The decline in consumer and producer confidence, combined with a further deterioration in the real estate sector, all put pressure on investor sentiment. Housing starts unexpectedly fell 10.6% in April to 523K (annualized). Industrial production also fell short of market consensus with zero growth in output.

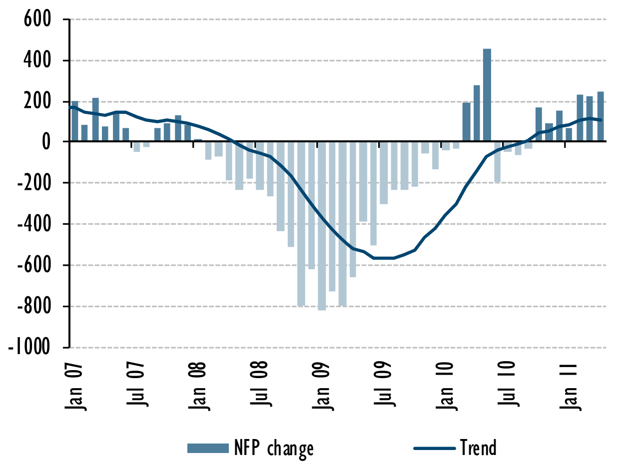
Employment statistics were also a disappointment. ADP reported an increase in payrolls of only 38K in May, which fell short of the 175K forecast and diminished drastically from the 177K reported a month ago.

China's external trade indicators, $ bln



Source: Bloomberg

Change in non-farm payrolls, thousand

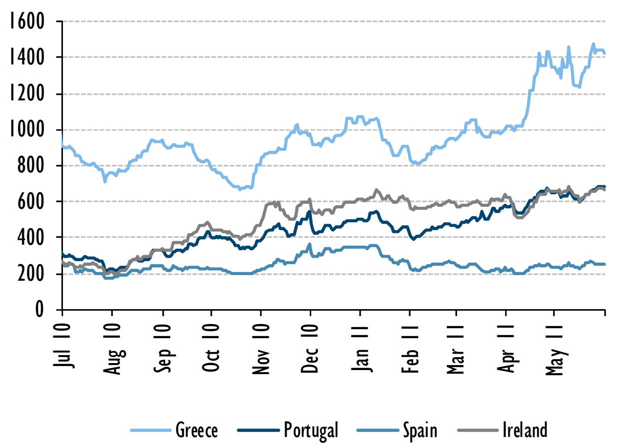


Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics

Source: Bloomberg

5-year CDS spreads dynamics on Eurozone members' debt



Source: Bloomberg

2. Commodity markets

- ### Oil

Weak labor market statistics combined with dollar appreciation against all major currencies in the beginning of May led to a sharp drop in oil prices, which exceeded 10%. During the rest of the month. oil prices consolidated within the range of $108 to $112/bbl (Urals).

The futures curve indicates that the market participants still anticipate a modest decline in oil prices in the future despite the already lower current levels as compared to a month before (the futures curve shifted downwards from its position at the end of April). However, the potential slump seems to be limited by 0.5-1.0% over the next 2-3 months.

- ### Metals

Fundamentals didn't look very encouraging for metals in May, as well. Chinese imports slowed down a bit in April (to 22% YoY), providing for a positive trade balance figure, while the Japanese economy struggled with the consequences of a devastating earthquake (a slump in industrial production in April, according to preliminary estimates, accelerated to 14% YoY from 13.1% a month before). Notably, the Chinese PMI in May decreased further to 51.6, indicating a slowdown in economic activity growth.

Base metals prices in May dropped by almost 4.0% after adding a modest 1.0% in April. Demand for gold resumed rising as global risk aversion rose. Prices climbed 4.2% after correction in the beginning of May that followed gold reaching a historical high of $1563.7/oz on the last trading day of April.

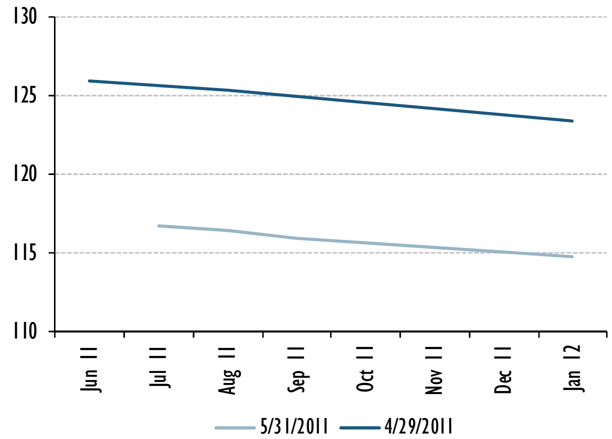
- ### General indicators

The Baltic Dry index, which measures commodity-shipping costs, rose 16.6% in May in response to higher demand for iron ore from China. Record scrapping (ca. 40 capesizes have been sold for demolition this year) has also contributed to smaller oversupply of this type of vessels, while higher fuel prices have pushed costs upwards, adding to an increase in freight costs.

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**

  Key money market spread dynamics in the US was somewhat mixed in May, with swap spreads gaining modestly while TED-spread, on the contrary, declined. Both indicators, however, remained close to their pre-crisis levels of ca. 20 bps, which indicates the absence of liquidity shortage.

  A hike in global risk aversion as a result of highlighted tensions within the eurozone with regard to extending aid for Greece led to an increase in demand for safer assets, such as the UST. Yields on 10-year US government bonds neared 3.0% (-22.7 bps in May). LIBOR rates were almost unchanged in May.

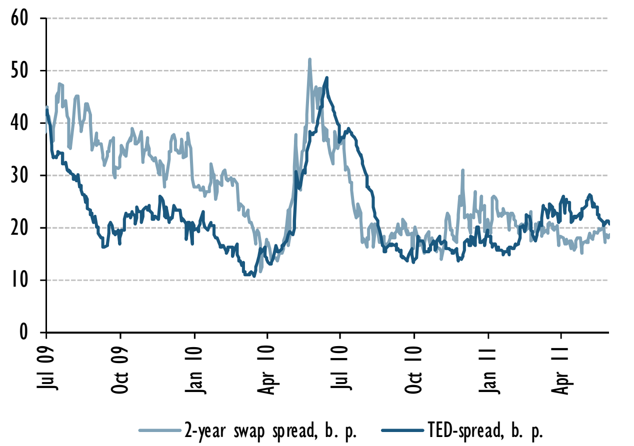
- **Russian money & FI markets**

  Ruble liquidity was in high demand during the second half of May as a period of tax redemptions drained more than 450 RUB bln from the banking system and eased pressure on the ruble to appreciate diminished CBR interventions in the FOREX. The balances on correspondent accounts and deposits at the CBR fell below 750 RUB bln, marking a record low since mid-December 2010, rebounding only slightly on the May 31 – presumably, due to budget expenses scheduled for the month.

  As a result of the liquidity squeeze the money market interest rates edged upwards towards the 4.2-4.7% range. As there would be no compulsory payments in the coming couple of weeks, we expect rates to fall to the level of 3.4-3.7%. The June tax season is unlikely to affect the banking system in a way similar to last month as there will be an inflow of ca. 455 RUB bln from OBR-18 redemption on the 17th of the month.

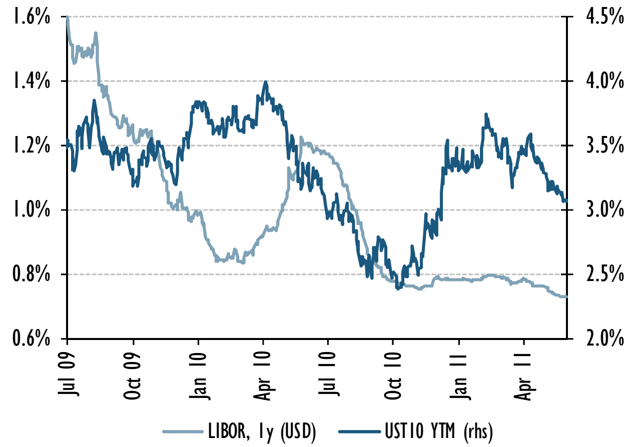
  The Russian FI instruments were all but exempt from the negative impact of deterioration in credit quality of European sovereigns. The yields on Russia-30 were down by 21 bps MoM (as of May 31 they were at 4.45%), and their spread over the UST remained almost unchanged – at ca. 137 bps.

Key MM spreads



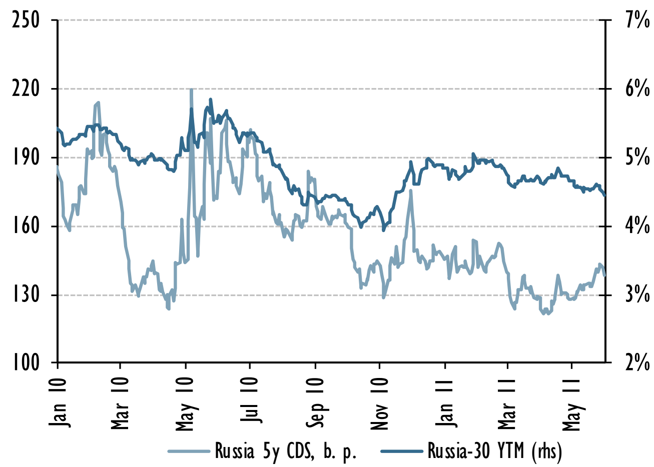
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



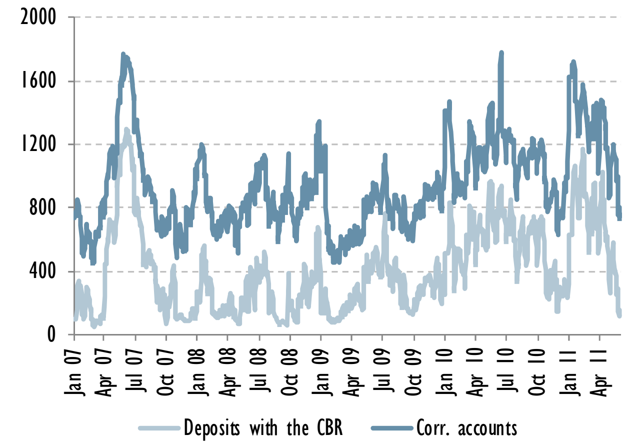
Source: Bloomberg

Russia credit quality indicators



Source: Bloomberg

Liquidity in the Russian banking system



Source: CBR

4. Stock markets

- Developed markets

May 2011 fitted nicely into the theory of 'spring correction'. Most of developed markets indicators fell, losing 1.5-3.0%. A local bottom was reached on May 23-25, after which indices were able to rebound on easing concerns over European debt resolution. Notably, the VIX index of implied volatility fluctuated in the range of 15.5-18.5 points, ca. 1-3 points higher than in previous month.

The banks underperformed the market in Europe as investors tried to evaluate exposure to troubled countries' debt and assess potential impact of restructuring on the banks' balance sheets.

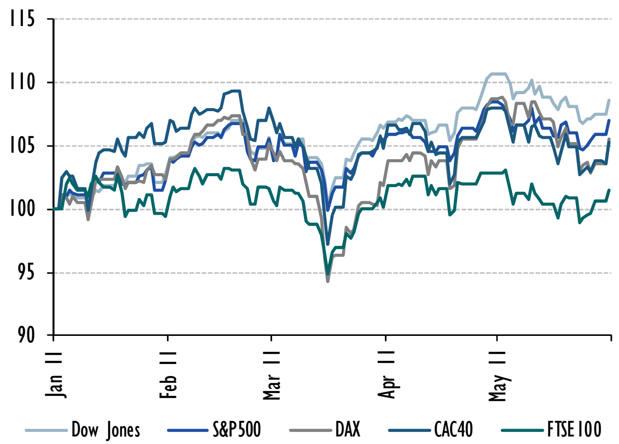
The key issues on the June agenda will be the results of the pan-European stress tests of banks and a decision on providing additional support to Greece. The Ecofin (economic and financial affairs council) summit is scheduled for June 14-15, and the results of stress test must be released till the end of the month.

- Developing markets

Emerging market equity funds received a net outflow of funds in May which amounted to $2.3 bln, approximately $2.0 bln of which were transferred to bond portfolios. As a result, stock markets performed worse than debt markets, with an average fall in prices of 2.5-3.5%, and China dropping almost 6.0%. The latter was partially attributed to weaker fundamentals (such as manufacturing activity) and partially – to further tightening of monetary policy (PBC raised reserve requirements to a record of 21% of total deposits).

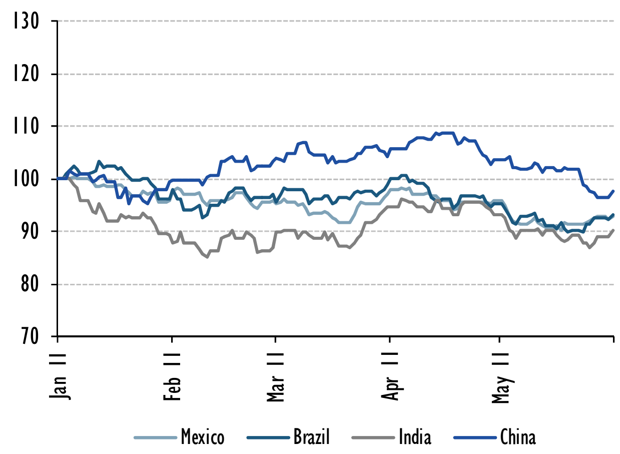
Additional pressure on Russian stocks came from commodities markets, where oil prices dropped by 6.5% in May. We believe that current levels are already attractive for purchases, but an improvement in market sentiment abroad is required to break the downward trend.

DM stock markets dynamics, January 2010=100



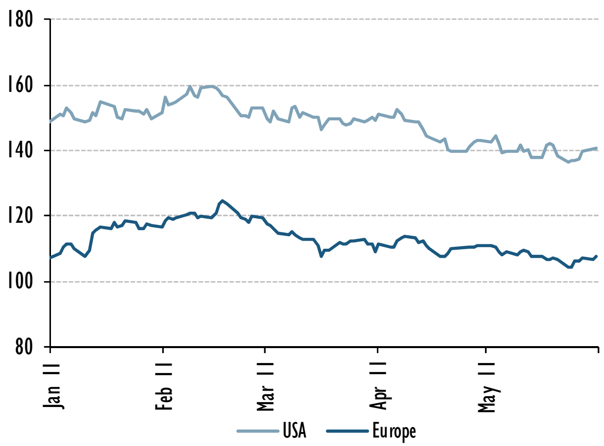
Source: Bloomberg

EM stock markets dynamics, January 2010=100



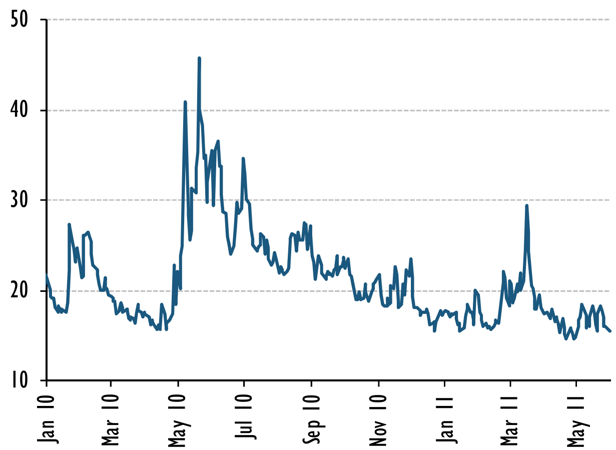
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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