October: conditional recovery

GAZPROMBANK

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- Macro data on Russian economy suggests that there was no serious slowdown in activity in August and September, yet, no acceleration was evident, either. Although consumer confidence is fuelled by stable labor market and positive income dynamics, producers complain about high uncertainty over the future demand. Although real sector indicators (such as industrial production and construction) revealed stronger dynamics in August than a month before, seasonal and technical factors cannot be ignored as highly influencing this statistics.
- It should also be noted that despite August's healthy growth rate of 7.0% y/y industrial production (after seasonal adjustment) has barely returned to the level of mid-summer 2009, while investment in working capital (+10.9% y/y in August) has only just leveled after reaching a bottom in 1Q10. However, a local spike in the investment activity has already sent shivers through Russia's trade balance (as ca. 42% of the total amount is comprised of machinery and equipment, highly dependent on investment demand), which has contracted sharply in August, when imports increased 1.5 times y/y.
- Although 70% (up from 65% a month before) of corporates reported an increased availability of credit in August, lending remains subdued. The average lending rates, according to CBR estimates, declined to 10% in August, but borrowing costs ceased to diminish, leveling at 6.1%, which limits the potential for further softening of credit conditions.
- Based on the current and perspective trends, we believe that:
  - Retail sales dynamics is likely to remain positive. Continuous rise in consumer prices can only partially be attributed to the influence of seasonal factors (including the draught effects), and, therefore, considered as evidence of persistent demand for some goods. Yet, we expect retail turnover to decelerate to 5.2% in October due to easing influence of the low base effect. At the same time, we do not anticipate a slowdown of inflation anytime soon, largely due to inflation expectations. Thus, October CPI figure might rise to 7.7% y/y. However, the CBR is unlikely to lift the refinancing rate under the present circumstances.
  - We share a positive view on the near-term commodity price levels, based on expectations of liquidity provision by the monetary authorities worldwide. Under this scenario, we do not anticipate that the trade balance will fall below $8.0 bn in October, even if imports continue to grow at a rate of 50% y/y (which is unlikely, in our opinion, as consumption demand cannot contribute to such a drastic rise in imports, and producers lack confidence to enhance their investment activities instantaneously).
  - We believe that the risks of ruble depreciation have been overestimated, and the recent movements were mostly speculative in nature. Although cheaper ruble might benefit both manufacturers and the government, it seems unlikely that the exchange rate will be driven by political will, while fundamentals remain rather strong. As a result, we expect the average exchange rate of RUB30.8 per USD in October, while the euro–dollar pair is likely to be volatile. Therefore, we expect the bicurrency basket to remain within the 35.0-35.6 range over the coming month.

Key indicators: October forecast

Indicator	October 2010F	MED*	2010F GPB Research
Real sector			
GDP, y/y	-	4.0%	4.1%
Industrial production, y/y	6.5%	7.6%	2.7%
Capital investments, y/y	5.9%	2.5%	2.5%
Retail sales, y/y	5.2%	5.2%	3.1%
Private sector			
Real income, y/y	7.4%	4.4%	4.4%
Accrued salary, RUB	-	20,838	19,710
Foreign economy			
Trade balance, $ bn.	8.0	137.2	138.5
Average oil price (Urals), $/bbl.	77	75	75.5
Stock market			
RTS, points	1,500-1,550	-	1,650
Exchange rate, inflation and rates levels			
Inflation (CPI), y/y	7.7%	7.0-8.0%	8.1%
Refinancing rate	7.75%	-	7.75%
Bicurrency basket, RUB	35.0-35.6	34.5	34.6
Exchange rate, RUB/USD (avg.)	30.8	30.4	30.5

- no forecast available;

Source: MED, Gazprombank estimates

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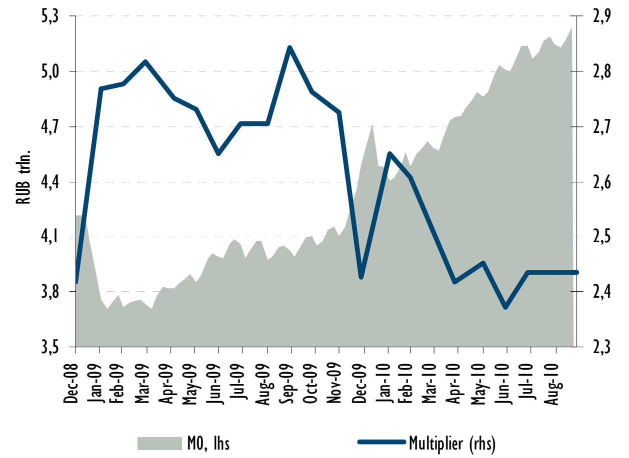
Leading indicators

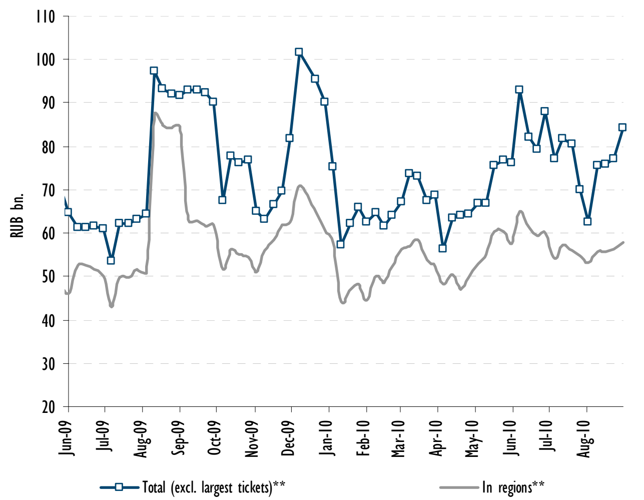
- Credit activity within the Russian banking system remains subdued. Although Sberbank has extended loans by more than 1/3 during the four weeks ended 22 September (amounting to RUB344 bn) as compared to the previous period, money multiplies remained stable in July – September, signaling a stagnation of the money-creating function of banks.
- The sentiment in the manufacturing sector continued to rebound in August: according to IET survey, the Index of Producers' Optimism (IPO) added 2.7 points as compared to July figure. Yet, only one out of four components of the Index has exhibited a positive dynamics – namely, satisfaction with the current sales level. Most companies are reluctant to increase their stocks of finished goods as demand for their output remains unstable.
- Whereas modest optimism prevails in manufacturing, the sentiment among services providers worsened unexpectedly in August: PMI fell below the 50-point threshold (neutral) for the first time in more than a year (see respective Graph on the next page). The slowdown of economic activity in non-manufacturing sector is partially attributed to the weather conditions, which negatively affected employment and demand.
- Growth rates of power consumption have diminished somewhat in the last week of September (to 4.7% y/y from an average 6.6% y/y during the first three weeks of the month), but the level remained above month-to-date average, so it must have been due to a hike in respective period of the last year. August figures suggest a perfect correlation between power consumption and industrial production dynamics, but the relationship has been unstable since the beginning of the year, largely thanks to extreme weather conditions, as well as to the change in calculation method applied by Rosstat.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

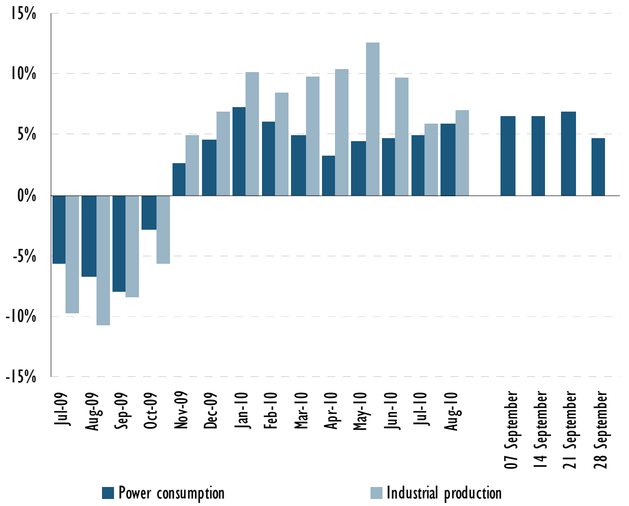
Sberbank's lending volume*, RUB bn.



* weekly volumes;
** 4-week average

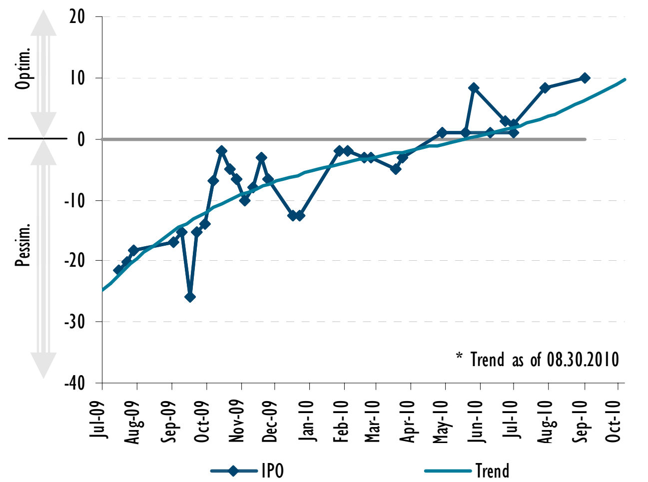
Source: CBR, Gazprombank estimates

Power consumption vs. industrial production, % y/y



Source: System Operator, Rosstat

Index of Producers' Optimism

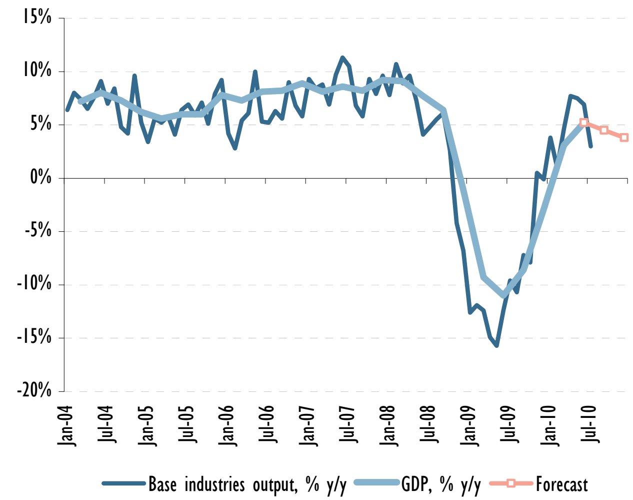


Source: IET

Current economic environment

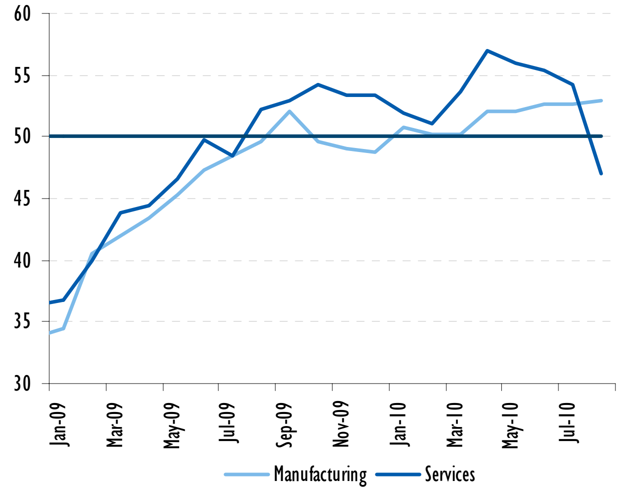
- Manufacturing activity in August remained on the uprise, with PMI stabilizing at above 50 points benchmark (52.9). This, combined with the low base effect, allowed the industrial production index to exhibit a healthy 7.0% y/y growth rate. Yet, we do not expect a serious rebound of the combined base industries indicator in August after its July's plunge to 3.0% y/y. A modest recovery in construction (+3.4% y/y) will most likely be offset by an almost doubling from a month earlier decline in agricultural sector output (-9.1% y/y). Thus, a higher figure for August would be necessary but not sufficient to conclude that economy is heading to recovery, given that transportation and retail sales dynamics didn't show much of an improvement.
- MED estimated that Russian SA GDP continued to decline at a pace of 0.4% in August. The last positive SA figure was detected in 2Q10, therefore, we expect that growth rates are unlikely to accelerate in 3Q-4Qs.
- Worrisome signals came from the side of Russia trade balance, which, according to MED estimates, shrank to $8.3 bn in August from almost $11.0 bn in July. To a large extent, this was a result of a surge in import volume, which accelerated from an average 20-30% y/y in 1Q-2Q 2010 to more than 50% y/y. Yet, the outlook for commodity prices remains rather positive (see Commodities section for more details), therefore, we consider that export revenues are unlikely to fall below the costs of imports, at least till the end of the year.
- However humble the prospects of a negative trade balance are, the risk of capital outflow weighs on the Russian ruble. The cost of bicurrency basket has increased by 2.2% since the beginning of September, while euro appreciated by almost 5.0%. Yet, CBR continued to accumulate foreign exchange reserves (+$5.5 bn during the last three weeks), which indicates reluctance of the monetary authorities to support the ruble at the range of 33.4-36.4 for the basket.

Base industries output vs. Russia's GDP in 2004–2010



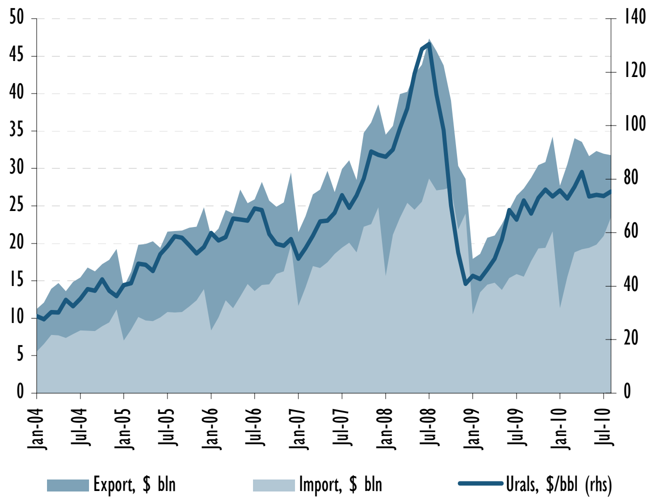
Source: Rosstat

Russia's PMI, points



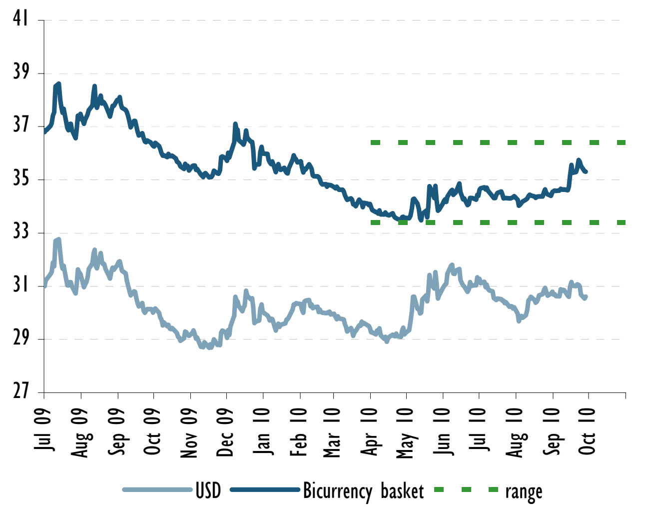
Source: Bloomberg

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

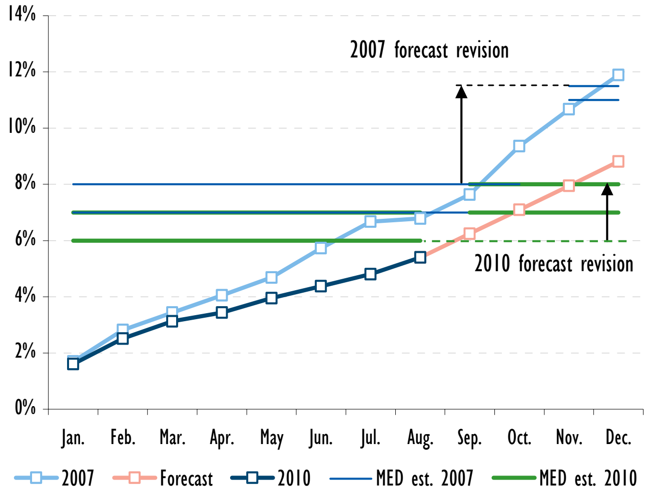
Ruble rate curves



Source: Bloomberg, CBR

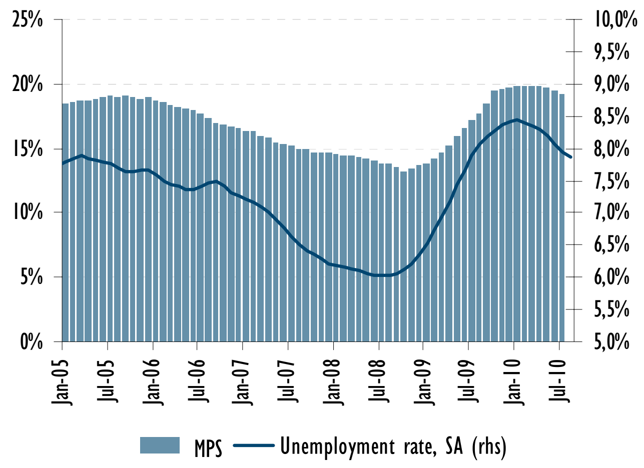
- The hopes of a slowdown in consumer prices dynamics during the last week of August to continue throughout September were not rewarded. CPI was increasing at a weekly pace of 0.2% since the beginning of the month (+0.9% mtd). Although monetary authorities expect inflation pressures to subdue in the coming months, we see no reasons for that. On the other hand, seasonal demand factors, combined with the lagged effect of money supply increase, are likely to contribute to persistent price rise. Actual inflation figures for the year will only comply with official forecast if the average increase in the price level in October – December is not to exceed 0.5%.
- The indicators of consumer confidence continued to improve in August. Retail sales added 6.5% y/y, fuelled by an acceleration of disposable incomes (+7.9% y/y). Although the actual unemployment level remained virtually unchanged in August (at 6.9% of the economically active population), the SA trend is descending. As a result, the marginal propensity to save is expected to have declined further, although at a diminishing pace.
- Russian stock market underperformed most of its EM peers in September. Inflow of funds into GEMs since the beginning of the month totaled $5.2 bn, while respective figure for Russia alone was negligible. RTS gained 4.7% month-to-date, while MICEX added 3.6% over the same period, its growth was restricted by ruble risks.
- Russian bond market was again dominated by OFZ supply: Minfin sold RUB 67.0 bn worth (at par) of government bonds in August, almost doubling that figure in September (RUB 130.8 bn). Although the plans for the 4Q were revised slightly downwards – to RUB 300 bn, this year's borrowing program only sets the stage for the next year, when Minfin intends to offer as much as RUB 1.7 trln of domestic debt to finance budget deficit.

Inflation: a pessimistic scenario



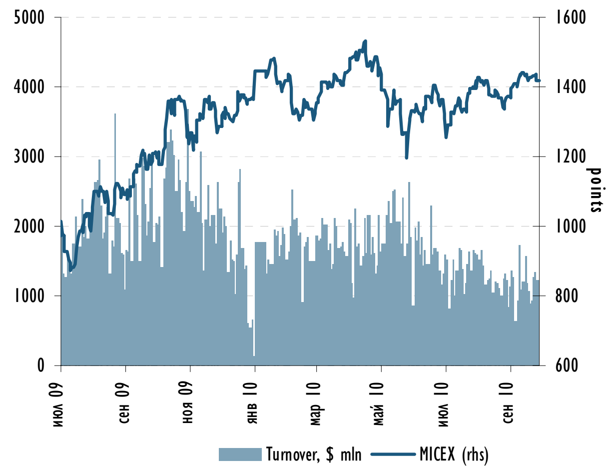
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



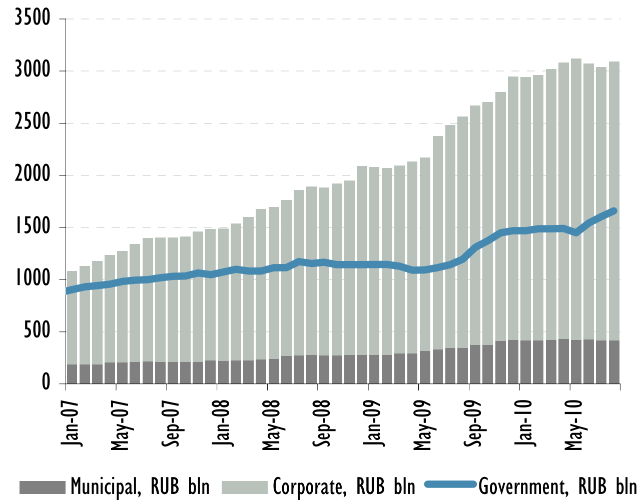
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



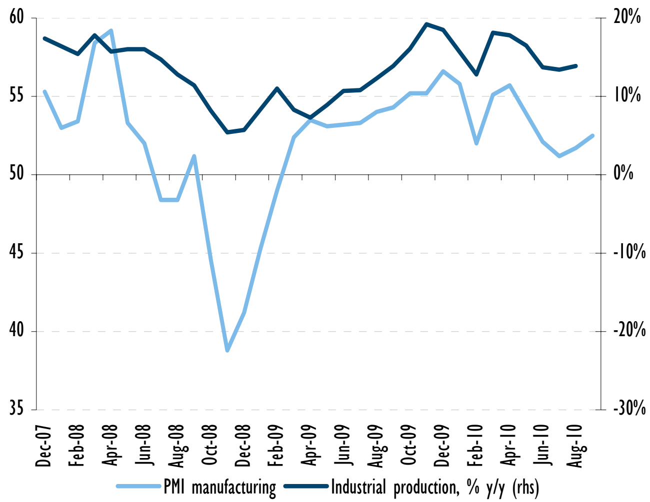
Source: Cbonds

Appendices

1. Economic situation in major Western countries

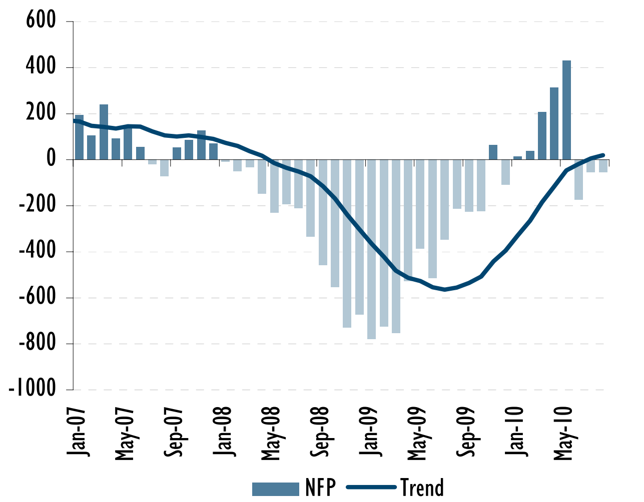
- Macroeconomic releases in USA and Europe so far do not provide enough evidences of steady recovery. Despite strong growth in Germany in 2Q10, surveys of economic sentiment reveal absence of confidence among producers in one of the key European economies. Moreover, OECD kept revising its forecasts downwards, suggesting a slowdown of GDP growth rates in G-7 countries to 1-1.5% q/q in 2H10 as compared to 2.5-3.2% in 1H10.
- Given high degree of uncertainty over the state of the developed countries, Federal Reserve has reaffirmed its commitment to extend stimulus measures if economy is to keep stumbling on its path to recovery, should inflation risks remain feeble. Although Fed's commitment to reinvest the proceeds of maturing debt instruments on its balance sheet into UST to keep the rates low might support speculative activity in the markets, we believe that the fundamental problems of the US economy are more complicated.
- Recent developments in China seem to spur some confidence in the country's economic growth. PMI manufacturing continued to rebound in September after declining to 51.2 in July. It should, however, be noted that the US Congress voted yesterday in favor of implementing protectionist measures for domestic companies in order to stimulate China to allow Yuan to appreciate, which might affect Chinese economy.
- The credit risk associated with European sovereigns continues to bother investors. 5-year CDS (representing the cost of insurance against the issuer's default) on Portuguese and Irish debt resumed climbing in September, adding 25% and 40%, respectively. Market participants are anticipating disclosure of total costs of the Anglo-Irish Bank bailout. The tension also escalates on rumors over Spain's sovereign rating that might be downgraded in response to the country's struggling out of recession while trying to grab control over government finances.

China's manufacturing indicators



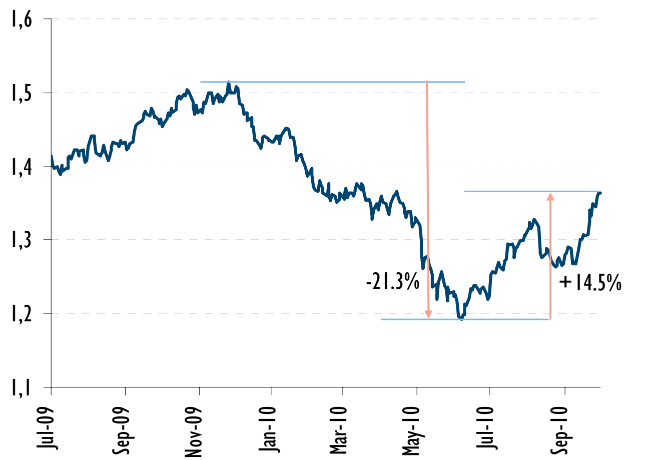
Source: Bloomberg

Change in non-farm payrolls, K



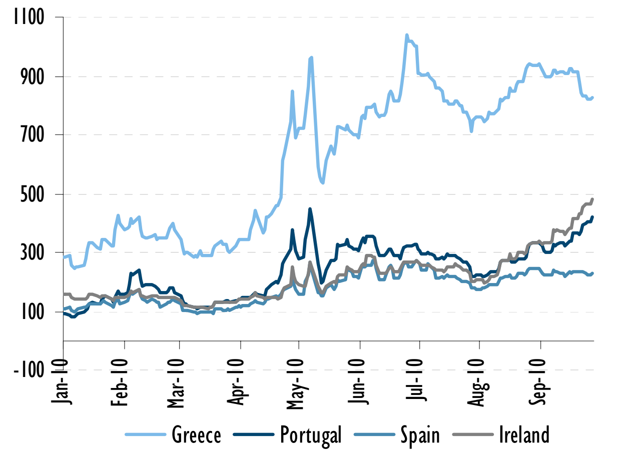
Source: Bloomberg, Gazprombank estimates

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics (eurozone)

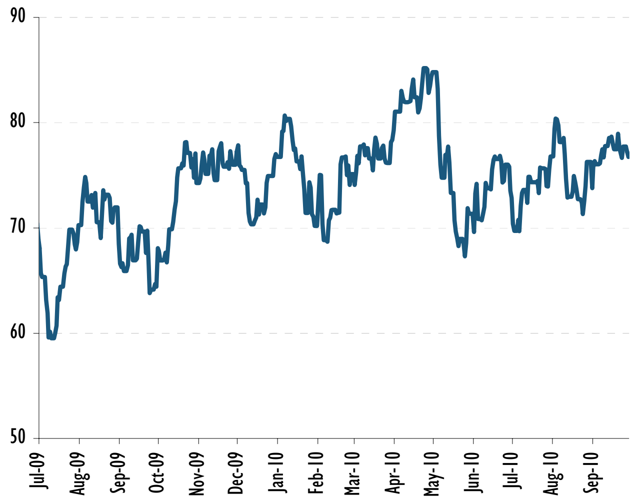


Source: Bloomberg

2. Commodity markets

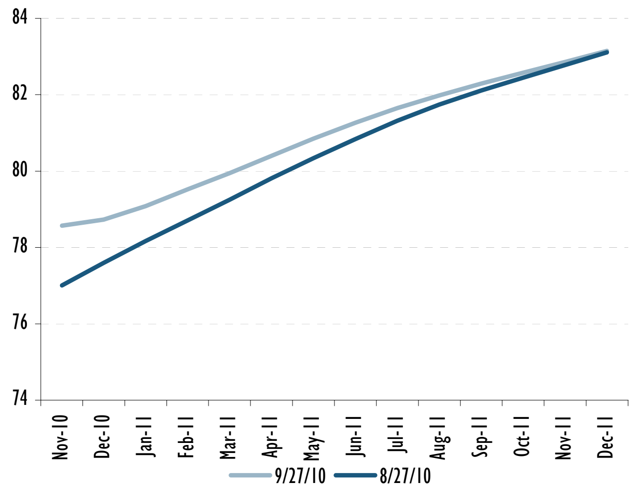
- Commodity prices in September were under the influence of mixed macroeconomic data. Although US crude stockpiles tended to increase, indicating a weaker-than-expected demand, manufacturing activity in China remained stable, according to the PMI figures. Urals oil in August was priced between $75 and 80/bbl.
- Base metals have generally grown during September: the price index added almost 10.0% from the beginning of the month. Metals futures demonstrated a slightly smaller rise, but still trade above the base asset value, which indicates a positive outlook.
- Market participants share rather optimistic outlook over future oil price dynamics. Brent contract curve is (1) upward-sloping, which indicates expectations of a price rise on the horizon of 1-12 months, and (2) it shifted slightly upwards as compared to the previous month's curve. Although the fundamentals of the demand for crude oil remain rather weak, we believe that potential US dollar depreciation (in response to the Fed's commitment to provide additional stimulus if needed) will be able to support the prices for commodities.
- Baltic Dry Index – an indicator of shipping costs – has been declining during the last 12 days, losing a total of 18%. The plunge can be basically attributed to the diminishing demand for iron ore from China, but the figure might be somewhat biased by the fact that Chinese markets were shut for four days last week. The dynamics is expected to persist for another week, at least, as the holidays in one of the biggest world consumers are going to halt delivery of iron ore till October, 8. However, any further plunge in the freight costs is likely to be interpreted as an indicator of the world trade slowdown.

Urals price dynamics, USD/bbl.



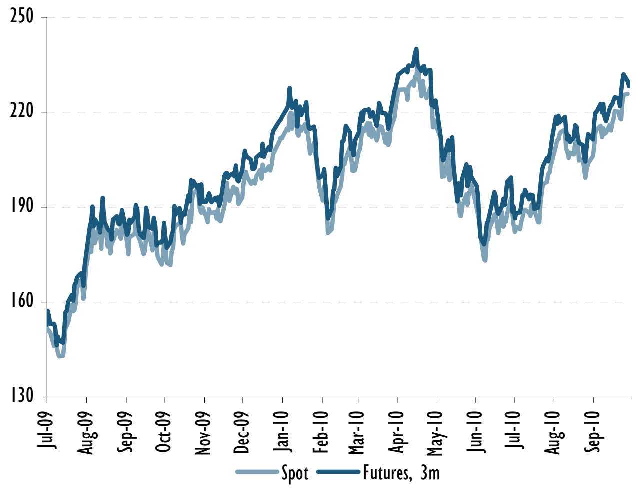
Source: Bloomberg

Brent futures, USD/bbl.



Source: Bloomberg

Base metal price indices, points



Source: Bloomberg

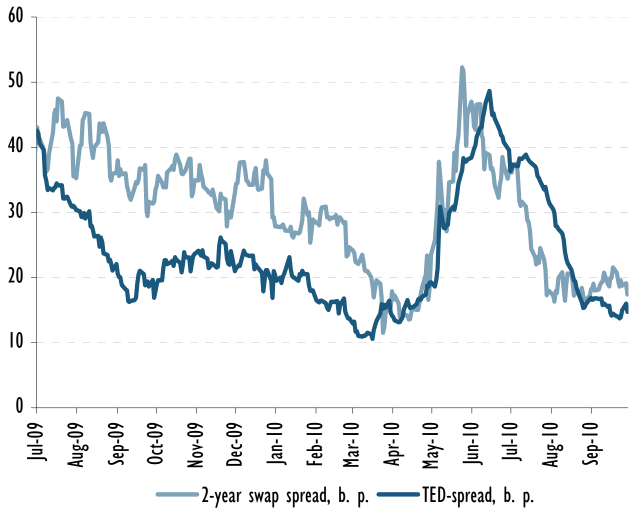
Baltic Dry Index (shipping rates), points

Source: Bloomberg

3. Money and fixed income markets

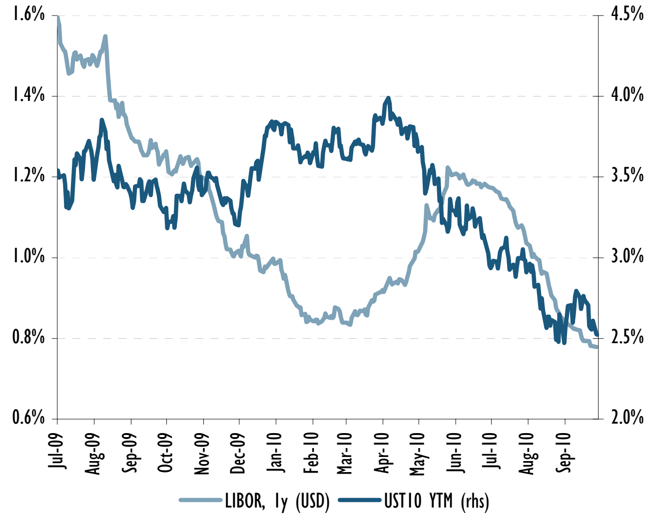
- Liquidity remains the overwhelming idea in the money markets worldwide. The primary gainers in the US are USTs, the demand for which is supported by the Fed's commitment to sustain the amount of assets on its balance sheet at a constant level. Successful reinvestment of redemption proceeds into the benchmark 10-year USTs pushed their YTMs down to 2.5%, and is likely to keep them close to the current level. The borrowing costs (LIBOR) continued to decline, as well, falling below 0.8% (1-year interbank loans). The dynamics of the key money market spreads (such as TED-spread and US swap spread) indicate stabilization of the risk-premiums demanded by lenders over the UST yields.
- The perception of EM credit risks is rather plausible, too. Spread offered by EM bonds over the USD remained stable in the range of 275-290 b. p. As contrasted with the stock markets, a decline in the Russia-30 YTM indicates persistence of interest towards investment into debt instruments with good credit quality. The latter is indicated by the smooth dynamics of the 5-year CDS prices, which fluctuate in a close range of around 160 b. p.
- Russian money market was only marginally affected by the tax payments and the turbulence in the currency markets. The interbank rates are at their bottoms, with o/n loans priced below the rate on CBR deposits. 3m NDF rates exhibited a modest increase (to 3.0-3.2%), but their levels do not indicate a drastic revision of ruble expectations. Accumulated volume of liquid assets on the banks' balance sheets is somewhat below RUB 1.9 trln – an amount insuring the financial system against almost any unexpected liquidity drain.

Key MM spreads



Source: Bloomberg

1y LIBOR and 10y US Treasuries yield

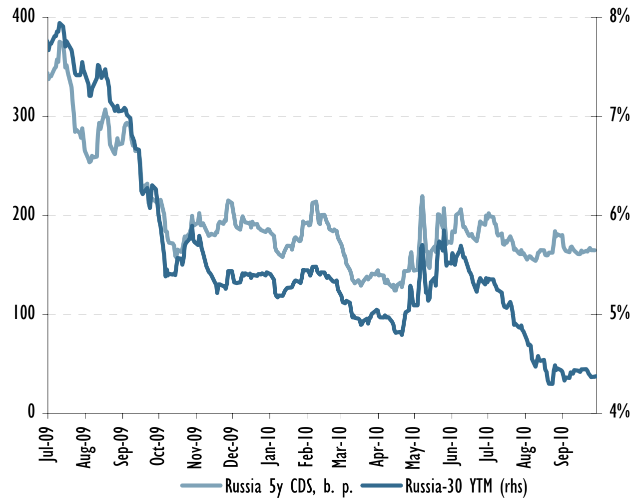


Source: Bloomberg

EMBI+ spread

Source: Reuters

Indicators of credit quality of Russia's sovereign debt

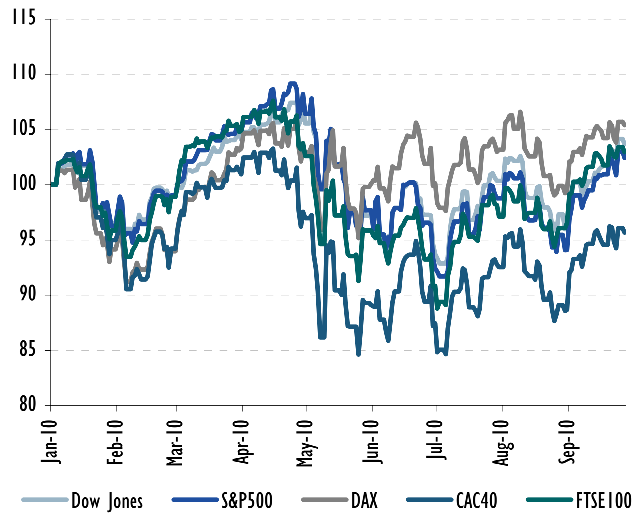


Source: Bloomberg

4. Stock markets

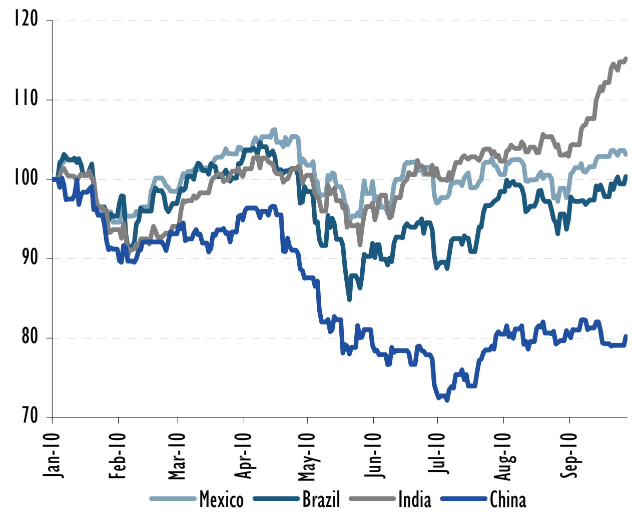
- Most of the developed stock markets in September were dominated by purchasers. Key DM indices rose by 3.0-6.0% month-to-date, partially rebounding after the last month's slump.
- Among EMs, Indian Sensex was the best performer (+10.5% in September), while Chinese Shanghai Copm. was the worst-performer (+0.2%). The latter was explained by investor's confusion over the likelihood of the credit tightening given rather solid data on the real sector. US pressure on China to allow the Yuan to appreciate has also intensified lately, which might weigh on the shares of export-oriented companies.
- Financial stocks have underperformed other sector shares during September. US banks added 2.3% month-to-date, while their European peers exhibited a minor decline (by 0.2%) over the same period. The key issue in the sector was the proposed tightening of banking regulation. Basel committee has developed the new framework, which is subject to approval by the G-20 leaders during the Summit in Seoul in November this year. Although the proposed increase in the capital adequacy requirements is unlikely to be fully implemented prior to 2018, the longer-term effect on the banks' profitability might be priced in as soon as the transition schedule is set.
- Uncertainty over the US stock markets in September was modest: VIX index (which indicates the implied volatility) remained in the range of 20-25 points, almost at its pre-crisis level.

DM stock markets dynamics, January 2010=100



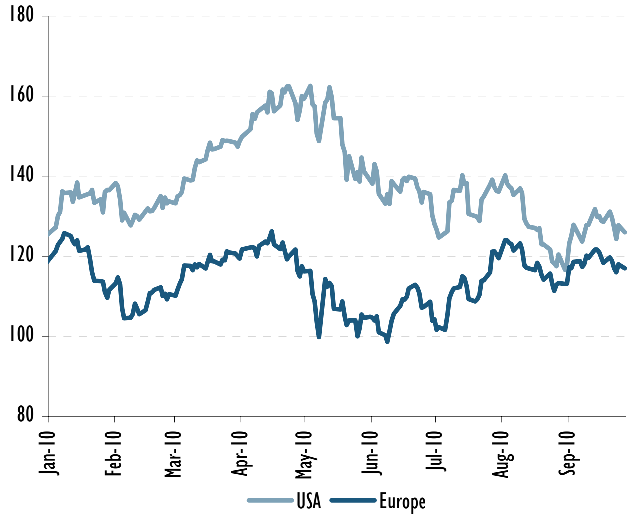
Source: Bloomberg

EM stock markets dynamics, January 2010=100



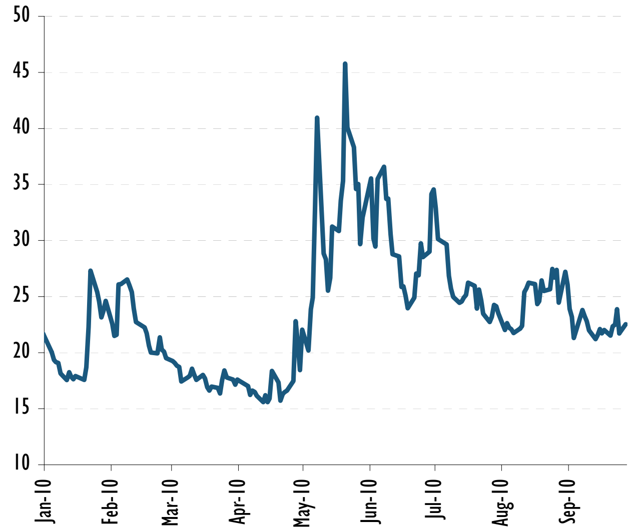
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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